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ADB Institute Discussion Paper No.3

**Corporate Governance in Banking and Economic Performance -
Future Options for People's Republic of China.**

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Corporate Governance in Banking and Economic Performance - Future Options for the People's Republic of China (PRC).

Executive Summary

State Ownership in Banking

Enhancing the corporate governance of banks in PRC requires looking at the overarching progress of the transition to a market economy. The landscape of the Chinese economic structure has been transformed after a quarter century of economic reform. As it stands now, 70 per cent of GDP is contributed by the non-state sector, where a major wave of new unfettered capitalists emerged. Nevertheless, the continued involvement of the government has created severe agency problems, particularly through the sick relationship between State Owned Enterprises (SOEs) and State Owned Commercial Banks (SOCBs), two segments of the Chinese economy where the gradualist approach didn't fasten adequate structural adjustment thus loading unbearable amounts of NPLs at banks. The role of the government in the economy will have to evolve from the previous "owner and player" in the economy to that of "rule-setter and regulator". To reflect this reality, political interference in the banking sector should be cut off. We argue that ownership diversification represents an effective first step in the direction of improving the corporate governance of banks in PRC with the long-term goal of reducing the ownership role of the central government in the banking sector.

Nevertheless, in order to enhance such corporate governance and, hence secure that bank monitoring produces the good incentives for SOEs and other firms to be efficient, broad structural reforms are called for in three specific areas: the ownership configuration of the banks, institutional building and the promotion of competition in banking. Within such improved environment, practical plans can be formulated and implemented to reach the ultimate objective of improving the corporate governance of banks. Accordingly, we first address the three areas of structural reforms and then exemplify practical plans that the Chinese authorities may want to pursue, hinging on the diversification of the ownership of the banks that currently have the State as the sole owner.

Economists generally agree that State ownership of banks in low-income countries is an impediment to establishing an efficient banking system, to financial sector development and, thus, to sustained economic growth. Specifically, government ownership of banks distorts both competition and managerial incentives, leading to inefficiency and politically connected lending, which causes misallocation of resources. In the case of PRC, the political guarantee has prevented State owned banks from performing an efficient screening and monitoring of SOEs. Such soft budget constraints for SOEs have resulted in huge amounts of NPLs, which are endangering the solvency of the banking system and, at the same time, challenging PRC's fiscal sustainability. Burdened by the large amount of NPLs, Chinese banks have become increasingly reluctant to lend: the resulting credit crunch is undermining the potential of PRC's dynamic economy and might preclude the continuation of the country's persistently high growth. NPL resolution should be given high priority but is not enough: it should be accompanied by corresponding ownership changes to avoid serious moral hazard problems and the perpetuation of the banking system's inefficiency.

Scope for the Private Sector

Concentrated ownership of banks is desirable, in principle, because dispersed shareholding undergoes a free-rider problem and managers may go unsupervised and, thus, insider control

may result leading to inefficiency, while these problems do not arise when a significant blockholder is present. However, the presence of the blockholder has also potential costs since there is a tradeoff between the effectiveness of his monitoring of the bank and the possibility that he holds up other stakeholders or expropriates minority shareholders, e.g., via connected lending. To limit these costs stemming from bank blockholders' self dealings, laws and regulations were introduced in major economies following the crisis of the 1930s to separate banking and commerce. These restrictions have been partly lifted in the late 1990s in the major OECD countries, but we believe that, given the country's institutional and financial market development, PRC should require that controlling bank owners do not have significant interests in non-financial businesses. In other words, PRC should establish some type of Bank Holding Company regulation whereby investors have to divest their commercial interests if they want to obtain control of a bank, i.e. holding a share participation beyond a low limit (e.g., 5 percent in the USA).

While this is the general framework that should accompany the privatization of banks, some ownership structure changes can be effective also in the short-run to improve the corporate governance of Chinese banks, particularly of the SOCBs, even without requiring fully-fledged privatization. In the first place, PRC should not underestimate the potential of its newly bred banks (Joint Equity Commercial Banks and also City Commercial Banks, that we condense under the name of Diversified Ownership Commercial Banks, DOCBs). These banks have clearly shown good vitality. Their corporate governance structure permits them to reach better performance than SOCBs. As a result, DOCBs are effectively intensifying banking competition in some important parts of PRC. But why is corporate governance better at DOCBs than at SOCBs? In our view, the answer lies with their ownership structure. Even though they usually enlist local and/or central State institutions as significant shareholders, DOCBs are not owned just by the central government. In other words, what distinguishes DOCBs from SOCBs is that they have a plurality of shareholders. Even when all shareholders are institutions belonging to the public sector, their plurality ensures that multiple interests are represented in boards of directors. The plurality of their shareholders minimizes the risk that DOCBs fall captive to influential customers (this is even more likely if foreign shareholders are present, see also below). This also enhances DOCBs' monitoring capacity and gives their managers the right incentives to appropriate behavior. The good functioning of these banks' corporate governance, however, demands that DOCBs' minority shareholders should somehow be protected. Before going into the specifics of how the expansion of DOCBs may be favored, however, we must outline the two other areas of broad structural reforms (institution building and the promotion of competition in banking) that are necessary complements to make the transformation in banks' ownership effective in carrying out more efficient banking.

Competition and Regulation

Strengthening or establishing external independent authorities, together with appropriate ownership structures and proper competition policies, delivers good corporate governance of banks. In particular, as said, good corporate governance at DOCBs hinges on the diversity of interests among their shareholders, but in order to work its way to ensure efficiency at these banks minority interests must be helped make their case. External independent authorities, together with the discipline of competition, look indispensable, as it may take some time before minority interests in PRC can be defended in courts. Thus, strengthening bank/finance

Authorities is a top priority. The external independent authorities mainly relevant to this task are: (i) the Central Bank, PBOC; (ii) the Securities & Regulatory Commission, CSRC; (iii) the Antitrust Commission, not yet established.

The Antitrust Commission should be established and given wide scope, also on banking and finance, as the Central Bank and the Securities & Regulatory Commission might cater for the interests of their specific constituencies and not give enough weight to general welfare. Bank-related issues that fall under the jurisdiction of the Antitrust Commission emerge in the many instances where banking comes across positive network externalities. For example, it appears that DOCBs presently suffer a disadvantage vis-à-vis SOCBs as the former have to rely on the latter for access to the national clearing system. Also the establishment of a centralized Credit Bureau (a key step to help banks' screening and monitoring of borrowers) requires that DOCBs can adhere to it on equal footing with respect to SOCBs.

The Securities & Regulatory Commission should be strengthened, expanding its powers. Specifically, the CSRC has a primary role to protect minority shareholders; it can supervise that corporate statutes are effectively enforced; it can enforce adherence to its directives on the structure and functioning of the Board; it can favor the establishment and effectiveness of independent directors.

Furthermore, as government ownership of banks is reduced, the implicit guarantees that go with that will also be removed. Thus, the issue of Deposit insurance should be addressed early on to facilitate the passage from State to private ownership of banks. Naturally, ways to secure depositors' safety have to be balanced against the possible moral hazard coming from the deposit insurance scheme.

Regarding the Supervisory Authority, the choice has been made to place it with an outside new body rather than leaving it with the Central Bank, though there are pros and cons to this solution. Now, it is important for PRC to expand official supervisory powers and upgrade supervisors' salaries to reduce the risk of supervisory capture. At present, in fact, the international comparison tells that Chinese supervisors have relatively little power on their supervisees and PRC's supervisory officials are also more likely than the average to move into banking. Expanding supervisory powers should render banking supervision more effective. This and other equally crucial aspects, like strengthening on-site banking inspections and banks' balance sheet analysis, demand that the Supervisory Authority is able to form and retain adequately skilled personnel. In turn, this requires that the salary gap between the Supervisory Authority and the banking sector be minimized. More generally, and this pertains not only to the Supervisory Authority, the building of a better institutional set-up necessitates removing the public sector ceiling for the salaries of independent agencies' officials. Its expanded powers should help the Supervisory Authority, in conjunction with the CSRC, to protect minority shareholders of DOCBs and, thus, help these banks' corporate governance to function well. To this end, the Supervisory Authority should also promote increased disclosure and transparency at all banks, to allow shareholders to monitor management. These steps (e.g., through the frequent publishing of bank statement) could also help establish some type of "Prompt Corrective Action" procedures so that decisions to close a bank may be made quickly on a technical level, thus preventing political interference.

In addition, in order not to depress the franchise value of banks, liberalization of interest rates should be pursued with good sequencing: start from interbank rates, move to loan rates, leave deposit rates last (APF, 2002).

Adequate bank ownership structures and a stronger institutional set-up will ensure that good governance of banks is achieved only if competition policies are also enacted. To facilitate effective competition in the banking sector, PRC needs to further develop some crucial market segments, such as: (i) T-bill and T-Bond markets to fill the yield spectrum and favor private bond market development (particularly for banks to help reduce the extent of their maturity mismatch and also to promote bank monitoring by subordinated bond holders); (ii) interbank market to improve the allocation of short-term liquidity and also to allow interbank monitoring; (iii) a nationwide clearing and settlement system whose access is based on membership so that the current monopoly of SOCBs in this segment can be eliminated.

Another area of intervention to make competition effective is to create some basic infrastructure to share information on borrowers across the banking system. Building a Credit Bureau can indeed improve information sharing among banks (about bad borrowers only or also on performing borrowers). According to the findings of Jappelli and Pagano (1993, 2002), better developed and longer established information sharing leads to: i) deeper credit markets (larger credit/GDP ratios); ii) better allocation of credit, as indicated by fewer defaults. They also show that information sharing among banks increases with: i) higher mobility of households and size of the consumer credit market; ii) lower competition in domestic banking market; iii) better status of technological development in the banking industry; iv) public intervention to make up for the lack private sector initiatives (since there is a clear externality). It can also be argued that information sharing is vital particularly for loans vis-à-vis less transparent borrowers, such as small firms: as such, the establishment of a Credit Bureau in PRC could be an important step to diminish liquidity constraints for the small and medium-sized enterprises. In this regard, PBOC's efforts to create a centralized Credit Bureau should be given high priority. The upgrading of these essential market segments would reduce barriers to entry, thus facilitating the access of DOCBs and foreign banks.

As argued, by enhancing competition and contestability and also through technology spillovers, foreign bank entry can be part of the solution in promoting ownership diversification, improved banking efficiency, the formation of adequate skills and risk management. Foreign bank entry can be most effective to this end when it happens through the acquisition of subsidiaries in the target country, rather than via the opening up branches. In this sense, the presence of DOCBs provides an interesting outlet for foreign banks to enter PRC's retail banking: even though up to now only minority shareholding has been the rule, in the future this could rapidly change. In fact, limited experience from the field study proves that foreign banks have already been active acquiring DOCBs in the past and also foreign banks' presence as minority shareholders is key to improve corporate governance. Thus, foreign banks play both a (limited) direct role through their branches in Mainland PRC and also indirect role via joint ventures with DOCBs. Furthermore, PRC's WTO entry can only guarantee that obstacles to the entry of foreign banks will be phased out shortly.

In spite of these benefits from foreign bank entry, given its size, PRC can hardly count on them alone to provide "the solution" to better banking. Better banking has to be found at home. In this respect, PRC should not underestimate the role its DOCBs can potentially play.

Recommendations – Ownership Diversification.

Letting the winners (in this case the better-managed individual DOCBs) increase their market share is not necessarily detrimental to banking competition. Limited merger and acquisition (M&A) activity for PRC's banks have already started but these need to be further encouraged. With regard to SOCBs' restructuring, as said, the first step should contemplate the quick

resolution of NPLs accompanied by strengthened corporate controls. In the past, although the State was the sole owner of the SOCBs, its effective control on them was hindered by the multiple layers of political interference leading to: (i) appointments of managers made by the party; (ii) supervisory responsibility split among different agencies, whose cooperation was jeopardized by conflicts of interests; (iii) the fact that the main shareholder was passive. To overcome these problems, a State Banking Holding Company could be set up to streamline the existing arrangement, so that the State's interests as a shareholder can be fully conveyed. To minimize the risk of political lending, the State Banking Holding Company should be kept rigidly separated from any other State Holding Company administering non-financial SOEs. The State Banking Holding Company would provide a filter between political interests and commercial interests.

The second step of the plan is to speed up ownership diversification. We propose to go for the ownership diversification of one of the SOCBs. If the State Banking Holding Company wants to make a bold move, it could try to apply this to ICBC (the largest of the big four), alternatively, it could start with the Agricultural Bank of China, the smallest and the weakest among the big four SOCBs. The assets and branch network of the SOCB that the State Banking Holding Company decides to sell could be acquired by DOCBs that have an interest (breaking up could be considered) and/or by foreign banks. This strategy serves at least two purposes. First, it creates an environment in which bank M&A activity is encouraged. Second, it sends a signal that the other three SOCBs will be potential targets if their performance fails to satisfy remuneration of shareholder's value. To make this signal more potent, and give SOCBs' management further incentive to perform, the State Banking Holding Company could grant them stock options that would help increase their diligence in skill formation and risk management. The experience with the ownership diversification of the first SOCB that is sold would be precious for the State Banking Holding Company to organize the following rounds. Simple simulations show that, if this strategy were carried out at the start of 2004, by 2010 PRC could have a new banking landscape that would no longer be dominated by the big four SOCBs but, on the contrary, would have seen the newly bred DOCBs be rewarded their better performance.

1. Introduction: Why are corporate governance issues key in PRC?

The economic development attained by PRC over more than two decades has been exceptional, with average yearly real growth rates of GDP reaching above 8 per cent. As a result, between 1973 and 1998 PRC has more than doubled its share in world GDP (from 4.8 to 11.9 per cent; Maddison, 2001). Sustained growth has also come along a substantive poverty reduction: between 1978 and 2000 using the World Bank one dollar a day poverty line the poor have dropped from 260 to 100 million (Weiss, 2002), or from 31 to 8 per cent of the population.

PRC's success story may have something to do with its gradualist approach to reform and transition from planned to market economy. In particular, even though PRC was quick to liberalize exports, it resisted international pressure to early capital account opening, financial liberalization and quick privatization avoiding the external fragilities imposed by a shock therapy. With the benefit of hindsight, the emergence of "third generation" financial crises (Balance of payments cum financial sector "twin" crises; Kaminsky and Reinhart, 1999) shows PRC was right. PRC could reap the benefits of increasing trade integration while escaping the vulnerability triggered by early capital account opening, financial liberalization (Stiglitz, 2002). Instead of the shock therapy, PRC's transition let private business (the second track) gradually supplement State owned enterprise SOEs (the first track, leftover of plan economy). Again, the strategy proved right in view of the failure in Russia's shock therapy: lacking prior institution building, privatization fatally generated private rent seeking and held up transition (Black and Tarassova, 2002). A major wave of new unfettered capitalists emerged, able to stand up to competition in global goods markets (Lau, Qian, and Roland, 2000).

However, lacking major institutional reforms, the success story of the second track did not hasten structural adjustment of SOEs (Opper, 2001). In turn, the first track loaded on banks mounting Non Performing Loans (NPLs), with estimates ranging at 40 per cent of GDP or above (Liu, 2002; IMF, 2002). This poses a major macro challenge that cannot be evaded to prevent a meltdown of the banking system while securing fiscal sustainability (Liu, 2002; APF, 2002). In other words, in spite of past accomplishments, sustainable growth in PRC may now be threatened by the acute structural imbalances produced by loss-making SOEs.

Also, the sick banking system, loaded with huge burdens of NPLs, is dysfunctional; it does not enforce governance on firms, leading to further misallocation. Even the disposal of NPLs looks only a necessary step, but not a sufficient one for at least two main reasons. First, NPL resolution might be achieved through a shift in bank assets away from loans, thus possibly inducing a credit crunch and damaging the vital private sector. Second, newly healthy banks can still allow soft budget constraints.

At the present juncture, it seems crucial for PRC to improve its corporate governance setup, particularly vis-à-vis SOEs. But, to harden the budget constraint for SOEs, Chinese banks' own corporate governance needs to be upgraded. Yet it is not an easy task to introduce the right incentives and functioning in a banking sector that is still largely dominated by four State owned commercial banks (SOCBs) and where also regulation and supervision needs to be improved. In spite of the difficulty of this task, it appears that PRC must deal with it. We suggest that PRC might follow a three-pronged approach.

Firstly, a key role may be played by the new generation of banks featuring diversified ownership. Specifically, by Diversified Ownership Commercial Banks (DOCBs) we refer to those Chinese banks that, rather than having the central government as the sole owner, have an ownership structure enlisting various different shareholders, possibly including foreign banks. Even though

some of these shareholders may still belong to the public sector, the diversity of interests among such multiple shareholders is vital to cater for an improved corporate governance in PRC's banking system.

Secondly, it is indispensable to tighten the institutional set up on banks and financial institutions. This requires that regulation and external independent supervisory authorities should be strengthened to help improve disclosure, transparency and also protect the banks' minority shareholders.

Thirdly, it is imperative for PRC to favor competition and financial market development. Along with this, it seems important to improve information sharing and remove barriers to entry to nationwide payments systems. Further suggestions include opening up to foreign bank entry and allowing more efficient banks to enjoy faster growth via raising subordinated debt and equity on financial markets.

We envisage that, by pursuing the above strategy, PRC would be able to improve corporate governance of its banks, thus enforcing corporate governance also at SOEs and removing perhaps the main fragility to its sustainable economic growth.

