

# Asian Business Dialogue on Corporate Governance 2004

## Strengthening Asian Capital Markets through Corporate Governance

October 28, 2004 (Full-day Event)

Organiser :

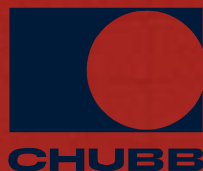


Asian Corporate Governance  
Association

Grand Hyatt Shanghai, Jin Mao Tower  
88 Century Boulevard, Pudong, Shanghai

A high-level and hands-on discussion about the ways in which corporate governance can contribute to deeper, stronger and more credible capital markets in China and Asia.

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# **Asian Business Dialogue on Corporate Governance 2004**

**Strengthening Asian Capital Markets  
through Corporate Governance**

October 28, 2004  
Grand Hyatt Shanghai

## **Conference Report**

**Editors: Jamie Allen, Helen Wong, Sharmila Gopinath**

**Organised by the Asian Corporate Governance Association**





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**Speakers**

Our sincere thanks also goes to our keynote speakers — Dr. Zhu Min and Professor Lawrence Lau — and to all our moderators and speakers for giving so generously of their time and sharing their knowledge and insights.





## Opening Keynote Speech<sup>1</sup>

### "Corporate Governance and Banking Reform in China"

**Dr. Zhu Min**

**Executive Assistant President, Bank of China Ltd, Beijing**

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*After more than two decades of reform, China has discovered that competition, decentralisation and openness, while producing a rapidly expanding banking system, are in themselves not enough to resolve lingering issues such as a high non-performing loan ratio, low returns on capital and weak bank management, says Dr Zhu Min. The emphasis in the new stage of reform is firmly on diversifying ownership, improving risk management and building good corporate governance.*

I would like to start by quickly reviewing China's experience with banking reform over the past 25 years. I will then explain why corporate governance has become so important for us and, lastly, introduce our new efforts to improve the financial sector.

Our main aim over the past 25 years of reform has been to introduce competition. In the past, the main tool we used was decentralisation of economic decision-making and the opening of the market to international companies. Before reforms started in the late 1970s, there was only one bank in China — the People's Bank of China (PBOC). It was the country's central bank and also its commercial bank. In 1979, the Bank of China and the Agricultural Bank of China separated from the PBOC, and a few years later the Industrial and Commercial Bank of China (ICBC) was founded. In 1986, we set up the first national "shareholding banks". Then 10 years later we set up the first local "city commercial banks". From being the bank 25 years ago, the PBOC has seen more and more of its commercial banking functions being taken away.

I remember the first foreign financial representative office in Beijing. It was set up by a Japanese bank. We gradually opened the door, many more foreign banks came in and eventually we let them participate in foreign exchange business as well as renminbi (RMB) business. In 2001 we entered the World Trade Organisation (WTO) and the following year we opened the door more widely to foreign banks. They are now competing with Chinese banks.

After 25 years of financial sector reform, China has an interesting banking system. We have a central banker, the PBOC. On the regulatory side we have the PBOC, the China Banking Regulatory Commission (CBRC) and the China Securities Regulatory Commission (CSRC), each supervising different financial companies. On the commercial banking side we have three "policy banks", four major state-owned commercial banks, 13 shareholding banks, 100 city commercial banks and around 3,000 rural credit organisations. Meanwhile, we have a total of 568 foreign financial institutions in China, of which 199 are operational financial institutions. The assets of these foreign institutions have increased quite dramatically, rising from US\$7.5 billion in 1993 to almost US\$77 billion in 2003.

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<sup>1</sup> Dr Zhu's full slide presentation can be found on the ACGA website ([www.acga-asia.org](http://www.acga-asia.org)). Go to: ACGA Archives > Events > Annual Conferences > Asian Business Dialogue on Corporate Governance 2004

In terms of market share (as measured by size of assets), the four major state banks still control roughly 63%, while the other commercial banks have just over 11% and foreign banks about 1.6%. Interestingly, when we joined the WTO three years ago, foreign banks in China had a market share of almost 2.5%. So their share has fallen.

It is not only the structure of the banking system that has greatly changed. The sector has also grown immensely:

- The total assets of financial institutions have increased from Rmb 241 billion in 1981 to Rmb 31.5 trillion (US\$3.9 trillion) today.
- Residential savings deposits have increased from RMB 27 billion in 1979 to RMB 12 trillion today.

This means that in 25 years the assets of the banking sector in China have increased by more than 120 times and personal savings have multiplied more than 400 times. This has never happened before in human history.

### **Coping with NPLs**

During the peak of the Asian financial crisis in 1998, we found that our banks had a big non-performing loan (NPL) problem — a ratio of about 45% of total bank loans. In that year the government provided Rmb 270 billion as a capital injection for the four major state banks. In 1999, the four banks were allowed to write off Rmb 880 billion in NPLs and we set up four asset management companies to handle Rmb 1.4 trillion in problem loans. In 2001, we allowed banks to make provisions for more than 1% of NPLs — previously they were allowed only 1% — and now they can write-off as much as they can, as long as they have the money.

Around the same time, commercial banks like us began putting a lot of effort into enhancing our internal risk management systems. We introduced a loan-classification system, independent risk management functions, including policies and procedures, and manuals. We worked hard to set up these systems.

I remember when I joined the Bank of China eight years ago there were no risk management systems. I will give you a little of my personal experience. The Bank at that time had two loan departments called "Loan Department 1" and "Loan Department 2". I was puzzled as to why we needed two loan departments, but was told that the first was for Rmb loans and the second for foreign exchange loans. I thought that this was not convenient for clients, since they may need loans in both denominations. But further investigation concerned me, because I realised that everything was done within the one department: raising money, finding clients, doing the risk analysis, giving the money to clients and managing the loans. The general manager of the department had a lot of power, there were no checks and balances, no oversight. This guy was king. The first thing we did was to merge the two loan departments and in the back we set up what we called a loan-management department. After eight years, the loan department was split into corporate and retail loan departments and the loan management department became the risk management department. It took us eight years.

Although I think we did well in setting up procedures, manuals and instituting necessary changes, the numbers are not very encouraging. In a ranking of the world's largest 1,000 banks in 2003, the first was Citibank, third was HSBC and Bank of China came 29th. We follow procedures and report on our economic capital, but the most important difference is that our return-on-assets (ROA) is only 0.26% and our return-on-equity (ROE) only 6%, whereas Citibank has an ROA of 2.08% and an ROE of almost 42%. We have almost 30% as many assets as Citibank and about one-fourth of its capital, but only 12.5% of its ROA and 14% of its ROE. Immediately you see the gap between capital and returns.

After five years of government buyouts, after much effort put in, the banking sector in China still had on average almost 17% in non-performing loans. At that point the government realised that it needed to do something more to protect itself. We as executives realised that we needed something to protect ourselves from intervention by the government and to exercise proper control. And employees in the banking sector realised they needed something to protect themselves: if they didn't have that, then someday the whole system would blow out and they might lose their jobs.

### **Building governance from scratch**

After much discussion all the three parties realised that they needed something to protect them from other government bodies. It's a very interesting picture, because although the state is the owner of the commercial banks, other government bodies intervene from different angles and make business extremely difficult in China. After many discussions we realised that corporate governance was a very important issue and that we needed to have good governance to be able to run banks commercially. The country would then have a healthy banking system. Management would be able to exercise managerial authority and also gain a certain return for themselves. And the jobs of employees would be more protected.

We realised that we could not achieve good governance before because, if you take into account all the stakeholders of state-owned banks in China, the first is the state as the owner, then there are regulators, borrowers, management, employees and, lastly, other levels of governments. I emphasise these other government stakeholders because there are always local governments with different perspectives and that want to intervene in banking business. It is not only one level of government.

If you look at the six parties, they are really the one party — the government. Although the six groups have different interests, there is only one party because they are all linked together. There is no room to exercise good corporate governance. The state is the whole thing: it's the owner, the regulator, the borrower (as in state enterprises), the manager (as in government officials), and the employees are servants of the nation. We are all the same. We are brothers. It is really an issue, because when state enterprises borrow money they say "why should I return the money to you, because we work for the same entity". Because there are various parties with multiple objectives, and because there is no clear responsibility and delegation of powers, or checks and balances, there is no accountability, no incentive scheme and no transparency.

To summarise our past 25 years of experience: we have had high growth in assets, but a low return on capital, a high NPL ratio and a poor banking infrastructure and management. We realised that we still had a weak financial system and quite weak management. The system did not make much money for the country, for management or for employees. We realised that to rectify this we needed to set up a system of good corporate governance.

### **The BOCHK case**

The particular case we have learned from is the Bank of China Hong Kong (BOCHK). Three years ago when we restructured and listed BOCHK for the international market, the one thing we particularly emphasised was setting up a corporate governance system. We set procedures and rules, transparent incentive schemes and many other things. We are honoured that Ambassador Linda Tsao Yang is one of our independent directors in Hong Kong.<sup>2</sup>

Many people know we have had some governance incidents, but these are in the past and, in response to them, we hired KPMG to review all the bank's processes, especially its governance. The abuses in Hong Kong have given us some very useful lessons and we can see that if we introduce good governance we will probably be able to manage the bank better and will be able to build a healthy financial system for the country. This is very important.

### **The new stage of reform**

We have realised that in the next phase of reform the key issue is to build corporate governance throughout the financial sector. This is very much a new concept in China. If you followed the reform process, you would know that we never mentioned governance before. We now realise that we need a diversified ownership base and must also bring in foreign partners.

The new stage of reform will therefore have a different approach. Before we always promoted competition, decentralisation and opening. Now we emphasise change of ownership, change of (risk management) systems and building good governance. How do we do that? The first thing we have done is to set up Huijing, a holding company for all our shares. The Bank of China in Beijing converted itself from a state-owned enterprise to an incorporated company on August 26, 2004. Many people have asked what has really happened? On the surface it might appear that nothing has happened, since we are still 100% owned by the government and still the same size. But it is also different because Huijing has become our sole government shareholder and that potentially changes the whole picture.

In the past the state was our owner and regulator (with the regulator in practice exercising management oversight of banks). For example, the China Banking Regulatory Commission (CBRC) issued ROE and ROA targets for us and the People's Bank of China (PBOC) gave the policy guidelines. They really acted like owners and performed day-to-day management. We also had other levels of government intervening as well. When we set up Huijing, however, it was given all the power, so now we have only one boss. Before we had many bosses who could ask us to do different things. Today we have only Huijing and it has consolidated all the government's authority. I think this is very important, although it is just a starting point.

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<sup>2</sup> Ambassador Yang, ACGA Chair, was appointed an independent director of BOCHK in November 2003.

Because of Huijing we will be able to corporatise our company. We will have the shareholders' meeting, non-executive directors, independent directors, a board of directors, a separate management team and also employees as stakeholders. Our board of directors will create bylaws and procedures so that everybody understands the rules of the decision-making process, what their authority is and how to behave themselves. This is a significant development, although it is just the beginning.

Because of Huijing, we can build a real ownership and governance infrastructure. We will have a clearly defined goal, which is to make profits. Different interests will be represented on our board of directors and each party will be able to understand their responsibilities because there will be written rules and procedures. The chairman and CEO will be separated, and overseeing the whole structure (ie, board and management) will be a supervisory board. Hence, we now have a system of checks and balances. This is extremely important and provides the infrastructure for governance.

### **The new look Bank of China**

Our board of directors already has two independent directors, nine executive directors and five sub-committees (to be chaired by the independent directors). As independent directors we have Tony Neoh, a former chairman of the Hong Kong Securities and Futures Commission, and Peter Cook, a former senior executive for the Bank of England and the Bank for International Settlements (BIS). More independent directors are on the way.

With the help of PricewaterhouseCoopers (PWC), we are converting all our financials to meet international accounting standards. PWC has had 350 people working 12-hour days for nine months and we aim to finish by the end of this year.

We have Boston Consulting redoing our whole IT blueprint to support our new financial systems. And we have Hewitt Associates working on a new human resources package, including reforming our human resources policies, setting up clear responsibilities, compensation packages and key performance indicators.

Looking to the future, we are searching for strategic investors to diversify our ownership structure and to bring in foreign companies to enhance our corporate governance. We will also be going to market and when we list we will have public investors too.

I feel that we have come quite a long way in nine months, but there is still a long way to go. There are many remaining issues. For example, although Huijing has consolidated all government authority into one organisation, it is still too early to say how it will exercise its powers. Intervention from other government bodies remains. And whether the state will keep to its reform objectives is also an extremely important issue and will affect whether state enterprises are able to build good corporate governance.

We need to empower our board. But whether it will have real power — for example, the ability to fire the CEO — will be a really tough challenge. The behaviour of borrowers is another issue: state enterprises still do not want to pay back loans and do not want to provide real information; while banks need more legal support, a better legal system, to handle this issue.

Internally we still need to do a lot. We need to re-engineer business processes; separate front, middle and back office functions; and build better budgeting processes. We need to build an infrastructure of internal control. The Bank of China has 230,000 employees and to change their behaviour and mindset is not easy. It will take a lot of training. What really matters is the culture of the organisation and I think that will take a long time to change. Head office is one thing, but to implement reforms at the branch level is another big issue.

I want to re-emphasise a few things. Over the past 25 years we emphasised competition and were able to grow the financial sector very quickly. We now have a market and competition, which is good. The bad news is that we don't have good governance yet. Competition cuts prices, but nothing else. Prices are so low that margins narrow and profitability decreases. After 25 years, all parties realise that we need good governance to protect the interests of each party and that is the reason we have shifted the emphasis of financial reforms this year to building good corporate governance. That is the reason we set up Huijing, incorporated the Bank of China, and why we are going to privatise the bank, list on the market, set up a board, proper procedures, and so on. We are doing everything, but still it's only the beginning.

I will end on the big question for me and for everyone here. We still don't know what will be a good model of corporate governance for us as a state-owned enterprise. There is still no clear answer. The good news is that we know where we are and where we want to go: we want to build good corporate governance. We know what we have and what we don't have. We know that this is another Long March. The good news is that we are working on it. Thank you, we need your support.



## QUESTION & ANSWER SESSION

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**QUESTION:** I'd like to ask you if you could follow up on one of the lines in your last slide, which is where you want to go? Could you tell us what you think the ownership or management structure of the bank will look like in 10 years?

**ZHU MIN:** That's a good question. We have a good base today, which means we have very strong government support and strong support from management and employees. We have started to build a board, procedures, committees, more transparency, and we're adapting to international accounting and reporting standards. However, I don't want to exaggerate. We have started doing this, but to complete the whole exercise will take a long time. I would say another three to five years at least for the board of directors to be able to act as a real board, for the people to behave like commercial bank employees and we need three to five years to develop IT system support. We will need about eight to 10 years to change the culture and people's behaviour. But the real issue is the culture. I think that will take a long, long time.

As for the ownership structure, we are still 100% owned by the government but we are looking for a strategic investor to take at least 15-20% and for public investors for another 10-15%. This is over the short term. And then, if China evolves gradually towards more of a market, we believe we will be able to further sell down the state-owned shares.

**QUESTION:** Could you say something about foreign banks in China and how you think they will look five years from now?

**ZHU MIN:** Three years ago when China joined the WTO, the local newspapers had headlines saying, "The wolves are coming". By the way, we call you guys wolves! A year later, the headlines said, "Dancing with wolves." Today you open the newspaper and there is nothing about wolves. But there are some whispers that the wolves have become paper tigers. Is this true? Of course it's not true. But statistics show a funny picture: three years ago foreign banking assets totalled almost US\$43 billion, accounting for 2.48% of total banking assets in China; today their market share has dropped to 1.62%. The reason the foreign market share has dropped is, firstly, we have grown so fast: our bank has grown by roughly 15-20% and many small banks by 30-40%. But the most important thing is that foreign banks have realised that if they want to do corporate lending they must have RMB credit. They can borrow money from Chinese banks in the inter-bank market, but you cannot have a sound and healthy debt business if you only rely on a few people to provide the RMB credit. And you cannot do retail banking because you don't have branches. We give you approval for one new branch each year, so it takes you 100 years to have 100 branches! Whereas the Bank of China already has 11,000 branches.

When foreign financial institutions get into China, they are usually very excited and you see a lot of advertising here in Shanghai. When you walk into the airport, the first advertisement you see is HSBC. When you are on the highway, the first advertisement you see is Citigroup. But it is not easy for them to break into China.

In the middle of last year (2003), or thereabouts, foreign financial institutions realised that they would not be able to do a good job in China on their own. We also realised that we alone would not be able to do a good job. We realised that for us to serve our Chinese clients and build healthy financial institutions, we needed foreign participation. But not from more market competition — that's a key issue. They realised that if they wanted to catch the wave of China's economic growth, they did not want to compete directly with us; they wanted to work with us. So that is how the idea of partnership came about. This year the whole concept of banking has changed dramatically: we're looking for partnerships. That's the reason HSBC has acquired 19.9% of Bank of Communications; Citigroup bought into the Shanghai Pudong Development Bank; the International Finance Corporation has invested in five banks; and Hang Seng Bank has been in negotiations with Minsheng Bank. Now we really are working together. For us the goal is to build a healthy banking system. For them it is to catch the wave of growth. I think that in five years you will see more and more foreign and Chinese banks partnering together. I think that's a great thing and will also build a base for good corporate governance in China.



# Session 1: SOE Governance – the Changing Role of the State as Dominant Shareholder

## Moderator:

### Pote Videt

**Managing Director, Private Equity (Thailand) Co Ltd, Bangkok**  
**Council member, ACGA**

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*When investing in emerging markets, and especially in state-owned companies, it is the governance of the economic system that counts as much as the governance of individual corporations, says Pote Videt.*

I would like to tell you a story from what I call the prehistoric days of finance in Asia. We have to go back 20 years to the fall of 1985, when I was involved in what I would call the first international privatisation of a state enterprise in Southeast Asia. That was a little regional airline called Singapore Airlines. The Singapore Government decided that for the first time they wanted to place shares globally — in the United States, Europe and in Asia. At that time I was with Goldman Sachs and we were hired to place the shares. Singapore Airlines back then had very strong growth potential, a good brand, very high service quality, a young fleet and capable management.

We were able to place the shares: they were oversubscribed at S\$5 a share and we expected it to begin trading a few days later, a day before Thanksgiving, at well over S\$5 a share. But a funny thing happened on the way to the first day of trading. There was a little known company called Pan Electric, which happened to be a huge speculator in the stock market. It defaulted on a few trades and, interestingly, this triggered a string of defaults and threatened the collapse of several major brokers in Singapore and, in fact, the workings of the stock market itself. Instead of trading at a huge premium, Singapore Airlines didn't trade. The stock market was closed

for three days and I remember clearly that the front page of the *New York Times* had a picture of the vibrant, exciting, dynamic Stock Exchange of Singapore — it was a trading floor with nobody there, totally deserted, and in the middle was an old Chinese lady doing her knitting.

As you can imagine, there were quite a few panicked investors in the United States frantically calling me on Thanksgiving Day. Many of them had just invested in shares in Asia outside of Japan for the first time and were a little fearful of their job prospects. My own Thanksgiving was quite memorable that year — my turkey had its wings clipped. When Singapore Airlines started trading, it traded down 25%. The offering was at S\$5, but it started trading at S\$3.80, if I remember correctly. But despite the initial turbulence, Singapore Airlines shares did soar in the intervening years and today, 20 years later, it is a blue-chip, must-own stock in many of the global portfolios around the world.

The question I would like to pose is: what lessons can we learn from that initial aborted take-off of Southeast Asia's first major international privatisation? The lesson, I believe, is: when investing in emerging markets in Asia, especially with regards to government-linked

companies, governance is important not only in relation to that corporation, but in relation to the governance of the economic system as a whole. In 1985 there really was no problem with the issue of corporate governance of the company; the problem related to the regulatory framework, the governance of the stock market, the governance and the control systems of the financial intermediaries.

In this panel what I would like to explore is the complex issues of how factors such as government regulation, government ownership, public policies and yes, politics — how these factors impact the governance of state enterprises in China and the rest of Asia.

## Session 1 Speakers:

### **Maroot Mrigadat**

#### **President, PTT Exploration and Production, Bangkok**

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*Khun Maroot argues that PTTEP has enjoyed the best of both worlds — the advantages of state backing and the freedom to operate commercially. Relying on the international capital markets for a lot of its funding over the past 10 years, and with a unique charter that freed it from much bureaucratic regulation, PTTEP has shown that growth, efficiency and corporate governance can go hand-in-hand in a state-owned enterprise.*

I have to admit that I am not an expert on corporate governance. My profession is in oil and petroleum engineering, and my views are based more on logic and common sense, rather than on theory. But I am more than willing to share with you my experience with my company, PTT Exploration and Production (PTTEP), a company listed on the stock market of Thailand.

Let me provide you with a snapshot of PTTEP, so that you might have a good context of the corporate governance issues relevant to oil companies. PTTEP was established in 1985 as a wholly owned subsidiary of the integrated oil and gas entity, the Petroleum Authority of Thailand (now called PTT). PTT is also listed on the stock exchange of Thailand and is the country's largest corporation in terms of market capitalisation. It is larger than us (we are about fifth).

We were set up to develop the upstream exploration & production opportunities in the country. I am very proud to say we were the first major state enterprise in Thailand to be listed and we achieved this over 10 years ago, in 1993. Since 1993, PTTEP has issued additional shares to the public. Our parent company was listed in 2001. While our corporate goals involve making a good return and achieving solid growth, we also recognise that our company has been established to achieve certain objectives that benefit the

country as whole. These include, for example, securing and expanding the indigenous supplies of natural gas to be utilised for generating electricity (and this has expanded rapidly). Another objective is partnering with world-class exploration and production (E&P) companies for technology transfer. A third is probably to develop into a "national champion" that would expand regionally or even beyond, and perhaps one day we could be a world-class player in the E&P arena.

During the past 19 years I believe we have been very successful in achieving both our corporate goals and the goals of the government. In balancing these objectives, I believe that success is due to three factors. One is the specific background to how PTTEP was set up. The second is openness to the suggestions and discipline of the market place (which has become the culture of our company). And the third is that we always take proactive steps, either by the board or by management, to move towards better corporate governance.

### **The best of both worlds**

The founders of our company had substantial foresight. They recognised that in order to be successful we had to compete with much larger, more established multinational companies in the E&P sector. Although government-owned, we had to develop commercial decision-making abilities. Our charter was unique among Thai state enterprises because we did not have to be

encumbered by bureaucratic regulation, which was commonplace at that time. For example, we were free to set up our own rules in areas such as personnel, recruitment and compensation, so as to be in line with international E&P companies operating in Thailand.

Furthermore, the government provided us with several natural advantages. For instance, the right to exercise government options to take interests in oil and gas acreage in concession agreements with international oil and gas companies. The fact that our parent company, PTT, owned the pipeline system that transports the gas also gave us a very strong strategic advantage.

One other important point concerns the balance of representation on our board of directors. We have 15 directors, with myself as president and an executive director. There are four types of directors on the board: independent directors; what we call "connected directors"; private-sector directors; and we have, by charter, the Director-General of the Department of Mineral Fields, the government agency looking after E&P business, as a permanent board member as well.

We think the board members of PTTEP comprise a good mix of experts from oil and gas, legal, finance and business. They are able to express their opinions on the company's operations or strategic plans independently. They are free to make comments about — and to object to any issues-based on their own views with no intervention. Currently one-third of the board are independent directors. How did we achieve this? In Thailand, since 1997, the issue of corporate governance has become very important and directors of many companies have full awareness of its importance. In the past you might say that most directors were not inclined to express different opinions in board meetings, but since the crisis of 1997/98 a lot of people have been educated about

the role and responsibilities of the board of directors. I must admit that 10 years ago many directors would not have known what were the roles and liabilities of a board director. But now there are courses that these people have to attend. Directors now know what their liabilities are, which makes them more responsible and accountable as directors.

In short, we were set up to take advantage of the best of both worlds: the advantage of being state-owned, combined with the advantage of a corporate and board structure that allows for commercial decision-making. Once listed in 1993, I must say that the discipline of the financial markets was a great motivator for good corporate governance. After listing we offered US\$39.96m of shares globally in 1993, US\$50m in 1994, and again raised US\$16m in a global equity offering in 1998. In the meantime, in 1995, we were the first state enterprise in Thailand to obtain an international credit rating and completed a Yankee bond placement in 1996. We also issued Samurai bonds in 1997 and tapped the domestic bond market several times during 1999 and 2003.