The rest of the paper proceeds as follows: Section II draws on the literature to argue that bank monitoring is needed to enforce corporate governance at firms in PRC. Section III discusses how to improve corporate governance of banks. In particular, after synthesizing the literature on the specific problems with the corporate governance of banks, the paper addresses two key issues: (i) the link between State ownership and the corporate governance of banks; (ii) the possible role of foreign bank entry to improve the corporate governance of domestic banks. Section IV studies the status of corporate governance of banks in PRC. First, it is shown that DOCBs outperform SOCBs in terms of efficiency/profitability. Second, the paper evaluates whether DOCBs offer a possible option to "grow out" of SOCBs. Third, drawing on new data gathered via field surveys, the paper documents that DOCBs already possess a better corporate governance structure vis-à-vis SOCBs. Section V concludes articulating a set of concrete policy proposals.

2. Bank monitoring is needed to enforce governance at firms in PRC

Can enhanced bank monitoring be key to improve the corporate governance of firms in PRC? To answer this question, we need to consider which different corporate governance models are usually discussed by economists and policy makers. In an extensive representation, the literature has contrasted two systems of corporate governance: the Anglo-American market-based (MB) system and the long-term large investor models of, say, Germany and Japan, often referred to also as bank-based (BB).

In the 1960s, based on his “transactional” view of finance –whereby transaction costs will be minimized by multilateral markets, something that bank intermediation cannot intrinsically achieve– Raymond W. Goldsmith (1966, 1969) proposed that the passage from BB to MB financial systems is basically a “natural evolution”. Thus, as industrial economies grow more affluent we should observe the deepening of financial markets everywhere together with the weakening in banks’ role.

The evolutionary view was questioned in the 1980s as it lacked deep analytical foundations in economic theory –theories of financial intermediation moved away from a “transactional” to an “informational/agency” approach casting doubts on the substitutability between banks and markets– and because the fact that some bank-based systems in high performing industrial countries –Germany and Japan– were quite resistant to change was puzzling to the evolutionary view (Mayer, 1988), while their economies were perceived to be overtaking the UK and the USA –the champions of MB systems. Thus, in the 1980s the Japanese and German long-term investor corporate governance perspective¹ were seen as strengths relative to the Anglo-American market based on a short-term perspective²: thanks to the close relationships with banks and other long-term debt and equity holders, corporations in Germany and Japan had a lower cost of capital than their American and British counterparts (Fukao, 1995) and, especially Japanese corporations, had higher investment rates than their U.S. counterparts (Prowse, 1990).

But the recovery of high growth in the USA in the second half of the 1990s –while Japan suffered a decade of economic recession and Germany went through costly post-unification adjustment– promoted Goldsmith’s view once again: the engine behind the new American boom, the “new economy”, was largely intertwined with high reliance on venture capital finance and, ultimately, the stock market that experienced an unprecedented boom, which significantly reduced the cost of capital in the US. In the late 1990s, pundits growingly pointed out that greater minority shareholder protection was needed across the globe to allow countries to enjoy the faster growth associated with the higher reliance on the Anglo-American type equity financing. While the issue of global convergence in corporate governance models had already surfaced (Balling, Hennessy, and O'Brien, 1998), this was the time, by the end of the 1990s, when the American corporate governance model was hailed as the model for all to follow (Hansmann and Kraakman, 2000).

¹ Japanese corporate governance was praised in the 1980s also because of the long run nature of relationships between the multiple stakeholders in the corporation, which made greater involvement by employees and suppliers possible, in contrast with the costs of potential ‘breaches of trust’ following hostile takeovers in the U.S. (Shleifer, and Summers, 1988).

² Anglo-American market-based corporate governance was accused of obsessing managers with quarterly performance measures and forcing them to have an excessively short-termist perspective. For instance, among others, Porter (1992) argued that U.S. managers are myopically ‘short-termist’ and pay too much attention to potential takeover threats: on the contrary, in the corporate governance setup at German and Japanese corporations, the long-term involvement of investors, especially banks, allowed managers to invest for the long run while, at the same time, monitoring their performance.

After being lauded just a few years earlier, the Japanese corporate governance model was now stigmatized: its low cost of capital was a sign of excesses leading to over-investment (Kang, and Stulz 2000). At the same time, now hostile takeovers were no longer accused of bringing about short-termist behavior but lauded as an effective way to break up inefficient conglomerates (Shleifer, and Vishny, 1997). In passing, it should be noted that while Anglo-American corporate governance is praised because of its hostile takeovers, since the early 1990s the market for corporate control in the U.S. has essentially collapsed as a wave of anti-takeover laws and charter amendments is now protecting most U.S. corporations against hostile takeovers with their control being no longer contestable.

The idea that all countries should converge to the Anglo-American corporate governance model has lost momentum, as the US model experienced its own debacle with the massive over-investment in the technology sector and with its major bankruptcies and corporate governance scandals. The low cost of equity capital –lost by Japan after its 1990 stock market crash– was gained by the US throughout the unprecedented bull market: many saw this as resulting from superior minority shareholder protection (see e.g. La Porta et al. 1998) but now, with the benefit of hindsight, it seems that the low cost of equity capital in the US in the late 1990s had more to do with the technology bubble than with minority shareholder protection, just as the low cost of capital in Japan in the late 1980s depended more on the real estate bubble than on Japanese corporate governance (Bolton, Becht, and Röell, 2002). Also, it is clear that corporate governance problems were at the origin of the mega bankruptcies of Enron and Worldcom, companies that looked like exemplary “Anglo-American” corporations. Moreover, as stock prices fell, it became clear that executive remuneration at U.S. corporations was increasingly out of line with corporate reality and also the effectiveness of outside directors was heavily questioned (for a critical note on the role of outside directors see, e.g., Klein, 1998). It was discovered that pervasive conflicts of interest at financial and accounting firms produced major distortions in the information offered to investors.

Thus, although the global corporate governance reform movement is still pressing ahead, its chosen direction may not be the U.S. model, which is itself under reform. We can only draw the conclusion: little help comes from the alleged “best practice” while a coherent system of corporate governance must be thought of in a tailor-made way appropriate to the specific contingencies of the country under analysis. In this regard it must be considered that the degree of development of the institutions needed for a MB type of corporate governance to work is still unsatisfactory in PRC. For instance, on the basis of data taken from Chan-Lee, and Ahn (2001), Figure 1A confirms the positive cross-country relationship between the quality of the Institutional and Governance Environment and the level of per capita GDP (Purchasing Power Parity adjusted in US \$ terms for 1998) and shows that PRC is slightly below the interpolating line. Also, Figure 1B, restricting the focus to non-OECD Countries Only, confirms both of the previous findings.

Naturally, this does not automatically imply that the MB model should not be considered for PRC. But, even in that case, the MB model does not seem to offer PRC a solution for the short-medium run. Thus, in view of this and also considering the extensive importance of bank financing for Chinese corporations, a BB corporate governance model could be the only solution available for the short run to PRC (Yoshitomi, and Shirai, 2001). However, as experience shows, even when banks secure the bulk of firms’ external financing, there is no guarantee that a BB model will automatically emerge. This depends very much on whether banks can really be effective at monitoring firms. In this respect, the experience of PRC’s neighboring countries hit by the East Asian financial crisis is particularly telling.

2. 1 Lessons from the Asian Financial Crisis

The Asian financial crisis, which can be characterized as a capital account crisis with twin financial crisis - i.e. an international currency crisis and a domestic banking crisis - unveiled the weaknesses of the domestic banking system in East Asia. Since the bulk of external finance in Asia is bank credit, banks were naturally expected to have effectively monitored borrowing firms during the Asian miracle decades. However, in retrospect, banks failed this task. There are several reasons for the weakness of the banking system in Asia, as synthesized by World Bank (1998):

The East Asian crisis has underlined the importance of the rules, norms, and organization that govern corporate behavior and define accountability to investors. East Asian corporate finance markets typically are dominated by banks. Because securities markets require a more sophisticated institutional and regulatory framework, bank dominance of corporate finance is probably the best way for developing countries to grow, provided they are not subject to undue state influence, are exposed to competition, and are prudently regulated (p. 56)

However, it is too simplistic to associate banks' dominance as providers of external finance with their ability to monitor borrowers. One needs to ask whether the "location" of banks in the overall industrial and financial structure of the economy allows them to perform such monitoring effectively (Khan, 1999). Specifically, if banks are under the strong influence of large family business groups (or of government lending directives), they may be ineffective at monitoring those groups, particularly when those borrowers are selected by the government. The typical family group with a captive bank may be exemplified by the pre-crisis (1996) structure of the Ayala family group in the Philippines (see Claessens, Djankov, and Lang, 2000). The pervasiveness of family group control of banks in the case of Thailand is quantified in Khan (1999).

As the Japanese experience teaches us, depending on the position of the bank vis-à-vis the firm, we will have banks captive to conglomerates (e.g., the zaibatsu experience, where banks' shareholding was with the family groups) or banks monitoring corporations (e.g., the keiretsu experience, where banks are in a good position to monitor the keiretsu) (Okazaki, and Yokoyama, 2002). Thus, family-controlled banks may be able to play an effective monitoring role for firms that do not belong to their own group but are in a weak position to perform a true monitoring function on firms belonging to their own group. This means that adequate institutional strengthening is needed to prevent and monitor connected lending and the other potential distortions within family-based groups, which could go unchecked otherwise.

Recent developments in Korea can exemplify the issue further. Since the crisis of 1997-98, there have been difficulties copying the Anglo-American type of governance, but the signs of an evolution towards alternative bank-centered external governance like in Japan or Germany are not yet there. Despite the intensive efforts to enhance the market, most corporate bonds still bear bank guarantees, and the role of banks remains significant, while there are still nationalized. The prospects for the governance system may not become clear until the banks are all privatized and the character of banks as institutional investors as well as creditors are better defined. Corporate governance reform in Korea is very different in character compared to more mature economies, where the governance system faces a transition but is soundly established with a strong legal background. As a young capitalist economy, the governance of family businesses has to start from the very basic point that management must be monitored by

outsiders. In Korea minority shareholders remain still weak and with silent banks, corporate governance still remains at the early stage of transition. Especially after the Daewoo debacle in 1999,³ achieving good governance of financial institutions has become crucial for Korea. At least for a transitional period, it is expected that the banks will have to perform a substantive role in governing chaebols. Indeed, after nationalization, the management of banks was reformed intensively. Now, in most banks, the Chairman of the Board is to be elected separately from the non-standing members of the board, and checks and balances between the standing and non-standing members are carefully designed. Credit management systems were introduced, with the support of foreign banks, to create a credit rating system through the databases and information accumulated by banks to avoid discretionary decisions by certain individuals. But, will these changes suffice for Korean banks to start enforcing corporate governance of the chaebols? In light of what we discussed above, it appears difficult because the location of Korean banks is not (yet) over business groups, even though banks are not (yet) below the groups (Fukugawa, 2002).

The Korean case also illustrates how shareholder activism can be important to enhance corporate governance. Often, in Korea, NGOs, in alliance with minority-shareholders and stakeholders at large have played an important role to prevent the reform from ending up as window-dressing efforts.⁴ Other stakeholders –like employees and sub-contractors external to the group– may also help. Also benefits may be achieved by upgrading internal corporate governance mechanisms. This implies improving the working of the Board, by increasing the presence of outside directors and making their vigilance effective through forcing more disclosure and transparency in accounting and firm level information.

However, internal mechanisms are hardly enough and they can only be supportive when corporate governance is guaranteed through an effective external mechanism, which, again, in the case of East Asia as well as PRC points to bank-based monitoring. But, for bank-based monitoring to work, banks themselves must have good corporate governance. This is the question we turn to next.

3. How to improve corporate governance of banks

3.1. What is special about banks?

In view of our main interest here, we need to cast the major issues of corporate governance within the specificities of banks (Freixas, and Rochet, 1997). According to many authors, what makes banks really different from other businesses is the fact that they jointly (i) offer access to the payment system and (ii) process information and monitoring borrowers.^{5, 6} Specifically,

³ The Daewoo crisis was a turning point for the Korean reform for three main reasons. First, the scale of Daewoo – one of the big-five chaebols– was unprecedented. Second, it was the first time that a chaebol had to be dismantled because of market pressure. Third, it was virtually the first time that the Korean government abandoned the tradition of “too-big-to-fail” (Fukugawa, 2002).

⁴ E.g., since the reform, the People’s Solidarity for Participatory Democracy (PSPD), an NGO has mobilized minority-shareholders and foreign institutional investors to file several lawsuit against the explicit case of expropriation. The members as the minority-shareholders, have attended the annual shareholders’ meeting every year to check management, and indeed, in some case, their activism moved the government to strengthen the legal requirement for corporate governance. For instance in confronting SK’s family, the NGO succeeded in obtaining two outside directors who are given authority to approve intra-affiliate transaction.

⁵ See, e.g., the influential paper by Fama (1985). Also, Mester, Nakamura, and Renault (2001) provide evidence that by observing the borrowing firm’s checking account balances the bank has exclusive access to a continuous stream of borrower data that helps it to monitor the borrowing firm.

these two joint core functions they perform contribute to explain why banks are special and also why they are subject to a specific set of regulations, which differ from what normally applies to other businesses. Banks hold fixed-value deposit liabilities, whose prompt liquidity is vital to the good functioning of the payment system, against uncertain-value loans, which are crucial external finance for opaque borrowers, who would otherwise be rationed on financial markets. However banks are subject to a major moral hazard problem. Their fixed-value deposits enjoy some form of public support –either explicitly (deposit insurance) or implicitly (lender of last resort interventions)– that is needed to prevent breakdown of the payment system. Bank runs might otherwise ensue even without justification, reducing welfare (Diamond, and Dybvig, 1983), thus depositors must be assured they do not stand to lose in order to prevent unwarranted runs and the consequent breakdown of the payment system. Unfortunately, this also means that depositors have no incentive to monitor banks’ risk taking and there may be an incentive for bankers to take more risk than they would in the absence of deposit insurance. Since part of the franchise value of the bank depends on the existence of the deposit insurance, it is then paramount that banks are subject to regulation on allowed activities and also to effective supervision: it is no surprise that weak supervision along with deposit insurance without risk-related premia was the recipe for the increasing gambling and bankruptcies in the US Saving and Loan crisis (Barth, and Bradley, 1989).

The key question, in this respect, is whether prudential regulation and supervision are enough to secure the corporate governance of banks. The answer is negative for two main reasons. First, regulators can only intervene after the crisis has been revealed and, even here, it is not easy for them to be timely and detect weaknesses or even fraud at banks before it is too late to act. Second, authorities frequently lag discovering new risks generated in association with financial market innovation and/or with the exercise of managers’ discretion, or even grant banks supervisory forbearance.⁷

Then the big question is “who monitors the monitor”? In other words, who monitors that bank managers exercise effective monitoring on borrowers, thus avoiding excessive risk taking?⁸ In

⁶ First, banks contribute to the payment system reducing transaction costs and, thus, enlarging the opportunity for exchanges. Second, banks play an important role in dealing with information and agency problems that are at the center of financial markets; banks invest in informational technologies that allow them to: screen applicants (thus, reducing the adverse-selection problem due to asymmetries in information); perform interim monitoring of entrusted borrowers (thus, lowering the moral hazard problem that borrowers behave opportunistically); carry out ex-post monitoring of borrowers, in a way to ensure that the loan contracts will be enforced (thus avoiding that borrowers use defaults strategically to expropriate lenders). According to many commentators, banks also have two additional functions: transforming assets and managing risk. Banks transform assets in three different ways: (a) establishing a convenience of denomination, i.e. choosing the unit size of denomination of products to make it more convenient for their customers (e.g., transforming small deposits in large loans); (b) providing quality transformation, e.g., due to indivisibilities of investments, individual depositors may gain better diversification by channeling their funds through banks rather than investing on their own; (c) performing maturity transformation, typically holding shorter term liabilities vis-à-vis longer term assets. Banks manage various types of risks: credit risk (appraising risk and returns on a bank loan), interest rate risk, and liquidity risk (both deriving from maturity transformation).

⁷ That is why some authors have proposed new monitoring schemes to complement the deposit insurance system while reducing the moral hazard problem: e.g., Calomiris (1999) suggests requiring banks to maintain a minimal proportion of subordinated debt finance so that unsecured lenders will have to step in with the right incentives to monitor; Rochet, and Tirole (1996) advocate reducing systemic risk –and, thus, the undesirable effects of deposit insurance– through peer monitoring among banks in their decentralized mutual lending in the interbank market.

⁸ At first, Diamond (1984) held that this question (and the potential duplication of monitoring costs for depositors) could be ignored, by showing that if the bank is sufficiently well diversified then it can almost perfectly guarantee a fixed return to its depositors and they do not need to monitor the bank’s management continuously but only need to inspect the bank’s books when it is in financial distress. However, later it was recognized that the banker’s incentives to monitor are preserved only if there is no deposit insurance and the first-come first-served feature of bank deposit contracts is maintained, so that the threat of a bank run by depositors still acts as a disciplinary device on managers (Diamond, and Rajan, 2000). Even though one were to consider abolishing deposit insurance to restore the right incentives for the banker to monitor borrowers, many are skeptical of depositors’ ability to monitor bankers due to the

particular, if depositors do not monitor banks and regulators/supervisors may not be enough, are outside directors and/or shareholders effective at monitoring bank managers? Outside shareholders will typically have different objectives than bank managers and hence there is scope for potential conflicts among the two. Outside directors normally do not have direct access to key information to assess the bank's performance, rather they receive such information from management: by and large, this limits the effectiveness of outside directors' monitoring on management (see, e.g., Klein 1998), as the recent corporate scandals (e.g., Enron, Worldcom, etc.) made clear.

Can then the shareholders monitor bank managers effectively? Here we come to a key point. That may depend on whether the bank has a block shareholder. To be sure, in a situation of dispersed ownership, there is not enough incentive for individual shareholders to monitor the company,⁹ whereas the presence of a block-holder –i.e. some form of concentrated ownership structure with at least one large shareholder– may offer a solution, as shown by the experience of continental Europe and other OECD countries outside the Anglo-American tradition:¹⁰ the block-holder has both the interest in monitoring management and the power to implement management changes.

It is then no surprise what Prowse (1995) finds in one of the few papers specifically addressing the issue of corporate governance of banks. He discovers that both a lower takeover threat – partly abated by regulation– and fewer interventions by outside directors weaken the effectiveness of corporate governance of Bank Holding Companies (BHCs), thereby leaving bank managers less disciplined than managers at non-financial corporations. Furthermore, Prowse shows that, lacking action via internal controls, banks running into trouble because of mismanagement will require regulatory intervention, but this late external interventions implies large costs. Finally, he finds that banks in need of regulatory intervention have markedly lower ownership concentration: this suggests that higher ownership concentration at banks might improve performance by motivating greater oversight and monitoring by large shareholders and their representatives on the board of directors.

In addition, if –by disciplining management– the block-holder solution ensures a lower turnover of managers, this will be efficiency improving as the bank will operate under less severe information asymmetry: since banks specialize in information gathering, the turnover of management is costly, as some of the information is going to be lost.¹¹ However, the block-holder is not a solution without cost. There is a tradeoff between the effectiveness of the monitoring of the company via the block-holder and the possibility that he holds up other stakeholders –thus removing the incentives for them (e.g., employees and managers) to make costly firm-specific investment in the company, without which efficiency

expensiveness of processing information and monitoring banks' performance and hence the associated free rider problem (Dewatripont, and Tirole, 1994).

⁹ In an interesting comparative analysis of the three typical modalities of corporate discipline (dispersed ownership with takeovers; bank monitoring; concentrated ownership), John, and Kedia (2000) conclude that the optimal governance mechanism is either: i) concentrated ownership (when bank monitoring is costly and takeovers are not a threat), ii) bank monitoring (when monitoring costs are low and takeovers are ineffective), or iii) dispersed ownership and hostile takeovers (when anti-takeover defenses are low and monitoring is costly).

¹⁰ Among the reasons why block-holders are missing in Anglo-American type countries we may list: the presence of regulatory restrictions on block-holder actions and also the higher liquidity of secondary markets that, by making exit easier, reduce the incentive for block-holders to use voice (in the Hirshman sense) and, thus, their effectiveness as a monitoring device.

¹¹ For example, Ferri (1997) shows that lower branch manager turnover is associated with lower NPL ratios at individual banks; Scott (2000) finds that low account manager turnover at the bank and frequent social contact with the owner of the firm strengthen relationship banking and benefit borrowers in terms of both credit availability and loan pricing.

gains are forgone— or indulges in expropriation, via self-dealing or collusion with management at the expense of minority shareholders. The issue debated in the literature is whether it is possible to design the corporate ownership structure or charter to limit the power of the blockholder in a way to prevent expropriation (due to conflicts of interest) without phasing out the incentives for him to monitor the company effectively (Bolton, Becht, and Röell, 2002).

In fact, strict limits to active and passive bank-firm shareholdings dating back to the 1930s were imposed as a response to the Great Crash: much of the financial fragility condemning the world to a prolonged crisis was seen to depend on misallocation caused by pervasive conflicts of interests. Commercial and investment banks were separated in the US (e.g. the Glass Steagall Act in 1933) and in other countries: their intermingling of interests was judged a culprit behind the 1920s bubble. Though bank-firm cross-shareholding is desirable from the angle of fostering relationship banking and reducing lender-borrower informational asymmetries (Hoshi, et al., 1990), it is dangerous from a moral hazard perspective because it can lead either the lender (or the borrower) under the capture of the borrower (or of the lender), thus producing misallocation of financial resources. Indeed, cross-shareholding strengthens relationship banking and may distort the allocation of credit in both loan and bond markets. While investors can price the latter distortion (Kroszner and Rajan, 1994), this is not so for credit: as argued above, depositors are (and should be) protected by the (explicit or implicit) deposit safety net, hence a major moral hazard problem arises. However, there has been a trend during the 1990s to weaken or remove the limits imposed in the 1930s: e.g., in the US, the Glass Steagall Act was abolished in 1999 as, according to the authorities “market evolution made it redundant” (Krainer, 2000). At present, comparing the major OECD countries, the European Union is the least restrictive (with no limit to shareholdings in both directions), while limits apply in Canada, Japan and the USA (Table 1).

3.2. Does State ownership affect corporate governance of banks?

The heavy regulation that banks are subject to diminishes the extent to which ownership and control over banks can be exercised freely. In view of the literature review above, however, there is still ample scope for corporate governance to influence bank performance and, more generally, to affect the way banks will or will not monitor borrowers effectively. There are two special situations deserving particular attention: (i) State ownership of banks, and (ii) foreign ownership of banks. We will discuss the former in this section and the latter in the next section.

Various papers by La Porta et al. (e.g., La Porta et al., 1997, 1998) analyze the nexus between institutional setup and the functioning/development of financial markets. In general, they find that the degree of investor protection is crucial in this respect: the degree of investor protection is at a minimum in countries with French origin law, while it is at a maximum in countries in the tradition of the common law (UK, USA). Obviously this introduces also the role of the State, as the State itself is always the key actor in drawing up market rules, from which investor protection derives. Indeed, the authors show that, comparing countries, as State ownership increases investor protection & financial market development decrease. Further according to Pagano and Volpin (2002) the degree of investor protection is negatively correlated with the degree of protection in the labor market. They show that “corporatist” economies (especially with coalition governments) deliver low investor protection in exchange for high labor protection while, on the contrary, in “non-corporatist” economies they find high investor protection and low labor protection. Finally, the more widespread is shareholding, the higher is the level of investor protection chosen by the government: i.e., there is a ‘lock-in’ effect of privatizations (Perotti and van Oijen, 1999). According to Rajan and Zingales (2001) choices by “interest groups” hinder financial market development, while ruling governments may oppose financial market

development since, by raising competition, this limits their discretion and their power. They predict that government opposition to financial market development is lower if the economy is open to trade and to capital flows. What is more relevant here is that in a later paper, La Porta, et al. (2002) directly address the issue of government ownership of banks. The authors maintain this is a very special case to verify the “political” theories of the distortions induced by State intervention in financial markets. Their main finding is that, again comparing countries, after State ownership of banks increases, the growth of financial markets, of per capita income and of productivity are all lowered. Thus, even though some preliminary work by respected scholars fails to find a negative effect of State ownership on bank profitability indicators (Lang and So, 2002),¹² the general consensus in the literature is that State ownership of banks is detrimental to bank efficiency, to the development of financial markets and, through these channels, also to economic growth.

3.3. The role of foreign banks: wholesale vs. retail; small vs. large countries

In recent years there has been a growing debate as to whether the entry of foreign banks benefits emerging economies. Such benefits would accrue through various possible channels but would essentially stem from two main considerations: (i) the fact that foreign banks are likely to be more efficient (and possibly more independent) than banks in emerging economies and, thus, their entry might foster virtuous competition for the receiving banking systems; (ii) the fact that their business in emerging economies is a small share of the group’s total business and, thus, foreign banks’ presence might provide a cushion against negative shocks hitting a specific emerging economy.

To better understand how these channels could operate, it is important to describe the different modes through which foreign banks may enter emerging economies. There are essentially three ways in which foreign banks may expand their business in emerging economies: (i) providing loans and asset and liability management to foreign counterparts in those countries; (ii) opening a foreign branch in those countries; (iii) acquiring a foreign bank (subsidiary) in those countries.

The first of these three modes is the least interesting for our purpose. Indeed, there may be little impact in the receiving country if foreign banks extend loans there from their own home base without physically entering the market with either a branch or a subsidiary. In such a case, in fact, the foreign bank operates arm’s length lending and does not make specific investments into the receiving country. Most likely, only large companies will benefit from such foreign bank operations. Also, even though this type of international loan has increased over the years (BIS, various years), its growth has been much slower than that of the other two modes of foreign bank penetration.

¹² It is worth mentioning three among the objections that were raised in the discussion of this preliminary study. First, the paper refers to listed banks only. As such, it is possible that the performance of the State owned banks is biased upwards. Differently from private owners, governments will decide to list the banks they own only if they are well performing: as a matter of fact, none of the four Chinese SOCBs is listed, as it happens in other transition economies and less developed countries with little developed capital markets. Second, restricting the attention of the effects of government ownership on bank profitability indicators only is too narrow. On the one hand, one should focus on bank efficiency rather than profitability, as higher profitability could just derive from larger market power. On the other hand, the paper does not disprove the finding by La Porta, et al. (2000) that after State ownership of banks increases the growth of financial markets, of per capita income and of productivity are all lowered. Third, the study relies on data for one year only (1997) and may be unable to capture the benefits from the privatization of banks which are expected to accrue over time.

As to the number of foreign bank branches, they increased very rapidly from about 1960 to the mid-1980s but slowed significantly after 1985 (Brealey and Kaplanis, 1996). In contrast, the number of cross-border mergers and acquisitions in the banking industry has risen rapidly in the 1990s (Berger, 2000). Acquiring a subsidiary entails a much more significant cost and may have a much more pervasive effect than opening up a branch. Acquiring a subsidiary, in fact, involves a much larger sunk cost than opening a branch. Branches are usually smaller-sized and more flexible structures that may be opened or closed with relatively lower cost; on the contrary, subsidiaries imply significant costs of various types (from undergoing host country laws and regulation to taking on host country risk, as revealed by the Argentine crisis). In addition, foreign bank branches will typically specialize in wholesale activities (thus replicating on a larger scale what already achieved through foreign banks extending loans abroad from their own home base), whereas subsidiaries are much more likely to venture into retail activities. As a consequence, it is expected that the impact exerted by subsidiaries will be much deeper in terms of heightening competition for domestic banks.

Overall, it appears that a significant retail presence of foreign banks is desirable for emerging economies since it may improve the efficiency of domestic banking systems (Claessens, et al., 2001; Focarelli and Pozzolo, 2001) and better management fortifies banks versus negative shocks: e.g. the East Asian crisis saw a large number of distressed financial institution but none of them was owned by a foreign bank (Bongini, et al., 2000). Also a large retail penetration by foreign banks may cushion emerging economies against negative shocks as these foreign banks' business there is a small share of the group's total business (Dages, et al., 2000). As such, foreign bank penetration may reduce the macroeconomic cost of regulatory stiffening in emerging economies (Chiuri, et al., 2002) and, possibly, even prevent the twin crises of the exchange rate and the banking system (Kaminsky and Reinhart, 1999).

But what is the status in terms of foreign bank entry in emerging economies? Foreign bank entry has been especially pronounced there, although the pattern of entry has not been geographically uniform. In some Latin American and Central- and Eastern-European countries over 50 percent of total banking assets are now foreign-controlled (Figure 2A). In Asia, Africa, the Middle East and the former Soviet Union progress has been slower, but the trend is similar. Furthermore, even though cross-border mergers and acquisitions are significantly fewer in banking than in other businesses, towards the end of the 1990s the trend for the former has increased more than for the latter (Figure 2B). Focarelli and Pozzolo (2001) argue that the lower incidence of cross-border mergers and acquisitions in the banking sector can depend on the high information asymmetries in banking relationships (e.g. it might be more difficult to judge the value of a bank than that of a manufacturing firm) and on the presence of stronger regulatory restrictions in banking. They also find empirical support for their claims on the basis of data for 24 OECD countries.

In a subsequent paper, Focarelli and Pozzolo (2002) address three additional relevant issues pertaining to the expansion of foreign banks abroad. First, still on the basis of a large sample of OECD countries, they find that the banks that are more likely to expand abroad are: larger-sized banks; more efficient and more profitable banks; banks from countries with more developed banking systems; banks from countries that are more open to international trade. Second, they try to identify which factors are most relevant in affecting the choice of the target country, where foreign banks decide to expand abroad. Empirical studies generally suggest that three major factors affect the choice of the host country and of the strategy of expansion: (i) the degree of integration between home and host countries ("follow the client" strategy); (ii) profit opportunities in the destination country; (iii) the institutional set-up of the destination country. Using data on investment in foreign branches and subsidiaries of 260 large banks from 29 OECD countries into each one of the other OECD countries, they find evidence that banks are more likely to choose a

target country that has: (i) larger trading activity with their own home country (i.e. countries where home national customers have larger activities linked to the “follow the client” hypothesis); (ii) the same language and other cultural similarities with their own home country (the institutional set-up hypothesis); (iii) lower per-capita GDP (the profit opportunities hypothesis); (iv) higher education levels (institutional set-up hypothesis); (v) larger credit/financial markets (profit opportunities hypothesis); (vi) less efficient banks (profit opportunities hypothesis); (vii) a similar legal and institutional framework to that in the home country (institutional set-up hypothesis); (viii) a high-quality legal and institutional set-up (institutional set-up hypothesis); (ix) lower regulatory restrictions on banking activities and lower concentration of the credit market (institutional set-up hypothesis). They also ask how banks expand abroad – by opening up branches or acquiring subsidiaries, and find that foreign banks are more likely to open branches in financial centers, while the choice to open a branch abroad instead of acquiring a subsidiary is not much affected by the existence of regulatory restrictions or the quality of the legal system. Overall, Focarelli and Pozzolo’s findings suggest that, while in Europe and in the U.S. domestic banks are generally more efficient than foreign-owned banks, by contrast, in emerging economies foreign entry seems to improve banking system efficiency and to contribute to overall banking stability.¹³

It is important to stress that retail entry by foreign banks is more desirable than their wholesale entry, which might even channel to the country “hot money” and favor procyclical swings in capital inflows. In turn, foreign banks will more likely wish to go retail (a long-term investment with sunk costs) if they come from countries with strong trade integration (Focarelli and Pozzolo, 2002) and industrial FDI flows to the destination country because this generates economies of scope.¹⁴ For PRC, then this could mean that the most promising foreign banking partners would come from Germany, Japan, Singapore, Taipei, China, UK large banks chartered in Hong Kong, China and the USA.

A separate issue that has thus far received not enough attention in the literature relates to the timing with which foreign banks are more likely to enter a target country. Figure 2A is telling in this respect: over the period of observation (1994-99) virtually all of the countries experiencing a quick penetration by foreign banks are countries suffering a financial crisis. Thus, it looks like financial crises are likely to trigger a situation in which both demand for better banking and lower resistance on the part of national authorities pave the way for easier penetration by foreign banks.

3.4. Some Empirical Relations

To be sure, specific considerations are needed for larger-sized emerging economies. As is apparent from Figure 2A, even among countries experiencing financial crises, the extent of foreign bank penetration is smaller in larger-sized countries: e.g. it is smallest in Brazil and Mexico, the largest emerging economies in this list. This type of relationship may be exemplified by the following two graphs, where we report by country both the population on the horizontal axis (logarithm of millions inhabitants) and the share of foreign banks’ assets (percentage) on the vertical axis. Figure 3A refers to all countries for which we could gather data for 1999 from

¹³ Once more, even though preliminary work by respected scholars does not find a positive effect of foreign ownership on bank profitability indicators (Lang and So, 2002), the relevant literature tells us quite firmly that the presence of foreign banks can be beneficial to bank efficiency, to the development of domestic financial markets and, thus, also to economic growth in emerging economies.

¹⁴ See, among others, Yamori (1997) and Esperanca and Gulamhussen (2001) for evidence on foreign banks’ FDI following or leading their home national customers.

Barth, et al., (2001), while Figure 3B focuses only on the sub-sample of non-OECD countries. It is interesting to note that, limiting our attention to countries with more than three millions inhabitants (smaller countries are often financial centers and respond to different motives), both figures imply a strong negative trend as population increases. Comparing the two figures, it is interesting that the negative relationship is stronger for non-OECD countries, as testified by the better fit of the interpolating line, as well as by the fact that the predicted foreign banks' penetration decreases faster for non-OECD countries. Indeed, comparing a hypothetical country with 3 million inhabitants drawn from the total sample and a country with the same population drawn from the non-OECD sub-sample, the estimated foreign bank penetration is 27 percent for the former and 34 percent for the latter; however, as we increase the population of the two countries to 675 millions, foreign bank penetration becomes zero for both.

Furthermore, it is important to ascertain whether there is any evidence of a negative relationship between the extent of government ownership of banks and foreign banks' penetration. Such a relationship could, in fact, be the result of government ownership directly shielding domestic banks from acquisition by foreigners and/or government ownership indirectly proxying for hidden obstacles to acquisition of domestic banks by foreigners. The cross-country evidence confirms the existence of such a negative relationship. Figure 4 shows that the share of foreign banks decreases as government ownership increases. To check that this relationship is statistically significant, we run a cross-country regression, where foreign banks' asset share is the dependent variable and we include the extent of government ownership of domestic banks plus other control variables as regressors. The result of the estimate is reported in Table 2. It is confirmed that the penetration of foreign banks is larger in emerging economies (positive sign of the non-OECD dummy) and decreases with the size of the country (as measured by its Gross National Income). In addition, foreign banks' asset share is larger in non-English speaking countries (negative sign of the ENGL dummy), which might on average have less efficient banking systems and, thus, more likely offer targets for banks from (on average, more developed) English speaking countries. What is most important to us here, however, is that the negative relationship between government ownership (negative sign of GOVTOWN) and foreign bank penetration is strongly confirmed: if country A and country B are otherwise similar and country A has 10 percent more government ownership than country B, foreign banks' asset share in country A is going to be 4 percentage points lower than in country B.