Our reliance on capital markets to fund growth means that we have had many opportunities to listen to and learn from parties from all round the world who are analysing and making decisions on whether to invest in our company. We have also looked seriously at the issue of full transparency to our investors (in terms of distribution and disclosure of information) and the promotion of corporate governance in our presentations to investors as well as in non-deal roadshows and equity conferences in Asia, Europe and the US. We have also improved the corporate governance section on our website.

As a side note, the market capitalisation of our company has grown from around US\$400m at the time of our listing in 1993 to

approximately US\$5.36 billion at present. That makes PTTEP the fourth largest company on the stock exchange of Thailand in terms of market capitalisation.

### **Four simple points**

I will not bore you with all details about the steps that we have taken to improve the corporate governance within our company, but I would like to share a few examples. At our weekly management committee meeting, we appoint champions for corporate governance — one is the vice-president of finance and the other is the corporate secretary. These two people always devote time to explain how our stock has performed and, more importantly, describe how outside parties, in particular equities and ratings analysts, view our company on issues like corporate governance. This regular update provides a useful system of checks and balances, and we always welcome outside views on our company. Recently, we invited the Thai Ratings and Information Service (TRIS), a company selected by the Securities and Exchange Commission to rate the governance of listed companies, to conduct a rating for our company. We have been rated well and are very pleased with the result, but we are all aware that there is still room for improvement and are fully committed to doing so.

Additionally, PTTEP has received a number of awards that reflect our commitment to corporate governance. For example, in 2003 and 2004 we received the Best Performance award and Best Corporate Governance Report award from the Stock Exchange of Thailand (SET) for two years in a row. We also received the CG Disclosure award from SET in 2004.

The process of improving our corporate governance culminated in 2003 when we published the PTTEP corporate governance book, which spells out our vision, mission and corporate values. All employees are required to read the book and certify in writing that

they will comply with the policies and ethics outlined in the book. Our policies encompass the role of the board of directors, conflicts of interest, internal control systems, ethics, accounting and financial transactions, gifts and benefits, confidentiality, security laws, and health and safety.

But most of all we want corporate governance to be simple as well. Our aim is to make it a way of life rather than just rules that people have to memorise and follow. As such, corporate governance in our terms translates into four simple points that we hope are not too complex for our staff to remember and to get into their hearts and pursue.

We think corporate governance is not only a matter of transparency, but most importantly means efficiency in the workplace as well. We have to make sure that people make decisions whenever they have to make decisions and not to cite corporate governance or transparency as a cause of delay.

The second point is transparency itself. Transparency is not only disclosure in annual reports, but something we want to cultivate in the culture of the company at all levels.

We also want to make sure that whatever activity we do, we have concern for all stakeholders, not only the major stakeholders or the government, but also the minor shareholders, employees and other stakeholders including our business partners.

The fourth and last point is awareness of risk management at all levels. In whatever activity, in whatever project we do, we want to make sure that we identify the risks and the ways that we will deal with them as well.

We recognise that maintaining the trust and confidence of shareholders, employees, customers, partners, regulators and other

people with whom we do business, as well as the community in which we work, is crucial to the company's continued growth and success.

In conclusion, I sincerely believe that good corporate governance is vital to the long-term welfare of all our stakeholders. I believe that achieving good corporate governance is also in the best interests of all stakeholders, including the government. Not only should the value of the government's stake in our company be enhanced, but the government's objectives in energy policy and attracting foreign investment should be better satisfied.

**Dr. Fan Gang**  
**Director, National Economic Research Institute, Beijing**

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*The keys to developing good governance in state enterprises in China today include, on the one side, improved supervision by the state of its own assets and, on the other, the existence of private strategic investors capable of balancing the interests of the dominant state shareholder, argues Dr Fan.*

My institute is involved in preparing a draft of a new state assets management law. We are suggesting that there should be a more generalised legislative body in the National People's Congress as a general representative of state ownership. Dr Zhu Min said he was happy that Huijing was consolidating all his government supervisory bodies into one super organisation. We are suggesting consolidating Huijing into a more general ownership structure.

Do you know what the Chinese state assets management system is? The current state assets management commission<sup>3</sup> only oversees so-called productive industrial assets. State financial assets are separately owned by Huijing or other bodies, while the People's Bank of China and the China Banking Regulatory Commission play the role of regulator. So-called productive state assets are another story. Nobody knows how much they have and who is supervising them.

The main purpose of this consolidation of ownership, from our point of view, is to properly regulate the sale of state assets and carry out the reduction of state ownership at

the corporate level in a more orderly manner. At the moment it is kind of a mess and is not supervised. This is an important dimension of this topic, but what I mostly want to talk about today relates more directly to corporate governance. I will address some issues that ACGA asked me to speak about.

**Can state ownership be positive?**

The first issue is whether state ownership could play a positive role in a developing country undergoing an economic transition? This question really made me reflect on whether there is a positive aspect of state ownership in this early stage of development. We should recognise this as a possibility, otherwise we probably cannot explain why China has grown so fast. If state ownership was only negative, China could not have grown in this dynamic way. Number one: it's true that government may be able and willing to invest in certain industries that are important for development, but are not yet attractive to private investors. These could include some very risky, early stage industries and some industries where the investment is too large for smaller private investors. Number two: because a state company may not be profit-oriented, it may not cheat too much, despite the fact that a sound legal framework is still not yet in place, whereas the private sector cheats a lot in the early stages of economic development. The word of a state-owned enterprise in China is still good, in some sense people trust it, because these enterprises do less cheating. When state assets are not profit-oriented, development may be faster because there

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<sup>3</sup> The State Assets Supervision and Administration Commission (SASAC) was formed in early 2003 to take over ownership and control of almost 190 of the most productive state-owned conglomerates in China – the economic rationale being to further separate state ownership from management and to centralise ownership under one body. Similar bodies have been formed at the provincial level.



could be more investment, quicker expansion and prices could be lower. In the early stage of development, maybe this does have a good impact. The issue is what you do in the next stage of development.

Other issues related to the legal framework and the cultural conditions for corporate governance and development. Some years ago I was in Kenya, Africa. I didn't see many private companies, even though they were allowed, and I asked some local businessmen why was this? They said, "Yes, we have a law permitting private ownership, but only you foreigners can do it". Only the Indians, Taiwanese, Japanese and British living in Kenya had private companies. "If we set up a private company, our tribe members will come and ask for this and that, and then on the second day your company will be closed because everything will be taken away."

That I think explains why a lot of African countries establish state-owned enterprises: they are something beyond tribal culture, beyond your relatives, an entity that is above everybody else and that provides some kind of protection of ownership. There is a similar situation in China. When you are in the very early stages of the transition from a state-owned economy, there is not much sense of private ownership or legal protection for it. It takes time for people to start developing the concept of private ownership and a legal framework for it.

In the past 25 years I think what we have experienced in China has been the development of a new ideology and a new legal framework for private ownership and better corporate governance. The issue is how you recognise there is a problem (with state ownership) and when you need to transit to another stage.

The problem of state ownership is a general

one in China. ACGA asked if governance might be better in certain enterprises or sectors? Were there differences? Well, there might be differences, but I think that state-owned enterprises in general have similar problems everywhere. There might be some well-governed ones, but that would be due to good leadership at one point in the development of a company. Generally speaking, you only see that occasionally in China and the problem is permanent and constant.

Where there is a difference in China is between what we call "old" and "new" companies. Old companies have a history of operation under the former planned system and carry a huge burden of employment and financial problems, including the behavioural patterns of their employees. New companies, which are those established in the 1990s, normally do not have much of a historical burden and their people already have some concept of how corporations should be run and how corporate governance should be. Historically, there is a difference between types of companies, because there are differences in the cultural, social, legal and ideological frameworks in which they were set up.

### **Strategic investors are key**

The most important factor, I would say, in distinguishing between poorly governed and better governed state enterprises is the existence of private strategic investors. This is the key factor in China right now to promote improvement in corporate governance. Independent outside directors cannot play much of a role unless there are strategic investors. The conflict of interests between two or three owners, between minority owners and the dominant state owner, is not only a check and balance mechanism in itself, but the conflict reveals information about the company and allows the independent directors to play a more useful role as go-between, to get to know the issues, and to get



to know some of the commercial secrets of the company. Otherwise, as an outsider it is very difficult to play much of a role.

Most listed companies in China don't have strategic investors — their private shareholders are mostly small retail investors. But if all your minority shareholders are just public shareholders, I don't believe that your independent directors can play a role. It is an impossible job to ask them to represent the interests of thousands of outsiders. In contrast, lawyers (representing small shareholders in lawsuits) and the media can play a much greater role in checking the behaviour of corporates.

That is why I agree with the Bank of China's plan to invite strategic investors to become its second and third largest owner before going to the public. That could create a good foundation for the improvement of corporate governance, because that will create a kind of check and balance that I think is most important. This is also why I always refuse to become an independent director of a listed company without any strategic minority shareholders, because it's really an impossible job and I could not make much contribution to the improvement of its corporate governance. If fundamentally there are no ownership constraints in a listed company in China, it really is hard for outsiders to play a positive role — at least in the current environment.

### **Improving supervision**

The last issue I want to talk about is how the state can improve the supervision of its listed companies. We need further improvement of the legal framework and the system of supervision. There are many issues here, some have already been addressed, some not. It is especially difficult for the Chinese government to have really effective supervision of Chinese companies. You may not realise that in Chinese state-owned enterprises there is a special system where all the profits after tax

are retained by the state company. No profits from state assets go to the state budget. Maybe some banks give some of their profit to the budget of the Ministry of Finance, but other companies, including China Petroleum, a huge state monopoly, don't give their profits to the state. All the profit after tax is retained and used by the state company. They are the controller of the residual profits (not the owner). That is why the central government and SASAC is now focussed on financial issues, specifically the supervision of the use of these profits. This has created a special difficulty: there is no government body or representative of state ownership that can make a decision on how much profit state enterprises should return to the public. There is no such control power at the state level, it's all at the corporate level. This creates special difficulties and special problems. This brings me back to my first point: that alongside other improvements in corporate governance, we need a better system for the ownership and management of state assets.

## QUESTION & ANSWER SESSION

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The issues raised in this Q&A session included:

- Dealing with requests from government to invest in national projects that do not produce a commercial return.
- The role of supervisory boards is quite confusing. Will it be clarified as the reform process moves forward?
- How can executive directors, as well as independent directors, be made more robust?
- How can strategic investors be cultivated in China (with a view to providing stronger support to independent directors)?
- How should independent directors keep in touch and communicate with investors?

### **The influence of national policy**

**POTE VIDET:** Dr Zhu, what if the Ministry of Finance or a key advisor comes to you and says, "We have a national policy to build up the steel sector in China. We want you to lend to this sector, and we have a couple of individuals we'd like to support to develop that sector." But then you do your analysis and find problems with the credit of the project. What do you do?

And to Khun Maroot, in the energy sector there is a great desire by governments for self-sufficiency of energy, but you know there may be certain projects that could increase self-sufficiency yet do not meet your return requirement. Again the minister says you should invest in this project even though it doesn't meet an adequate return criteria. What do you do?

**ZHU MIN:** I have to specify a different scenario. If it was five years ago and the Ministry of Finance said that, I would do it. The issue today is that although we are all owned by the Ministry of Finance, the Ministry does not necessarily exercise ownership power.

State enterprises in China have so many so-called mother-in-laws, but we have no real boards. That's the real situation. It is very confusing. You have to split the government into two parts. One is the central government, which is the real owner, and the other is the various government bodies, which have their own interests.

If you look back five or 10 years, at that time the government and owner was the same and they shared the same interests. We were one instrument. All the stakeholders were the same. Everything was acted out on a planned base. But because of market reforms, now we have different parties with different interests. So the issue of monitoring costs arose and even though the owner is the central government, that owner has difficulty in exercising ownership authority and we have difficulty exercising managerial capacity.

Five or six years ago the central government clearly prohibited any level of government from intervening in state enterprises. That meant that nobody could give direction to a bank, for example, asking for commercial lending for a specific project. But it still happens at various levels.

To answer your question again, I don't think the Ministry of Finance would say that today. And we could protect ourselves by referring the whole thing to Huijing and to our board.

**MAROOT MRIGADAT:** When the government decides that a particular state enterprise should be listed on the market, they want to make sure that that particular enterprise is not a vehicle or tool to be used only to implement their policies. In other words, they want to make sure that that enterprise can work within the business environment. For a company of our size, if

the government imposed some policies that we could not justify to the public, then they need to understand that the stock price would go down and this might jeopardise the stock market as a whole. To be frank, this needs to be restated all the time: the government cannot just impose policies that will have an adverse effect on the company's performance.

For the question that Pote was asking, what if the government says, "Look, we are net importers and we want you to go and develop certain fields even though the economics is very marginal or may not be justified"; in fact this has been happening. But in this case we have the Director-General of Mineral Fields, who looks after the oil and gas industry in Thailand, sitting on our board as well. What we do is talk to him and he understands very well because he's wearing two hats. We try to come to a win-win solution where we say that we understand the need to try to develop every last drop of oil in the country (we are not a country with a lot of reserves), but you need to modify the physical regime in order that we can justify our hurdle rate too. He understood this very well. In this particular example we are setting up a joint working team between our staff and the staff of the mineral fields department to try to work out a scheme that would enhance the development of marginal fields. The government is very comfortable too. They wouldn't be comfortable working this scheme with a private oil company, because they couldn't trust whether the costs provided by the company were real costs or inflated costs. I find it is working very well.

But just to keep the rest of my answer short: you cannot prevent government coming in and asking you to implement certain policies, but you probably can find some win-win solutions that serve the government's objective and at the same time protect your own economics. From time to time in the high oil-price environment, the government will come in

and ask whether we can reduce gas prices (as gas prices are linked to a certain extent to oil prices). What we say is, "Yes, but in turn we want more volume to be committed." It's a game of give-and-take that you have to play.

### **Whither the board of supervisors?**

**QUESTION:** Dr Zhu, in Chinese companies that have been converted to shareholding companies, and especially those dominated by the state, there's both a board of directors and a board of supervisors. The regulations are somewhat confusing. The CSRC requirements for listed companies say that the audit committee should report to the board of directors. In other regulations (such as for banks) the audit committee reports to the board of supervisors. It's not clear what role the board of supervisors plays. Although their role is written down, it's not always clear in practice what role they play vis-à-vis the board of directors. As the reform process goes forward, do you see the role of the board of supervisors changing or being clarified?

**ZHU MIN:** There is always historical background. During the early stages of reform, there was no governance issue and the government tried to exercise direct control. One method they used was to send their supervisory committee<sup>4</sup> to companies. It's very interesting that in the Bank of China the committee reports directly to the State Council. At the end of the day almost nobody reads the report, although the Premier might read it, but obviously it's not very effective. These efforts to enhance direct control were also a form of governance, but in a different format. When we converted into a corporation we changed the structure: we still have a supervisory committee, but the committee comes under the shareholders' conference. Meanwhile,

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<sup>4</sup> Boards of supervisors are sometimes also referred to as "supervisory boards" or "supervisory committees". (Ed)

our audit committee reports directly to the board, not to the supervisory committee. The supervisory committee adds one extra layer to make sure we behave well. Its role is to supervise the board and management, but they don't go down any further. All the authority and legal responsibility belongs to the board. This is in the Bank of China's case.

### **Empowering executive directors**

**QUESTION:** I was very interested in Dr Fan Gang's suggestion about empowering independent directors by introducing more strategic investors. That's okay as far as it goes. However, it continues to place a great burden on the shoulders of independent directors for corporate governance. It would be interesting to hear what further strategies might be being considered to also make other directors — the executive directors — more robust in terms of their capacity to consider the interests of all of the company, rather than merely those who have appointed them (the holding or parent company). How do we empower the whole board rather than just the independent directors? That seems to me to be the bigger challenge.

**POTE VIDET:** I think this is a very important issue, because government is dominant and very powerful. Therefore the management and the independent directors — to the extent they have disagreements with the state — need to be empowered by a countervailing force. Khun Maroot, you have teamed up with Total, Unocal and others. Are they a countervailing force vis-a-vis the government? Dr Fan, could you also discuss this.

**MAROOT MRIGADAT:** In our case, we are in a unique situation. In all our projects we have always had strategic partners investing with us. For example, in one field we had Total of France and British Gas co-investing, so whatever decisions had to be made regarding that project — costs, prices and so on — all had to be agreed

by the three parties. We had what we called a joint venture management agreement that bound all the decision-making with regard to that project. When issues came to the board, they had already been consented to by this group of investors. In this case, minority benefits were protected and looked after.

In another field we are partnering with Unocal, so it sort of balances out when issues come to the board. There's no big burden for the independent directors to have a big contest. I have to remind you that most of our product is sold to our parent company, PTT, which is our major shareholder, so the one common issue is the conflict of interest when a company like us is selling product to a parent company. But as I mentioned this has been discussed, negotiated and agreed with the partners already.

**FAN GANG:** If there are strategic investors, then the minority shareholders will have more say and the independent directors will have more scope to play a much bigger role in providing checks and balances and aligning with the minority shareholders. In China now, some large minority shareholders have much bigger powers and, in many cases, can appoint the CEO (with the majority shareholder only appointing the chairman). It also depends on the leadership and attitude of the owners.

**MAROOT MRIGADAT:** Just one small point I would like to add: in shareholder meetings we always invite as many board directors as possible, so that it is not only the CEO who is sitting there and answering questions from shareholders. By doing that I think directors have an awareness that whatever decisions they make, they have to be able to justify them with the shareholders in the annual meeting.

**ZHU MIN:** I agree with what Fan Gang has just said. I slightly disagree with what he previously said on independent directors. I think independent directors play a very important

role today in the Bank of China's case. In Hong Kong we have Victor Fung, C.C. Tung, Shan Weijian, Linda Tsao Yang — all these people play a very important role.

**FAN GANG:** But it's in Hong Kong!

**ZHU MIN:** Also in Beijing! In Beijing we have independent directors chairing our board committees and they immediately check all the procedures and meeting information. A few things are important, as Fan Gang says. Number one: those independent directors have to be true independents. Number two: they must have experience and knowledge. Number three: they must have a good reputation. The power of independent directors really comes from the power of knowledge and of experience and reputation. This is very important. Of course, overall whether they play a big role depends on leadership — whether there is a major shareholder and management that have open minds and aim towards a market economy. The good news today is that the Chinese government and company management are determined to move the whole thing forward. That's the way to make the independent board system work pretty well today, particularly in the Bank of China's case.

**POTE VIDET:** You'll be glad to know I agree with both of you, but I want to add my two cents to this. My experience in sitting on boards is that the audit committee plays a crucial role, if you can really focus it on related-party transactions. That is the key issue, especially with government ownership. The Thai government is the major shareowner of PTT. It is the one who provides the rights to develop and explore, and is the sole purchaser of gas. The whole issue of empowering the audit committee, the independent directors, and particularly checks and balances on related parties, is critical.

**ZHU MIN:** But also it depends on the integrity

of accounting firms.

### **Cultivating strategic investors**

**QUESTION:** Dr Fan, you mentioned that in enhancing the role of the independent directors, strategic investors were quite significant, especially in the case of China. How do you anticipate that strategic investors will be cultivated in China's capital markets?

**FAN GANG:** This is about the development of everything. If you don't have a good stock market, you won't have many strategic investors wanting to invest. Then there is also the legal framework, the development of independent directors — the role they play and how the legal framework should be developed to allow them to play their role. All this needs time to develop. These issues are all linked together, so that's why I would say this is still at an early stage and we need to make an effort in every aspect. The bottleneck for China is that the stock market is not really developed. This discourages a lot of investment, including a lot of strategic investors.

### **Linking independent directors and investors**

**QUESTION:** In terms of working hard to make the role of independent directors more meaningful and useful in state-owned enterprises, I would be interested to know the panel's views on how independent directors should keep in touch with and be informed of the views of investors on corporate governance issues. Should they come out on some of the roadshows and accompany the executive directors? Or should there be other channels of communication to reinforce the role of the independent director?

**POTE VIDET:** How can you assist in empowering the role of independent directors in your respective business communities?

**ZHU MIN:** I'm very happy you mentioned

the communication issue. I think this is key, as it brings management and major shareholders to better understand what market expectations are and what the market needs. This is another way to empower independent directors. There are various ways — roadshows, meeting investors in their office or outside — and we do a lot of this type of thing. It's very helpful, because it gives us a sense of what the market expectation is.

**MAROOT MRIGADAT:** What has happened in Thailand is that there has been a lot of awareness about this and there are courses that directors, both independent and executive, attend so that they understand their role, responsibilities and their legal liabilities. Once they understand that, they have to speak out on whatever their thinking is, not just go along with all the other directors. Once people know what their liabilities are, they want to make sure they are protecting themselves too.



## Session 2: Institutional Investors — Creating a Catalyst for Good Governance in China

### Moderator:

**Douglas Pearce**  
**CEO/CIO, British Columbia Investment Management Corporation**  
**Victoria, Canada**

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*While the principles of corporate governance may be universal, foreign institutional investors must understand and appreciate the different cultures and ways of doing things in Asia, says Doug Pearce.*

Many of you are experts on China and Asia and, for the sake of full disclosure, I should say that I am not an expert in this area. I remain a student of China, its culture and institutions. I admittedly look at this market through North American lenses. I know there are many more ways of implementing corporate governance change and behaviour than we have in North America, but the fundamental principles of good corporate governance remain the same: transparency, full disclosure, management of conflict, and respecting the shareholder. These are universal.

Looking at corporate governance in my home market (Canada), I would say we are moving in the right direction. But even after 100 years of a market economy, we're far from perfect and we still have a long way to go, too. It takes a collective effort. As large as our fund is in Canada, we find it is useful to join with other institutional investors to bring about real change. I suspect that is what will happen

in China, and the journey has just begun.

In North America, there are basically three groups of investors: institutional, which includes pension and endowment funds; mutual funds; and individuals. Historically, the drive for change in corporate governance has been on the shoulders of institutional investors. This is due to a number of reasons: the long-term focus of their investment time horizon; their member constituency, which typically is more activist; and the fact that they have the resources to spend on corporate governance engagement, and research. My view is that this burden will also fall on the shoulders of institutional investors in China and Asia. This is quite a responsibility, particularly for the foreign investor. Not only do we have logistical issues, but there are also differences in culture that we must understand and appreciate. I am hoping that this panel will give us some insights into how we, as institutional investors, can make effective changes in Asia.

## Session 2 Speakers:

### Brian Doyle

#### President, CITIC Provident Management, Shanghai

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*To improve the governance of mainland companies, investors need to be able to not only purchase control, but to exercise effective control over management. But China is not for dabblers — if you want to be successful as an investor, you have to be fully committed, argues Brian Doyle.*

For China to ultimately have better corporate governance, there has to be a market for corporate control and a deeper base of skilled investors. A market for corporate control encompasses both the ability of investors, foreign or local, to purchase control of companies, and the means to *effect* control after the investment has been made.

At present there are legal limitations and regulatory challenges associated with foreign or domestic investors coming in and taking over control of mainland companies. Although there are legal mechanisms on paper allowing tender offers, proxy voting, general offers and so forth, I don't know if there is really the political or regulatory desire backing this up.

The means to effect control, by which I mean changing the management, is very difficult to accomplish here. There have been some instances of it, but it's not commonplace. One of the biggest challenges, and to some extent frustrations, for foreign investors coming into China is that while they may legally own more than 50% of a company, this does not necessarily translate into control. Management will often do what they want, irrespective of who the owner is. There has to be a means not only to purchase legal ownership, but also to effect control in practice.

Going back to the point of having a deeper base of skilled investors, we need experienced people who have the ability as investors and the commitment to the local market. And here

I point the finger back to myself and to other practitioners in the investment community. For better or worse, a lot of people practising investment in Asia today have limited experience. Some of them are former bankers or consultants, and certainly that's a great place to start your career — I started mine in banking, but I've been investing now for 10 years. Investing is very different from banking, or consulting, however.