Finally, examining the credit ratings obtained by national banks may shed some light on whether the presence of foreign banks helps strengthen the credit standing of national banking systems and, thus, reduce the cost of capital for banks. Following Liu and Ferri (2003), we apply a commonly used market-monitoring indicator, credit ratings of banks, to assess the overall risk profiles of national banking systems around the world. Since 1995, a new rating scale -bank financial strength ratings (BFSRs) - has been published by Moody's to grade the intrinsic strength of a bank as a standalone, thus disregarding any external support. BFSRs are published in addition to overall bank credit ratings (BCRs), where BCRs take into account not only banks' own financial performance but also other institutional factors such as the macroeconomic environment, the quality of supervision, and the implicit or explicit deposit insurance setup. Liu and Ferri show that there is a gap between BFSRs and BCRs and quantify the credit enhancement that can be attributed to the institutional factors mentioned above. Specifically, they show that the ratio between BCRs and BFSRs can be taken as a proxy for the potential liabilities for governments stemming from sovereign guarantees markets perceive behind national banks.

In particular, what we need to establish here is whether the extent of foreign bank penetration and/or of government ownership of banks affects these hidden liabilities. For this we may look

at the ratio between BFSRs and BCRs and check whether it varies across countries together with different values of foreign bank penetration and/or government ownership of banks. If the ratio BFSR/BCR is above 1 or just a little below 1, this suggests that the government is bearing only little (or no) hidden liabilities. On the contrary, hidden liabilities will mount as the ratio BFSR/BCR moves much below 1.

Figure 5A shows that the ratio BFSR/BCR tends to increase (i.e., government bank-related hidden liabilities tend to decrease) as foreign banks' asset share increases. Furthermore, Figure 5B demonstrates that the positive relationship between foreign bank penetration and the ratio BFSR/BCR is much stronger in emerging economies than in the sample including all of the countries. As to government ownership, Figure 6A, for all the countries, confirms that the ratio BFSR/BCR tends to decrease (i.e., government bank-related hidden liabilities tend to increase) as the government ownership share in the national banking system rises. Analogously to the above, Figure 6B shows that such a negative relationship is stronger if we limit the analysis to non-OECD countries only.

Next we checked whether the relationships we outlined between the ratio BFSR/BCR, foreign bank penetration and government ownership are statistically significant. In practice, we estimated two different regressions, the first linking the ratio BFSR/BCR to the extent of foreign bank penetration while the second relates the ratio BFSR/BCR to the level of government ownership.¹⁵ The ratio BFSR/BCR is always the dependent variable while foreign bank share and/or government ownership of domestic banks plus other control variables feature as regressors. The result of the estimate relating the ratio BFSR/BCR to foreign bank penetration is reported in Table 3. As expected, the ratio BFSR/BCR tends to decrease as BCR increases (negative sign of LBCR). In other words, the extent of hidden bank-related government liabilities tends to increase for countries with high average BCR, likely reflecting the relatively high sovereign ratings these countries also enjoy. It appears that this effect is relatively stronger for emerging economies (negative sign of NOLBCR). Country size does not seem to affect the ratio, as both POP and SURF turn out not to be significant. Also DIST is not significant. We detect a positive impact of per capita Gross National Income (positive sign of GNIPC) suggesting that liabilities tend to be smaller in richer countries (but this coefficient is only marginally significant). Liabilities are also smaller in English speaking countries (positive sign of ENGL). What is, however, most interesting to us here is our finding on foreign bank penetration. It appears that as foreign banks' asset share increases there is no effect over the whole sample but there is a positive and significant impact for non-OECD countries. This confirms that opening up to foreign banks is associated with a reduction in the government's bank-related hidden liabilities for emerging economies. It is expected that this effect comes from sounder banking, which causes an increase in BFSR (the numerator of our ratio), as suggested by Crystal, et al. (2002) for Latin America.

The results of the estimate relating the ratio BFSR/BCR to the extent of government ownership of banks are reported in Table 4. As above, the ratio BFSR/BCR tends to decrease as BCR increases (negative sign of LBCR) and is positively related to the country's per capita Gross National Income. Interestingly the share of government ownership of banks has a strong negative impact on the ratio BFSR/BCR. It is likely that this happens because a larger share of government owned banks is associated with a less efficient banking system. This is consistent with La Porta, et al. (2002), although the result is obtained with a different measure of efficiency.

¹⁵ The reason we chose to estimate the two relationship separately stems from the fact that we have fewer observations for government ownership of banks.

4. The status of corporate governance of banks in PRC

What is the position of PRC in the above? PRC is no outlier: its large government ownership of banks is associated with very low penetration of foreign banks and large hidden bank-related government liabilities (as revealed by the low value of its BFSR/BCR ratio). Perhaps, it is no surprise that PRC's gradualist approach to transition has not yet adequately addressed the problem of reforming its banking system. As much as the success story of the second track did not focus on structural adjustment of Chinese SOEs due to lack of major institutional reforms (Oppen, 2001), this lack of focus also slowed banking reform. However, it seems that PRC is now coming to grip this problem, which is potentially endangering fiscal sustainability with estimated bank NPLs at some 40 to 50 percent of GDP (Liu, 2002; APF, 2002).

The crux of the problem lies with SOCBs and their corporate governance. Figure 7 reminds us that these four banks (Industrial and Commercial Bank of China, Bank of China, China Construction Bank, Agricultural Bank of China) account for more than two thirds of bank assets. Government ownership made SOCBs unable to deny credit to SOEs. SOEs would then face soft budget constraints and SOCBs would get large amounts of NPLs in return.

Upgrading the corporate governance of SOCBs is urgent. While infeasible (and possibly even counterproductive) in the short-term, introduction of private capital into these banks should be viewed as a long-term goal (control must be contestable even if the State remains as the main shareholder). However, in the short term measures can be taken to shore up mismanagement and build a consistent set of incentives to improve the functioning of these banks. At the same time, PRC should not underestimate the potential of its newly bred banks (Joint Equity Commercial Banks and also City Commercial Banks, which we will term Diversified Ownership Commercial Banks, DOCBs). These banks have clearly shown good vitality. Their corporate governance structure permits them to reach a better performance than SOCBs. As a result DOCBs are effectively intensifying banking competition in some important parts of PRC. It is then crucial for us to assess in detail the differences between SOCBs and DOCBs. In the first place, this will help us judge whether the growth of DOCBs can effectively be a major part of the solution to upgrade banking in PRC. Secondly, we need to understand what is (and what is not) working in their corporate governance, in order to evaluate what can be learned to improve the corporate governance of the SOCBs. In what follows, we will use various instruments to accomplish these tasks. After comparing performance indicators for SOCBs, DOCBs and a selected group of international Asian peers, we will argue that it is possible to think of a "growing out option" where DOCBs could easily overtake SOCBs by as early as 2010. We will then draw on field survey evidence on the workings of corporate governance at some selected institutions. The evidence collected for the Bank of China (perhaps the best performing SOCB) will be contrasted with that for the City Commercial Bank of Shanghai and with that for other listed banks.

Foreign banks should also be considered. First, as minority shareholders they are already involved in the success story of some DOCBs (e.g. the City Commercial Bank of Shanghai). Furthermore, foreign banks are an essential ingredient to step up competition and contestability in PRC's banking market. At the same time, in view of what we spelled out above, since PRC is such a large country, we cannot expect that foreign banks replace domestic banks to a large extent. The best scenario we may envisage is one in which foreign bank competition adds to the competition exerted by domestic DOCBs and SOCBs are, thus, forced to restructure and become more efficient in order to survive.

4.1. DOCBs and SOCBs: some performance comparisons

The difficulties of PRC's SOCBs have recently gained much attention and are judged to have serious macro consequences (IMF, 2002). Informed estimates are hard to make but credible assessments put the NPLs accumulated at SOCBs at around 40 percent of GDP (Liu, 2002; APF, 2002). To a large extent these NPLs were generated by the fact that State ownership of both firms and banks engendered political influence making it virtually impossible for SOCBs to deny loans to SOEs. This even though it was expected that poor performing SOEs would hardly be able to pay back. As SOEs are being corporatized and as SOCBs have been asked to rein in their lending, the previously very soft budget constraints of SOEs may have become a little harder.

It is important to observe that a new breed of domestic banks has been expanding relatively fast over the last few years in PRC. These banks belong to the two groups of Joint Equity Commercial Banks and City Commercial Banks. Even though not owned just by the central government, these banks usually enlist local and/or central State institutions as significant shareholders. However, what distinguishes them from SOCBs is that they have a plurality of shareholders. Even when all shareholders are institutions belonging to the public sector, their plurality ensures that multiple interests are represented on boards of directors. Although, pursuing maximization of shareholder value may be complicated because of multiple interests, at the same time the plurality of shareholders minimizes the risk that the bank is captive to influential customers, and can improve banks' monitoring capacity and give managers the right incentives to take efficient decisions.

Hereafter, we will discuss both Joint Equity Commercial Banks and City Commercial Banks under the name of Diversified Ownership Commercial Banks (DOCBs) and, using balance sheet and profit and loss account data drawn from Bank scope, we will compare the performance of DOCBs with that of SOCBs. We will also judge the four SOCBs against a group of four large international Asian banking peers, - Hong Kong Shanghai Bank Corporation (Hong Kong, China), United Overseas Bank (Singapore), Tokyo-Mitsubishi Banking Corporation (Japan) and Kookmin Bank (Korea). The list of DOCBs for which we could recover data from Bankscope includes 22 banks, in decreasing order of size: Bank of Communications, China International Trust and Investment Company (of which we took data for the bank subsidiaries only), China Merchants Bank, China Everbright Bank, China Minsheng Banking Corporation, Hua Xia Bank, Fujian Industrial Bank, Bank of Shanghai, Beijing City Commercial Bank, Hangzhou City Commercial Bank, Xiamen International Bank, Bank International Ningbo, First Sino Bank, Tianjin City Commercial Bank, Qingdao International Bank, Shenzhen City Commercial Bank, Wuxi City Commercial Bank, Xiamen City Commercial Bank, Dongguan City Commercial Bank, Nanjing City Commercial Bank, Ningbo City Commercial Bank, Sin Hua Bank Limited. Finally, we also included for comparison the basic performance indicators for two subsidiaries of SOCBs incorporated in Hong Kong, China, namely Industrial and Commercial Bank of China, Hong Kong, China and Bank of China, Hong Kong, China.

We considered three basic measures of productivity: assets per employee, returns per employee and employees per branch. Figure 8 reports the comparison across the first three groups for 2001. SOCBs show significantly smaller assets per employee and returns per employee vis-à-vis both DOCBs and the international Asian peers. As to assets per employee, SOCBs have just 9 millions RMB, compared to 38 for DOCBs and 123 for the Asian peers. As to returns per employee, SOCBs have just 14 thousands RMB, compared to 237 for DOCBs and 411 for the Asian peers. In addition, SOCBs show clear signs of overstaffing with respect to the international Asian peers (20 employees per branch against 8) but not with respect to DOCBs

(30 employees per branch). The large number of employees per branch of DOCBs can perhaps be explained by the fact that they are urban banks and, thus, their branches are city branches.

We also looked at two usual profitability indicators: returns on average assets (ROAA, defined as the ratio of profits in year t to the average of assets at end year t and assets at end year t-1) and returns on average equity (ROAE, defined as the ratio of profits in year t to the average of equity at end year t and equity at end year t-1). Figure 9 compares the four groups of banks in terms of these two indicators for 2001. SOCBs' profitability is very low: their ROAA and ROAE are 0.16 and 3.13 percent respectively, just about one third of what achieved by DOCBs (0.46 and 10.18 percent) and just about one fifth of what achieved by the international Asian peers (0.86 and 13.60 percent).

It is particularly instructive to notice that the subsidiaries of the two SOCBs operating in Hong Kong, China by and large match the profitability of the international Asian peers, with a ROAA of 1.47 and ROAE of 9.44. The message we can draw from this is that SOCBs are not always badly managed and their poor performance depends on their operations in mainland PRC. In other words, it is of utmost importance to upgrade their corporate governance.

We also looked for some other major differences between SOCBs and DOCBs that could be spotted from balance sheet data,¹⁶ and found indications that the former are less liquid and undergo more maturity transformation than the latter. As shown in Figure 10, interbank net liabilities are 4.1 percent for SOCBs, as against only 1.4 for DOCBs; dependence on short term funding is, respectively, 74.2 and 61.9 percent; short-term liabilities' excess over short-term assets (a measure of the extent of maturity transformation) is, respectively 27.7 and 12.6 percent. In all, SOCBs appear less liquid and more exposed to the risk of sudden withdrawals of short-term funding. However, consistently with the rapid growth experienced by these banks, deposits appear to be less stable at DOCBs, representing a potential vulnerability.

Two further qualitative findings identified via the field survey are worth mentioning. First, DOCBs usually choose an 'in-big-city' development strategy (like locations in Beijing, Shanghai, Guangzhou, and Shenzhen) which should pay off since these areas might grow faster. Second, it seems that DOCBs outperform SOCBs also in terms of product and process innovation; for example, they pay special attention to non-credit assets business and off-balance-sheet activities; all strive to lead the trend of new products, especially e-banking.

4.2. Growth of DOCBs: is a growing out an option?

The fact that DOCBs show better performance and a more balanced asset/liability structure tells us that their progress may be well grounded. It is then important to quantify how quickly DOCBs are gaining market share because, at least in principle, their emergence could offer PRC a way to grow out of its SOCBs and their problems. Comparing 1997 and 2001, the start and end of the five-year period for which it was possible to reconstruct acceptably continuous data for these banks from Bank scope, we see that DOCBs' market share has increased by 37 percent (from 11.3 to 15.5 percent) in terms of total assets, and by more than 26 percent (from 9.9 to 12.5 percent) in their market share over deposits. They had a 73 percent increase (from 7.9 to 13.7 percent) in their market share over loans and an even greater 208 percent increase (from 9.7 to

¹⁶ We refrained from comparing NPLs because such data were either missing for some SOCBs or their reliability was particularly dubious.

22.2 percent) in their market share over loan loss reserves (Figure 11). The relatively larger expansion of DOCBs' market share in terms of loans suggests that these banks have been enlarging their loan supply at a time when SOCBs were apparently retrenching their supply of credit. As such, DOCBs may have contributed to attenuate the credit crunch that has reportedly afflicted PRC over the recent years.

Can then DOCBs offer PRC a "growing out option"? In other words, can DOCBs replace less efficient and troubled SOCBs quickly enough? Though it may seem exaggerated to even contemplate the possibility that a group of banks presently accounting for just one eighth of PRC's deposits might quickly enough supplant SOCBs, we wanted to evaluate some reasonable scenarios before discarding such an option. To this end, we performed a simple computation by extrapolating up to 2010 the asset growth effectively recorded on average by SOCBs and DOCBs over the period 1999-2001. The annual rate of growth of assets for this period was, respectively, 9.7 and 25.3 percent. Simply extrapolating such recent rates of growth would bring DOCBs' market share up to 38 percent by 2010 (Figure 12). We also computed two alternative scenarios in which one of the SOCBs (alternatively the smallest, Agricultural Bank of China, or the largest, Industrial and Commercial Bank of China, ICBC) is transformed into a DOCB at the beginning of 2004.¹⁷ By 2010, the DOCBs' market share rises to 58 percent with the transformation of Agricultural Bank of China and to 69 percent with the transformation of the ICBC.

Naturally, these computations are crude, but they convey the message that a gradual growing out option relying on DOCBs to replace SOCBs is not totally unrealistic. Even though improving the corporate governance of SOCBs is a top priority, at the same time the experience of other transition economies shows that more rapid progress can be made relying on new banks as opposed to rehabilitating old State-owned banks (Claessens, 1998).

4.3. Internal governance of banks: field survey evidence

To reveal the current status of corporate governance at the various categories of banks in PRC, surveys of bank executives were conducted as part of this study. The banks covered were: the Bank of China (one of the four SOCBs) and representing the DOCBs four listed joint stock commercial banks (China Merchants Bank, China Minsheng Bank, Shanghai Pudong Development Bank and Shenzhen Development Bank) and the Bank of Shanghai (one of the best performing City Commercial Banks, CCBs derived from the consolidation of urban credit cooperatives).

According to the survey evidence, the corporate governance structure of PRC's banks still needs to be improved. However, significant differences emerge between the DOCBs and the SOCBs.

As represented by the experience of the Bank of China, at SOCBs the functions of the Board of Directors and the Board of Supervisors prove generally inadequate: even though these banks have established the two boards, most of the directors and supervisors are appointed or selected by the relevant departments of the government. The Bank of China has a Board of Directors with 60 members, which clearly makes the Board only a formal and perfunctory committee, rather than a decision-taking one. In practice, the Party substitutes for the function

¹⁷ To keep our computations simple, we assumed that, upon turning DOCB, the SOCB that is transformed takes on the rate of growth of assets of DOCBs. Overall the Chinese banking system's asset growth by 2010 spans a minimum of 15 percent in the baseline scenario, to 18 percent in the case where the Agricultural Bank of China is transformed, and to 20 percent in the case where the ICBC is transformed.

of the Board of Directors: all of the senior managers of Bank of China are appointed by the Party Committee and in effect the Board of Directors is made up of 'inside directors'. The weak governance of SOCBs is further complicated by the fact that PRC's government has not established a department to exercise its rights as the investor and owner of the banks, and the four major state-owned commercial banks do not hold shareholders' general meetings. Consequently, in practice, the shareholder rights of the state are exercised separately by various departments of the central government (e.g. PBoC, Ministry of Finance, State Council, Central Financial Commission of Chinese Communist Party, National Audit Office). Since the policy goals of the various departments may often be inconsistent, there is the risk of lack of clear direction for the banks. A further problem is the lack of information transparency; SOCB operational and financial data are national economic secrets, not to be disclosed for a long time. Poor credit management is a key problem at the Bank of China (possibly representative of all SOCBs) stemming also from the inadequate distribution of information and credit assignment authority between headquarters and branches. Furthermore, the audit system in the headquarters is not independent—rather it is one of the functional departments responsible to the Party Committee—and audit results are not transparent—usually kept highly secret making it impossible to rectify and improve the loan performance via supervision. As a result of their poor credit management, as noted above, the loan market share decreased significantly for SOCBs in recent years.

Lack of responsibility also represents a serious problem. At SOCBs, though a clear division of responsibility and functions is in place, since senior managers (including the President) are 'government officials', they are rarely held accountable for their operational decisions. As a matter of fact, to date no senior manager of a SOCB has been demoted or removed for failing to reach targets (e.g. on operating cost, profits, loan quality or service quality). By the same token, the achievement of better performance does not carry economic incentives for senior managers, but only brings them praise and from superior officials. Since 1997, the Presidents of PRC's four SOCBs have been rotated and reallocated over and over making it extremely difficult for a President to carry out a long-term plan for their bank.

Additional problems derive from the fact senior managers obey administrative rules (a remnant of the planned economy) rather than market incentives. This has a significant adverse effect on SOCBs' governance structure. Problems include

- (1) Since senior managers (including the President) are appointed, removed and examined by the administrative departments of the government, once a problem arises, the senior managers would rather challenge the Boards of Directors or Supervisors rather than the superior government departments.
- (2) "Insider control" prevails, with directors and supervisors possibly echoing the opinions of senior managers rather than the other way around.
- (3) Due to the constraints of the property rights system and the administrative system, the goal of an SOCB is rather ambiguous: it is dubious whether banks really have to strive for profits since, from time to time, they also have to fulfill 'political tasks' indicated by the government.
- (4) Banks generally lack basic incentive-constraint mechanisms. At SOCBs it is only too difficult to establish any incentive mechanism as governmental administrative departments heavily influence the remuneration and treatment of senior managers (including the President) which have to be identical with that of civil servants at the same administrative rank. As a result, relevant data may not even be collected; for the example the Bank of China does not have a quantitative performance evaluation system.

Even at the four surveyed joint stock commercial banks the majority of shares are still held by the public sector.¹⁸ In spite of this, at these banks the shares owned by individual shareholders are clearly defined, and these banks also convene annual shareholders' meetings. However, since the shareholders are state-owned enterprises, there are still problems with their shareholders' general meetings. Shareholder representatives from SOEs

- (1) Tend to be rather passive;
- (2) Have a high turnover and, as the newcomers lack sufficient knowledge of the previous meetings, they can only vote in a perfunctory manner;
- (3) Are seldom proactive in putting forward proposals on key issues (e.g. internal governance, operation and development, financial innovation);
- (4) Pay little attention to the protection of minority shareholders.¹⁹

Contrary to the situation at SOCBs, at joint stock commercial banks and CCBs, most directors and supervisors are recommended by the shareholders and elected at the shareholders' general meeting; however, we should recall that controlling shareholders generally belong to the public sector. Furthermore, independent directors account for about 1/3 of all directors on the Board of Directors of the surveyed four listed banks. Yet, even where directors and supervisors are more effective, they are not entitled to directly appoint, relocate or remove senior managers (including the President) of the bank, and they do not even have a right to make recommendations. On the contrary, almost all proposals to the Boards of Directors and of Supervisors are put forward by senior managers (including the President).

Compared with SOCBs, the situation is better at joint stock commercial banks and CCBs in terms of:

- (i) Disclosure, but even these banks do not yet conform to international standards—e.g., some relevant details about shareholders' views and voting records at shareholder meetings are not (yet) disclosed at the four surveyed listed banks;
- (ii) Managers' responsibility—over the past few years, in a number of cases senior managers have been removed due to poor performance;
- (iii) Managers' incentives—e.g., the remuneration and other welfare of senior managers and bank clerks can embody some incentive, but there is still a huge gap if they are compared with foreign banks.

Perhaps with the exception of the Bank of Shanghai (BoS) and a few others, most of the CCBs share the same problems with joint stock commercial banks. BoS was the first domestic commercial bank to attract equity investments from foreign commercial banks, with foreign investment accounting for 18% of total equity by end 2002.²⁰ Equity participation by foreign financial institutions (they appoint two out of twelve Board Directors) strengthened ownership diversification and accelerated progress in corporate governance at BoS. The government's

¹⁸ Actually, this is not true for all of the four banks, as China Minsheng Bank is the exception. Also, for all of them, the ten largest shareholders are still related to each bank's sponsoring background, the degree of ownership concentration is high and also high are the proportion of non-negotiable shares and that of shares held by legal entities, where, according to some empirical research, the latest feature is negatively correlated with corporate performance.

¹⁹ Shenzhen Development Bank is the possible exception in this respect.

²⁰ Soon after its incorporation (in 1995), BoS engaged to build a strategic partnership with the International Finance Corporation (IFC). After various contacts and auditing (1997-99), BoS and the IFC reached an effective agreement on equity investment (Sept. 1999). In Dec. 2001, BoS attracted equity investments from the HKSBC Ltd. and (Hong Kong, China-based) Shanghai Commercial Bank, while the IFC increased its equity stake in the bank.

power to influence the decision-making of management has been weakened: at present, the number of non-government-related directors greatly exceeds that of government-related directors (respectively, ten to two), hence, ownership diversification helps BoS reduce the interference of the local government, which is still a problem for some of the CCBs in PRC.²¹ In turn, the establishment of non-preferential relationships with the local government helps in information disclosure: for example, it was easier for BoS than for many other banks to disclose the real situation of its NPLs.²²

BOS took various steps to improve its corporate governance.

- (i) It started introducing international accounting standards to gradually standardize and improve information disclosure and, though it is not listed yet, it is planning to fulfill the requirements for listed companies in this respect;
- (ii) It introduced a performance assessment mechanism for management.

The specific way in which it enhanced its ownership diversification—with new foreign bank equity participation—helped BOS expand its capital base, thus improving its capital adequacy ratios without cutting loans, especially to SMEs.²³ The case of BoS indicates that increasing capital adequacy ratios through external sources is a feasible way to alleviate financial difficulty or credit crunch for SMEs during the process of banking consolidation. By absorbing external capital, especially the capital of foreign banks, BoS not only improved its capital adequacy ratio in a short time but also increased its credit to SMEs. During 1999-2001 BoS registered an increase of 31% and 77% in its short-term and long-term loans respectively, and most of them went to SMEs. In fact, in spite of its strong growth (average annual growth of assets was about 15% since 1995), BoS maintained its traditional specialization in loans to SMEs.

All in all, it seems that further growth of the DOCBs, the development of the capital market and the introduction of foreign competition are key components to enhance corporate governance at PRC's banks. Indeed, BoS' experience shows that foreign bank equity participation may be an important trigger to promote better governance. In addition, a major obstacle to DOCBs'

²¹ At present, the local government appoints the Chairman of the Board of the bank but cannot directly designate the general manager of BoS. Still, the general manager is nominated or even selected by the Chairman of the Board, even though the appointment has to be approved by the Board of Directors. To further improve the situation of BoS and bring to international practice, the members of the Board especially the Chairman should be selected by the shareholders' general meeting.

²² In fact, NPL write-offs and provisioning directly reduce the bank's profit, and hence, shrink the tax base of the government. For SOCBs, such actions curtail the income of the Fiscal Department and when they want to go for NPL write-off and provisioning, SOCBs often face obstacles from the government. Accurate information about NPLs cannot be disclosed, thus contributing to the accumulation of NPLs at SOCBs. However, with diversified ownership, all shareholders, not just the government, have to ultimately undertake the loss. Thus with more diversified ownership the government is more flexible in dealing with NPL write-off than when it is the sole owner. In the case of BoS, the Fiscal Department of Shanghai seldom bargained with the bank on the amount of write-offs. Thus, reducing the institutional distortion in information disclosure is one of the important by-products of the improvement in corporate governance.

²³ It is believed that SMEs are most vulnerable to bank consolidation, since to increase capital adequacy ratios, banks usually decrease credit portfolios, especially loans to SMEs. In 1998, when PRC's financial sector accelerated its restructuring, SMEs were reportedly hit by a credit crunch. In this respect, improving capital diversification and attracting external capital may prove an effective approach to protect SMEs from the credit crunch. On this, compared with large-sized banks, it is easier for small and mid-sized banks to attract external equity investment, increasing the capital adequacy ratio, while keeping credit flowing to SMEs. More importantly, during the process of attracting external capital, better corporate governance improves the control on credit risk. In this way, improving corporate governance is an effective way to evaluate the credit worthiness of SMEs and hence reduce credit rationing to SMEs by the bank.

expansion comes from the difficulties in account settlement as, given the economies of scale entailed, they cannot run a separate system on their own and need to rely on the network run by SOCBs, where they do not seem to have access on an equal footing. Expansion of DOCBs is a key step to quickly reduce the administrative nature of SOCBs in terms of their corporate governance structure. In addition, with new DOCBs the mechanism of appointing, removing, reallocating, and transferring senior managers should change, returning these powers to such organizations as the shareholders' general meeting and the board of directors. While single state ownership poses major problems, it appears that DOCBs may offer a way out.

5. A proposal to improve the corporate governance of banks in PRC

Enhancing the corporate governance of banks in PRC requires looking at the overarching progress of the transition to a market economy. The landscape of the Chinese economic structure has been transformed after a quarter century of economic reform. As it stands now, 70 per cent of GDP contribution is from the non-state sector. The continued involvement of the government has created severe agency problems. The role of the government in the economy will have to evolve from the previous "owner and player" in the economy to that of "rule-setter and regulator". To reflect this reality, political interference in the banking sector should be cut off. As we argue below, ownership diversification represents an effective first step in the direction of improving the corporate governance of banks in PRC, while maintaining the long-term goal of reducing government ownership of banks.

To enhance corporate governance and hence ensure that bank monitoring produces the best incentives for SOEs and other firms to be efficient, broad structural reforms are called for in three specific areas: the ownership configuration of the banks, institution building and the promotion of competition in banking. In such an improved environment, practical plans can be formulated and implemented to reach the ultimate objective of improving the corporate governance of banks. Accordingly, in the following we will first address the three areas of structural reforms and then exemplify practical plans that the Chinese authorities may want to pursue, hinging on the diversification of the ownership of the banks that currently have the State as the sole owner.

5.1. Ownership structure of banks

Economists generally agree that State ownership of banks in low-income countries is an impediment to establishing an efficient banking system, to financial sector development and thus to sustained economic growth. Specifically, government ownership of banks distorts both competition and managerial incentives, leading to inefficiency and politically connected lending, which causes misallocation of resources. In the case of PRC, the political guarantee has prevented State owned banks from performing an efficient screening and monitoring of SOEs. Such soft budget constraints for SOEs have resulted in huge amounts of NPLs, which are endangering the solvency of the banking system and, at the same time, challenging PRC's fiscal sustainability. Burdened by the large amount of NPLs, Chinese banks have become increasingly reluctant to lend: the resulting credit crunch is undermining the potential of PRC's dynamic economy and might preclude the continuation of the country's persistently high growth. NPL resolution should be given high priority but is not enough: it should be accompanied by corresponding ownership changes to avoid serious moral hazard problems and the perpetuation of the banking system's inefficiency.

Concentrated ownership of banks is desirable, in principle, because dispersed shareholding undergoes a free-rider problem and managers may go unsupervised and, thus, insider control may result leading to inefficiency, while these problems do not arise when a significant blockholder is present. However, the presence of the blockholder has also potential costs since there is a tradeoff between the effectiveness of their monitoring of the bank and the possibility that they exploit other stakeholders or expropriate minority shareholders, for example via connected lending. To limit these costs stemming from bank blockholders' self dealings, laws and regulations were introduced in major economies following the crisis of the 1930s to separate banking and commerce. These restrictions have been partly lifted in the late 1990s in the major OECD countries, but we believe that, given the country's institutional and financial market development, PRC should require that controlling bank owners do not have significant interests in non-financial businesses. In other words, PRC should establish some type of Bank Holding Company regulation whereby investors have to divest their commercial interests if they want to obtain control of a bank, i.e. holding a share participation beyond a low limit (e.g., 5 percent in the USA).

In the short term some modest ownership structure changes can be effective in improving the corporate governance of Chinese banks, particularly of the SOCBs. In the first place, PRC should not underestimate the potential of its newly bred banks (Joint Equity Commercial Banks and also City Commercial Banks that we label Diversified Ownership Commercial Banks, DOCBs). These banks have clearly shown a good performance, partly due to their corporate governance structure. As a result DOCBs are effectively intensifying banking competition in some important parts of PRC. But why is corporate governance better at DOCBs than at SOCBs? In our view, the answer lies with their ownership structure. Even though they usually enlist local and/or central State institutions as significant shareholders, DOCBs are not owned just by the central government. In other words, what distinguishes DOCBs from SOCBs is that they have a plurality of shareholders. Even when all shareholders are institutions belonging to the public sector, their plurality ensures that multiple interests are represented on Boards of Directors. The plurality of their shareholders minimizes the risk that DOCBs fall captive to influential customers (this is even more likely if foreign shareholders are present. This also enhances DOCBs' monitoring capacity and gives their managers the right incentives. The good functioning of these banks' corporate governance, however, demands that DOCBs' minority shareholders should somehow be protected.

Before going into the specifics of how the expansion of DOCBs may be favored, we must outline the two other areas of broad structural reforms (institution building and the promotion of competition in banking) that are necessary complements to make the transformation in bank ownership effective in carrying out more efficient banking.

5.2. Institution and market building for better banking

Strengthening or establishing external independent authorities, together with appropriate ownership structures and proper competition policies, delivers good corporate governance of banks. In particular good corporate governance at DOCBs hinges on the diversity of interests among their shareholders, but in order for this to create to efficiency at these banks, minority interests must be helped make their case. External independent authorities, together with the discipline of competition, look indispensable, as it may take some time before minority interests in PRC can be defended in courts. Thus, strengthening bank/finance Authorities is a top priority. The external independent authorities mainly relevant to this task are: (i) the Central Bank

(PBOC); (ii) the Securities & Regulatory Commission (CSRC); (iii) the Antitrust Commission, which is not yet established.

The Antitrust Commission should be established and given wide scope, also on banking and finance, as the Central Bank and the Securities & Regulatory Commission might cater for the interests of their specific constituencies and not give enough weight to general welfare. Bank-related issues that fall under the jurisdiction of the Antitrust Commission emerge in the many instances where banking comes across positive network externalities. For example, it appears that DOCBs presently suffer a disadvantage vis-à-vis SOCBs, as the former have to rely on the latter for access to the national clearing system. Also the establishment of a centralized Credit Bureau (a key step to help banks' screening and monitoring of borrowers to which we will return below) requires that DOCBs can access it on an equal footing with respect to SOCBs.

The Securities & Regulatory Commission (CSRC) should be strengthened, with expanded powers. The CSRC has a primary role to protect minority shareholders; it can supervise that corporate statutes are effectively enforced; it can enforce adherence to its directives on the structure and functioning of the Board; and it can ensure the establishment and effectiveness of independent directors. Further, as government ownership of banks is reduced, the implicit guarantees that go with that will also be removed. Thus, the issue of Deposit Insurance should be addressed early on to facilitate the passage from State to private ownership of banks. Naturally, ways to secure depositors' safety have to be balanced against the possible moral hazard coming from the deposit insurance scheme.

Regarding the Supervisory Authority, the choice has been made to place it with an outside new body rather than leaving it with the Central Bank. There are certainly good reasons to have the supervisory responsibility entrusted to a body outside the Central Bank:

- (i) The potential inflationary bias stemming from having monetary policy and supervision under the same wing;
- (ii) The fact that, given its sensitivity to macroeconomic objectives, the Central Bank might indulge in issuing directives or incentives to banks that might distort their intermediation function, potentially causing misallocation.

However, there might also have been some good reasons for keeping the supervisory responsibility within the Central Bank. In the first place, it seems that PRC needs a stronger Central Bank and PBOC could be weakened by losing its supervisory powers. As Goodhart (2002) states: "in LDCs, more weight needs to be placed on ensuring the quality of the supervisory staff, i.e. their professional skills, independence from external pressures, and adequate funding. This tells strongly towards retaining banking supervision under the wing of the Central Bank in such emerging countries" (p.1). In addition, the large budget autonomy of PBOC, due to its seignorage revenues, could have made it easier to grant officials market-based salaries. However, irrespectively of where banking supervision is situated institutionally, PRC should expand official supervisory powers and upgrade supervisors' salaries to reduce the risk of supervisory capture. At present, in fact, international comparison shows that Chinese supervisors have relatively little power on their supervisees and PRC's supervisory officials are also more likely than the average to move into banking. Expanding supervisory powers should render banking supervision more effective. This and other equally crucial aspects, like strengthening on-site banking inspections and banks' balance sheet analysis, demand that the Supervisory Authority is able to form and retain adequately skilled personnel. In turn, this requires that the salary gap between the Supervisory Authority and the banking sector be minimized. More generally, and this pertains not only to the Supervisory Authority, the building of a better institutional set-up necessitates removing the public sector ceiling for the salaries of

independent agencies' officials. Its expanded powers should help the Supervisory Authority, in conjunction with the CSRC, to protect minority shareholders of DOCBs and, thus, help these banks' corporate governance to function well. To this end, the Supervisory Authority should also promote increased disclosure and transparency at all banks, to allow shareholders to monitor management. These steps (e.g., through the frequent publishing of bank statement) could also help establish some type of "Prompt Corrective Action" procedures so that decisions to close a bank may be made quickly on technical grounds, thus preventing political interference.

In addition, in order not to depress the franchise value of banks, liberalization of interest rates should be pursued with the proper sequencing starting from inter-bank rates, moving to loan rates and leaving deposit rates last (APF, 2002).