### Adding value

As an investor, you also need to add value. One of the frustrations we have had in Japan, where we also invest, is the attitude there towards investors. About a year ago we were looking at buying a stake in a company that had a significant 15% block for sale. As a courtesy we went to talk to the management team and they said, "Thank you, but before we talk to you about selling our shares, why don't you tell us about the value that you can add to us?" I am more accustomed to the North American model, where if you want to buy shares, you buy them, and then you talk to the management team about the value they can bring to the company — not the value that you, as a shareholder, will bring to the management team. That's inverted logic. Nevertheless, it is the logic that often prevails in Asia. My point is that as an investor here you can't just show up and say "Hi, I'm your shareholder, make me money." If you want a seat at the table, you have to find ways to add value to the management team, above and beyond just saying better corporate



governance. That's nice, but you also have to say: "Look, I have a deep base of international relationships. You need to develop customer relationships in Europe or Japan. Let me open the door for you. You also need to hire a CFO. And you need help with investment bankers." You have to add value. You can't just show up as a passive investor and talk to people about corporate governance. If you are lucky they will listen politely, but that will probably be the end of the conversation.

Finally, you must be committed to the local market. I have been in China for six years. It's a tough market and a tough place to live. It's a tough place to do business as well, but it is also a wonderful place from a business and human perspective because it is one of the most exciting places in the world. Some people look at China and say: "Well, I could put my money in China, or I could put it in the Philippines or India". That's fine, but if you really want to be successful in China you have to change your mindset and say: "I am committed to the China market, I am going to stick this out, and we are going to be successful in this market". One of the problems is that a lot of investors come here with the wrong mindset. They think they can dabble a bit, put a little money to work and see how it goes. I will tell you upfront that that's not going to work. If you want to be successful here, you have to take a long-term view. Some people aren't going to like hearing this, but when I say "long term" I mean five to 10 years. That doesn't mean it is going to take five to 10 years before you make money. But that is how long it will take before you see people making the changes and taking the steps that are needed. You have to be patient, you have to work hard, but if you do those things then you can make real money here. There are obviously many instances where people have not made money. But we are starting to see evidence of people who have been successful at investing.

**Dr. Fred Hu**  
**Managing Director, Goldman Sachs (Asia), Hong Kong**  
**Director, National Center for Economic Research (NCER), Tsinghua**  
**University, Beijing**

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*While good corporate governance depends on a variety of different factors, investors have a particularly vital role to play, Fred Hu argues. It is investors' money that is at stake, and good corporate governance ultimately matters most to investors themselves.*

Good corporate governance depends on a variety of factors: an effective and independent board; a management team that is incentivised to align its interests with that of outside investors; a sound regulatory, legal, and supervisory framework; an open and free press; and an active, professional investor base. All these elements are needed in order to promote good corporate governance.

I would like to highlight the particularly vital role of investors. After all, it is their money that is at stake. And whether corporate governance is good or bad, it matters most to investors themselves. Beyond the normal legal protections offered to investors, there is no outside body, be it a government regulator or some other kind of watchdog, that will always be there to look after investors. They have to take the system into their own hands and become a potent force to ensure good corporate governance.

There are two kinds of investors: retail and institutional. The role of retail investors, as far as corporate governance is concerned, is quite limited. In order to monitor a company's management behaviour, and to make sure they are indeed maximising shareholder interests, or indeed are aligned with outside-investor interests, you need a lot of information (financial, business, and other kinds of information) to do the job effectively. The cost of acquiring such information is high. Even in well-developed and transparent markets like the US, with its robust disclosure rules, the cost is high. It is always difficult to get the

information you need to make an informed judgement about corporate governance. Besides, and this is particularly true in this country, retail investors tend to be very myopic, very short-term oriented.

The Chinese capital markets may be very small in terms of market cap, but look at the trading volume — it is one of the largest in Asia. Why? Because Chinese retail investors are good at trading stocks. They are really perfecting the Chinese cooking art of stir-frying: you buy today and flip tomorrow! This kind of myopic behaviour is not conducive to good corporate governance. Therefore, it is up to institutional investors to do the job.

But China has an infant capital market and the investor universe is dominated by retail. Ninety-five per cent of trading volume is created through stir-frying by the retail investors. The mutual fund industry is still nascent, with combined assets under management of only around US\$30 billion. We just heard Doug Pearce telling us about his fund, which has C\$65 billion under management. This is just one pension fund and it is twice as big as the entire Chinese mutual fund industry. So China has a very small institutional investor base and it is the weak link in the corporate governance system in this country.

### **Emerging Trends**

Developing a vibrant, professional, forward-looking and long-term institutional investor base will be a critical part of strengthening corporate governance in China. In this context,

I would like to point to several trends that I consider to be extremely encouraging.

First, the emerging mutual funds industry. Although it is very small, as noted above, the number of mutual funds and, more importantly, their quality, is rapidly on the rise. This effectively institutionalises the vast pool of retail money in this country. As Dr. Zhu Min mentioned in his opening speech, China has a very large pool of savings because Chinese people are very frugal. As this retail money is institutionalised through mutual funds, the long-term effect on corporate governance should be positive.

Second, the successful launch and operation of the Qualified Foreign Institutional Investor (QFII) scheme. There are a large number of global institutions, including Goldman Sachs, participating in the Chinese domestic capital market — both the bond and equity markets. With the implementation of the QFII programme, a group of experienced, large and professional investors have come to play in the domestic market, and become a potent force as well.

Third, the greater presence of insurance companies in the capital markets is another encouraging trend. The government has been relaxing the rules governing the investing of insurance assets, so there is a greater equity component in their investments (alongside fixed-income securities). Insurance companies like China Life, Ping An Insurance and PICC are big institutions, and they will help to form and strengthen the whole institutional investor base in China.

Fourth, the emergence of big banks, which, if you think about it, play a similar supervisory role as institutional investors. They are creditors to almost all the leading companies, including the publicly listed companies. Dr Zhu mentioned that in the old days banks tended to treat their customers as family, so never did

anything to monitor a borrower's behaviour — how it was using its loans, when the money would be repaid. Now banks, led by the Bank of China, are making sweeping reforms and restructuring. They are becoming more active in monitoring credit risk and the borrowing company's behaviour. This is very important. Even though you may have mutual funds, insurance companies, stocks and bonds, at the end of the day the banking system is the largest pillar of the financial industry: 90% of capital formation in China still comes from credit, not from equity. If banks, as large creditors, do a good job in monitoring companies, they will be instrumental in strengthening corporate governance for publicly listed companies as a whole.

Finally, the National Council for Social Security Fund and pension fund development. I would emphasise the unique role and importance of the social security system and reform, and how it can help corporate governance. China faces a demographic time bomb. Elderly people, who are defined as those 60 years or older, make up only about 8% of the total population. Compared to OECD countries, the problem seems minor. But the real problem is the aging process. Aging will happen fast because of the stringent one-child population control policy and rising life expectancy. If you do some standard projections, in 30 years China will be as grey as many OECD countries today. One projection I have seen is that by 2030 China will have more elderly people relative to its population than the US. So China will have to confront its old-age problem much sooner than many expect and at a much lower level of per capita income. Reforming the social security system is very important and requires changing it from a pay-as-you-go to a fully funded scheme, such as individual retirement accounts or other fully funded provident schemes. This will not only enable China to confront its demographic pressures, it will help it to develop its institutional investor base and capital markets. This is what I call 'one stone hitting two birds'.

## QUESTION & ANSWER SESSION

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The issues raised in this Q&A session included:

- What is the best way to improve corporate governance in China — through aggressive, public activism or through quieter dialogue with companies?
- Initiating shareholder resolutions.
- To what extent are Chinese institutional investors independent? Or are they fraught with the same conflicts of interest as those in the West?
- Don't foreign exchange controls limit the interest of foreign investors in China's stock market? And how can the government sell state shares without causing the market to fall?
- Should institutional investors be bound by law to enforce good governance practices in the organisations in which they invest?
- Launching lawsuits against negligent directors.
- What takes priority for institutional investors — maximising value or ensuring good corporate governance?
- In a legal environment that lacks clear corporate-governance rules and the tools to enforce the law, how are investors expected to play in the market?
- If governments want market forces to truly work, they need to look first at creating a level playing field for investors and companies.

### **Public activism vs quiet dialogue**

**QUESTION:** In North America there are basically two approaches to corporate governance: a very public route, which is often done through the press and is an in-your-face approach; and a private route that involves discussions with managements and boards. Do you have any views on what would work best in China?

**BRIAN DOYLE:** Let me answer that by looking at an analogy for what's happened in

Japan in the last couple of months, because I think that Japan's economic and shareholder system is similar. In Japan a significant portion of listed companies, about 40%, if my numbers are correct, trade at or below their book value. It has continued this way for at least five years. People said this didn't make sense. You could buy a company that had a market price and a cash value of \$3 a share. In other words, you could buy the cash and get the company for free. It didn't seem to make sense. But in fact it was right, because people viewed the company and its management team as destroying value. Which then begs the question, why not buy the company and switch the management team? There has to be a way to invest and capture some of the value of doing that. But the answer is that — until recently — nobody went out and tried to switch management teams. Now two or three American funds have come in — including CalPERS — and invested in "focus funds". They have effectively arbitrated this opportunity and said, "We're not going to allow this inefficiency to exist, we are going to tender". In three cases they've already begun tendering and several more were announced recently.

Doug Pearce alluded to two approaches to corporate governance. I call the first the "confrontational" or "antagonistic model", some of which is done through the press, but some of which also involves directly tendering and trying to switch management teams after one buys control of a company. The second is what I call the "buddy-buddy model". You try to be the buddy of the management team. You say, "Hey buddy, why don't you try to do this or do that", and that can work. In Japan, people have been trying to apply the buddy-buddy system for some time, but it hasn't worked. There have been instances of people making it happen; one or two firms are doing a good job with it. But I think you will see a lot more of the confrontational approach in

Japan in the next two to three years.

As for China, part of my answer is that power is respected. If you try to be a buddy, I am not sure how successful you will be. On the other hand, a massively confrontational style probably won't get you the reaction you want either. It doesn't entirely fit the culture. You also see this in Japan: when you go after Japanese companies, they often pull back and circle the wagons, and it doesn't work.

There are aspects of the confrontational approach that might be helpful. For example, you have to assert yourself if you want to get anything done in China, that's a reality. But you can't go too far or you end up insulting people.

Interestingly, in Japan some shareholder rights are fantastic, better than the US in some respects. But that's not necessarily the case in China where these rights and other laws are still evolving. We'll see how this plays out, but it is likely that shareholder rights will become more codified here.

So to answer your question — the winning strategy will be achieved by assertive people who can add value and walk the fine line between being friendly and pushy, but not pushy to the point where a management team simply tells you to go away.

**FRED HU:** To ensure corporate governance you need a lot of internal and external pressures, a lot of checks and balances. Whether this pressure is manifested through quiet persuasion, or open confrontation, is secondary. Either could work if you have a responsive corporate board and management, which set high standards for governance practices. Maybe even a gentle reminder could do the trick and change their behaviour.

But if you have a weak, unresponsive board

and management, you probably have no choice but to resort to open pressure. That doesn't mean you have to take the company to court. In China the legal system allows you to do that, but in practice it is impossible because the judiciary is not independent and is ill-equipped to do the job. Most judges are PLA<sup>5</sup> veterans, they are not legal experts, and they cannot effectively deal with matters like corporate governance or securities disputes. I would say robust government supervision, an open and independent press, public opinion and moral pressure will be very important.

### **Shareholder resolutions**

**QUESTION:** Dr Hu, is there a regulation in China to establish or initiate shareholder resolutions?

**FRED HU:** Both Chinese corporate and securities laws have very detailed requirements and procedures for publicly listed companies to organise annual shareholder meetings, and almost all the decisions have to have a shareholders' resolution. A very elaborate procedure.

### **The independence of domestic institutions**

**QUESTION:** I have a question on the evolving structure of institutional investors in China. If I understand you correctly, you say this group is small but rapidly growing. The other dimension for institutional investors, as we know from the West, is that they tend to be fraught with conflicts of interest. You can't tell me that Goldman Sachs investment bankers, who peddle services to the very corporations where governance is supposed to be improved, do not try to influence its investment arm. What is the growth of independence in the structure of Chinese institutional investors? Do we see truly independent institutional investors coming up, or is it just like the rest of the world, where all these folks have tremendous

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<sup>5</sup> People's Liberation Army

conflicts of interest? I'm speaking as a soon-to-be-pensioner who is dependent totally on the charity of the institutional investors that administer my pension fund!

**FRED HU:** I think you have raised a very important question in light of what has happened over the last couple of years in markets everywhere, including the US. The scandals, the conflicts of interest, have led to a lot of harm being done to investors, including pensioners like you. But a lot of lessons can be learned. The fact that we have this conference here in Asia as a forum to promote good corporate governance is one.

As far as institutional investors are concerned, I do not necessarily see independence as such a big issue, because investors have the biggest stake in corporate governance. Although I think you have raised a subtle issue of what happens when retail money like your's is institutionalised — how can you ensure that the institutional investors themselves, the mutual funds, pension funds or insurance companies will maximise your interests and returns?

Again, the basic elements we talked about earlier are relevant: having an effective and independent board, strong oversight by government regulators, including maybe pension regulation, an independent press, and active investors (in this case, pensioners like yourself). When you put money into a pension fund, your money is in jeopardy. You have to be active, and proactive, about looking after your money. Monitor management's behaviour. Make sure the pension-fund and mutual-fund money managers are doing their job to protect your interests and maximise the return on your assets.

**BRIAN DOYLE:** One of the challenges of corporate governance activity in China is that there is an inherent conflict — and I think the gentleman touched upon it in his question

— facing the private equity affiliates of the major international investment banks. They are the ones in the best position to effect change. They can go to companies and ask them to install better corporate governance practices. They can take them to task if they do related-company transactions or undertake uneconomic, value-destroying activities. These corporations are some of the best suited to do this work by far, both from an experienced-investor perspective and because of their scale and might.

However, the inherent conflict comes from the fact that they also have the most to lose — these are essentially unpopular decisions. To go to companies, such as a steel factory in Shenyang for example, and say, "Listen, this is ridiculous. You are destroying value. You have far too many workers. You are doing related-party transactions. You are giving two-year credit terms to your customers. Here are the things we want changed." If they did this, the foreign banks would soon be fielding phone calls from both the municipal and provincial governments, and it would hit the press. Are these organisations really courageous enough to engage in corporate activity in a way that is so upfront? That's the challenge.

My gut feeling is that it's not going to be the multinational investment banks, or commercial banks, that are going to be in the forefront of change. There's a role for them in corporate governance in a passive, behind-the-scenes way, but I think it will be what I would call "boutique" domestic investors who will force companies to make the necessary changes. They are Chinese nationals, many will be foreign-trained, they will understand corporate governance and have the skills and willingness to confront management. Foreign entities with nothing to lose will also force changes. The people who have been successful in Japan had nothing to lose. I think it's going to happen with foreigners in China as well.



## Foreign exchange controls

**QUESTION:** Dr Hu, you have suggested five different types of institutional investors that will enhance corporate governance in China. But without fundamental changes to foreign-exchange controls, won't it be very hard for multinational institutional investors to invest in China? Also, the functions of domestic institutional investor are still quite limited. Following WTO rules, there is a schedule for relaxing the financial system, but in order to have a better and fully developed capital market China will have to remove its foreign exchange controls and capital account limitations. How do you look at these things? There are a lot of risks to take in bringing about a more flexible exchange rate system. Secondly, in China most state-owned enterprises are owned by government. A few years ago the Chinese government tried to sell part of its stake in some state enterprises, but it brought such strong downward pressure on the stock market that the sale was cancelled. How do you see the privatisation of state-owned equities without a lot of pressure being put on the stock market?

**FRED HU:** I will answer your second question first. State-owned share disposal is a big issue. China has probably 1,200 or so publicly listed companies, with the government and "legal-person" shareholders<sup>6</sup> owning a combined 70% of the shares of these companies. The government and the former prime minister intended to dispose of some of those shares in part to fund the social security system, but that caused a big uproar in the retail investor base, the media and academia, so the government had to scrap it. In my view, and I have written a fair amount on this subject, I believe it is very

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<sup>6</sup> "Legal-person" shareholders include other state entities such as state enterprises and, in some cases, private companies. Legal-person shares, like state shares, are not tradeable on the Chinese stock markets.

important for the government to press ahead with the disposal of state shares, because corporate governance cannot improve as long as 70% of the shares are in government hands. Retail investors and minority institutional shareholders have no say in how corporations are run, how the board is formed, or how the management team is appointed — despite owning the other 30% of shares. This is the root of the problem.

The irony is that there is a coalition of domestic economists and investors who think that it will hurt their interests if the government disposes of state shares. My answer to that is there are proven technical ways that would allow the government to dispose of its shares in an orderly, smooth way and create a win-win situation for everyone. It does not need to depress the secondary market, as we have seen in Hong Kong. For example, in 1999/2000 my institution was involved in helping the Hong Kong SAR government devise the Tracker Fund into which the government transferred the shares it had bought during the Asian Financial Crisis. After the launch of the Tracker Fund, the Hang Seng Index did not sink as people feared. It continued to perform strongly. My point is that, yes, it is essential for the government to have the political courage to go ahead and do this. Once it is done, I am sure it will pave the way for better corporate governance in China, because once the shares are in private hands more stakeholders will be willing to take on an active role in monitoring company behaviour.

Now to your first question about capital and exchange controls. I totally agree with you that larger, deeper and more liquid markets are important for corporate governance. The government understands the need to liberalise capital controls, but it needs to be done gradually in light of what happened to Asia in 1997/98. Premature lifting of capital controls could cause a lot of trouble, particularly if

the domestic financial system and regulatory infrastructure is weak, and transparency is low. Currently, the government is focussed on financial reform, particularly banking reform, as we heard from Dr Zhu Min in the opening speech. This is the most pressing task. Once meaningful progress on banking reform is made, I expect many of the capital controls will gradually be lifted over the next five or at most 10 years, paving the way for a fairly open capital economy.

### **Binding institutional investors by law?**

**QUESTION:** A follow-up from the earlier question about the role of institutional investors and how to get them to do something on corporate governance. Institutional investors are meant to increase the coffers of the pensioners and other investors investing with them. They do play a large role, especially the multinationals. The US and the UK governments in 2003, and the OECD in April 2004, have made it fairly clear that institutional investors should have a role to play. With the OECD it's not a regulatory matter but in its code of corporate governance that institutional investors should take a proactive role. Hong Kong recently decided not to go down that road, instead leaving it to market forces in its draft code of corporate governance. Singapore is likely to follow Hong Kong's lead and also leave it to market forces. Should we statutorily, or through regulatory means, force institutional investors to play a monitoring role? In other words, should they not only ensure their own corporate governance, but use their heavy hand to enforce corporate governance within their portfolio companies? So, rather than just leave it all to market forces, use legal means.

**BRIAN DOYLE:** It's incumbent upon individual institutional investors as to how they want to manage their portfolio of investments. There are three options. One is

for institutional investors to be activists, to be assertive about their rights. There are certain institutions in the US that have taken that role. The UK has groups that have also been forthright about protecting and asserting their rights. The second is to do what I would call an "enhanced version" of activism — not being passive, but taking some steps to protect their rights, being assertive when needed, but more on the margins, not necessarily through proxy votes, fights or things of that nature, but taking steps to enhance their rights. The third option is the ultimate form of protest for an institutional investor — sell the shares. Ultimately, that will probably be one of the most effective ways in China for foreign investors to make companies understand how they view them. If you don't think a company has good corporate governance, and you are not willing to roll up your sleeves to do the work to fix it, then the obvious way to get your point across is a protest vote. This is to refuse people your capital. I don't think you need to legally mandate it, though.

**FRED HU:** The two approaches you summarised — leaving it to market forces or legally mandating investor involvement — need not be mutually exclusive. You also need strong legal protection, and good regulations, because often money is at stake and you need the system to protect that money. But you also need market forces and market discipline. Investors themselves have to be proactive and monitor managerial behaviour to ensure that management interests are aligned with investor interests.

**DOUGLAS PEARCE:** Often in North America the investor punishes the company very quickly in the stock price. It is not left up to the regulator. They come after the fact.

### **Lawsuits against directors**

**QUESTION:** You have said that if the framework of a corporate governance



system in a company did not live up to your expectations, you would sell your shares. But if you truly believed that there was shareholder value that could be retained, should you not look into taking more substantive steps, such as seeking to remove certain directors from the board or seeking other punitive measures such as threats of a civil suit? In a recent survey commissioned by Jardine Lloyd Thompson on directors' and officers' liability in Singapore and suits against directors, it was reported that these suits were started by retail investors or, more often than not, substantial shareholders, but never by institutional investors. What would be your response to removing certain members of the board if you thought that they had gone too far and done significant damage to a company?

**BRIAN DOYLE:** You are touching on an important point, which is the term "institutional investor", and that is a large pool. What is an institutional investor? Are we talking about index funds or actively managed funds? Or are we talking about hedge funds? What I want to do is throw it back to some of you who come from institutional investor backgrounds, or might put yourself in that pool — what is your business deal with your investors? The people that give you money, what do they want you to do? What is your investment mandate? What are you incentivised to do?

In our case, as a firm that buys companies in a private equity-like format, our mandate is clear — we are there to improve corporate governance and do whatever we need to, legally, to accomplish and maximise value. But our incentives are also aligned to do that — our investors know they are going to pay a certain management and incentive fee to allow us to do that. Institutional investors themselves have to be clear in their own minds, "What do we want to do? What do our investors want us to do?" You can't manage an equity fund at 50 basis points a year with no incentive fee. Corporate gover-

nance activities are expensive. Especially if you want to conduct a tender fight, go to court, get sued and counter sue. There are legal and due diligence costs, reputation issues.

Institutional investors should have an introspective, internal conversation as to what exactly it is we are trying to do? Where are we on tolerance? Do we want to be purely passive or assertive? Are the internal mechanisms aligned to allow our managers to do what we've told them to do in the investment mandate? In our case, we are fully committed, and if a management team is not producing value, we will try to get them out, whatever it takes legally to do that. That's what we're paid to do. We're there to use our best resources to make sure the asset is appropriately managed.

### **What really matters to investors?**

**QUESTION:** When we talk about the role of institutional investors, what takes priority in corporate governance terms? Is it maximising the return on funds under management? Or is it ensuring good corporate governance practices in listed companies? Secondly, how can banks be classified as institutional investors?

**FRED HU:** As an institutional investor your first, and foremost, duty is to maximise the risk-adjusted return on your funds. Your first duty is to generate the best possible return, while controlling the risk. Risk is not in conflict with the need to ensure good governance, because the mounting evidence in academic and other research is that good governance is generally conducive to shareholder value creation. It is not in conflict at all. Rather it is consistent with your central goal.

As for your second question, maybe there was some confusion. When I said banks had a major role to play, it was in their capacity as large creditors or lenders, not as investors in bonds. My definition of corporate governance is the classic conflict of interest between corporate

insiders (ie, management) and outside investors (which includes equity and bond investors), and lenders. Much is at stake, so far as the money invested in the company. Banks meanwhile lend a lot of money to corporations, including H-share listed and A-share listed corporations, and as large lenders or creditors they have the power as well as the obligation to monitor these companies. That's the message I was trying to deliver. I am not advocating that banks put depositors' money into stocks and bonds. I have friends in China, who are economists and who have made this suggestion. It really makes me lose sleep at night!

### **The un-level legal environment**

**QUESTION:** I want to comment on the current corporate governance structure in China from the perspective of a legal academic. In terms of governance structure, China is a big market that has huge potential, but one that is also full of pitfalls and risks. Under the current legal system we have national laws passed by the National People's Congress, or its Standing Committee. At the next level, we have the so-called administrative regulations passed by the State Council. At the third level, we have the so-called administrative directives released by the ministries. Under Chinese administrative procedure law, these administrative directives do not bind the courts. When courts hear cases, they are not subject to these directives. Currently, national laws, such as company law and securities law, have very general provisions on directors' duties. The securities law lacks provisions on directors' civil liabilities when they breach their duties, so in practice this problem has to be solved by administrative directives released by the China Securities Regulatory Commission (CSRC). The CSRC has, for example, released a code of corporate governance for listed companies. But if a case is brought to the courts, the courts are not subject to these codes or rules released by the CSRC.