5.3. Competition and contestability

Adequate bank ownership structures and a stronger institutional set-up will ensure that good governance of banks is achieved only if competition policies are also enacted. To facilitate effective competition in the banking sector, PRC needs to further develop some crucial market segments, such as:

- (i) T-bill and T-Bond markets to fill the yield spectrum and favor private bond market development (particularly for banks to help reduce the extent of their maturity mismatch and also to promote bank monitoring by subordinated bond holders);
- (ii) An inter-bank market to improve the allocation of short-term liquidity and also to allow inter-bank monitoring;
- (iii) A nationwide clearing and settlement system, whose access is based on membership, so that the current monopoly of SOCBs in this segment can be eliminated.

Another area of intervention to make competition effective is to create some basic infrastructure to share information on borrowers across the banking system. Building a Credit Bureau can indeed improve information sharing among banks (about bad borrowers only or also on performing borrowers). According to the findings of Jappelli and Pagano (1993, 2002), better developed and longer established information sharing leads to deeper credit markets (larger credit/GDP ratios) and better allocation of credit, as indicated by fewer defaults. They also show that information sharing among banks increases with a) higher mobility of households b) the size of the consumer credit market; c) lower competition in the domestic banking market; d) better technological development in the banking industry; e) public intervention to make up for the lack private sector initiatives (since there is a clear externality). It can also be argued that information sharing is vital particularly for loans vis-à-vis less transparent borrowers, such as small firms. Hence the establishment of a Credit Bureau in PRC could be an important step to diminish liquidity constraints for SMEs. In this regard, PBOC's efforts to create a centralized Credit Bureau should be given high priority. The upgrading of these essential market segments would reduce barriers to entry, thus facilitating the access of DOCBs and foreign banks.

As argued, by enhancing competition and contestability and also through technology spillovers, foreign bank entry can be part of the solution in promoting ownership diversification, improved banking efficiency, the formation of adequate skills and risk management. Foreign bank entry can be most effective to this end when it happens through the acquisition of subsidiaries in the target country, rather than via the opening up branches. In this sense, the presence of DOCBs

provides an interesting outlet for foreign banks to enter PRC's retail banking: even though up to now only minority shareholding has been the rule, in the future this could rapidly change. In fact, limited experience from the field survey of banks for this study shows that foreign banks have already been active acquiring DOCBs in the past and also foreign bank presence as a minority shareholder is one of the keys to improved corporate governance. Thus foreign banks play both a (limited) direct role through their branches in PRC and also an indirect role via joint ventures with DOCBs. Furthermore, PRC's WTO entry implies that obstacles to the entry of foreign banks will be phased out shortly.

In spite of these benefits from foreign bank entry, given its size, PRC can hardly count on them alone to provide "the solution" to better banking. Better banking has to be found at home. In this respect, PRC should not minimize the potential role its DOCBs can play.

5.4. Accelerate the pace at which DOCBs are replacing SOCBs

Letting the winners (in this case the better-managed individual DOCBs) increase their market share is not necessarily detrimental to banking competition. For instance, Perotti and Suarez (2001) propose the following argument. Less competition raises the charter value of banks, hence a deliberate policy promoting takeovers of weaker banks by solvent banks benefits the latter, and grants their managers an incentive to pursue less profitable but safer lending strategies, thus breaking down the strategic externality of risk-taking strategies. A temporary phase of concentration in banking can thus reinforce stability and pre-emptive closures may in fact reduce the risk of a systemic banking crisis.

Limited merger and acquisition activity for PRC's banks has already started, but it needs to be encouraged further. With regard to SOCB restructuring, as argued above, the first step should be the quick resolution of NPLs, accompanied by strengthened corporate controls. In the past, although the State was the sole owner of the SOCBs, its effective control on them was hindered by the multiple layers of political interference leading to: (i) appointments of managers by the party; (ii) supervisory responsibility split among different agencies, whose cooperation was jeopardized by conflicts of interests; (iii) the fact that the main shareholder was passive. To overcome these problems, a State Banking Holding Company could be set up to streamline the existing arrangement, so that the State's interests as a shareholder can be fully conveyed. To minimize the risk of political lending, the State Banking Holding Company should be kept rigidly separated from any other State Holding Company administering non-financial SOEs. The State Banking Holding Company would provide a filter between political interests and commercial interests.

The second step should be to speed up ownership diversification. We propose the ownership diversification of one of the SOCBs. If the State Banking Holding Company wants to make a bold move, it could try to apply this to ICBC (the largest of the big four), alternatively, it could start with the Agricultural Bank of China. Perhaps the second option is more feasible at this stage, since the Agricultural Bank of China is the smallest and the weakest among the big four SOCBs. The assets and branch network of the SOCB that the State Banking Holding Company decides to sell could be acquired by DOCBs (breaking up the SOCB to be sold could be considered) or by foreign banks. This strategy serves at least two purposes. First, it creates an environment in which bank merger and acquisition is encouraged. Second, it sends a signal that the rest of the three SOCBs will be potential targets if their performance fails to satisfy remuneration of shareholder's value. To make this signal more potent, and give SOCB management further incentive to perform, the State Banking Holding Company could grant them

stock options that would help increase their efforts in skill formation and risk management. The experience with the ownership diversification of the first SOCB that is sold would be important to help the State Banking Holding Company in organizing subsequent rounds. As depicted in Figure 12 above, if this strategy were carried out at the start of 2004, by 2010 PRC could have a new banking landscape that would no longer be dominated by the big four SOCBs but, on the contrary, would have seen the newly bred DOCBs be rewarded their better performance.

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Figure 1A. Institutional and Governance Quality and Per Capita GDP – All Countries

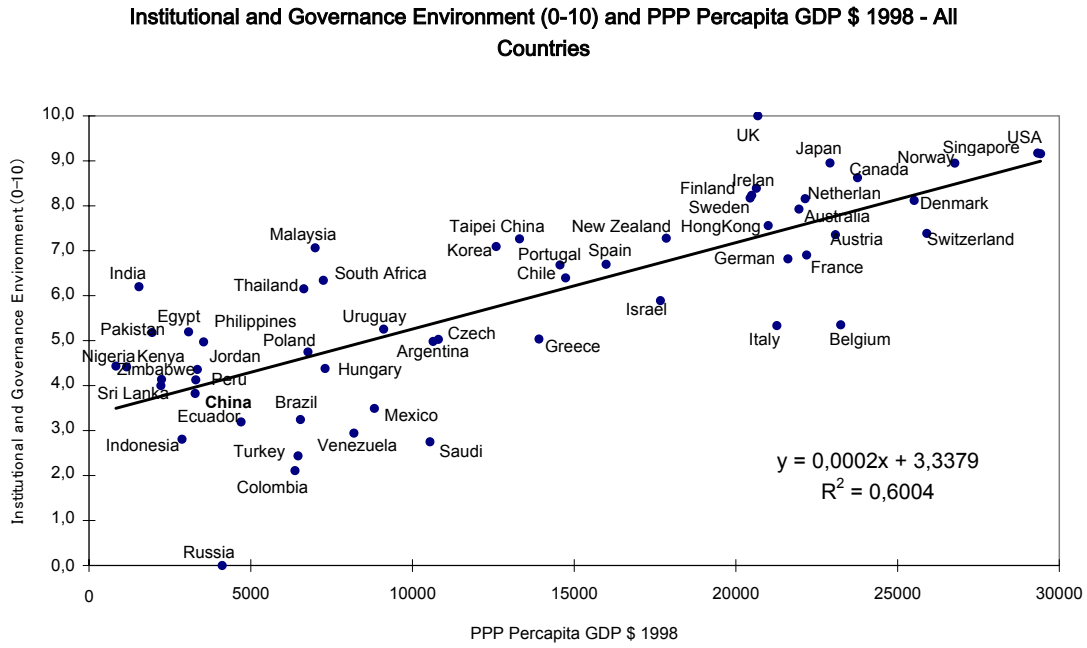


Figure 1B. Institutional and Governance Quality and Per Capita GDP – Non-OECD Countries

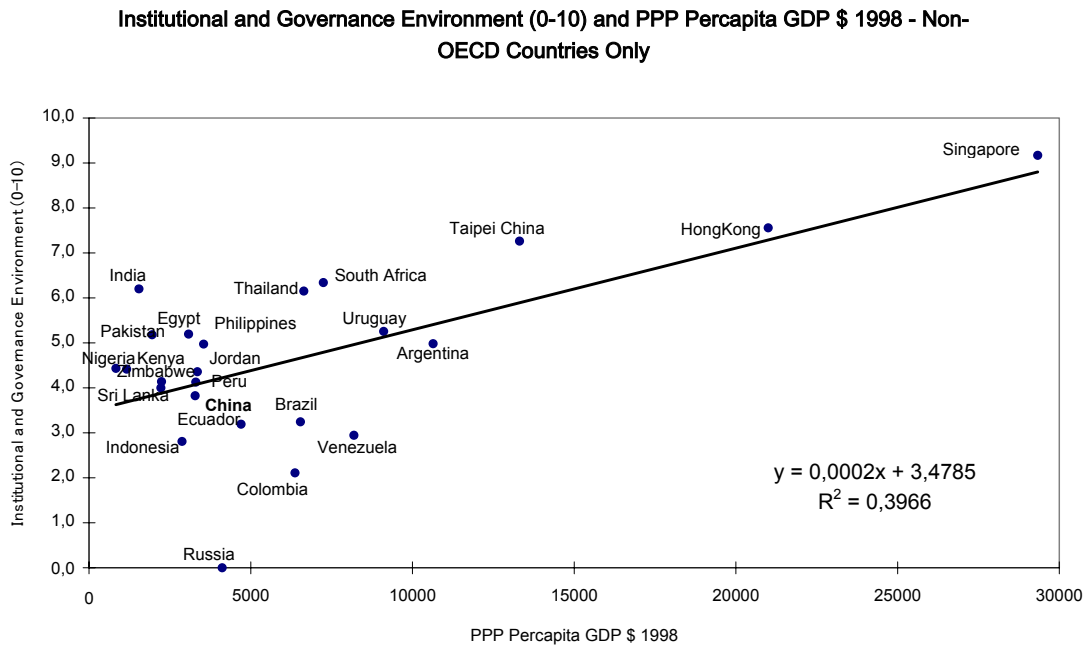


Figure 2A. Asset Share of Foreign Banks in Selected Countries (1994, 1999)
 (Source: Clarke, Cull, Martinez Peria, Sánchez, 2001)

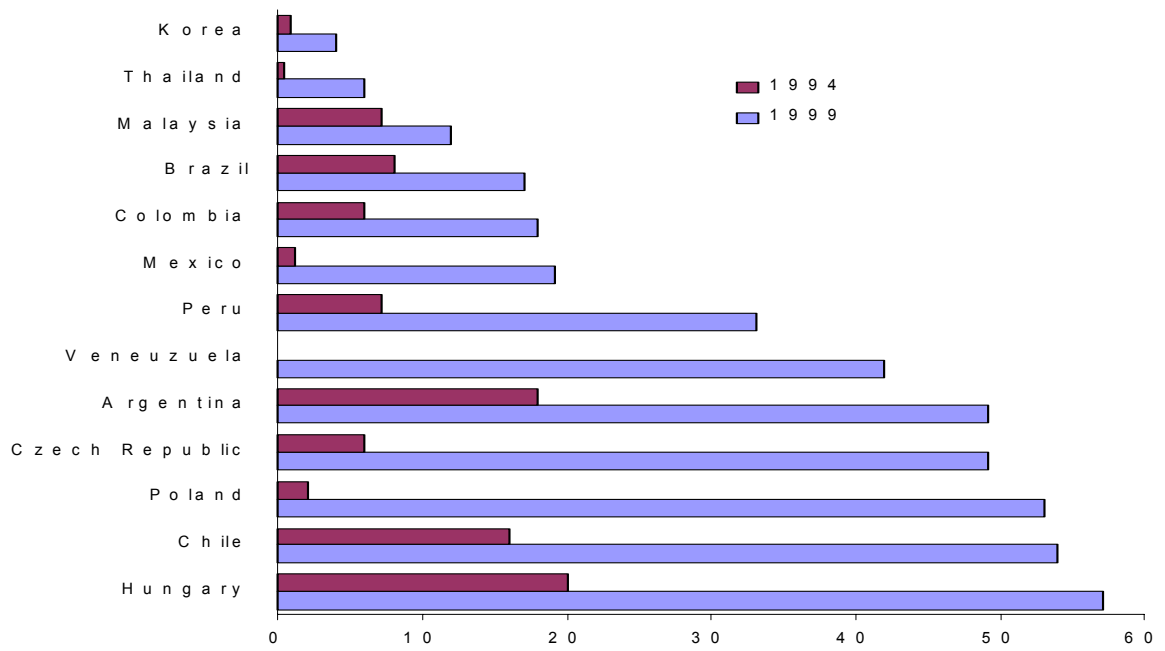


Figure 2B. Cross-border M&As in the banking sector and in the non-financial sector
 (Source: Focarelli, Pozzolo, 2001)

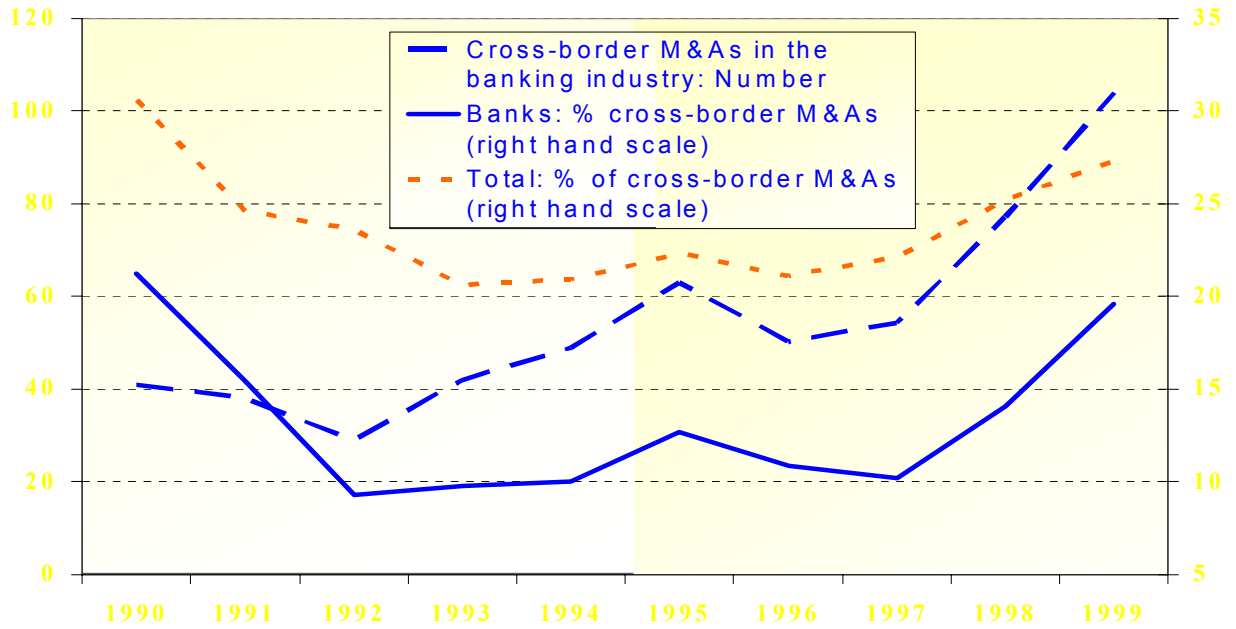


Figure 3A. Country Population and Foreign Bank Asset Share: All Countries
(Source: data on population from World Bank, data on foreign bank share for 1999 from Barth et al. 2001)

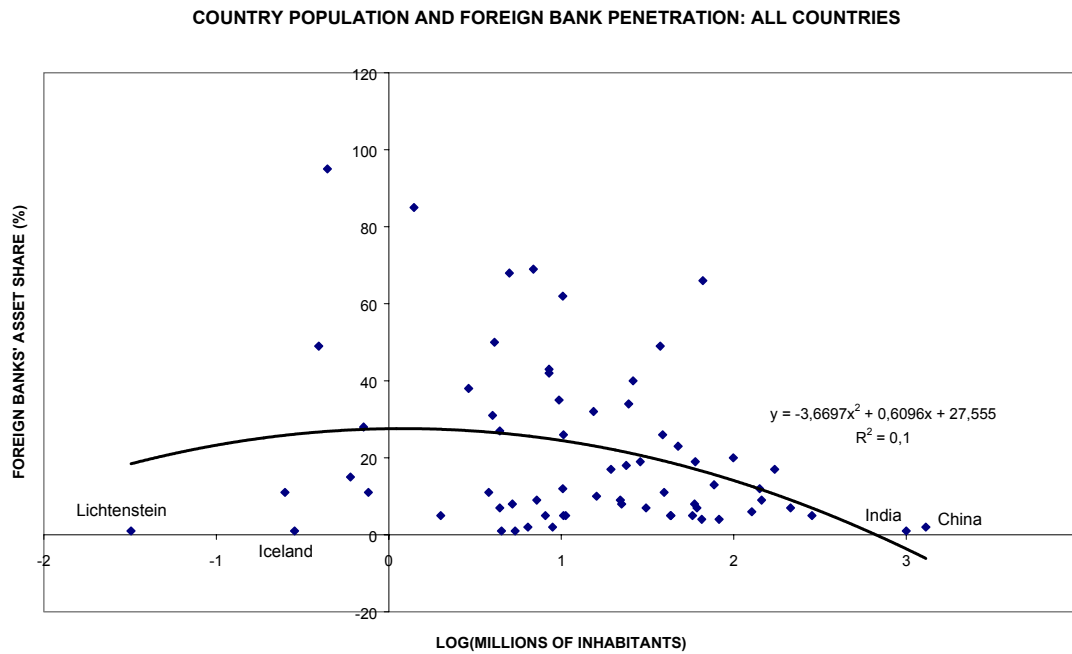


Figure 3B. Country Population and Foreign Bank Asset Share: Non-OECD Countries
(Source: data on population from World Bank, data on foreign bank share for 1999 from Barth et al. 2001)