Another problem in the national laws is the

lack of provisions on the protection of minority shareholders. For example, there is no derivative action. This means that minority shareholders cannot bring action on behalf of the company against directors who have breached their duties. They can only bring action on behalf of themselves. In China, how many investors or shareholders can bring such an action? Secondly, according to the interpretation of the Supreme People's Court, if individual directors or even institutional shareholders want to bring an action against company directors who have breached their duties, under the current securities law these people have to go through a procedure with the CSRC first. The court will only hear the case if the CSRC says, "Yes, there is something wrong in this case". This creates more problems in terms of cost, energy and time, and causes problems for shareholders. In such a legal environment, where there is a lack of clear corporate governance rules and the tools to enforce the law, how do you, especially foreign investors, play in this market? Dr Zhu Min mentioned that we now have this playground, but given the problems in the playground, how can you play? The next question is, as investors, if you come across a conflict of interest between profit-making for the company and enhancing corporate governance, which would be more important?

**BRIAN DOYLE:** In terms of how you deal with situations where the laws are unclear and difficult to enforce, you have to triangulate your response. One, you have to use the law: there are legal mechanisms in place, not perfect, not complete, but I think you have to use the law to your advantage where and when you can. Two, you have to work the management team. It can be your best friend or your worst enemy. It can either be fully supportive of working with you, or it can go out of its way to undermine what you're trying to do. Three, you have to work with the government, both at a municipal and provincial levels, as well as at the national level,

if you have the appropriate relationships.

Look at the case of what happened to Newbridge when it bought the Shenzhen Development Bank. It's an interesting case study. Newbridge went in, identified its ability to add value to the bank, and came to a general deal with the management team. Subsequently, the management team realised that it may not have been the best deal for them, because certain rights might change in future, so they tried to find another group to come in and take them over. Newbridge did three things at that point. First, it worked the legal system as best it could. As it turned out, it had to go to the US courts, but it also worked domestically to put pressure on the company and the different parties. Second, Newbridge showed the value it could add as an accomplished and skilled investor in banks. Third, it worked behind the scenes on both the national and regional levels to show the government all that would be gained by bringing it in. And in a subtler manner, it showed some of the things that China could lose by not acting according to the law. You have to use those three mechanisms.

### **Creating a level playing field**

**COMMENT FROM FLOOR (Linda Tsao Yang):** Our colleague from Singapore commented that because the Hong Kong government has chosen to let market forces decide what role institutional investors should play in corporate governance activism, Singapore will probably follow suit. But in order to allow market forces to play their due role, it's important that all the major players share a level playing field. Our research at the Asian Corporate Governance Association has shown, for example, that it is very difficult for institutional investors to participate in annual general meetings in Singapore because of certain technical impediments. This needs to be changed.

Another example comes from Japan: many

institutional investors complain that most companies still choose the same date for their annual general meetings. There's no law to say they must do this. In order to level the playing field, there's no reason why the government or the Tokyo Stock Exchange couldn't say: "Here is a window of six or eight weeks, and you guys draw lots as to which day you will hold your annual general meeting", or some other impartial, neutral system. Then you can really allow market forces to work. For a government to say that it will simply 'allow market forces to work, period', is a cop out. It's not doing its duty to understand fully the impediments facing different market players. And I am speaking as a former financial regulator.

Further, in terms of corporate governance and institutional investors, you are right, Brian Doyle, when you say there are many kinds of institutional investors. My experience in the US is of the public pension and endowment funds, which came together and pushed for corporate governance. I realise that in Asia there is a different environment, but there's no reason why institutional investors could not get together and, rather than address the abuses of individual companies, go to work with the regulators on issues such as access to annual meetings, the setting of general meeting dates, and the kind of administrative measures that institutional investors can take to exercise their rights. By working together, you are not seen as picking out any particular company and being confrontational. There are many ways to advance corporate governance.

In terms of corporate governance, I would like to see it defined as much more than maximising the shareholder value in the short-term, but rather maximising shareholder value over the longer term. If a company violates the law, pollutes the environment or tolerates sexual harassment, one of these days it will be penalised. It will be the shareholders who pay and the company's reputation will suffer.



## Luncheon Keynote Speech:<sup>7</sup>

### **"Microeconomic Reform and Macroeconomic Stability in China"**

**Professor Lawrence J. Lau**

**Vice-Chancellor, The Chinese University of Hong Kong; and  
Professor of Economics, Stanford University, United States**

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*Professor Lau argues that China's macroeconomic instability — its cycles of boom and bust — has much to do with problems at the corporate level, in particular excessive fixed investment. While these cycles can never be completely eliminated, they could be brought under better control through a series of micro-level reforms such as a more careful screening of investment projects, a tighter loan approvals process and a reduction in debt-to-equity ratios. Improved corporate governance would also help.*

Today I want to talk about microeconomic reform and macroeconomic stability in China, because I think a good deal of the macroeconomic instability is caused by problems that occur at the micro level, not at the macro level.

First, I would like to talk about the macroeconomic situation in China. Secondly, what I regard as the two most important sources of macroeconomic instability. And third, I would like to go over the failures of the market, many of which are well known to you: asymmetric information, incentive incompatibility, moral hazard, adverse selection, and externalities. These are everything that gets in the way of good governance. I will give some examples. That will lead us into talking about what I call macroeconomic stability-enhancing microeconomic reforms. These are reforms that potentially could enhance macroeconomic stability. I will conclude with some brief remarks.

### **Prepare for a soft landing**

The Chinese economy shows signs of overheating in selected sectors and regions. Rates of growth of GDP for the first three quarters of 2004 were in excess of 9% year-over-year. The rate of inflation as measured by the Consumer Price Index may be estimated at approximately 5% year-over-year for the same period, but is at its highest since the mid-1990s. If there was any concern about deflation, the remaining concern has largely dissipated and been replaced by consumer inflation. However, if you look at the core rate of inflation in China — that is, inflation in the prices of energy and agricultural products, principally food — it remains very, very tame. If you go back and look at the data for the period mid-1997 to 2002, a period during which most people thought there was deflation, the core rate was actually around zero. It was not a very obvious deflation.

In any case, in the long run there is really no upward pressure on the real wage rate of unskilled, entry-level labour in China, because the agricultural sector basically can supply as much entry-level, unskilled labour as the economy requires for probably the next two to three decades. That, coupled with growth in the labour productivity, should imply a relatively stable price level and, hence, relatively low rates of inflation.

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<sup>7</sup> Professor Lau's full slide presentation can be found on the ACGA website ([www.acga-asia.org](http://www.acga-asia.org)). Go to: ACGA Archives > Events > Annual Conferences > Asian Business Dialogue on Corporate Governance 2004

Efforts by the Chinese government to engineer a soft landing have met with some success: the rate of increase in the prices of certain manufactured products, such as cement and steel, the rate of growth of fixed investment and the prices of real estate have all begun to come down. The Chinese government has demonstrated its ability in macroeconomic control, albeit not relying exclusively on the mechanism of the market. For example, interest rates haven't changed but everybody in business here can feel the squeeze. There are good reasons why interest rates have not changed. The major one is that when you look at borrowers who do not intend to repay their loans when things go sour, raising interest rates by 200 basis points is not going to change their behaviour. So, to a certain extent, not moving interest rates on the lending side can be justified. It is much harder to justify not raising rates on the deposit side, because depositors are now faced with substantial negative real rates of return.

I believe that a soft landing is achievable. My forecast is for a rate of growth of real GDP of somewhere between 8.5% and 9% this year (2004), a rate of inflation of less than 5% for the entire year, followed by a rate of growth of about 7.5% next year and a core rate of inflation of less than 2%.

### **Moderating booms and busts**

I want to talk about the two principal sources of macroeconomic instability. The first one is what I would call boom and bust cycles. The macroeconomic instability in China is caused primarily by boom and bust cycles in real fixed investment undertaken by enterprises, both state-owned and private. These cycles are driven mostly by domestic demand, not by external disturbances. This is something that is important to remember.

Because of moral hazard, which I will go into a little later, a boom inevitably leads to excess capacity and low investment returns. This is because there is really no downside for the senior managers of a state-owned enterprise that makes an unsuccessful investment. You inevitably get over-investment. It would be a surprise if there was no over-investment! Therefore, when you have over-investment, you get excess capacity, low investment returns and then there is a subsequent bust and a decline in real fixed investments by enterprises. Hence, a boom and bust cycle.

I want to emphasise that these are not public investments of the infrastructural type, they are basically investments in plant, structures and equipment. Bad investments have externalities: they result in lower rates of return not only for themselves — which is alright, since you can say it is their project — but for otherwise good investments affected by the competition for resources, capital, raw materials, talent, markets and so forth. The automobile industry is an example of over-investment in the auto and steel sectors. Automobile investment drives up steel prices and that eventually raises costs for everybody, even for the more successful, better-run enterprises.

The other source of macroeconomic instability is what I call the "spill-over effect". That is, the spill over or domino effect caused by failures of large enterprises propagating through the economy. This is due to the very high debt-to-equity ratios in China (which are more comparable to Japan, Korea and Taiwan than to the United States, where the debt-to-equity ratio is much, much lower). Once you have high debt-to-equity ratios enterprises are more prone to fail and, when they fail, they tend to drag down otherwise sound enterprises, such as their suppliers. A supplier could be



a perfectly well-run enterprise but, through no fault of its own, could also fail. Then if too many enterprises fail, the banks will have a serious problem on their hands. This potential for a spill-over could be a source of very significant instability, as it was during the East Asian financial crisis. This is what happened in Korea, Thailand and Indonesia, with some well-managed firms failing because of the influence of their customers.

### **Market failure**

There are various reasons why a market may not be expected to work and I just want to give you a couple of examples here. As I mentioned before, the overheating of the Chinese economy is largely due to excessive investment in certain sectors — cement, steel, automobiles, aluminium and real estate. But these investments are made possible not through public funding of investment. It turns out that, in recent years, state investment by the Central government now accounts for only about 5% of total real fixed investment in China. So that's not going to cause too much instability one way or the other. Also, all this excessive investment is only partially financed through properly approved bank loans. Of the 30-odd new automobile factories that are being set up, I would say that only a very small fraction have officially approved bank loans. Most of these plants are financed through what I would call "diverted bank loans and funds". I might be a textile manufacturer and have a line of credit with a bank. I take out the line of credit and put the money in an automobile factory. That is usually what happens, and that is why this behaviour is so hard to control.

One objective of the microeconomic reform that I am proposing is to try and distinguish between the good projects and the bad projects, so as to allow the good ones to proceed and the bad ones to stop. The current method of macro control is to say everything must stop. That works, but it also means that good projects have to be stopped as well. If there could be a way of screening, that would be very desirable. Now I am not so bold as to say that I have the magic formula for screening, but there is a method that would help to screen out the worst projects and that would be an improvement. This consists of reforming the microeconomic process of loan approval and disbursement. That would really take a change at the banking level and would actually result in a much better mix of projects getting funded.

The other thing about the desirability of doing this is that if you succeeded in differentiating between good and bad projects, it would to a certain extent help prevent a renewed rise in the non-performing loan (NPL) ratio in the Chinese commercial banking system. That is very important because if projects turn bad either because of diverted loans or improperly made loans, they will show up as NPLs and that is not a good idea.

### **Sharpening the instruments of control**

Because of the existence of moral hazard, as I mentioned earlier, raising the lending rate by even 200-300 basis points is not going to discourage loan demand. Most borrowers are not personally and financially liable for any losses and do not intend to repay in the case of enterprise failure; on the other hand, they stand to make substantial gains if successful. That really is a classic moral hazard situation.

While aggregate quantity constraints — either through changes in the reserve ratios of banks or in targets for new loans — have worked reasonably well, they deter both good and bad

projects. And the interesting question that I ask here is: is it possible to discriminate between good and bad projects? The idea is a very simple one: that if you could discriminate, that would actually bring some advantages. It would moderate boom and bust cycles, because if there were fewer bad projects it would help to smooth out the bubbles. Now what we need here to reduce information asymmetry between borrowers and lenders — as well as for good corporate governance — is accurate, reliable and timely information. And having more shareholders with a long-term interest in the enterprise is also essential for improving its corporate governance and, hopefully, corporate performance.

While I don't have time to go into it here, I am actually a believer in having controlling shareholders. But an active controlling shareholder (ie, a family), not the state. The idea is a very simple one: the other shareholders can piggyback on the major shareholders, you don't have an incentive incompatibility between the owner and management, and the only thing you need to worry about is related-party transactions. I think that transparency on related transactions is very important. I don't have time to go into it, but family-owned corporations have some advantages and shouldn't be dismissed simply on the grounds of corporate governance.

### **Reforming the loan process**

This is actually nothing new, it is basically what is being done almost everywhere except possibly in China. The first reform would be an equity requirement. To require every project to have an equity requirement seems pretty obvious, but it is more than that because in China the equity requirement is typically implemented not in terms of the borrower having to turn over money to the lender, but just showing a statement that says "I have this equity" and the lender will write a cheque for the balance. So that basically results in loss of control. What I am proposing is that an equity requirement of at least 25% ought to be implemented and a potential borrower would have to turn this over to the lender before the project can be initiated and payments disbursed to third-party suppliers, subcontractors and so forth. It is actually very standard practice outside.

If you did that you would have two things: one is that people would begin to realise that if they lost money, they would lose real money, their own money, or at least a substantial part of it. To a large extent that can actually substitute for the information asymmetry that exists, because I think it's too much to expect bankers to know whether a project is good or bad. But if people are willing to risk their own money, real money upfront, then it can't be too bad. It is an important idea — that you make use of the equity requirement as a way of forcing people to view how confident they are of the success of any new project. If you have a 100%-financed project, even I would do it. If anyone wanted to lend me 100%, I'll do anything. But that doesn't tell you whether I think this project is likely to be successful or not.

The second part of the reform would involve what is called the "progress method of loan disbursement". This is basically where a lender controls the disbursement of funds so they can't be diverted elsewhere. If I borrow money for a textile factory, it would have to go into building the factory and buying textile machines. This doesn't guarantee that my project will be a success, but it guarantees that all the funds were disbursed for the project and, in case of any auction off of the project, the lender would hopefully get back 50 cents in the dollar. It wouldn't be a total loss.



This is something that is relatively simple and could be implemented at the micro level in China. It would have the advantage of reducing a good deal of over-investment and especially the bad ones that people are unwilling to put real money into. And when you talk about equity requirements as a percentage of the value of an entire project, proper appraisal makes a big difference. China urgently needs to train many more professional appraisers so as to avoid the common practice of over-valuing assets.

### **Reducing debt, raising equity**

There are two major ideas here. One is that reducing the debt-to-equity ratio that will reduce moral hazard. The simple way to think about it is as follows: if you have more equity involved in your firm, you will be more careful because it's your money; whereas if you have a lot of debt, it's the bank's money and if you lose it, it's the bank's loss, not your loss. So if you can actually lower the debt-to-equity ratio, you would reduce the amount of moral hazard.

The other thing — and this is actually more important — is that if you could bring down the debt-to-equity ratio, that would stop propagation. That is, when one enterprise fails and takes down other enterprises with it. This would help people get away from the idea that any enterprise is too big to fail. The idea of being too big to fail is simply that if I fail, I drag you down and you drag somebody else down, and then eventually everybody fails, so that the government has to come bail me out. But if you can reduce propagation by having lower debt-to-equity ratios that would greatly improve the potential macroeconomic stability, and again reduce moral hazard.

How do you go about reducing the debt-to-equity ratio? I think the government could do a lot more in promoting the equity markets and it should also begin by reducing or eliminating the double taxation of corporate income in China. Right now Chinese corporate income is taxed in the same way as the US used to tax corporate income, namely that the corporation pays taxes on its profits and, when dividends are distributed from after-tax profits, individuals who receive the dividends also have to pay tax on them. This also means that firms are more likely to want to issue debt, as opposed to equity, because the latter is taxed twice. Eliminating double taxation would level the playing field a little bit and companies would be more likely to issue equity than debt. Of course, there are other reasons why management might prefer debt to equity — fewer shareholders to bother them and so forth — but I think that overall one should also try to reduce the debt-to-equity ratio.

### **Liberalising interest rates**

This is actually much harder to do because of the issue of moral hazard. Interest rate liberalisation is a worthy goal of the People's Bank of China, but it can only be phased in as the appropriate institutions and culture takes root. For example, as long as borrowers do not suffer personal financial consequences from corporate losses, the demand for loans will be higher than can be economically justified and the resulting rates of interest will be too high, crowding out other borrowers who may be more deserving. A thin market for bonds, bills and notes, due to a scarcity of potential investors, is another problem to overcome. And there is the problem of moral hazard on the part of the employees of commercial banks. Thus, in the process of liberalisation, it may be necessary to impose minimum lending rates and maximum deposit rates.

One must also bear in mind that even in the United States, as capitalist and as market an economy as one can get, the short-term interest rate is still largely determined by the Federal Reserve Board and not in the market.

### **Maintaining positive real rates of interest**

There is now a negative real rate of interest for depositors in China and, on top of that, they have to pay a 20% tax on their interest income, which I think is quite unfair since you are already getting a negative return and you still have to pay a tax. But the real worry is a potential financial disintermediation, because if you continue with a negative rate of real interest then sooner or later money is going to leave the banking system. Already there are some signs that underground financial institutions are on the rise. They are taking deposits illegally and financing at exorbitant interest rates, which is a potentially dangerous situation. I remember the 1980s in Taiwan, which for a while had a huge number of underground financial institutions, all of which went bust eventually. There was a similar episode in China in August 1988, when much higher inflation and negative real interest rates on deposits caused panic buying and a run on the banking system.

On the deposit side, therefore, one really needs to do something. It may be useful for China to introduce indexed government securities similar to the Treasury Inflation-Protected Securities (TIPS) of the United States. They would be both an inflation hedge for Chinese citizens and an indicator of inflationary expectations in the market.

### **Turning traders into investors**

Another question is how to convert short-term traders into long-term investors? I am very sympathetic to the idea that we should improve corporate governance, but fundamentally it can only be improved if shareholders are long-term. Short-term shareholders have no interest in governance, no matter how well you do, so you have to try to promote the idea of long-term stock ownership either through institutions or individuals. I keep hoping that China will have some great stocks, such as AT&T around 20 years ago, when every American household owned 100 shares of the company and it paid a steady dividend. That's no longer true, so don't rush out and buy AT&T, and it has since been broken up. But the idea is that good companies like that will persuade new buyers into the equity market. They would shift their bank deposits into a safe, sound blue-chip dividend-paying stock. There are various things the government could do to promote this and eliminating the double taxation on corporate income is one such measure.

### **The tyranny of low expectations**

There will always be people who say that the market doesn't demand a dividend-paying stock. And currently there are few stocks paying substantial cash dividends in China. But I think this is because of self-fulfilling expectations: enterprises believe that most shareholders are short-term traders, not long-term investors, who don't care about cash dividends or, for that matter, corporate governance. The enterprise will literally declare no cash dividends because "people don't need them, so why should we do it?". But it is precisely because there are little or no cash dividends that only short-term investors are attracted to the market. Why should long-term investors put their money into the market when there are so few cash dividends and so much volatility? Hence, expectations are self-fulfilling. And since there are no long-term investors, it would be a waste of time to promote or raise cash dividends.

This is an equilibrium that is stable and persistent. In order to break it, you need to change expectations. You need major and highly visible action, such as eliminating double taxation or granting some sort of dividend-income tax relief, such as for the first Rmb2,000 (US\$240 approx) of dividends. That would be a real change and could get people thinking and new money coming into the market, because what the Chinese equity market needs right now is both new demand from new investment and a new supply of good blue-chip stocks. Chinese people complain to me that they cannot buy Petrochina, whereas Warren Buffet can<sup>8</sup>. This makes no economic sense. China ought to introduce better stocks, because that would attract new buyers. It need not be a zero-sum game: introducing good IPOs<sup>9</sup> would not necessarily drive down the price of existing stocks, because they would attract long-term investors interested in these newly listed companies.

The other example I want to give of self-fulfilling expectations is Japan, which has been in recession for almost 15 years and is a perfect illustration of this idea. If firms think that next year is going to be bad, they will cut back on investment. If consumers think things are going to be bad, they will cut back on spending. Next year will indeed turn out to be bad and everyone will say, "we were right". So it becomes self-fulfilling. They will say that the following year is going to be worse, so they cut back again, and then you get into a cycle that is very hard to break out of. What you need is some major action to bring the system out of this low-level and persistent equilibrium.

### **Sharing the ups and downs**

How do you align the incentives of owners and managers? One insight that I would like to share is that stock options, which are common in the United States, do not completely solve the problem of incentive incompatibility because while people share the upside of options, they don't share the downside. If you really want to line up the incentives between management and shareholders, you ought to force managers to share the downside as well. One idea that I have proposed — but so far no takers, although it is not an unreasonable idea! — is to require senior management to own stock in the company. The company would lend money to senior managers to buy the stock, but with recourse (since no recourse would be like an option). This would go a long way towards aligning the interests of management and shareholders, because if one lost money, both would lose money. Options, in contrast, are very one-sided. But you can see why this is an uphill proposition for most management. Shareholders will really have to exercise themselves to achieve it.

### **Managing moral hazard internally**

Reducing moral hazard internal to enterprises relates to things such as internal controls and risk management. Higher salaries are very important here, as are long-term career advancement prospects, because you really want employees to feel that they are a part of an organisation, part of a family. Long-term prospects, coupled with higher salaries, really changes people's behaviour.

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<sup>8</sup> This is because Petrochina is listed only in Hong Kong and New York, not in China. Currency controls limit the ability of domestic Chinese investors to buy the stock of such overseas-listed mainland blue-chips. (Editor)

<sup>9</sup> Initial public offerings.

There are techniques to reduce opportunities for corruption. Let me just give you one. I was talking to the CEO of a major bank here and he had a smart idea about how to structure credit committees. In the Chinese context if a credit committee is small and its membership is known, then prospective borrowers may try to influence those members and there could be problems. What this CEO did was to set up a roster of 50 people, any three of whom could be picked for a particular credit committee meeting. Those chosen would be told in the morning, "you three are it!" It may be a second best solution for resolving corruption, but it works on the principle that you can buy three people but not 50. This allows the process to work reasonably well.

Ultimately corporate governance can improve only if there is a demand on the part of shareholders and their agents. Shareholders have to want corporate governance to improve, not just the regulatory agencies. These shareholders must but be long-term oriented. I don't think short-term holders, if they're going to flip every week or like Fred said, "stir-fry", are going to be interested in corporate governance. But it also depends very much on the reduction of information asymmetry and moral hazard. If boom and bust cycles can be moderated through a more careful screening of investment projects and by reforming the banking processes, and the spill-over effects can be minimised through a decrease in the debt-to-equity ratio, then macroeconomic stability in China could be greatly enhanced. You can't eliminate cycles altogether, but the cycle would be of much smaller amplitude. Bubbles would still be inevitable, but they would be smaller and much more containable.

## QUESTION & ANSWER SESSION

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**QUESTION:** This is a question and a statement about your last point on long-term shareholders wanting good corporate governance and short-term shareholders not really caring that much about it. It seems to me that all shareholders want good corporate governance, but only the long-term ones are willing to pay for it. If you look at the hedge-fund phenomenon, what's going on? Hedge funds are probably not going to invest in China in a major way until they see good corporate governance, nor will other short-term shareholders. The key is that you've got to have shareholders that are willing to bear the burden, to pay the price, whether it's in legal fees or in time spent ensuring that sound corporate governance is actually there. And that's going to make the market efficient for the short-term shareholders. I believe that you need short-term shareholders to make a market efficient. If you go back to Japan, 15 years ago the Japanese market had lots of long-term shareholders and there were a lot of cross shareholdings. I ran capital markets for Goldman Sachs at that time and if we wanted to do a US\$100m offering for someone like Matsushita you couldn't do it because you would have destroyed their valuation at the time. There were huge valuations and a lot of parallels with what's going on today in China. Huge valuations, the markets become totally dysfunctional, and what you really need are short-term shareholders to come in and trade, and be in and out of the markets. But they are not going to pay for corporate governance.

**LAWRENCE LAU:** I really don't disagree with you. I would cheerfully accept your amendment that both short-and long-term shareholders want good corporate governance, but it's like motherhood — nobody can be against it. But only long-term shareholders are willing to invest the time to ensure there's good corporate governance. I think the Japanese case is actually a bit different, because my idea of long-term shareholding is not corporate cross-shareholdings (which really means nothing). What I mean are shareholders who hold long-term for investment reasons, because they really believe in the stock, not for corporate-control reasons. Cross-shareholders probably don't care about corporate governance either.

**QUESTION:** Professor Lau, you indicated that you were comfortable with the idea of a dominant shareholder within companies, and you gave the example of family companies. Of course, that's a very different situation from where you have the state as the dominant shareholder, which of course brings a very different sense of obligations, in terms of public obligations. I wonder whether you wish to address that particular problem, as it seems to be the fundamental problem affecting corporate governance in China today. The state is, and remains, such a significant shareholder in so many of the larger enterprises. Thank you.

**LAWRENCE LAU:** You are absolutely right. I was very careful to say the family as opposed to the state. The state as the dominant shareholder has the following risk: it belongs to everybody and to nobody, so nobody is paying attention. You've all come to China often enough and you will notice that when a new hotel opens, whether five-star or six-star, whether privately or state-owned, they all look great. But three years later the state-owned one will look 10 years old, while the privately owned one will still look good. And that's the difference between having an owner and not having an owner. I think you are right about state ownership. I will go back to what Fred Hu said earlier, namely that eventually state-owned shares should be turned over to the National Social Security Fund. It would take a serious look at corporate governance issues. But I think that at present the

state has neither the ability nor the willingness to spend the time necessary to improve corporate governance.

**QUESTION:** You were talking about the macroeconomic measures that have been applied to kill, basically, all projects without regard for good or bad. But there's been a lot of rumour in the market that these measures have been directed more at private projects than at state projects. I'm just wondering if your research shows evidence of that and, if so, is that contributing to greater inefficiency in the market?

**LAWRENCE LAU:** I think that's inevitable in an economy where most of the banks are state-owned. But I think that many private projects now — not all of them, but some of them — are being funded through these unofficial markets. I think that is potentially a problem. But what you describe is probably correct in that private enterprises probably are under greater pressure than state-owned ones in terms of the reduction in their credit from formal financial institutions.

**QUESTION:** Just a quick question about linkages. Some people trace the increase in over-investment in China to a strong increase in renminbi money supply. As large amounts of US dollars have come in, so the money supply of renminbi has increased as well. I'm curious to see if you think there are any linkages there and how you see those connections working?

**LAWRENCE LAU:** I wouldn't say there is no linkage, but I think that the People's Bank of China has been very successful in sterilising the influence. It has not been passive in this process, so I would say that there is some linkage but it's not an important one.

## Session 3: Independent directors — How to be Effective in China

### Moderator:

**Ambassador Linda Tsao Yang**  
**Chair, Asian Corporate Governance Association, Hong Kong**  
**Independent Director, Bank of China Hong Kong**

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*Prospective independent directors need to do their own due diligence before joining the board of any company, says Linda Tsao Yang.*

The subject of independent directors came up again and again in this morning's sessions. Serving as an independent director in a state-dominated and state-owned entity is a challenge. Traditionally and culturally, these enterprises have very much a government mentality: promotions by seniority, strong risk aversion, and staff that are good at taking directives, but not good at coming back with new ideas or discussing issues.

How can an independent director be effective in making changes or incentivising management, other colleagues on the board and the dominant shareholder to be open and willing to listen to what they have to say? How does an independent director prepare himself or herself in such a way as to offer value-added advice to management? Such directors also need the social skills to bring about a consensus on a concept so that, when it is supported by the group as a whole, will be implemented and realised. It is a very demanding, but exciting, position.

When I was asked whether I would serve on the board of the Bank of China Hong Kong (BOCHK) as an independent director, I gave it very serious thought. I met with the chairman, other executive directors and other independent directors to find out why they wanted another independent director and to help me assess whether there was an opportunity for me to be effective. I made it clear that at my age I am not very good at being a flowerpot! I also wanted to let them know that I have the distinction of being the one and only high-level government official in the State of California — in its history — to be suspended for insubordination! But they seemed to tolerate my two qualifications and still wanted me. It is a great challenge, but I felt that my initial assessment was correct: I do see a commitment on the part of management to change and that means there is an opportunity, if I do my part right.



## Session 3 Speakers:

### Lee S. Ting

**Managing Director, W R Hambrecht & Co, San Francisco**  
**Independent director, Lenovo (formerly "Legend")**

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*Independent directors can play an important role in helping mainland Chinese companies internationalise and develop better business strategy, argues Lee Ting.*

As Linda Tsao Yang mentioned, I have been an independent director of Lenovo — previously known as Legend, the largest IT and PC company in China — since early 2003. I am one of three independent directors on a board of seven members.

When I was first approached by Lenovo to be a board member, like Linda I was hesitant or even sceptical. I wasn't sure whether, as an outside member, I would truly be a value-added board member or just window-dressing. So I did some of my own due diligence. (By the way, I'm not sure if you are aware that Lenovo is listed on the Hong Kong Stock Exchange, not in China, and that a majority shareholder today remains the Chinese Academy of Sciences). After meeting with the board and the chairman, I felt they were serious about corporate governance because as a technology company they recognised that they had to become more of a global company. A technology company cannot survive just by defending its home turf, because with the WTO and everything else opening up, competition is going to grow substantially. For these reasons I felt they were serious about addressing the issue of corporate governance, and that's why they were recruiting outside board members.

Having served on the board, I would like to share some of my observations from those years of experience. The concept of independent board members in a Chinese company, or for that matter a lot of Asian companies, is something relatively new. I also serve on the

board of a publicly listed company in Taiwan.

This morning Dr Fan Gang made a comment that independent board members cannot really be effective unless there is a significant minority shareholder (a strategic investor) as well. I should say that is not the case with Lenovo. What I've found is that the board is still learning how to use outside board members and it is probably not utilising them to the full extent, given my experience outside of China. One of the reasons for this is that management still does not completely view outside board members with confidence. My experience working with companies outside of China, especially with technology companies, is that you utilise outside board members not just to be audit or compensation committee members, but also for your business strategy. That is a phase that companies in China have not quite reached yet. They use outside board members today primarily in a formal sense, more for financial and control purposes, and not so much for business strategy.

How do we feel outside board members can really be effective? They can help Chinese companies on a couple of fronts. Chinese companies are not very international in the way they do things. I'll give you an example. When I first joined the Lenovo board, all the meetings — even those held in Hong Kong — were in Chinese and all the presentations were in Chinese. Well, guess what, I can hardly read Chinese because I was never educated in Chinese! I can speak it, but I cannot read it very

well. The first comment I raised was, "Wait a minute, if you want me to be an effective board member, you have got to have something in English as well." They started doing that. I think that's good for them, because they need to begin to internationalise their way of doing things.

The other thing you learn is that you don't join a Chinese company board for the compensation. They have not quite got to that point yet. But they need to think about that a little more seriously, because if they are going to attract top-calibre outsiders to their boards, they have to look at how to be competitive. Everybody is busy, everybody has other options. The reason I am doing it is partly because I want to help Chinese companies improve. But going forward they have to address this issue.

**Dr. John Langlois<sup>10</sup>**

**Chairman, Morgan Stanley Properties (China), Beijing**

**Director, Bank of Shanghai and Nanjing City Commercial Bank**

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*John Langlois believes that a good independent director needs to keep four things in mind — mouth, money, sunlight and embarrassment. But none of these will work unless you also have a receptive audience within the board.*

My first directorship in China was the Bank of Shanghai in 2000. The head of the International Finance Corporation (IFC) told me he was planning to acquire 7-8% of the shares of the Bank of Shanghai and asked me if I would mind being nominated as a director to represent the IFC. I said OK and flew to Shanghai before it all started to say hello to the management there. We had this nice meeting, everyone was very friendly because the IFC is a bullet-proof name in China, and they arranged a mini press conference with a couple of reporters who wanted to see this funny foreigner.

One of the reporters asked, "Now let me get this straight. You (meaning the IFC) own 7% or 8% of this company, right?" "Right", I said. "So you're not a controlling shareholder of this company, right?" "Right", I said. "So what makes you think you can have any influence at all over the way this company is run?" The cameras were going, so I blabbed away and I said, "Well, we could have 70% of the company and it would be exactly the same question." Basically I said that it all depended on whether or not, as a director, I could present some intelligent ideas and persuade the other directors and management that they made sense. If I had 70% of the shares we could jam a decision down their throats, but they might not honour it after we walked out of the room. On the other hand, if you could persuade them, then you've got a shot at it.

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<sup>10</sup> Dr Langlois is now Advisory Director, Morgan Stanley Japan Limited (Investment Banking Division), Tokyo

### **Mouth, money, sunlight, and embarrassment**

I have tried to analyse the things that you need to do to be effective as an independent director. I came up with four: one is "mouth", another is "money", a third is "sunlight" and the last is "embarrassment". There are a lot of other things too. You have to have a receptive audience: if they don't want to hear from you, you can have all four things and they wouldn't matter at all. Let's assume that you have a receptive audience. I did in this case and that's partly a testimony to the IFC coming in. They wanted the IFC. They wanted to have people who could make an impact.

The first of these four things is what I call mouth, which means you've got to talk, persuade, educate and bring in your thought process — and present it to the group in the room so that they can understand it. I discovered at the first board meeting that nobody wanted to talk. Everyone sat there, saying nothing. Eventually I couldn't stand it any longer and started talking, which helped to break the ice. Pretty soon there were other people on the board who had mouth.

The second thing was money. If you are thinking about how to motivate people, money is a great motivator. It works for me and probably works for some of you in the room. But how do you use money in a board of directors to change behaviour? That's an interesting issue and I would love to hear what they do in Lenovo. We are talking about an incentive system, and there wasn't one at the Bank of Shanghai. As Linda Tsao Yang

pointed out, in the past you just had to show up and you got paid. It wasn't much, but you got it. The president, vice-president and other executives of the bank were all paid the same thing year after year; there was absolutely no incentive system. We are now using money, because that helps to overcome things like influence from outside.

The third thing is sunlight, and that's related to embarrassment. If you make people tell you what they are doing and the light shines on it, they do a better job. If they are in a little dark room and don't have to tell you what they are doing, they will just muddle along. Sunlight means making them talk. If the president of the bank doesn't talk, ask him! What are you doing? What's that guy doing? What's his job? Throw sunlight on it. And then "boom!", everyone else will jump in because now they can see.

The last thing was embarrassment. It's the selective use of the "no" vote. Basically, company directors hate to vote no on anything. They like everyone to be a nice big happy family, where everyone says yes. Remember that in the room there will be visitors from the regulators and they will all be writing notes. So if the IFC rep says no, that goes into a memo somewhere. I don't know where, but it goes somewhere. And then they have to explain it. They say, "what happened here, 12 votes to one, what happened?" They have to explain it and they get embarrassed. But you can't do that all the time, you can't be a crank.

Then I thought of two other points. One is that you need to help the people in the room prioritise (though I'm still not very good at that). We still get these laundry lists without any prioritisation from management. You don't know where they are going to spend the money, what are their priorities. You have to constantly get them to prioritise, and that is very hard.

Another point is making them recognise that the board is there for them. It's not a spy organisation. We (the shareholders) will pay you if you do a good job, so we want to know if you are doing a good job. We will stand behind you if something goes wrong. I've told them over and over again — the more we know about what's going on, the better. If there's a mistake somewhere, if you can say the board knew about it, voted on it and reviewed it very carefully, you're going to be a lot better off. But if you go out and do something we don't know about that really goes wrong, we're going to cut your legs off. So we can share the risk of the management. Once they understand that, then you get kind of a buy-in. Those are just a few thoughts.

## QUESTION & ANSWER SESSION

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The issues raised in this Q&A session included:

- The evolution of better governance at the Bank of China Hong Kong.
- Do mainland Chinese companies use English in the boardroom?
- How can independent directors get more information on particular subjects?
- The poor quality of information often provided to boards.
- The weakness of audit committees in mainland banks.
- The importance of asking questions, follow-up questions and setting deadlines for receiving information.
- Spending time with senior executives in order to understand their goals and priorities.
- Contrary to popular belief, independent directors should not be paid well, argues one delegate. But what is the proper form for such compensation?
- Increasing responsibilities are being placed on the shoulders of independent directors, but where does the balance lie? How much can be expected of them?
- How can the private sector in China develop the trust of the market?
- Who do independent directors represent?
- Is it good to restrict the number of boards one sits on?
- Do you have to be a foreigner to an effective independent director in China?

### Governance at BOCHK

**LINDA TSAO YANG:** I would like to share with you a little more of my working experiences on the board of the Bank of China Hong Kong. I have been there almost one year now. I am not a professional banker, although I was once a financial regulator, so I decided to set some goals for myself. My term is three years. What do I want to accomplish in the next three years as an independent non-executive director not representing any shareholding? I

thought hard and what I'd like to accomplish is to help the board and management work in such a way that they are guided by a clear set of processes and procedures. By this I mean knowing where the responsibility lies, what is the appropriate authority given to a body and how to hold that body accountable. A set of procedures that will make that as clear as possible, and are disclosure-based, so that senior management and the board knows exactly where they are. That was the goal I set myself.

Let me give you one example. Early this year the board had to deal with succession planning, recruitment of senior executives and personnel policy — minor items like that! Since the bank has now been listed for two or three years, it needs to have more of a commercial organisational structure. There was significant discussion within the board, in particular, on the recruitment of senior management, as there should be. The board has 12 directors: one is the CEO and the other 11 are non-executive. Of the 11 non-executive members, four, including myself, are truly independent non-executive members. The others are affiliated with, or working with, the parent Bank of China in Beijing. The independent directors were able to persuade their colleagues on the board that there should be an open, global recruitment process to fill senior management positions on the board, which was not the case in the past.

After a lot of good discussion, that precedent-breaking policy was adopted. When scandal broke out in August about some of the then-senior executives at the Bank of China Hong Kong, the board immediately came out and said, "We have a policy in place that will ensure the replacement of these senior executives, now disgraced, will be through open, global recruitment." That helped to

uphold the reputation of the institution and gave the investor community a degree of confidence. I remember I was never so embarrassed as when an acquaintance of mine in Hong Kong showed me a picture of five senior executives of the Bank of China Hong Kong taken on the day when it IPO-ed. He said, "Wow. Two are in gaol, two are detained, we've got one left. How many are in the pipeline?" I was pleased that I could say, "Don't worry, we now have a board-approved policy of open, global recruitment."

Speaking of using embarrassment, there was one case in which I felt it was important to register for the record that I did not agree and why. I don't think they find many of those on the record, but I think it is important to send a powerful signal that there are certain things that you may not agree with — and give the reasons why.

Embarrassment is important, mouth is important, and money. For the first time, the board of the bank has adopted a compensation structure not based on seniority. If a job requires certain qualifications and experience, you are paid accordingly. Rather than being paid so much since you have been there for 25 years and your salary has nothing to do with the job you do. It was not popular. Again it was unprecedented for what is still a state enterprise. But the board, working together, put that policy through.

To be a good independent non-executive director, one has to have something to add. You need to be clear as to why you want the job and have the tenacity, the perseverance and the social skills to bring people around over time to accept doing something — and then do it as group with a consensual push forward.

Before I open this discussion to questions from the floor, I would like to have a discussion

between the two of you, since you each raised some important questions and issues.

**JACK LANGLOIS:** So we should go at each other?!

**LEE TING:** You want me to embarrass him, right?!

**LINDA TSAO YANG:** Go ahead!

### **English in the boardroom**

**LEE TING:** Maybe I should go first. I find that most Chinese companies are run as Chinese companies (in not using foreign languages). Is your board meeting, Jack, conducted in English for your benefit?

**JACK LANGLOIS:** No, we do it in Mandarin, and I try to make sure that they stay away from Shanghai dialect!

**LINDA TSAO YANG:** Oh dear, that's unfair!

**JACK LANGLOIS:** When the directors get excited, they go into their Shanghai dialect; so I just say "Stop!" and they go back into Mandarin. But all the documents are in Chinese, there is nothing in English. They are an unlisted company, in Shanghai, and it's not an option to ask them to do everything in English. It would take them weeks to translate the stuff and they would need to have translators in the room, which is just not going to happen.

### **Getting sufficient information**

**LINDA TSAO YANG:** If sometimes you need additional information or explanation to help you formulate your ideas, how do you go about digging out more information than what is presented to you?

**LEE TING:** Before I address this, I should go back to the other point. Board meetings, when I started, were primarily oriented towards



finance, compliance and reporting. There was little discussion about business strategy. It's like Jack says, you've got to make a nuisance of yourself and keep asking questions. In board meetings now we have a session reserved for business strategy discussions, which is an improvement. But in terms of getting more information — because executives come prepared they will try to limit the discussion only to what they bring up. It is still very difficult to get into new areas that they are not prepared to talk about.

As an outside director, I also find it useful if your interaction is not limited only to the board level. Traditionally, an outside board member only deals with other board members. I think you can gain a lot if you also meet with some of the management people below that. What I am trying to do now is get the board to address the issue of additional information. In business discussion sessions I say that I would like to hear not just the CEO or other board members talking about the company's business strategy, but some of the general managers talking about their specific areas. There are two benefits: one is that you get deeper into the information flow; and the other is that, as a board member, you have an obligation to assess the management team.

**LINDA TSAO YANG:** Jack, what's your experience?

**JACK LANGLOIS:** Lee has made a good point, which is that the information they give to the board is often whatever they have handy. And usually that's completely useless for a board. For example, we might be given a tax report that is basically the CFO's quarterly tax filing turned into prose. I tell them that this is not useful, I don't have time to analyse it and they should give us material that they've analysed and has a point of view in it. So at the next board meeting they came back with another stab at it. It was still not very good. We've

been doing this for two years and it's getting better, but it's very hard for them to step back and ask, "What do you need? We don't know what you need." They can only find that out if we start telling them.

The other issue Lee raised is how do you know what's going on if all you know is what they give you? The audit committee is a tool that the board can use to go out and interview branch managers about whatever it wants. Go look at the credit books. Go wherever you feel like. If you feel that something is going on, if there's something that you don't like, send the audit committee out.

### **Asking follow-up questions**

**LINDA TSAO YANG:** When I need more information to help me understand an issue or formulate a certain idea, I ask questions and then follow-up questions, and follow-up, follow-up questions! If executives say, "This is still under investigation, we are researching this", I always ask for a date when they can give us an interim, if not a final, report.

Another thing I am beginning to do is to seek outside perspectives. Next week I will be in Hong Kong and will meet with investment bankers and security analysts who follow the bank. I want to hear their viewpoint as to the progress the bank has made over the last year in governance practices.

When I became an independent director, I asked the chairman that I be allowed to spend two hours with each of the senior executives, which they allowed me to do. Through those sessions, I tried to learn several things. What did they think was their most important job? What was their strategy to achieve what they wanted to accomplish? What were the impediments preventing them from realising those goals? What resources did they need to achieve them? How were they going to rearrange their resources to focus more on



their top priorities? Through that process I began to have a better understanding of how each executive saw his or her responsibilities. What I think their responsibilities are may not be the same as that person's perception of his or her responsibilities. To see their thought process, planning process, and the strategy of each person to realise the company's goals, was very informative to me.

I was also given the assignment, on an ad hoc basis, to help the board to review its 2005 budget. In order for me to understand better how the budget is put together, I proposed that the head of each business unit spend an hour with me to explain: 1) how he is going to implement the three-year strategy of the bank; 2) what are his priorities; and 3) what level of resources has he proposed in his budget to senior management. In other words, I am trying to make them feel that the budget process is not one where senior management says, "Hey, our next budget is going to \$100m or whatever, now this is how it is going to be divided up." I want to begin a process where it is built from the bottom up, because after all it is each business unit that has to realise the strategic plan set by the board.

### **Keeping independent director pay low**

**QUESTION:** I'm not only an academic, I also sit on five boards in the US and Canada. I would like to ask about the care and feeding of independent directors. That's an issue that all three of you mentioned and is very much in the forefront of my mind as I get older. Let me tell you where I am coming from. Lee Ting said Chinese companies did not pay their directors very well. Let me say that outside directors should not be paid well — how can you be independent if 20%, 30% or 50% of your income comes from director fees? You should be paid so little that you are willing to resign at the drop of a hat whenever you see something wrong going on that you cannot change.

Besides the size of compensation, there is also the issue of its form. Could you comment on the alternative options — cash versus restricted stock, and so on — because ultimately we want, as Linda Tsao Yang has just said, directors who are motivated to work for shareholders. How can you be so if you are only paid in cash? You should be compensated in stock that you cannot sell for say three or five years, in order to have that long-term perspective. What does your experience tell you about possible answers to these issues?

**JACK LANGLOIS:** I think that it goes to what the director's job is. If it is to create greater equity value through the job they do, then why not give them some of the value they create? If you want them to do a good job, they are going to be motivated to capture that value — or take some of their cash compensation and convert it into stock. So then the director has an alignment of interests in the value creation process. Conversely, what is the motivation of a director who just gets cash and goes home at night and takes no risk?

**LEE TING:** I don't disagree with Jack. You don't become a director because of the compensation *per se*. But like anything in life, if you don't put a value on the service provided, you are not going to get quality, simple as that. As for stock versus cash compensation, I have to tell you that in Lenovo we don't do that. We have talked about it, but it hasn't been implemented. My preference is that I would rather see directors paid on an equity basis than a cash basis. In other companies that I sit on, such as in Taiwan, they do a combination with the heavier weight on the equity side.

### **Balancing director responsibilities**

**QUESTION:** Our board of directors has 15 people. There are two insiders and 13 truly independent directors. It is a publicly listed company, a rather large one. These directors talk every month and every other month

meet in person for a day-and-a-half. The papers that the board gets are sometimes 10 inches high, usually at least five or six inches. And the papers for the audit committee are now bigger than those for the regular board meeting. We're listed on both the New York and Canadian stock exchanges, both of which have strong regulators. There are numerous things the board is supposed to be aware of, to approve and to study. Even boring tax papers have to be waded through.

Where's the balance going to be? How much influence can an independent director really have and how much responsibility can they be expected to take? How much did the Enron directors, some of whom we know, really know about what was going on? And how much should they have known? The burden on these directors is increasing, in particular following some of the corporate scandals that we've had. So where should the balance be?

**LEE TING:** I think you are right. That's why it is more and more difficult for people to accept directorships. It used to be that directorships were glamorous and self-promoting. But today you have to accept both the legal and fiduciary responsibilities, as well as the workload. In my case, the job is very time consuming because, in addition to going through all the documents, I have to travel to China for board and audit committee meetings. It is a one-and-a-half day meeting, but takes a whole week out of your schedule. It is a huge time commitment. I agree with you that you have to achieve a balance, otherwise it is going to get harder and harder to recruit the right directors.

### **Developing trust in private companies**

**QUESTION:** Today we have had a lot of talk about state-owned enterprises in China. I want to raise a question about another component of the equation, the private sector. This is one of the greatest miracles China has created: the transformation of the economy from one

where the private sector accounted for nothing 25 years ago to between 50-70% today, depending on how you classify "private". This morning Dr Fan Gang mentioned one of the positive roles played by state ownership — the issue of trust. This raises the interesting question of why such a dynamic sector of the economy cannot earn the same level of trust as the state-owned sector? I think it has a lot to do with transparency. The question is what could independent directors do to improve the overall transparency, or reduce the transaction cost, of the private sector in China?

Another interesting question raised a lot in China right now is how some of these private companies, after growing for 20 years from the family shop to great enterprises, are facing the dilemma of passing this power to the next generation or introducing outsiders to manage the firm. As outside investors, that is a dilemma as well. How do you face a family company that has been running well and say, "Hey, you've got to do things differently"? What role can independent directors play in the private sector to improve the overall efficiency of China's economy? I would appreciate your comments.