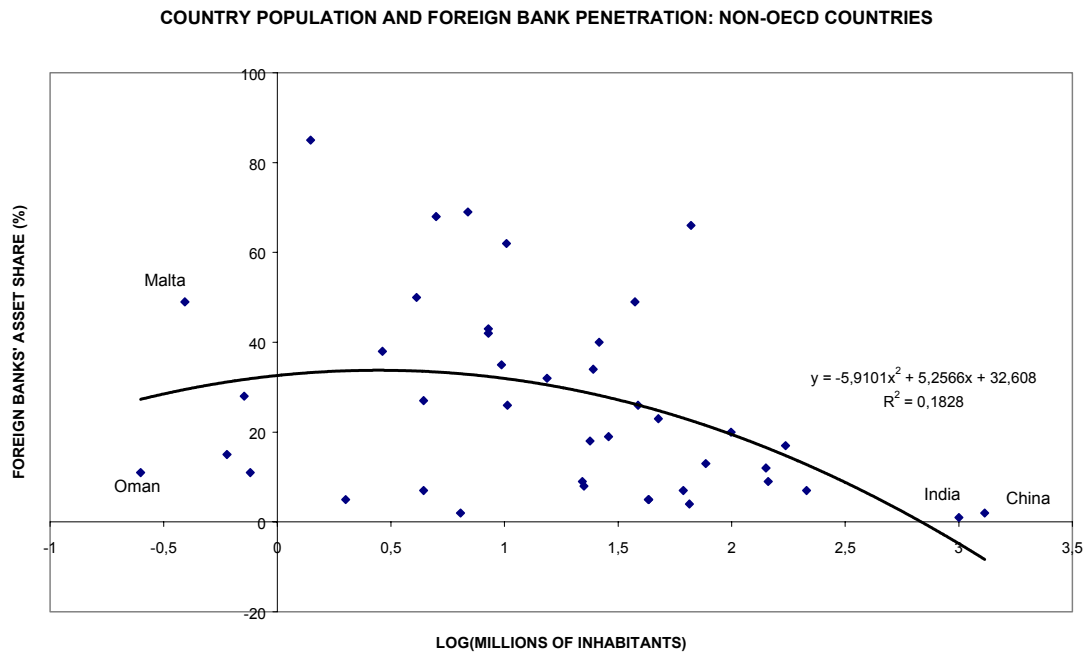


Figure 4. Foreign Bank Asset Share vs. Government Ownership of Banks
(Source: data on both government ownership and foreign bank share for 1999 from Barth et al. 2001)

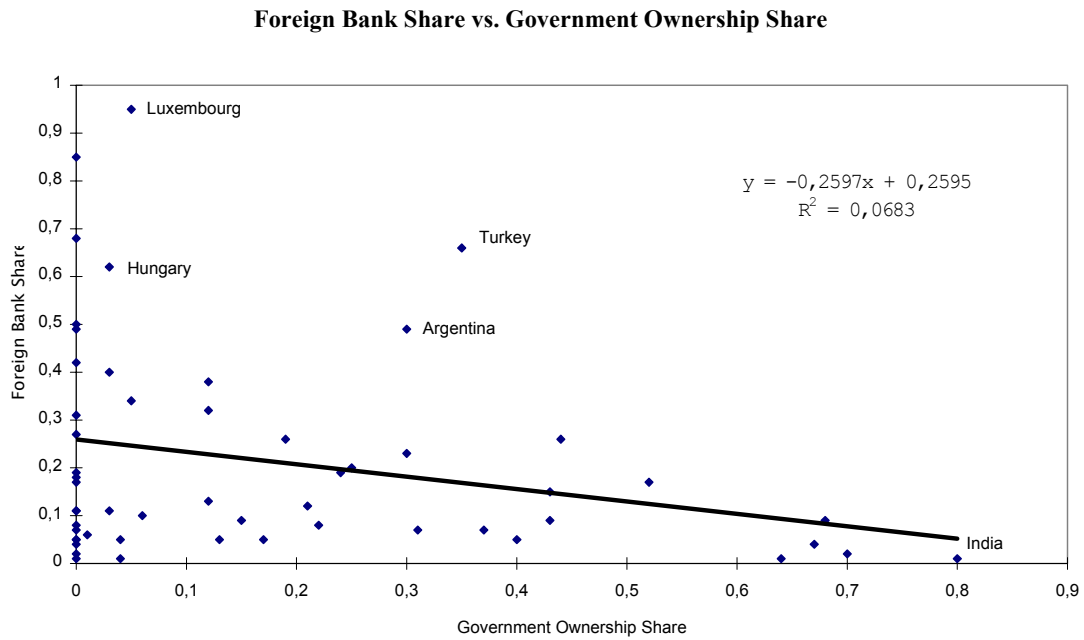


Figure 5A. Ratio BFSR/BCR and Foreign Bank Asset Share: All Countries
 (Source: data on ratings from Moody's; foreign bank share for 1999 from Barth et al. 2001)

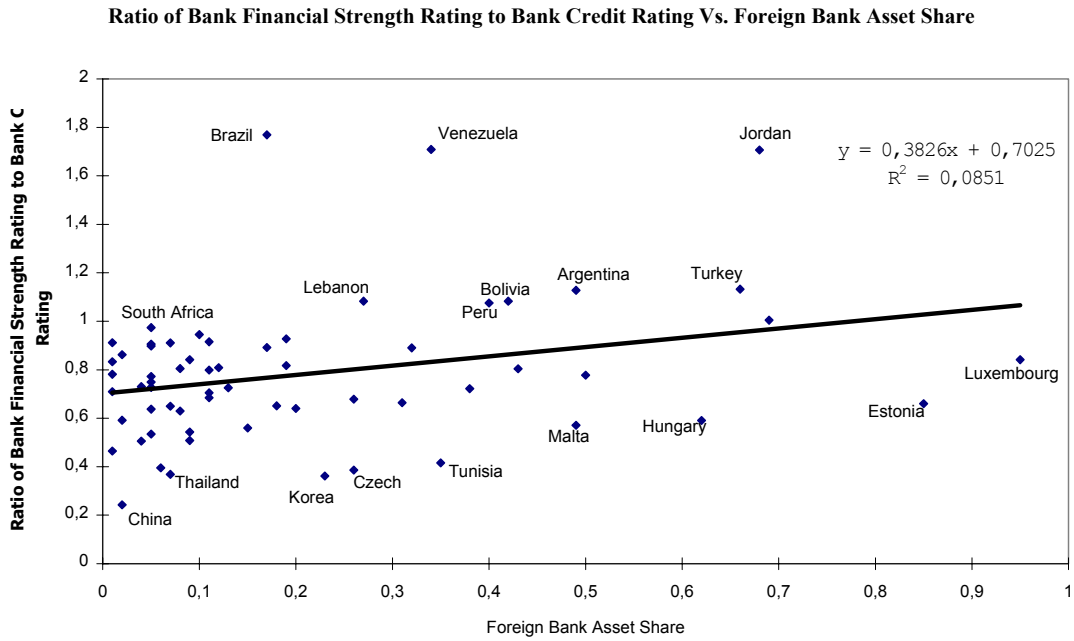


Figure 5B. Ratio BFSR/BCR and Foreign Bank Asset Share: Non-OECD Countries
(Source: data on ratings from Moody's; foreign bank share for 1999 from Barth et al. 2001)

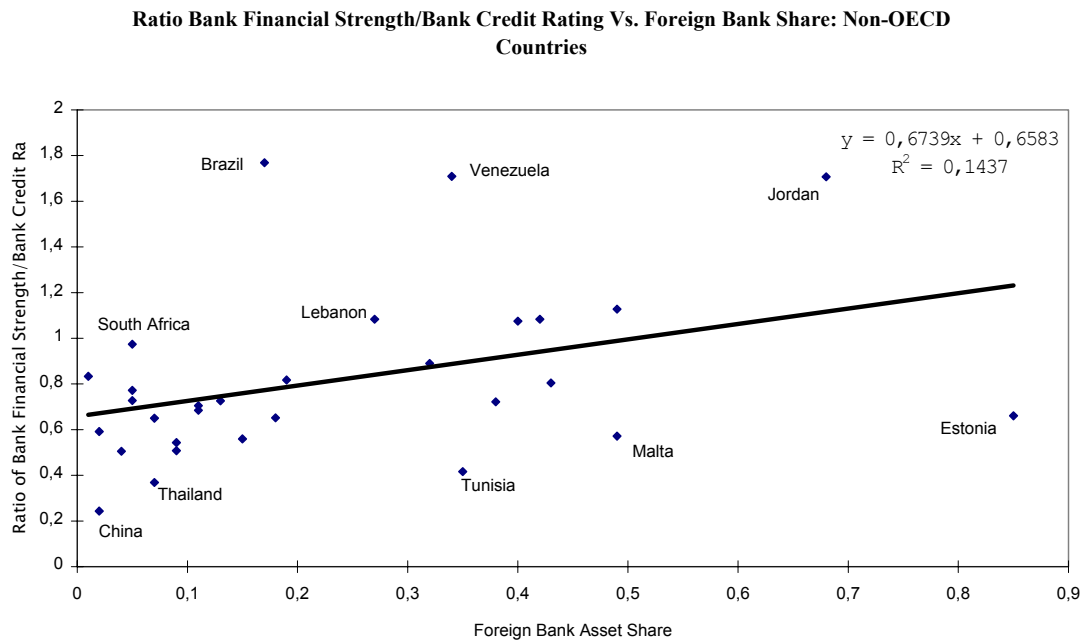


Figure 6A. Ratio BFSR/BCR and Government Ownership of Banks: All Countries
 (Source: data on ratings from Moody's; Government ownership for 1999 from Barth et al. 2001)

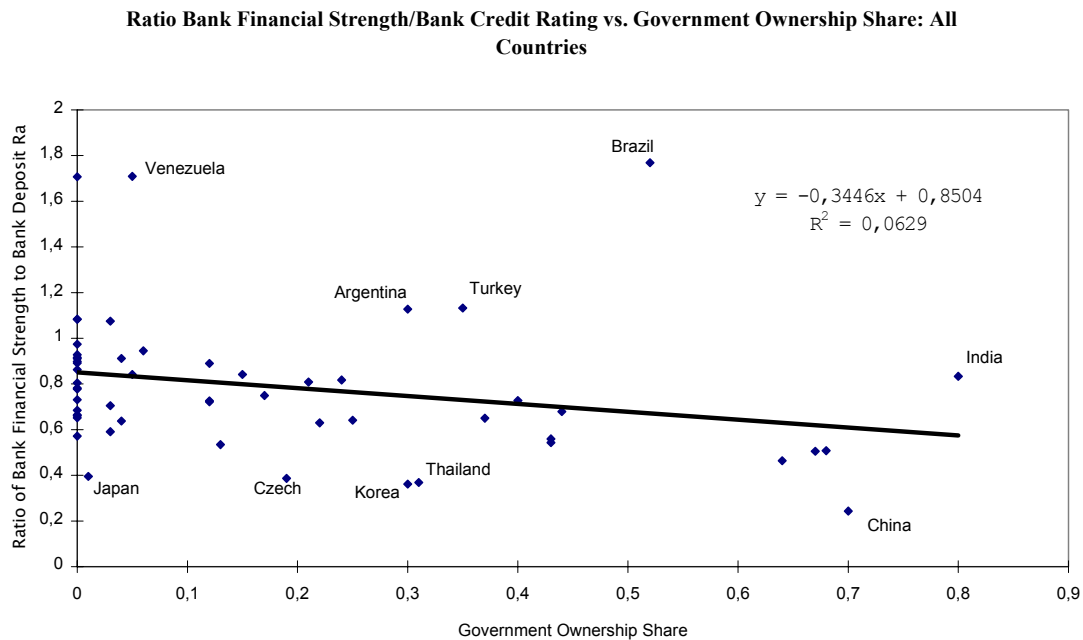


Figure 6B. Ratio BFSR/BCR and Government Ownership of Banks: Non-OECD Countries
(Source: data on ratings from Moody's; Government ownership for 1999 from Barth et al. 2001)

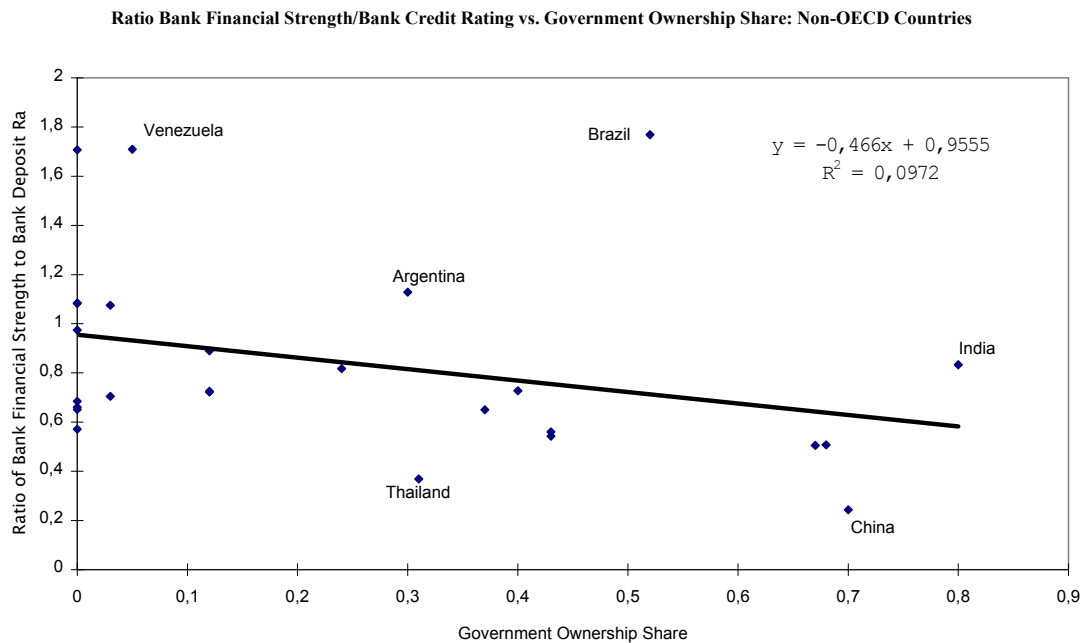


Figure 7. Bank Market Shares in PRC
(Source: data from Peoples' Bank of China, Annual Report)

Percentage Distribution of Assets at Banks in PRC (end-2001)

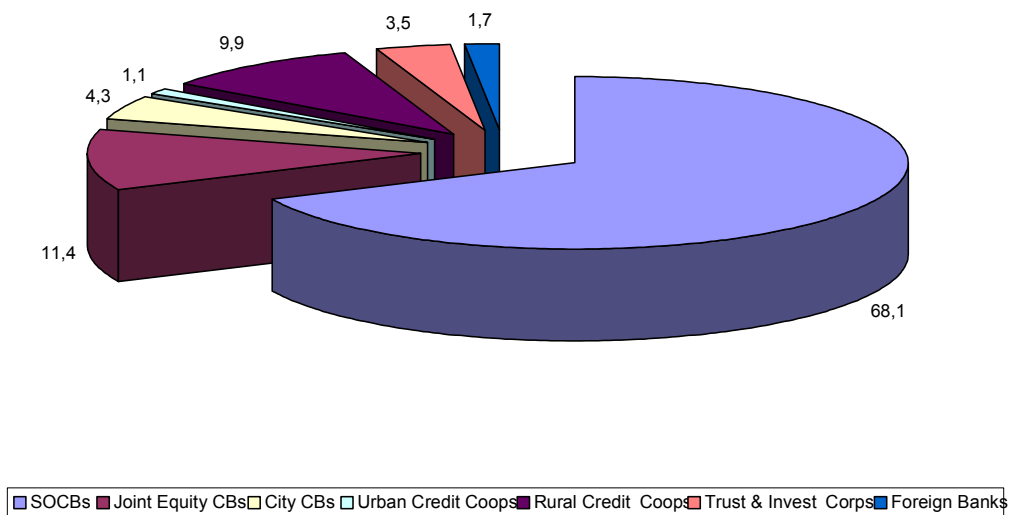


Figure 8. Productivity Indicators Across Bank Groups
 (Source: Our computations on data from Bankscope and Annual Reports of individual banks)