**JACK LANGLOIS:** I heard an interesting comment the other day from somebody who was aware of a report done by the People's Bank of China. I haven't seen this report, but the story goes that a couple of years ago the People's Bank decided to study the market for credit in Zhejiang Province because it has a private market for credit. A lot of privately owned and unlicensed financial institutions provide credit. They collect money from local people and make loans to local companies. The People's Bank was going to try and shut down this business because it is illegal. But it did the study and found that the default ratio on loans was about 0.1%, almost nothing, so it backed off. It recognised that this was a market functioning better, by one measure,

than the banking market that it regulated, where the default ratios are much higher.

That told me that there is something in the nature of credit and trust that can be built in this cultural environment and can be self-regulating. If you are talking about small- and medium-sized enterprises (SMEs), right now those companies are having trouble getting credit from the banking system because the state banks tend to gravitate towards the state-owned sector and not want to lend to the SMEs. So the SMEs are getting scorched. They have to raise funds in the quasi-equity markets and pay a lot more for their money. There's a kind of distortion there. I would recommend that there be some attention paid to the SME sector and that credit systems be encouraged to lend money to them (and at the same time create institutions for exchanging credit-quality information).

One of the problems a bank has when lending to the SME sector is information access. How do you know who's a good credit and who's not? In Zhejiang, it's all family. The banker says I know this guy's brother, I know where his kids went to school and I trust him, I'll lend him some money. There's no way that guy is going to default, because the credit system is a true trust culture among friends. But if you take it to another level, with a bank coming to lend to these companies, then they don't know the people, they need information and they need to be able to transfer that information to others so there is a self-discipline function.

### **Who do independent directors represent?**

**QUESTION:** I am interested in a more general question relating to Chinese-listed companies: there is a view on the mainland that independent directors are there to represent the minority shareholders. This a strongly held view and quite different to the one that we have in Australia and other parts of the

world. The regulatory authorities seem to support that perception, which is problematic given that the appointment of independent directors tends to be controlled by the majority shareholder. Could you give us a sense as to who independent directors should be representing in the mainland? How does that work, if at all, as a phenomenon? Because it seems a very big ask by the mainland system to impose this significant representational burden on independent directors.

**LEE TING:** I probably could not tell you of any specific company examples, but I can give you one example: a couple of years ago I was approached by a Chinese-listed company to be an outside board member, but after discussions with the company's management I was not comfortable that I could truly operate as an independent director. Even though I was not affiliated with the company, and was coming in from outside, I thought that their expectation was that I was still appointed by them — and so responsible to them — and I wasn't very comfortable with that kind of circumstance. That was my only personal experience with that, so I don't know if it is representative of most other Chinese-listed companies.

### **Restricting directorships**

**QUESTION:** Going back to the role of outside directors and their workload: in Korea there is a rule that a person cannot sit as an outside director on more than two boards. I don't know whether such a rule is desirable or if it exists in other countries. I guess the rule could be implemented if it was considered desirable on three levels. One is by law. The second is by exchange rules for public companies. And the third level is the board rules that you use when hiring an outside director. I am interested in your comments as to the desirability of this restriction.

**LEE TING:** I don't know of any rules that say you cannot sit on so many boards, but I think

that such a rule should be self-imposed. You have to know your limitations. I used to sit on three boards and I have just resigned from one for that reason. If you are spread too thinly, you don't feel you are doing justice to the role. If you want to be an effective outside board member, you cannot be passive. So the right thing is to know your limitations — especially having to travel to Asia for board meetings, which is almost automatically a limitation in itself! I tried another approach with a board in Singapore. I said, "OK, Singapore board, Hong Kong board, I need you guys to coordinate your timing so that I can make one trip", but that never works.

### **Must independent directors be foreigners?**

**QUESTION:** Coming back to the title of this session — "Independent directors: how to be effective in China" — we undoubtedly have an enlightened panel, but does it suggest that to be at all effective in China one must be a foreigner? Or foreign-trained? Or have had substantial experience in a multinational corporation? The reason I ask this goes back to something that was alluded to earlier: we as Asians grow up in a culture of "be seen but not heard", then suddenly when we are grown up, we are expected to be very independent minded, to question and ask for more (as independent directors). How do we balance this? It seems as if the panel comprises either foreign-trained Asians or foreigners who sit on Asian boards, and obviously you are very effective. How does it work for other companies in China?

A second question relates to the constitution of an effective board. There is a trend towards having a majority of members, if not substantially all, being independent. That presupposes that the board effectively performs a monitoring role only. To have an effective board, wouldn't it be better to have an equal number of independent and

executive directors? That would balance off strategy and monitoring, and ensure that sufficient information was made available at board meetings.

**JACK LANGLOIS:** I think you have just answered your first question. In my experience, my effectiveness depends a lot on other directors. You can't just be a lone wolf in the wind. You have to have other people speak out. Usually they speak out better than I do. I fumble out with my thought process, somebody in the room gets it and then makes an interesting comment that is much more to the point. But I am the catalyst. Once you have one or two allies on the board, you are much better off. I remember one case where the management had given a presentation and I said I didn't like it. Then a government employee — the main shareholder's designate on the board — stepped out and said, "This is worse than I've seen in any other state enterprise. This is more state-owned than a wholly state-owned enterprise." He just let them have it. I don't think there is any question that there are a lot of people out there who could be good and effective board members. They don't have to be foreign.

**LEE TING:** I agree: you just need somebody on the board to be the catalyst. A lot of people, as you said, are capable and have good opinions, but I guess that because of cultural factors you need somebody to stir it up. We're talking about stir-frying again! To your other point about the composition of boards, I think a board ideally should be comprised of a majority of outside members because if you have an equal number of insiders — management — then it's not really a balanced forum. Management as a bloc will always be of the same view, because they are part of a team, so right away half of your board is already on one side. What you want is to have independent board members who are individuals, who will look at things from their own experience and perspectives, so that they

can question things as true independents. If you shift the balance, you won't accomplish that.

**LINDA TSAO YANG:** To summarise, I would say that in order to be effective, an independent board member has to have a clear notion as to what the responsibilities of a board includes. The board's responsibilities are: 1) to set policy; 2) to set strategy and to realise it; and 3) to exercise an oversight function so that responsibility, authority and accountability are clearly understood and clearly defined. In order to be effective, I think we all agree, one not only has to offer some value-added to management, but at the same time you need to have the perseverance, persistence, curiosity and social skills to articulate to your colleagues and management why you are proposing certain ideas, why you are raising questions, and what your thought processes are, in order to bring about a consensus and to move ahead.



## Session 4: Privatisation and Public Offerings — Instilling Good Corporate Governance Early

**Moderator:**

**William Kerins<sup>11</sup>**

**Managing Director, Lombard Asian Private Investment Company, Hong Kong**

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*As China prepares for a second wave of privatisation, the question remains — has privatisation been a success for SOEs? Many SOEs have not performed as well financially after privatisation as before, but then again many companies in China are not doing as well as they were five or seven years ago. Drawing upon recent academic research, Bill Kerins points out that the more private a company becomes after listing, the better its performance in general. Both strategic and substantial shareholders have a positive role to play.*

Various speakers this morning talked about the era of reform and what has happened over the last 12 to 15 years in China: competition has increased, managers have been given more authority, subsidies have been removed, and the number of state-owned enterprises (SOEs) has fallen from 260,000 to 160,000. Through reorganisations and mergers, more than 3,000 SOEs have been shut down or reorganised, and around 40 million workers displaced.

In the first wave of privatisation, approximately 1,200 SOEs were partially privatised as joint-stock companies, issuing three types of shares: individual shares (typically one-third of the shares outstanding); state shares, issued to agencies on behalf of the central, state or local governments; and "legal-person (LP) shares", issued either to other SOEs or private companies. State and LP shares typically represent two-thirds of the shares outstanding, and most are still held directly or indirectly by the government.

We are now on the cusp of a second privatisation wave, where the government has stated its policy is to increase the pace of

privatisation. It recently changed the ground rules for privatising state enterprises, allowing direct sales of state or LP shares of listed SOEs to foreign investors. Listed and unlisted SOEs are open to foreign investors, although the latter must comply with new takeover rules, which are quite complex.

Today, about 50-70% of listed companies remain state-owned or state-controlled. By market cap, government control is probably higher. A reduction in state ownership has therefore become a major feature of government privatisation policy.

### **Has privatisation worked?**

If you review the government's policy goals over the past 15 years, much of what's been stated sounds familiar. With the introduction of private capital and private shareholders, you are supposed to get a range of benefits, such as: companies become more competitive, governance procedures are established, and the profit motive is introduced. But the question remains as to whether all of these benefits have accrued after privatisation of SOEs, and, in particular, whether things like administrative interference have been reduced.

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<sup>11</sup> Mr Kerins is now Managing Director, Oaktree Capital Management, based in Hong Kong.



Most research suggests that the performance figures of most SOEs (as measured by earnings per share) and their efficiency (as measured by return on assets) have declined after restructuring and listing in China. This is in line with what has happened in many other countries. Why is this? One issue is the “window-dressing” phenomenon, where companies preparing for listing — and working with investment bankers — dress up their income statements and balance sheets. In China this is a particularly difficult issue, because the assets to be listed are often peeled out of an existing, much larger state enterprise. Instead of proper audited financial statements you have pro-forma historicals, which look at the businesses thrown into the SOE listing candidate as if they had been standalone entities. Working with accountants and bankers, the company creates a set of historical financials. Then, lo and behold, one or two years after listing, things are not as good. The business has not necessarily declined. It was just never as good as it was made out to be. This is not a problem unique to China and regulators around the world have responded to such window-dressing in various ways. There is, in fact, a big debate going on in Hong Kong as to how this should be addressed.

Secondly, there are increased “agency costs” associated with privatisations as managers gain more direct control over enterprises after an IPO. These agency costs include both legal and illegal elements. Legal costs include such things as excessive managerial autonomy — managers are not necessarily doing anything illegal, but since there is no direct owner telling them what to do, they run the company as if they owned it. There are also illegal agency costs — people make a few extra widgets at the end of a production run and sell them for their own benefit. Or the cost of goods sold to an enterprise rises, as compared to what it had been under direct state ownership and control.

Corporate performance overall declined in China during the 1990s for both SOEs and private companies, so the macro effects may distort the data. Whereas in the 1980s there were a number of years of increasing performance (in the equivalent of earnings per share and return on assets), and for SOEs it was an era of increasing profitability and efficiency, in the 1990s margins came down across the board despite the China miracle. When one says that SOEs don’t do as well after privatisation, the fact is that nobody is doing as well as they were five or seven years ago.

### **Where ownership matters**

The University of Hong Kong and the University of Science and Technology have done a lot of good accounting-related research on privatisations in China. One study, correcting for macro effects, looked at nearly 1,000 companies after their listing and concluded that the transfer of more than 50% of a company’s shares to private investors had a significant positive effect on performance. The more private a company became after listing, the better its performance in general.

For corporatised or partially privatised firms, however, the level of government ownership of state shares was immaterial to performance. When I read this, I wondered how this could be. You would think the level of government ownership should be very material. But when you think about it, the government exercises its control through so many avenues: ownership of state shares, indirect ownership of LP shares in SOEs, and ownership of banks. We heard this morning about the “we are all in this together” mentality — that there is no separation of capital from managers and workers. Because of that the government had — and still has — so many ways to influence a privatised SOE, which is why the data shows that the ownership level is immaterial to a company’s performance.

The one-share, one-vote principle, meanwhile, was positively correlated with performance in these studies. But a highly dispersed ownership had a significantly negative effect on performance. Several speakers today alluded to this when they talked about the benefits of having a large strategic investor as part of the privatisation process. It may be because small shareholders don't yet have a good way to monitor managers, or know how to exercise their rights. This goes to the heart of corporate governance and the need to ensure that the right institutions are in place. We talked this morning about the issue of shareholder meetings in Singapore — about institutions holding shares on behalf of the ultimate beneficial shareholders and the inability of fund managers to attend shareholder meetings. There are many issues that may look small, but form the fabric of corporate governance. And in China it is obvious from these studies that the more dispersed the ownership of a private company, the worse the performance.

seems to have a significantly positive impact on performance.

The corollary is also true. Concentrated ownership among several large shareholders had a significantly positive impact on performance. This was true for both controlled and non-controlled privatisations. Whether a company was more than 50% or only 20% owned privately, if there were three, four or five large shareholders, statistically the company tended to perform better than if there was either dispersed ownership or only one shareholder. There is a checks-and-balances phenomenon, even for companies that remain government-owned. No one party can put its fingers in the cookie jar. No one party can run the company as a subsidiary for its own benefit. Multiple parties tend to offset each other in terms of influence.

Finally, the presence of a large foreign investor — this sounds self-congratulatory, but I am just repeating what I read in the university data —

## Session 4 Speakers:

### **Karin Finkelston**

**Associate Director, East Asia & Pacific Department, International Finance Corporation, Beijing**

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*In the new wave of privatisation in China, a defining feature is the rise of insiders as a significant shareholding group in partially privatised companies. But the privatisation process needs more outside participation, argues Karin Finkelston, because governance standards are not going to get close to international norms with only management playing the role of buyer.*

The IFC is the private sector arm of the World Bank group and we invest in private enterprises to help improve the overall economic situation in a country. The IFC has been active in China since 1985. We have invested a cumulative amount of about US\$1.8 billion in more than 80 projects. Our investment pace is picking up. Last year we committed some US\$400m of investment in about 20 projects, 15 of which were with domestic companies. We have a strong interest in corporate governance in China and much of what we do with our clients — apart from giving them capital, both debt and equity — is to try to help them upgrade governance standards. When we are taking equity, we focus especially on corporate governance so as to prepare them to list either domestically or internationally.

Privatisation is a key thrust of our strategy. We support the transfer of assets from the state to the private sector from the standpoint of both capital and standards. Privatisation in China, as Bill Kerins said, began as ownership diversification — large state enterprises using the stock market almost as a cash machine, listing about 30% of their shares and raising capital. Governance was quite questionable before the China Securities Regulatory Commission (CSRC) started to layer in more regulation.

We are now in a phase, as Bill Kerins alluded to, where the government and the Party are placing more emphasis on private ownership than ever before. That was illustrated by the

change in the Constitution last spring to support private ownership. It is a key opportunity now for private investors, such as us, to support the process. In contrast to the first phase, the current wave of privatisation is more focussed on relieving the state of the burden of SOEs, especially at the local level. When you talk to local governments about the criteria for privatising, including which investors they are looking at to buy these assets, they ask about what's going to happen to labour, and what will the social impacts be? Secondly, will privatisation help them in other ways, such as increasing their tax intake? And thirdly, how will these assets be utilised going forward, are the buyers going to make these assets more efficient, or are they going to level them and turn them into a real estate development? They care about what they call the future of that enterprise. In our research in 10 cities, we looked at what has actually happened. About 80% of SOEs have gone through some sort of reform, whether it is what Dr. Zhu Min talked about this morning (ie, the Bank of China becoming a shareholding company, but with the state as the major shareholder) or SOEs that have listed about 30% of their shares offshore or onshore, or companies that have fully sold down either to management or to private investors.

### **The rise of insider ownership**

Between 1995 and 2002, government ownership of SOEs fell significantly. Insider ownership, meaning top and middle

management — and this is where it gets interesting for corporate governance — rose from 5% ownership, on average, to 31%. In terms of the reform process, private investment stayed relatively flat at 19-21%. What is significant is that foreign direct investment (FDI) in reformed SOEs dropped from 10% to 3%, while domestic private sector investment rose from 11% to 16%. I think the drop in FDI was driven by the opening up of the wholly owned foreign enterprise entry path. Many foreigners decided: "I don't want a partner. I don't want to get involved in Chinese corporate governance. I'll just go at it myself". This is interesting when you look at Bill Kerins's last point about foreign shareholders being correlated with strong performance after privatisation. The FDI pattern may shift now that new mergers and acquisition rules have come out, because foreigners can now buy LP shares and IFC has done this. It is a cumbersome process, but it is possible.

The control of the larger shareholder has decreased alongside state ownership. The controlling shareholder, on average, now owns about 60% of a privatised company, with the second and third largest shareholders still around 20%. There is no diverse ownership in most privatised companies. The key point of this new privatisation wave is the extent of management influence and insider buying. In addition to the potential social and political outcomes, as we have seen in other countries, there are serious implications looking forward for privatisation. One is the board of directors. Typically, half the directors on these privatised firms are from senior management, while another 10% probably come from middle management. Our surveys have found that some 80-90% of all directors in China are from an engineering background. There is very little diversification among the skills brought to boards at this point.

Another problem is the lack of management

incentives in companies controlled by insiders. We found that 40% of the privatised companies owned by outsiders correlate management pay with performance, but only 20% of those run by management. Similarly, 60% of those controlled by outsiders have a separation between the CEO and chairman, but only 30% of those controlled by insiders. Insider-controlled companies rely on management to make profit-distribution and investment decisions, and don't throw these decisions back to the board, unlike outsider-controlled companies.

Finally, an interesting point is the government's role in companies bought by insiders. These companies rely more on Chinese government structures for their governance than on corporate governance structures like the board and shareholder meetings. The potentially interesting part is that the government still plays a relatively strong role in companies controlled by insiders.

These are some of the key issues to address in the new wave of privatisation. Each privatisation wave in China has involved a dominant shareholder, whether it is the state, a management player, or, in certain cases, a private Chinese, or foreign, shareholder.

### **More outsiders needed**

Corporate governance improvement should start as soon as possible. You should not wait until moments before an IPO to start putting in place a governance structure. And the privatisation process needs more outside investor participation, because we are not getting anywhere close to international governance standards with just management playing the role of the buyer.

But there are certain problems with legal-person shares. IFC, for example, is willing to buy these shares (which are non-tradable) in the Bank of Shanghai and four other banks, as

well as other privatised companies. Although we put a lot of effort into improving standards, we won't benefit at the IPO — whether in Hong Kong, Shanghai or New York — because our shares are locked up indefinitely. This needs to be changed if China is going to get people to invest in private equity and help to change the systems in companies.

There also have to be post-IPO incentives for companies to go beyond compliance. The obvious one is enabling companies to come back to the market on a market basis. It is difficult to tap the market a second time when you are a listed company in China. We have tried in other markets — especially in Latin America — to advise the regulator that there could be "tiered governance certifications". There is a compliance level, but then you rate companies. Certain companies would be rated as having level-one corporate governance, others would be level two, some level three, and at the bottom would be those doing no more than just complying with regulations. The market could then differentiate better between companies.

Jack Langlois is one of our best corporate-governance tools! We put directors on boards to act as catalysts for change. We provide technical assistance and training to these boards. And we also look for strong partners — either private Chinese or foreign companies — to buy these assets with. We have participated in four privatisations. One of the most interesting was with the New Hope Group, a private Chinese company based in Sichuan. We jointly bought Chengdu Huarong Chemicals in 2000 and within two years turned a bankrupt SOE into a profitable chemical company. There we made an impact on the governance of a former state enterprise and influenced the governance of the New Hope Group, which was the dominant shareholder. Just turning a company over to a private Chinese or foreign private entity may not necessarily mean the

governance will become perfect. You have to work at it.

**Jean Eric Salata**  
**Chairman, Baring Private Equity Asia, Hong Kong**

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*China is still at the stage where there is little separation, conceptually, between shareholders, directors and managers — even in the private sector. But the “owner-manager” model suits the current Chinese economy and we like investing in businesses where the management team feels a sense of ownership and are not just hired hands, says Jean Eric Salata. Investing in the private sector, rather than in partially or fully privatised Chinese SOEs, also allows for a much stronger alignment of interests between management and foreign investors, he argues.*

We are a private equity investor that manages about US\$600m and invests primarily in private companies in Asia. About a third of our investments, historically, have gone into China. We have made about 13 investments in China and I am happy to say that these investments are the best performing of any country that we have invested in — our returns have been in excess of 35% compounded annually. Based on these investments, we have had a positive experience and we feel it is possible to make good returns by investing in Chinese businesses. However, where we differ from some of the points covered already is that we do not invest at all in the state sector.

I have been investing in China since the early 1990s. Historically, you had to invest in the state sector through joint venture structures with local entities. But with the relatively recent advent of wholly owned foreign enterprises, it is now possible as an offshore investor to invest directly in assets with private companies through freely tradable shares that can be IPO-ed or sold to strategic buyers.

Where China is concerned, we need to think about corporate governance and privatisation in a historical context. It is still at a stage where there isn't much separation conceptually, even in the private sector, between shareholders, directors and management. All three are often the same. That is not uncommon — it happened in Hong Kong, Korea and Taiwan. It even happened in the United States, if you go

back far enough. We are at a phase now where the owner-manager model is still in effect. From our point of view, it is an effective model for companies, countries and economies that are at the stage of development that China is today. As companies become bigger, as economies develop, you can't have Henry Ford being owner, manager and director of the board. It happened in Korea, while in Japan it is much the same even today. In China we see progress being made, but it is early days yet. We like investing in businesses where the management team owns the business, where they feel a sense of ownership and are not just hired hands thinking of ways to line their pockets.

I would group privatisation into three categories. First there is “partial privatisation”, where a state enterprise lists a portion of its shares on the stock exchange, such as China Mobile, China Telecom, Petrochina and all the big state companies. To me, that is an unattractive place to be putting money, because you are providing a funding source to what is effectively a state entity run with objectives different to those of an equity investor. What concerns me most are asset injections that take place post-listing, where the parent company — having set up a listed vehicle, having obtained a nice valuation and some cash in — starts to sell more assets to the listed company. It effectively uses the market as a way to cash up and send the money home.

The second level of privatisation is what Karin



Finkelston was referring to, what I would call "full SOE privatisation", where you have a complete sale of assets to a group of domestic, or maybe foreign, investors. This idea of selling assets completely is relatively new, and to me as an investor it is a little more interesting. But I still wouldn't make that investment, since I would have to deal with a lot of legacy issues that remained in those businesses. There are management issues and lingering political involvement by local bodies that used to be shareholders (who I am sure retain a lot of influence in the company even though they may have ceased to be shareholders). These investments could be interesting maybe five or 10 years from now, and I think people will make a lot of money before then with them, but we don't want to be one of the first to try.

The third level is the area we focus on: the private sector. This is not privatisation per se, but a policy-led initiative that has resulted in flourishing private companies. The data on the number of privately owned companies is hard to come by. I have heard estimates as high as 30 million. But there are at least two million such companies contributing 60% of China's GDP. More than half of the country's economic output is no longer controlled by state enterprises.

This is the most dynamic segment and it is where we have been investing and getting good results. These are generally companies run by self-motivated, market-oriented individuals. When we invest in a company as a foreign investor, some education is required on governance, on what our objectives are, and how we can help them achieve their objectives. There is a stronger alignment of interests between a private company with an entrepreneur/founder and a foreign investor.

That alignment of interests is the key, because as Jack Langlois said earlier, even if you have

ownership control of a company on paper, and tell the board to do whatever you want them to, it does not mean they are going to do it. It boils down to an alignment of interests, which is very secure when you have the potential for significant equity value creations through say an IPO or the sale of a company. What is missing in the state sector is the economic incentive that allows everyone involved to make money by taking a company public (as opposed to finding ways to line their pockets or trying to earn a salary).

I would close by saying that as a foreign investor in China you have to be involved with, and attract, good people to the businesses you are working with. To do that, you have to have good people on your team who are from China and understand the local culture, who not only can communicate but can convince people to do things that will be in their best interests, and also in your own.



**Sanjiv Misra**  
**Head of Asia-Pacific Corporate Banking, Citigroup, Singapore**

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*Corporate governance is here to stay, and there is no going back, says Sanjiv Misra. Whereas 10 years ago an investment bank never had a conversation on corporate governance with companies about to IPO — except for a few technical compliance issues — today you begin a conversation on the need to achieve a high level of corporate governance almost before you start talking about a public offering.*

My perspective is that of an intermediary who, over the last 10 years, has been helping companies access capital in public markets and through strategic means. What I am going to talk about will have broader applicability than just China. The place to start is with the initial public offering or IPO. One of the questions that Bill Kerins asked me to think about was: What is the role of an investment bank when it comes to corporate governance? Is our job simply selling the shares at the highest possible price, collecting our fees, and walking away?

If life were so simple, it would be great! But when you take a company to the global capital markets, particularly from a country like China or from Asia-Pacific, you are opening the door to a new perspective and a new world. You are literally sponsoring the overall activity. We use the term "sponsor" in various technical ways, including the qualifying sponsor concept in China. But I am talking about playing an overall sponsorship role of the company — its candidacy and validity to the global investor universe. We try to be a turnkey advisor on the entire process. We are not lawyers and we don't profess to give legal advice. We are not accountants, so we don't vet books and write comfort letters. And we won't opine on technology. Rather, we spend a lot of time explaining to companies what is expected of them through the process of marketing themselves, selling their shares, and, most importantly, the process that begins once the shares have started trading publicly, the deal has been completed, and they have gone back

to running their businesses.

Ten years ago you never had a conversation along corporate governance lines, other than the technical requirements of having independent board members and complying with various listing requirements. Now you begin the conversation on standards, and the need for achieving a high level of corporate governance as a profile, almost before you start talking about a public offering.

When we talk to our clients about whether they are ready to go public, we talk about the fundamental company story, their financial performance and outlook, but we also ask, "Are you prepared to do what the world expects of you?" Private companies are run very differently from publicly listed ones. Not that the former are run in an improper manner, but they enjoy a level of flexibility and ability to make decisions. All that matters is the management group and this group tends to be synchronised with the shareholder group.

We make sure everybody understands how the IPO process works, all the way through to marketing the transaction to institutional investors, who take a rigorous approach to evaluating everything from whether the board looks balanced to a view on management and transparency.

**Taking a client to market**

I thought it would be helpful to tell you how

we have organised ourselves to meet this need. Anybody bringing an underwriting transaction to market goes through a committee process, where you go to a committee of senior management in head office and talk about the company, the transaction, and make sure everyone is comfortable with it — that the story makes sense, the structure and valuation processes work, and the right marketing strategy is being employed.

We now have an additional process — the independent investor committee. The equity research analyst, with the rest of the team, is put in front of this committee and has to say what he thinks of the company, not just whether the investment is valid and/or attractive, but whether the company has what it takes from a governance standpoint. Has it made the necessary commitments and does it have the will to follow through?

At a certain point the committee asks the banking team to leave the room, except the research analyst, and then asks him, "Is there anything that would hold you back from sponsoring this company, from going to investors and saying, "I am putting my reputation on the line in telling you that not only is this an attractive investment thesis, but from a standpoint of governance standards this company is committed to doing what it takes" ?"

One of the most important aspects of what has evolved over the years is the composition of the board. If you looked at the annual report of an Asian company 10 to 15 years ago, most of the board members would have had the same last name — mainly the extended family. Today you have the concept of outside directors. The interim step was boards packed with luminaries. It was almost like a country club — look at what a great company I have, all the important people you read and hear about, a who's who of society, who are on my

board. What has evolved now is something that is relevant and effective. While it is important to have people with credible backgrounds, experience and diversity of perspective, it is also important that these are people willing to commit the time and effort to participate in the board process. That is something we take seriously when making recommendations on how boards should be constructed. That has a lot to do with the public market process.

### **The strategic investor stamp of validity**

I also want to talk about the private, strategic investor process. A lot of transactions recently out of China — and other parts of the region as well, but predominantly China — have structured their initial public offerings with a strategic investor component. When the oil companies went public they had a number of the oil majors — BP, Exxon, Mobil — investing as minority partners. Why did that add value? This gave investors an opportunity to understand how the business worked and, from the standpoint of marketing the transaction, it was a stamp of validity. This is something that has worked well, but it is not necessarily replicable for all companies.

A variant is Hong Kong-listed mainland companies that have had anchor investors such as Cheung Kong, Sun Hung Kai and Henderson Land participating in the offering process. Whether it was intended or not, this also had the impact of telling the market — particularly one like Hong Kong where you have a significant component of retail investors — that XYZ company is attractive because a major Hong Kong company is investing in it (whether or not those retail investors know what XYZ company even does).

My last point relates to the strategic investment process itself. We advise companies coming into a market. And Citigroup has made investments itself, both outright acquisitions,

such as in Korea, to minority stakes, such as in China. The process of evaluating governance standards has to be rigorous — understanding how board processes work, whether board members not only have the right background, but if they have the courage to speak out and raise issues despite causing awkwardness, frustration and outrage.

An important component, which goes beyond the traditional checklist, is what we refer to as the “delta analysis”. If you are a British corporation coming into China, what is the difference between the obligations you have to your regulators and those that a Chinese company has? How do you get the Chinese company to meet that level of disclosure, such that you can make the representations you are required to make for compliance purposes? That sounds easy, but can frequently be complicated.

These are some of the factors we see as relevant. Corporate governance is here to stay, there is no going back. All of us, as we think about capital markets or strategic investment, need to factor that into our mindset.

## QUESTION & ANSWER SESSION

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The issues raised in this Q&A session included:

- What are the negatives in having a strategic investor participating in an IPO?
- Is management selection a problem in China, in both private and state-owned companies?
- Stock markets in China and some parts of Asia are somewhat dysfunctional to the extent that they do not facilitate such things as proper markets for secondary offerings. In China, meanwhile, there is the huge state-share overhang. When will the Chinese stock market become a fully functioning one?
- To what extent is an investment bank responsible for the financial and management integrity of the companies that it brings to market?
- Should part of the compensation of investment banks that sponsor IPOs be linked to equity participation, so their interests are aligned to shareholders?
- Has the governance of privatised Chinese SOEs really improved?
- What needs to be done by shareholders and stakeholders to screen out bad enterprises and restore confidence in China's private companies?

### Strategic investors in IPOs

**BILL KERINS:** Sanjiv, you mentioned the stamp of validity associated with bringing in a strategic partner. In most cases if it is done correctly, and if you know that a major foreign multinational will be coming in, there is some value there. Karin, I would like you to talk about the negative side of that. We manage money for the IFC, among other multilateral institutions, and I know that getting the imprimatur of the IFC is something that people seek. How much of an issue is that in China?

**KARIN FINKELSTON:** All of our clients in China come to us for more than the money.

Everybody says they are seeking to improve their standards, have better governance, and improve their environmental and social impact. But we find out very quickly who is seriously interested in improving and who's not.

We only work with private or privatised companies and they all have to get international audits done and meet our environmental standards. If they don't meet them on day 1, then they should meet them by the second or third year. It is a tough stamp of approval to get. The way to incentivise people in China is to say, "Look, if you want to list and you put all this in place now, and show that in two or three years you are meeting these standards, you are ultimately going to get a better price for your IPO."

Sanjiv, a lot of investment banks in Hong Kong come to us and say, "In six months we are taking this company to the market, why don't you guys come into the IPO or come in as a pre-IPO investor?" — although generally they don't say pre-IPO because they never want to give you a discount on the IPO price! We are wary of doing that. We did it last year with Wu Mei (WuMart) and it went well. We spent 49 days of solid work looking at it. But you have little ability to impact the governance at that point, since the company has already applied to the stock exchange. They are going to get their money and you are going to be sitting there. I would encourage Sanjiv to approach private-equity investors like us a year or a year-and-a-half earlier, and have us work towards the IPO.

**SANJIV MISRA:** I guess I was making the right point to the wrong audience! I think you are right — the pre-packaged, instant pre-IPO investment opportunity works for certain segments of investors but not for others. For private-equity investors, there is a desire

to come in earlier, there are higher target-threshold rates of return, and there is more of a charter or strategy to play a governance advisory role, as Karin pointed out.

Private-equity investors tend to get more actively involved — if not in day-to-day operations, but at the strategic level. When you are looking at traditional institutional investors, or quasi-strategic investors, they tend to have a more hands-off, I'm-in-this-to-participate-in-the-market type approach. It is a different universe and you have to learn to manage different strategies too.

**KARIN FINKELSTON:** But ultimately the impact on the market — the overall governance of the Hong Kong market even — could be strengthened if private-equity professionals got involved earlier. It is nice to see BP's name, and obviously it was nice for them to make a lot of money out of their strategic shares, but I don't know how much impact it had on the company.

**SANJIV MISRA:** Fair point.

### **Management selection**

**BILL KERINS:** Jean Eric, you said it was all about people. Several sessions this morning talked about management incentives and management selection. In the private sector, is hiring and firing an issue for you? Is management selection a problem at all for you?

**JEAN SALATA:** It is the single most important decision we have to make. Unfortunately, with people you can't run the numbers — you have to make a judgement call. You can do reference checks, hire private investigators to check on their legal history (which is important to do), but you have got to make some kind of a call.

In companies we invest in, we look for people

who don't have a lot of outside business interests. We want somebody that is wholly dedicated and committed to the business. That is easier to find in China than, quite frankly, it is in other parts of Asia where third- and fourth-generation family empires control many different entities. Oftentimes these entities feed each other. You might be on one side of the food chain, but not on the other side, and you don't get your fair share. So one thing we would look for is total commitment to the business.

The other problem with management in China is the issue of pay. We like to put in highly qualified, international-calibre people, especially in the CFO position. But you have to pay market rates for that kind of position. Many Chinese companies balk at this because this person's pay rate is so out of line with domestic wage rates. It is not that they can't afford it, because it is only one person. It is the idea of breaking the culture inside the company, where suddenly one guy is making three times more than the chairman and 15 times more than the next highest-paid employee. That is a challenge. We are trying to figure out ways to get around that, even if it involves subsidising that sort of expense.

On the issue of incentives, for us the key issue is the equity incentive. That is why we like people that already have significant stakes in the businesses we invest in, or we create equity incentives or equity stakes for them.

**KARIN FINKELSTON:** We face similar issues. Most of our investments are in private companies, while some are privatised SOEs. In the purely private companies we have influence generally on hiring a CFO, or chief actuary if it is an insurance company, a number two or somebody involved in the company. But it is tough for the reasons just mentioned. The pay scale is not in line. And the CEOs and owners of these companies are not used to

dealing with international search firms. They often want to hire an ex-regulator who knows the market and how to get things done. It can be complicated.

In companies and financial institutions undergoing privatisation that we have invested in, it is even more complicated because despite the privatisation — or in cases where the government remains the single, largest shareholder but is not the majority owner — the government still likes to play a role in some of these appointments. That is not transparent and it is hard to avoid. We had a case where a vice president was being appointed and the board's initial reaction was, "Let's see what the government says, who it wants to have the job". Our board members said, "No, no, we are the board, we need to nominate someone." The board nominated someone and in the end appointed two vice-presidents, one nominated by the government and the other by the board! That is a step forward, but it shows how the government is stepping in, at times, beyond its governance level. Management is not keen to go around this because it foresees other issues for itself later.

**JEAN SALATA:** I don't want to leave the impression that we don't think highly of the management talent in China. We are very impressed with the quality of management here. It has improved dramatically. The entrepreneurial spirit, drive, determination and hunger for success are hard to find elsewhere. You also have a highly educated workforce, with millions of graduate school students and secondary school students joining the market every year. The quality of management is there. It does tend to have an engineering bent, I would agree with that earlier comment, but they are becoming more commercial. And we are optimistic about the outlook on management generally.

**SANJIV MISRA:** One thing we have noticed

in the last five years is the returning Chinese professional. Ten or 15 years ago, if someone had left to study overseas and then to work, they did not necessarily find the work environment in China either professionally or economically attractive. While it is not in the millions, I would say there are thousands of people who have had western-style educations, worked in western-style organisations, understand the issues and can not only present themselves effectively to investors and regulators, but can help to build a culture that is truly a melting pot of both the West and East.

### **Dysfunctional stock markets**

**BILL KERINS:** In a discussion about privatisation it is hard to avoid the subject of the functionality of the capital markets in China or in Asia. Karin, you mentioned that people who do privatisations often don't come back for secondary offerings. In my view, that is what markets are for. They are there to raise capital and once you become a listed company you are supposed to be able to go back and access them again. Briefly over lunch I mentioned that in Japan we had a phenomenon back in the late 1980s where the stock exchange's valuation was larger than the New York exchange, but it was a totally dysfunctional market because you could not issue new shares. It seems to me that the overhang of government shares in the Chinese market today is so great that it will remain a problem going forward. Could you each comment briefly on how that is going to resolve itself and when the markets might become fully functioning?

**KARIN FINKELSTON:** People can go back to the market and they do. But it is not a market-driven process. It is an approvals-driven process. It just means it is not quite the same.

**BILL KERINS:** It is an allocation process as well.



**KARIN FINKELSTON:** And just because you are a better governed company, or are producing better returns, does not mean it is easier for you to go back to the markets.

There are two issues here. If you are a pre-IPO investor and you get legal-person shares, even if the company lists there is no way for you to get out and be paid for all the pre-IPO work you have done to improve the company. That is a big issue for people playing the private-equity role that we were talking about for Hong Kong.

Secondly, the overhang of state shares is huge. It was interesting in the institutional investor discussion this morning that there was mention of insurance companies, the social security fund and, obviously, the QFII investors all becoming more active in the market. I don't think these people are heavily invested in the Chinese stock market. Frankly, insurance companies are not even allowed to allocate money to the stock market, or very little amounts, so the concept of the "institutional investor base" is slowed down by the fact that everybody is waiting for the market to come down, because of the overhang. People are putting a lot of thought into this at the State Council and the CSRC.

**JEAN SALATA:** With all due respect to the CSRC, there are some very serious problems with the stock markets of China. They certainly don't work for private-equity investors for the reason that, as Karin said, you can't get out easily. That is one of the key functions of a stock market. If you want foreign capital to play a role in transforming businesses and putting in the right structures and governance so that you have higher quality businesses listing domestically, the best way to do it is to make sure that private-equity firms can actually tap the stock market.

The momentum is with Chinese companies

listing overseas. There is no interest at all in the domestic markets. It is unfortunate, because there is a huge pool of capital tied up in China in the public pension pool, the insurance companies, and the domestic savings of individuals. There is a lack of quality companies and a lack of regulation to allow foreign investors to actively participate in this market.

**SANJIV MISRA:** I think there is a lot of upside to the development of China's capital markets. This has been a predominantly government- and retail-oriented market. The concept of the sophisticated institutional investor is a new one. Qualified investors are just starting to get their licences, they are getting in with limited quotas, and they have got very modest investment limits. From conversations we have had it seems that the CSRC and the government understand the issues and the challenges, but also recognise that there are other factors that play a role, such as politics.

I had this conversation with the CSRC about a year ago. If you look at India, a market that we all constantly compare China to, the stock markets there 10 to 12 years ago were similar. If you wanted to take a company public in India, the price was fixed formulaically by the Finance Ministry. It did not matter what you did, what your profits were, there was a formula. The price was announced, put in the newspaper and then it was opened up for the retail investor — and much like the Hong Kong market, as we used to say in the trade, you priced it "to pop". You priced it so that it went up 50-75% on the second day. All the retail investors that had gotten subscriptions bailed out, somebody else came in, and then the price spiralled back down. This is a model we have seen in several other markets around the region. I suspect that it is going to take years before governments in Asia are able to balance the protection of the little guy with making markets worthwhile for the big



players and ensuring that their own economic interests are safeguarded. I am hopeful, but on a long-term basis.

### **The responsibility of investment banks**

**QUESTION:** This is a question for Sanjiv Misra, but I would be interested in the views of the other panellists. How much responsibility should an investment bank take for the financial data, the corporate governance, and the management integrity of the companies that you bring to market? In Singapore there are new rules on sponsors, much tougher ones. China has brought out tougher rules. Hong Kong was going to, but backed down (which wasn't a surprise). Should you bear some, or a lot, of the responsibility if a company you bring to market fails within a year or two, or there is massive fraud and shareholders lose either all or part of their investment?

**SANJIV MISRA:** This is not meant to be a flip response, but it almost does not matter what we want to do, the markets opine. If you bring a company to market, you bear a significant responsibility for making sure that it is prepared and structured the right way, presents data in a complete fashion, and then agrees to manage and govern itself in a certain fashion.

Having said all of that, we are not accountants so we have to rely on an auditor to say, "I've scrubbed the books, I've been to the factory, I've looked at the books of accounts, I've added up the inventory and it all adds up, and the numbers in the prospectus are accurate". I can't stand up and say I have done that. It is not our area of expertise. And similarly for the legal aspects of local regulations.

When we take a company to market, the company's name is at the top of the prospectus and our name is at the bottom of the front page. We take corporate governance seriously

as a part of the preparation process, because our reputation hangs on the success or failure of the company's offering, and what happens after that. How the company is received by the market, how the shares perform, how the company performs, is extremely relevant to our reputation and our track record as the sponsoring investment bank. Things frequently happen that you could never expect the underwriter to have had a handle on, but that does not mean we don't get stick for it. All of that raises the bar on us collectively to do a lot more than we have done in the past, to be able to demonstrate that we did everything necessary and then some.

**BILL KERINS:** If I could add a bit to that answer, which I agree with. Look at all the different solutions being put forth in Singapore, Hong Kong and China — my view is you shouldn't have to recreate the wheel. You have very developed markets in Europe and the US, and highly efficient capital markets. In the US you have 10b(5) language where underwriters get into serious trouble if there are material misstatements of fact, material omissions from a prospectus. Why not adopt those standards? Why go through this process of wanting to have a "qualified sponsor" system, where you rap somebody's knuckles if the numbers are wrong? Maybe the numbers are not their responsibility at all. Everybody's got to play a role. Accountants have to step up and play a role. Lawyers and bankers have to play a role. I am not trying to exonerate the bankers. I am just saying there are systems that work elsewhere in the world and I don't think we have to create new systems just because we are in a different place.

**SANJIV MISRA:** When we do due diligence, the typical last question of the session is: "Is there anything we haven't talked about that we should know?" You can't ask the question more precisely. You are talking to people who spend their lives running a business and they

have to know the company, its business, its operations and the issues and problems better than you. You could spend 50 days doing due diligence and — if management is intent on hiding something — still not pick it up.

### **Aligning interests of banks and IPO firms**

**QUESTION:** In terms of fees and aligning the interests of investment bankers and other participants in IPOs, to what extent do companies consider linking the compensation of their bankers to equity participation going forward, so that the position of the investment bank is aligned with that of the shareholders to whom the IPO is being marketed?

**SANJIV MISRA:** I thought you were asking a slightly differently question about how compensation is set — and the answer is, it is getting less and less, so companies are obviously doing a better job of it!

There are a couple of aspects to your question. The first is equity participation. Our role is that of an underwriter and an intermediary. We are hired to sell the shares and then make a market in the shares on a secondary basis. In some jurisdictions it is illegal to own the shares, because then you are an interested party. Secondly, it is not our business. There is another completely separate part of Citigroup — absolutely the rule today — that buys and sells shares for a living. It makes independent decisions and we have absolutely no influence whatsoever.

We have done transactions where people have said, we agree to a base fee and then we will make a decision on whether we will pay more — fully disclosed in the prospectus — if we believe the process has achieved certain objectives. To the point I think you are trying to make, interests are aligned. Where we have to take responsibility is, if the price being set is X, but a higher price of Y is achievable, the

investment bank has to decide is this good for our investors? Does it make sense to push the envelope that extra bit, because we have got a big constituency of investors who are going to have a point of view.

### **The governance of privatised firms**

**QUESTION:** Karin Finkelston, have you found that the governance of privatised corporations in China has improved, or is it practically the same as before privatisation?

**KARIN FINKELSTON:** With companies that list just a small percentage of their shares on the stock exchange, such as 30%, I don't think there has been much improvement in governance. In fact, I think it has become more complicated due to inter-company transactions.

For companies that have been bought by a dominant private company, whether it is a foreign or Chinese one, there is improvement. If you listen to the man who manages Chengdu Huarong Chemicals now, and you ask him what it is like to work for Liu Yong-Hao, Chairman of New Hope Group versus working for the Chengdu City government, he will tell you, "Before I just had to please my boss, the guy in the government who controlled or supervised our company. That is all I needed to do." It did not matter how the company performed. But now the New Hope Group gives him targets, and his pay depends on these targets; and frankly his job depends on them. Then IFC became a shareholder, and we gave them a loan. In the past he did not have to repay his loans. When we bought the company there was a huge outstanding loan. Now, he tells me, he loses sleep at night because he's worried about how he's going to pay back the IFC loan (which made me feel a little bit bad!). At least, in that case, there has been a change in governance.

Where we have issues is in management

buyouts. We are working with some companies where the state was a benign owner and did not get involved much. The managers are used to running around like it is their money or their company. Suddenly we get involved and you find out they are managing investigations from different government entities and there are all kinds of potential time bombs within the company that they haven't told the board about. You are saying, "Wait a minute, we gave you some money, we'd like to hear what's happening", and you have to sit down and talk through these issues very carefully. There is huge potential for change, but if the management remains in a dominant position it does not happen overnight just because new shareholders have entered. It is not the same as creating a new private company with a private entrepreneur. These guys have been managing the state enterprise their whole lives and they expect us to act like a state shareholder, but we don't. It takes a bit of education and training.

### **Restoring confidence in the private sector**

**QUESTION:** I have been investing in Greater China for about three years. I was educated in the US and I like to believe that private enterprises have better incentives and better corporate governance, but every year during the past three I have encountered corporate scandals in the private enterprise sector, such as Euro-Asia, Wah Sang Gas and Far East Pharmaceutical. I think this hurts investor confidence in this sector. I want to ask Jean Salata, since you have been investing in Chinese private enterprises and your fund has been generating impressive returns, what should investors and other stakeholders do to improve the whole system, to screen out bad private enterprises, and allow investors to have more confidence in this sector?

**JEAN SALATA:** Well, you should only buy the IPOs of the companies that we invest in for a start! For example, you mentioned Far East

Pharmaceutical. We looked at that company before it went public. We did not invest and we got nervous about it very quickly as we started to dig deeper into that business. Private equity investing in these kinds of businesses is quite important, which means you do a lot of due diligence. We spend six months turning a company inside out before we invest, and that is different to stock-picking once the company has listed. For us, an in-depth amount of due diligence is required. We not only do the accounting and legal due diligence, we will also spend time on the individuals in the company, to understand them, their backgrounds, and we do reference checks. We do a lot of industry cross-checking of the information that we are getting, to see if the sales numbers they are showing us are correct. We talk to wholesalers and distributors who are supplying them to see if the numbers match or not, and if they don't then we know that something is not right. It boils down to doing your homework. I don't know whether there have been more scandals among Chinese private-sector listed companies than in the US in the last two or three years. My guess is that there is a similar number; the only difference is that in the US they have been of a larger magnitude. I don't think this is a specific issue for China. It is a question of investor beware, buyer beware, and I would encourage everybody to be very careful in any investments that they made. There are people who don't buy any IPOs, they don't even invest in companies until they have been listed for at least five years, so they get a good sense of the track record of the company.

**KARIN FINKELSTON:** I would completely agree, we don't rush into anything. We take our time, we go through the audit process, we go through a serious due diligence process, we hire investigators at times, talk to people all over the place. I'm always telling my colleagues there is no reason to rush into any of these deals. But I would also like to make a comment, because I think something was said

earlier, about trust in the private sector. One important thing to note in China is that the press is government-owned. They don't have a huge incentive to investigate scandals in the state sector or in the 90% of listed companies that are state-owned. The scandals that you pointed out are scandals, fraud was committed, people did wrong, but there is also a tendency, when journalists are looking to write exciting stories, to go after the private sector because it is not related to them. Hopefully, that will change so the press can play a bigger role in the corporate governance process.

**BILL KERINS:** In conclusion, I would say that for institutional investors, having in place corporate governance form and structure, in the sense of having the institutions, audit committees, independent directors, is very important. Institutional investors in the US and Europe take a great deal of comfort from the form and structure that has been built up over the years. In China, where you don't have that yet, investors are wary. When Jean Salata or Karin Finkelston makes an investment in China they are not expecting it, so as private investors they can live without that form and structure for now. But you are not going to have major institutional investors coming in and out of this market unless you have the form and structure.

To answer your question, the lesson I would learn from the US is that when there is a failure in a system like that — where there is so much trust in the institutions — the failure is spectacular. Look at Enron and Worldcom as examples. I think they are relatively isolated incidents, but the failures were so spectacular because institutional investors trusted the system and were completely fooled by it. As I look at China and at the US, I think it is a good thing for China to move to a high degree of form and structure in its adoption of corporate governance principles, but the process is never over, you can never sit back and say, "OK, it is done".