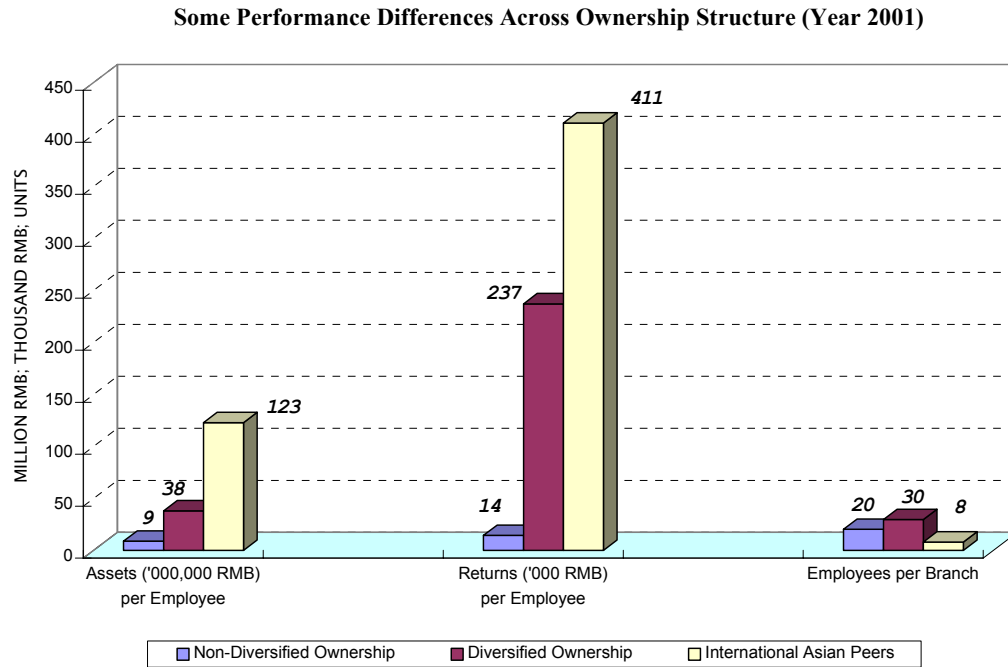


Figure 9. Profitability Indicators Across Bank Groups
 (Source: Our computations on data from Bankscope and Annual Reports of individual banks)

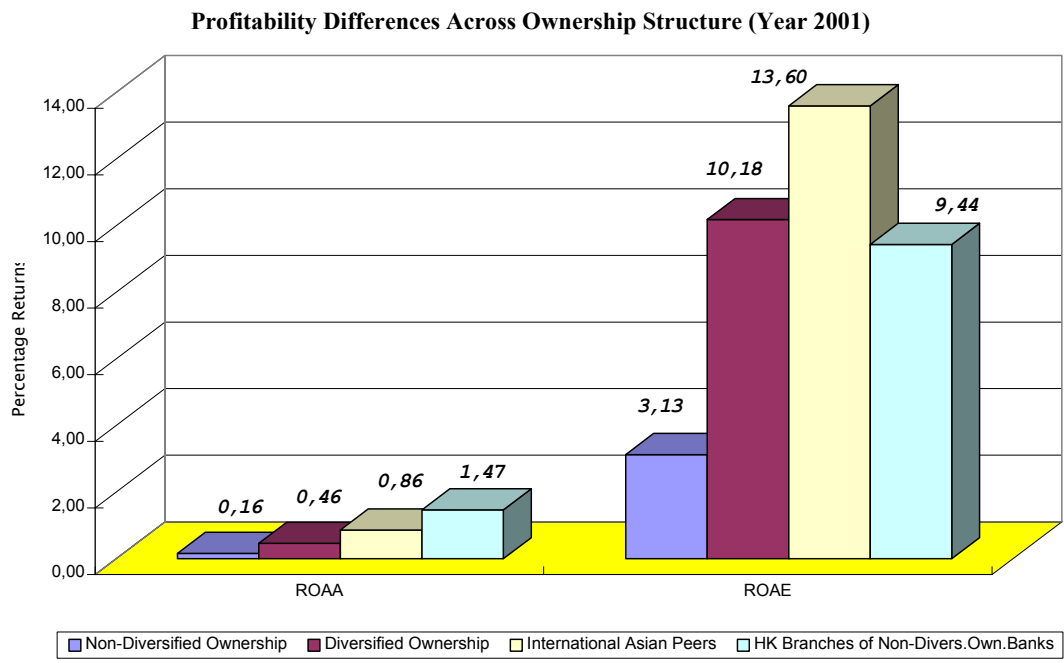


Figure 10. Liquidity and Maturity Mismatch: SOCBs vs. DOCBs
 (Source: Our computations on data from Bankscope and Annual Reports of individual banks)

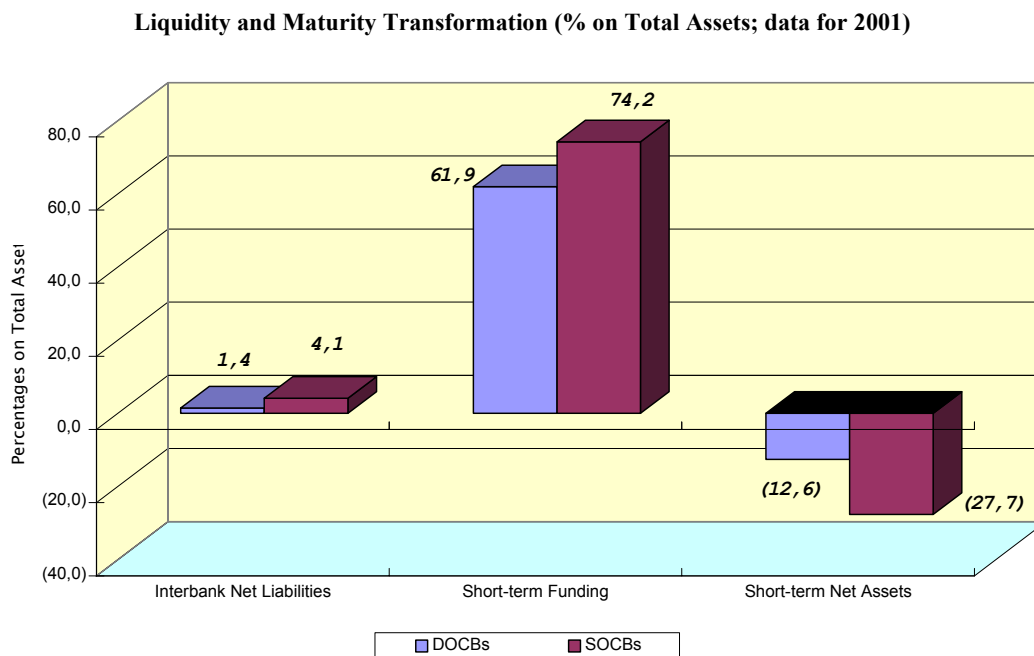


Figure 11. DOCBs' Market Share by Type of Activity: 1997 vs. 2001
(Source: Our computations on data from Bankscope and Annual Reports of individual banks)

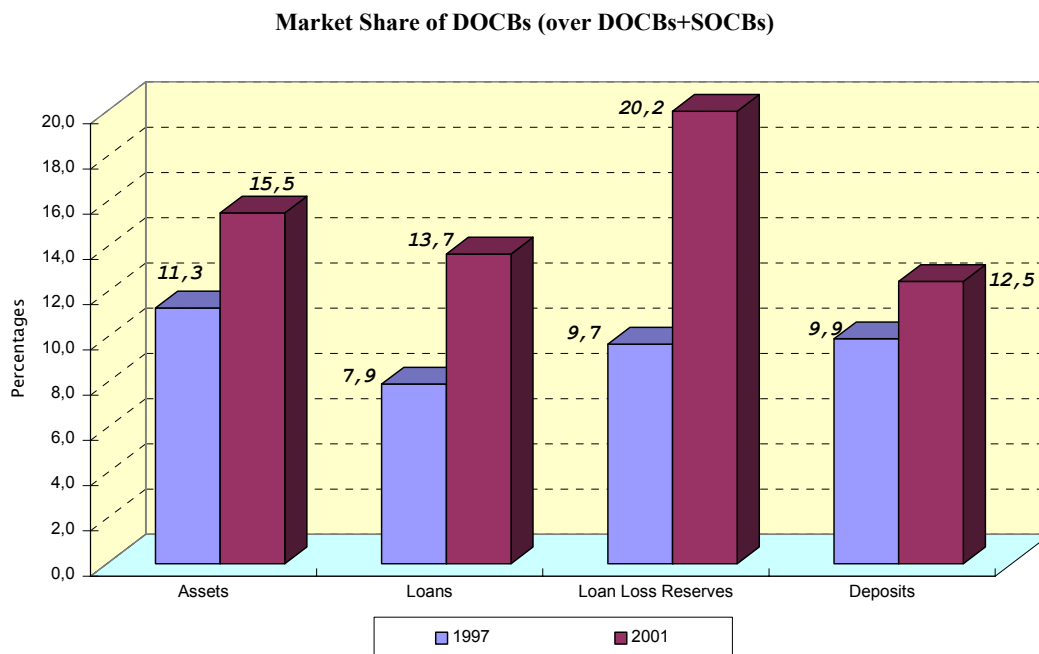


Figure 12. Three Scenarios for DOCBs' Catching-up until 2010
 (Source: Our computations on data from Bankscope and Annual Reports of individual banks)

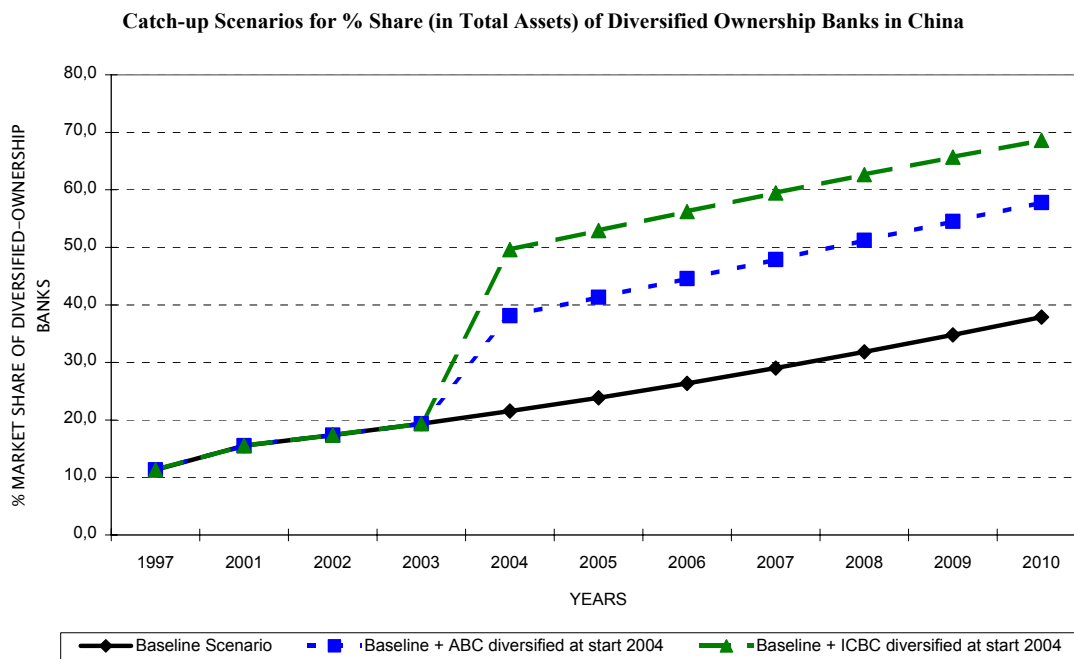


Table 1. Limits to Bank-Firm Cross-shareholdings: the Status in major OECD Countries

Maximum % of Voting Stock Allowed		
	Bank to Firm	Firm to Bank
Canada	10%	10%
EU (*)	no limit	no limit
Japan	5%	-
USA	5% voting/25% non voting	25%

(*) In UK, if bank owns > 20% of firm it must deduct investment in complying with risk-based capital.

Table 2. Cross-Country Regression of Foreign Bank vs. Government Bank Asset Share

We estimate an equation of the following form:

$$FBSH = \alpha_1 + \alpha_2 GOVTOWN + \alpha_3 ENGL + \alpha_4 LGNI + \alpha_5 NON-OECD + \alpha_6 LPOP + \alpha_7 DIST$$

The dependent variable (FBSH, foreign banks' asset share in 1999) and the asset share of government owned banks in 1999 (GOVTOWN) are both taken from Barth, et al. (2001). ENGL (a dummy taking value 1 for English speaking countries and 0 for the others) is meant to control for language similarity between the country of origin of the foreign banks (largely coming from English speaking countries) and the target country. LGNI (the logarithm of the country's Gross National Income, taken from the World Bank database) and LPOP (the logarithm of the country's population, also taken from the World Bank database) are aimed to control for country size effects. DIST (the distance in kilometers between the USA and the target country) is meant to control for transaction costs for US based banks (representing a significant part of foreign banks). NON-OECD is a dummy taking value 0 for OECD countries and 1 for non-OECD countries. Reported t-statistics are obtained via OLS and are Huber-White heteroskedastic consistent. The superscripts ***, ** and * indicate that the coefficient is different from zero respectively at the 1%, 5% and 10% confidence level.

Dependent Variable:	General specification		Preferred specification	
	Coefficient	t-stat	Coefficient	t-stat
FBSH				
GOVTOWN	-0.3859	-3.57***	-0.3871	-3.98***
ENGL	-12.0701	-1.80*	-13.1692	-2.16**
LGNI	-4.5059	-1.29	-4.6748	-2.06**
NON-OECD	14.7841	1.66	13.8659	1.89*
LPOP	0.2034	0.06		
DIST	-0.0005	-0.66		
CONSTANT	137.2139	2.13**	142.1427	2.27**
No. obs.	45		45	
F	(6, 38) 5.30***		(4, 40) 7.91***	
R2	0.376		0.373	

Table 3. Cross-Country Regression of BFSR/BCR vs. Foreign Bank Asset Share

We estimate an equation of the following form:

$$\text{RATIO} = \alpha_1 + \alpha_2\text{FBSH} + \alpha_3\text{LBCR} + \alpha_4\text{NOFBSH} + \alpha_5\text{NOBCR} + \alpha_6\text{ENGL} + \alpha_7\text{GNIPC} + \alpha_8\text{DIST} + \alpha_9\text{POP} + \alpha_{10}\text{SURF}$$

The dependent variable (RATIO=BFSR/BCR, the country average in 1999) is calculated on the basis of individual bank data taken from Moody's. FBSH (the foreign banks' asset share in 1999) is taken from Barth, et al. (2001). LBCR is the logarithm of the (national average) of 1999 BCRs for banks domiciled in the country. NOFBSH and NOLBCR are obtained multiplying NON-OECD (a dummy taking value 0 for OECD countries and 1 for non-OECD countries) by FBSH and LBCR, respectively. ENGL (a dummy taking value 1 for English speaking countries and 0 for the others) is meant to control for possible differences due to language/culture background. GNIPC (the country's per capita Gross National Income, taken from the World Bank database) controls for differences related to varying degrees of development. DIST (the distance in kilometers between the USA and the country) is meant to control for transaction costs, as Moody's is headquartered in the US, that might affect RATIO. POP (the country's population, in millions, also taken from the World Bank database) and SURF (the country's surface, in thousand square Km, taken as well from the World Bank database) are aimed to control for country size effects. Reported t-statistics are obtained via OLS and are Huber-White heteroskedastic consistent. The superscripts ***, ** and * indicate that the coefficient is different from zero respectively at the 1%, 5% and 10% confidence level.

Dependent Variable: RATIO	General specification		Preferred specification	
	Coefficient	t-stat	Coefficient	t-stat
FBSH	0.0351	0.29	0.0675	0.64
LBCR	-76.3309	-11.08***	-72.0733	-7.03***
NOFBSH	0.4127	1.78*	0.4400	2.01**
NOLBCR	-12.2595	-4.08***	-11.8814	-4.48***
ENGL	18.5405	2.59**	14.8469	2.87***
GNIPC	0.0007	1.45	0.0007	1.63*
POP	0.0016	0.10		
DIST	-0.0002	-0.15		
SURF	-0.0023	-1.06		
CONSTANT	408.5334	14.74***	385.2189	8.88***
No. obs.	63		63	
F	(9, 53)	25.13***	(6, 56)	12.63***
R2	0.666		0.641	

Table 4. Cross-Country Regression of BFSR/BCR vs. Government Ownership of Banks

We estimate an equation of the following form:

$$\text{RATIO} = \alpha_1 + \alpha_2 \text{GOVTOWN} + \alpha_3 \text{LBCR} + \alpha_4 \text{NOGOV} + \alpha_5 \text{ENGL} + \alpha_6 \text{GNIPC} + \alpha_7 \text{POP} + \alpha_8 \text{SURF}$$

The dependent variable (RATIO=BFSR/BCR, the country average in 1999) is calculated on the basis of individual bank data taken from Moody's. GOVTOWN (government owned banks' asset share in 1999) is taken from Barth, et al. (2001). LBCR is the logarithm of the (national average) of 1999 BCRs for banks domiciled in the country. NOGOV is obtained multiplying NON-OECD (a dummy taking value 0 for OECD countries and 1 for non-OECD countries) by GOVTOWN. ENGL (a dummy taking value 1 for English speaking countries and 0 for the others) is meant to control for possible differences due to language/culture background. GNIPC (the country's per capita Gross National Income, taken from the World Bank database) controls for differences related to varying degrees of development. POP (the country's population, in millions, also taken from the World Bank database) and SURF (the country's surface, in thousand square Km, taken as well from the World Bank database) are aimed to control for country size effects. Reported t-statistics are obtained via OLS and are Huber-White heteroskedastic consistent. The superscripts ***, ** and * indicate that the coefficient is different from zero respectively at the 1%, 5% and 10% confidence level.

Dependent Variable:	General specification		Preferred specification	
	Coefficient	t-stat	Coefficient	t-stat
RATIO				
GOVTOWN	-0.4154	-1.42	-0.5112	-3.04***
LBCR	-51.4867	-2.91***	-50.6660	-2.77***
GNIPC	0.0009	1.63	0.0009	1.84*
NOGOV	-0.1192	-0.37		
ENGL	2.1752	0.27		
POP	0.0010	0.04		
SURF	0.0001	0.04		
CONSTANT	287.1289	4.06***	284.1949	3.92***
No. obs.	45		45	
F	(7, 37) 2.560**		(3, 41) 6.26***	
R2	0.335		0.333	