## **SPEAKER & MC BIOGRAPHIES**

**MR. STEPHEN JULIAN BLASINA**  
**SENIOR VICE PRESIDENT**  
**SPECIALTY INSURANCE MANAGER, EUROPEAN ZONE**  
**CHUBB GROUP OF INSURANCE COMPANIES**

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Stephen J. Blasina, Bsc (University of New South Wales), MBA (Australian Graduate School of Management) is Senior Vice President of Federal Insurance Company.

Presently based in London, Mr Blasina is responsible for 25 offices in 11 countries in the European region that offers financial liability products through Chubb's Executive Risk Department and the Department of Financial Institutions.

The Risk and Financial Institutions department offers a wide variety number of specialized executive protection and professional liability products for privately and publicly owned companies, financial institutions, professional firms and healthcare organizations.

Mr Blasina has been an active member of the Asian Corporate Governance Association since 2001 and participates in many forums and speaking engagements organized for the industry.

He joined the Australian operation of the Chubb Group of Companies in 1993 as its Regional Manager and progressed to the Asia Pacific Region overseeing Specialty lines in 2000. In this role he was responsible for 12 branches in the Asia Pacific Region for Specialty insurance products.

Prior to making a career in insurance, Mr Blasina was a Merchant Banker with Citibank of New York, USA.

**MR. BRIAN J. DOYLE**  
**PRESIDENT**  
**CITIC PROVIDENT MANAGEMENT LTD**

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Brian J. Doyle is the Co-Founder and President of CITIC Provident Management Ltd, a private equity investment firm based in Shanghai, China. Previously, Mr. Doyle was a General Partner at J. H. Whitney & Co., the oldest U.S. venture capital firm, in the firm's US and Asian offices. Prior to Whitney, Mr. Doyle worked in the Mergers and Acquisitions Department at Morgan Stanley & Co. in New York. He received an MBA from Harvard Business School and a BS from Miami University (Ohio). Mr. Doyle is proficient in Mandarin Chinese.



**DR. FAN GANG**  
**DIRECTOR**  
**NATIONAL ECONOMIC RESEARCH INSTITUTE**

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FAN Gang, Dr., Director of National Institute of Economic Research, China Reform Foundation (NERI-China), Beijing, China; Professor of Economics, Peking University and the Graduate School of Chinese Academy of Social Sciences. He got his Ph.D. in economics from the Graduate School of Chinese Academy of Social Sciences (CASS) in 1988. He was visiting fellow of the National Bureau of Economic Research (NBER) and Harvard University, MA, USA, 1985-1987; Senior research fellow and deputy director of Institute of Economics, CASS, 1992-1995; chief editor, *Jingji Yanjiu* (Economic Research Journal, monthly), 1992–1993; His publications include over 100 academic papers published in Chinese and English academic journals; more than 200 articles in news papers and magazines; and 6 books on economic theories, Macroeconomics, and Economics of Institutional transformation. He is also a consultant to various departments of Chinese Central government and provincial governments; guest professor of number of universities and graduate schools; and consultant to The World Bank, IMF, UNDP, and OECD.

**MS. KARIN M. FINKELSTON  
ASSOCIATE DIRECTOR  
EAST ASIA & PACIFIC DEPARTMENT  
INTERNATIONAL FINANCE CORPORATION**

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Ms. Finkelston, a U.S. national, joined the International Finance Corporation in 1996 in the East Asia & Pacific Department. Prior to her joining the IFC, Ms. Finkelston was a Vice President in charge of multinational lending at Manufacturers Hanover Trust company in Hong Kong and a manager at KPMG consulting. Ms. Finkelston obtained an MBA from Harvard Business School and a BA from Dartmouth College.

Ms. Finkelston was appointed Chief Representative in August 2000 and then was appointed Associate Director in September 2004.

**MR. DOUGLAS HENCK**  
**PRESIDENT**  
**SUN LIFE FINANCIAL ASIA**

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Douglas Henck is President, Sun Life Financial Asia. In this capacity, he leads Sun Life Financial's development in all Asian markets. He joined Sun Life Financial on April 3, 2000 as Executive Vice President, Asian Operations, with overall management responsibility for Asian operations. Sun Life Financial, listed on the Toronto and New York Stock Exchanges among others, is a Fortune Global 500 financial services company offering insurance risk and wealth management products.

Prior to joining Sun Life Financial, Mr. Henck was Senior Vice President of the AIG Life Division of the American International Group. Based in Hong Kong, he was responsible for various strategic initiatives, such as merger & acquisition work and new country entries, as well as certain business line responsibilities and Asian country operations.

Mr. Henck moved to Hong Kong in January 1987, and established the Asia Regional office of the US-based Aetna Inc.; he remained as the senior executive in the region for the next ten years before he joined AIG. He first joined Aetna in 1974 after graduating with B.S. Mathematics from Rensselaer Polytechnic Institute in New York. Mr. Henck qualified as a Fellow of the Society of Actuaries in 1978.

Mr. Henck is a Past Chairman of the American Chamber of Commerce in Hong Kong, having led the organization during the historic 1997 calendar year. He also served two terms as Chairman of the Asia Pacific Council of American Chambers of Commerce from 1993 – 1995. A frequent spokesman for American business interests, Mr. Henck testified before the U.S. Senate Foreign Relations Committee in 1996 and has appeared numerous times on local and international television as well as in print media. He serves as Vice Chairman of the Asian Corporate Governance Association.

*Note: Mr Henck is now retired from Sun Life.*

**DR. FRED HU**  
**MANAGING DIRECTOR**  
**GOLDMAN SACHS (ASIA)**

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Mr. Hu is managing director at Goldman Sachs Group Inc. Before joining Goldman Sachs in 1997, Mr. Hu was a staff member at the International Monetary Fund (IMF) in Washington D.C., where he was engaged in macroeconomic research and policy consultations for a number of member country governments including China. In addition, Mr. Hu has since 1996 served as co-director and a senior fellow (non-resident) of the National Center for Economic Research (NCER) at Tsinghua University in Beijing, where he continues to teach a graduate course in macroeconomics and international finance. Mr. Hu has advised the Chinese government on financial reform, pension reform, and macroeconomic policies. He also sits on the advisory board for Bank of China, Huarong Asset Management Company, and the South China Morning Post. Mr. Hu has published extensively on China, Asia-Pacific economies, and financial markets. Mr. Hu is a member of the editorial board for several academic journals including International Economic Review. Mr. Hu holds an MS in engineering science from Tsinghua University, as well as an MA and a Ph.D. in economics from Harvard University.

**MR. WILLIAM F. KERINS**  
**MANAGING DIRECTOR**  
**LOMBARD ASIAN PRIVATE INVESTMENT COMPANY**

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William Kerins is a Managing Director of Lombard, an asset management firm focused on making private equity investments in Asia. Mr. Kerins began his career as an investment banker at Goldman, Sachs & Co., where he spent 13 years, and was a founding partner of The Kensington Group, an investment banking and advisory firm specializing in financial restructuring assignments and raising private debt and equity capital for companies located in emerging market countries. Mr. Kerins has extensive experience working in Asia, having served as Head of Capital Markets for Goldman Sachs in Asia (1988-1991) based in Tokyo, and Head of the Structured Financing Group in Asia (1991-1992) based in Hong Kong.

Mr. Kerins graduated cum laude from Harvard College with an A.B. degree (1977) and holds an M.B.A. (1984) from Harvard Business School.

*Note: Mr Kerins is now Managing Director, Oaktree Capital Management, Hong Kong.*

**DR. JOHN LANGLOIS**  
**CHAIRMAN**  
**MORGAN STANLEY PROPERTIES (CHINA)**

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Dr. John D. Langlois, Jr. is chairman of Morgan Stanley Properties China. He joined Morgan Stanley in September 2002. From 1999-2001 he was lecturer with rank of professor at Princeton University. From 1982-1999 he was employed at J.P. Morgan & Co. Incorporated, New York. His most recent assignment there was chief representative and managing director, Beijing Representative Office. He held previous assignments in New York, Tokyo, Hong Kong and London. Since 2001 he has been a director of the Bank of Shanghai, Shanghai, China, and since 2002 a director of the Nanjing City Commercial Bank, Nanjing, China. From 1973-1982 Dr. Langlois was professor of history, Bowdoin College, Brunswick, Maine, USA. Dr. Langlois received the PhD in East Asian Studies from Princeton University in 1974. He also received the MBA degree from New York University in 1986, the Master of Arts degree from Harvard University in 1966, and the Bachelor's degree from Princeton University in 1964.

*Note: Dr Langlois is now Advisory Director, Morgan Stanley Japan Limited (Investment Banking Division), Tokyo.*

**PROFESSOR LAWRENCE J. LAU**  
**VICE-CHANCELLOR**  
**THE CHINESE UNIVERSITY OF HONG KONG**

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Professor Lawrence J. Lau was born in China in 1944 and became a naturalized U.S. citizen in 1974. He received his B.S. degree in Physics and Economics, with Great Distinction, from Stanford University in 1964, and his M.A. and Ph.D. degrees in Economics from the University of California at Berkeley in 1966 and 1969 respectively. He joined the faculty of the Department of Economics, Stanford University, in 1966 and was promoted to Professor of Economics in 1976. In 1992, he was named the first Kwoh-Ting Li Professor of Economic Development at Stanford University. From 1992 to 1996, he served as a Co-Director of the Asia/Pacific Research Center, Stanford University. From 1997 to 1999, he served as the Director of the Stanford Institute for Economic Policy Research (SIEPR), Stanford University. His specialized fields are Economic Development, Economic Growth, and the Economies of East Asia, including China. He developed one of the first econometric models of China, in 1966, and has continued to revise and update his model since then.

Professor Lau has been elected a member of Phi Beta Kappa, a member of Tau Beta Pi, a Fellow of the Econometric Society, an Academician of Academia Sinica, a Member of the Conference for Research in Income and Wealth, an Overseas Fellow of Churchill College, Cambridge, England, an Honorary Member of the Chinese Academy of Social Sciences and an Academician of the International Eurasian Academy of Sciences. He has been awarded the degree of Doctor of Social Sciences, *honoris causa*, by the Hong Kong University of Science and Technology. He has been a John Simon Guggenheim Memorial Foundation Fellow and a Fellow of the Center for Advanced Study in the Behavioral Sciences. He is the author or editor of five books and more than one hundred and sixty articles and notes in professional publications.

Professor Lau is active in both academic and professional services. He is an Honorary Research Fellow of the Shanghai Academy of Social Sciences, Shanghai; an Honorary Professor of the Institute of Systems Science, Chinese Academy of Sciences, Beijing, Jilin University, Nanjing University, People's University, Shantou University, Southeast University and the School of Economics and Management, Tsinghua University; an International Adviser, National Bureau of Statistics, People's Republic of China; and a member of the Board of Directors of the Chiang Ching-Kuo Foundation for International Scholarly Exchange, Taipei.



**MR. SANJIV MISRA**  
**HEAD OF ASIA PACIFIC CORPORATE BANKING**  
**CITIGROUP**

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Sanjiv Misra was recently named Head of Corporate Banking for Citigroup in Asia Pacific. Prior to his recent appointment in this position, Mr. Misra was the Chief Executive Officer of the Global Corporate and Investment Banking Group (GCIB) in Singapore and Brunei and Citigroup Country Officer for Singapore. From 1999 to 2003, before assuming this role, Mr. Misra was Managing Director and Head of Asia Pacific Investment Banking for Citigroup, based in Hong Kong. From January 1997 to July 2000, Mr. Misra had served as Head of Equity Capital Markets in Asia and later Co-Head of Asian Investment Banking.

As the Asia Pacific Corporate Banking Head, Mr. Misra has responsibility for Citigroup's corporate client coverage business in Asia Pacific. This includes local and multinational corporations, governments and public sector companies, and the Structured Corporate Finance Business. He is also Co-Chairman of the Asia Pacific Coverage Operating Committee. The objective of this newly created role is to ensure that Citigroup can further refine and develop a highly customised model designed to serve its clients more effectively across Citigroup's entire spectrum of corporate and investment banking products.

Prior to joining Salomon Smith Barney in January 1997, Mr. Misra spent over ten years at Goldman Sachs & Co, in New York, Hong Kong and Singapore. He was a member of the Financial Institutions Group in New York from 1987 to 1992. From 1992 to 1994 he was Executive Director and Chief Operating Officer for the Investment Banking Division in Asia Pacific. From 1994 to 1996, he was responsible for establishing and heading that firm's business in India. This included the establishment of that company's first ever joint-venture, where Mr. Misra was a Member of the Board of Directors.

He holds a Bachelor of Arts degree in economics from St. Stephen's College, Delhi University, a post-graduate diploma in management from the Indian Institute of Management in Ahmedabad and a Master of Management from Northwestern University.

Sanjiv is married to Devika and has two sons.

**MR. MAROOT MRIGADAT**  
**PRESIDENT**  
**PTT EXPLORATION AND PRODUCTION PUBLIC COMPANY LIMITED**

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**Name:** Maroot MRIGADAT  
**Position:** President PTT Exploration and Production Public Company Limited  
**Effective date:** October 6, 2003  
**Age:** 51 years old  
**Education:** B.S. (Petroleum Engineering), The University of Texas at Austin, U.S.A.  
M.S. (Petroleum Engineering), The University of Texas at Austin, U.S.A.  
Certificate in Advance Management course from Insead, France

**Working Experience:**

1989 - 1994 Vice President, Production  
1994 - 1997 Vice President, Operations  
1997 - 1998 Secondment to TOTAL subsidiaries as General Manager Designated, Bongkot Project  
1998 - 1999 Vice President, Bongkot Project  
1999 - 2002 Senior Vice President, Operations Division  
2002 - Oct. 5, 2003 Senior Vice President, Business Development Division

**Other Positions:**

Director of Independent Power (Thailand) Company Limited Board of  
Commissioner, Medco Energi Internasional TBK, Indonesia Director of PTTEP  
Middle East Company Limited Director of PTTEP Algeria Company Limited

**MR. DOUGLAS PEARCE**  
**CHIEF EXECUTIVE OFFICER AND CHIEF INVESTMENT OFFICER**  
**BRITISH COLUMBIA INVESTMENT MANAGEMENT CORPORATION**

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Mr. Pearce is the Chief Executive Officer and Chief Investment Officer of the British Columbia Investment Management Corporation (bcIMC).

(bcIMC) is a statutory company established in 1999 by the Province of British Columbia. The corporation is responsible for the investment of public sector pension funds, sinking funds and other trust funds in the Province of British Columbia. Total assets under administration are approximately \$64 billion in a range of diversified assets, domestic and foreign.

Mr. Pearce is the Chairman of the Pacific Pension Institute based in San Francisco and a past director and chairman of the Pension Investment Association of Canada (PIAC). He is a member of the University of British Columbia Sauder School of Business, Faculty Advisory Board and a member of the business council for the Global Asset and Wealth Management (GAWM) program of Simon Fraser University. Mr. Pearce is also pleased to be a founding board member of the Forum for Women Entrepreneurs in British Columbia, an education and networking venue for women entrepreneurs and investors.

Mr. Pearce is a graduate of the University of Calgary.

**MR. JEAN ERIC SALATA**  
**CHAIRMAN**  
**BARING PRIVATE EQUITY ASIA**

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Jean Eric Salata, 38, Chairman and Founder of Baring Private Equity Asia, joined Baring Private Equity in 1997. Mr. Salata oversees and is responsible for all investment and divestment decisions made at the Firm, as well as its strategic direction. Mr. Salata has been responsible for all investment activity of the Firm since he joined in 1997 and was tasked with the creation of a regional Asian private equity program for UK based Baring Private Equity Partners Ltd, a subsidiary of the ING Group. Before that, Mr. Salata was a Director of Hong Kong based AIG Global Investment Corporation (Asia) Ltd., the Asian private equity investment arm of AIG. Before that, he was the Executive Vice President of Finance of Shiu Wing Steel, a Hong Kong based industrial concern, and prior to that a management consultant with Bain & Company based in Hong Kong, Sydney and Boston. Mr. Salata serves on the board of directors of several portfolio companies and is a member of the executive committee of the Hong Kong Venture Capital Association. Mr. Salata has lived and worked in Hong Kong since 1989 and graduated magna cum laude from the Wharton School of the University of Pennsylvania with a BS in Finance and Economics.

**MR. LEE S. TING**  
**MANAGING DIRECTOR**  
**W R HAMBRECHT & CO.**

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Lee is a former Corporate Vice President of Hewlett Packard Co. (HP) where he worked for more than thirty years. He started as an R & D engineer and was the founder and General Manager of HP Taiwan, General Manager of Far East Region, Managing Director of Southeast Asia Operations, Director of Business Development, and Vice President and Managing Director of Asia Pacific. His last position was Corporate Vice President and Managing Director of Worldwide Geographic Operations where he was responsible for HP's customer facing organizations in all the countries in which the company had a business presence.

During a two year absence from HP in the late eighties, Lee was a Senior Vice President of Hambrecht & Quist where he played a key role in the expansion of the firm's venture capital business into Asia.

Lee is currently a Managing Director of WR Hambrecht+Co, the investment bank based in San Francisco. He is an independent Board Member of the Lenovo Group, the leading IT company in China, and MTI, a supplier of satellite/microwave communications components and subsystems based in Taiwan. Lee is also an advisor to WK Technologies, a leading venture capital company with operations in Taiwan and US and other private companies.

Lee is a member of the Committee of 100 and a member of the Advisory Council to the Dean of Engineering at University of California, Santa Cruz.

Lee received his BSEE from the Oregon State University and has completed the Stanford Executive Program. He is fluent in English, Chinese, and Portuguese.

**MR. POTE P. VIDET**  
**MANAGING DIRECTOR**  
**PRIVATE EQUITY (THAILAND) CO LTD**

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Pote Videt is Managing Director of Private Equity (Thailand) Co., Ltd., an affiliate of Lombard Investments, which provides technical assistance to the US\$245 million Thailand Equity Fund in certain private equity matters. Previously Mr. Videt was Managing Director of Credit Suisse First Boston responsible for Southeast Asia and Managing Director of Goldman Sachs in Hong Kong. His transactional experience has ranged from small entrepreneurial concerns to several Fortune Global 500 companies, government enterprises and international organizations. In its first worldwide survey, *Global Finance* magazine named Pote Videt as one of the best bankers in the emerging markets.

In 1997, Mr. Videt served briefly as Deputy Minister of Commerce in the Thai Government. From 1998-2001, he served as advisor to Deputy Prime Minister Dr. Supachai Panitchpakdi with regard to international economic policy. He is currently on the Council of Economic Advisors to the Prime Minister of Thailand.

Pote Videt serves on the Board of Trustees of the Asia Society and is also a member of the Board of Directors of four listed Thai companies: K-Tech, Loxley, Trinity Wattana and Vinythai.

He graduated *summa cum laude, Phi Beta Kappa* from Yale University with a B.A. degree in economics and holds an M.B.A. with distinction from Harvard Business School.

**AMBASSADOR LINDA TSAO YANG**  
**CHAIR**  
**ASIAN CORPORATE GOVERNANCE ASSOCIATION**

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Ambassador Yang was the U.S. Executive Director on the Board of Directors of the Asian Development Bank in Manila from 1993 to 1999. She was the first woman appointed by the United States Government to the Board of a multilateral financial institution and the first Executive Director appointed by President Clinton and confirmed by the U.S. Senate.

Upon her retirement in December 1999, Ambassador Yang was presented the Distinguished Service Award by the then U.S. Secretary of the Treasury, Lawrence H. Summers. The award citation stated that, "Ambassador Yang has been one of the main forces behind the strengthening of the Bank's private sector operations and she has led the effort to put in place a Bank-wide approach to private sector development. Ambassador Yang played a key role in defining the Bank's participation in the international response to the Asian economic crisis, including pushing for early and expanded attention to social impacts and social development. She has provided strong fiduciary and operational oversight of Bank operations and has worked to make the Bank more transparent and accountable."

The first woman and the first minority appointed to serve as California's Savings and Loan Commissioner, she was responsible for the regulation and supervision of state-chartered savings and loan industry from 1980-82. She was the first Asian American appointed to the Board of Administration of the California Public Employees' Retirement System (CalPERS) and served as Vice President of the Board and Vice-chairman of its Investment Committee.

Ambassador Yang is Chair of the Asian Corporate Governance Association. She serves on the board of The Pacific Pension Institute, The Asia Foundation, The Center for Asia Pacific Policy, RAND Corporation, and The Committee of 100, a Chinese-American organization in the United States. She is a member of The Trusteeship for the Betterment of Women in Los Angeles and The Council on Foreign Relations. She is also an independent non-executive director and a member of the Audit Committee of the Board of Directors of The Bank of China (Hong Kong).

A graduate of St. John's University in Shanghai, Ambassador Yang earned her Master of Philosophy degree (Economics) from Columbia University of New York. Her areas of concentration were banking, finance and international economics.



**DR. ZHU MIN**  
**EXECUTIVE ASSISTANT PRESIDENT**  
**BANK OF CHINA LTD.**

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Aged 51, Dr. Zhu has been an Executive Assistant President of Bank of China since November 2003. He has been the General Manager of the Restructuring and Listing Office of Bank of China since December 2002 and the General Manager of Board Secretariat of Bank of China (Hong Kong) Limited since October 2001. Mr. Zhu was the General Manager of the Institute of International Finance and the Head of the Bank of China Project Office from April 1998 to December 2002.

Mr. Zhu graduated from Fudan University with a Bachelor's degree in 1982, and obtained a Master's degree from Princeton University and a Doctor's degree from Hopkins University in turn.

# Asian Corporate Governance Association

The Asian Corporate Governance Association (ACGA) is an independent, non-profit membership association dedicated to assisting the implementation of effective corporate governance in Asia. Highlights of our work in recent years include:

- Tracking corporate-governance developments across 11 countries in Asia and carrying out independent research.
- Creating a website ([www.acga-asia.org](http://www.acga-asia.org)) that provides comprehensive and concise coverage of corporate governance reform in Asia.
- Forming the "ACGA Investor Discussion Group", a confidential quarterly forum where leading institutional investors can share ideas and concerns.
- Developing exclusive services for ACGA members, including: semi-annual Member Briefings in Hong Kong and Singapore; premium website content; and a monthly "Member Alert" bulletin.
- Speaking at more than 120 conferences, seminars and workshops around the region.

ACGA was founded in 1999 by Lombard/APIC, a private equity fund management company, in cooperation with a board of senior executives and professionals from around Asia. Lombard continues to be a major sponsor. Other Founding Corporate Sponsors include: Chubb Insurance, CLSA Asia-Pacific Markets and Sun Life Financial Asia.

## Founding Corporate Sponsors:



## ACGA Corporate Members

Our aim is to build an effective network of members who support ACGA's goal of advancing governance reform that is both disclosure-based and market-driven. Members include:

- Aberdeen Asia
- AIG Investment Corp (Asia)
- British Columbia Investment Management
- CalPERS
- CalSTRS
- Chubb Insurance
- Citigroup Asset Management – Asia
- CLSA Asia-Pacific Markets
- Coudert Brothers
- Credit Agricole Asset Management (HK)
- Deloitte Touche Tohmatsu
- Dibb Lupton Alsop
- Fidelity Investments Management (HK)
- GIC Special Investments
- Hermes Pensions Management
- Hewitt Associates
- Hong Kong University of Science and Technology
- IMC Pan Asia Alliance
- ING Asia/Pacific
- ISIS Asset Management
- Jardine Lloyd Thompson
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- Mirant Asia-Pacific
- Neptune Orient Lines
- Prudential Asset Management (HK)
- Standard Life Investments
- Standard & Poor's
- State Street Global Advisors Asia
- Sun Life Financial Asia
- SUNDAY Communications
- Swire Pacific
- Templeton
- Value Partners
- Vtech Holdings
- Watson Wyatt

For details on membership benefits, contact Jamie Allen on (852) 2872 4048 or [jamie@acga-asia.org](mailto:jamie@acga-asia.org)