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Board characteristics and Chinese bank performance

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ABSTRACT

Using a sample of 50 largest Chinese banks during the period of 2003–2010, we explore a comprehensive set of board characteristics (size, composition and functioning of the board) and analyze their impacts on bank performance and bank asset quality in China. We find that the number of board meetings and the proportion of independent directors have significantly positive impacts on both bank performance and asset quality while board size has a significantly negative impact on bank performance. We find new evidence that the degree of bank boards' political connection is negatively correlated with bank performance and asset quality. The findings suggest that the board of directors plays a significant role in bank governance in China.

1. Introduction

In the wake of the recent financial crisis, much more attention has been drawn to banks' corporate governance. The Basel Committee on Banking Supervision (BCBS) (2006) points out that "effective corporate governance practices are essential to achieving and maintaining public trust and confidence in the banking system, which are critical to the proper functioning of the banking sector and economy as a whole." To date, most studies focus on the developed countries, while relatively little is known about the corporate governance structure and its role in the banking sector of emerging economies.

The Chinese banking sector is the largest and most complex among emerging economies. At the end of 2010, bank assets in China totaled approximately US$13.8 trillion. Banks have an overwhelmingly dominant position in the Chinese financial system, and are an extremely important engine of economic growth. Furthermore, with the huge size, Chinese banks have substantially increased their influence in the world financial system.

Since 2003, Chinese authorities have significantly deepened banking reforms and dramatically reshaped the banking sector. With the accelerated transformation of Chinese banks into modern market-oriented financial enterprises, a sound corporate governance system becomes vital, not only to improve the functioning of the banking sector, but also to ensure the success of the ongoing banking reforms. As pointed out in OECD (2006) in its "policy brief on corporate governance of banks in Asia": "shortcomings in corporate governance of banks, if widespread, can destabilize the financial system and pose systematic risks to the real economy". The modern corporate governance practices are not only introduced but also implemented and firmly enforced in the Chinese banking sector.

Among different governance mechanisms, the Chinese authorities place the board as an essential part of the bank governance reform. The China Banking Regulatory Commission (CBRC) issued "Guidelines for Board of Directors Code of Conduct of Joint Stock Commercial Banks" in 2005, aiming to standardize board structure and establish the boards of Chinese banks to be as strong and functional as those in developed countries. The boards of directors of Chinese banks are modeled after the practices in the Anglo-Saxon system, where the board is responsible for the operations of the banks and acts as both the monitor and advisor of banks' top management. Under the newly adopted governance rules and

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deepened reforms, the resulting changes in the board structure, especially the effectiveness of the bank board, become open and important questions.

This paper makes the attempt to comprehensively explore the role of the board of directors in the Chinese banking sector. The study aims to provide useful information about banks' board structure in the context of the ongoing Chinese banking reforms, and more importantly investigates the effectiveness of the board in the Chinese banking sector. To that end, we use a sample of top 50 Chinese banks, accounting for more than 70% of the total assets of the Chinese banking sector from 2003 to 2010.[1] We study an extensive set of board characteristics (size, composition and functioning of the board), analyze the impacts of board characteristics on bank performance and asset quality, and report new evidence on the role of the board of directors in Chinese banks. We show that board-level governance mechanisms, such as size, number of meetings, the proportion of independent directors and directors who are politically connected, have significant impacts on bank performance in China.

This study contributes to the literature in the following aspects. First, we extend the literature on bank board governance to a major emerging economy. Most of the earlier studies focus on the developed countries and document a significant role of corporate governance in bank operations (e.g., Denis and McConnell, 2003; Levine, 2004; Macey and O'Hara, 2003; Adams and Mehran, 2003, 2012; Adams et al., 2010). This paper re-examines the role of corporate governance in the banking sector of emerging economies using a unique sample of Chinese banks. The mechanism and effectiveness of bank governance could be quite different in China as an emerging economy, due to different stages of financial development, although the governance reforms in China borrow concepts and "best practices" from the developed countries. Such a new perspective on major emerging economies can provide more robust evidence against the potential data-snooping bias in the literature.

Second, this paper provides a more complete picture of the board structure and its role in the Chinese banking sector. We examine a comprehensive set of board characteristics to capture different aspects of board and their impacts on bank performance. The board of directors is the "apex body" of an organization's internal governance system (Fama and Jensen, 1983; Weisbach, 1988; Hermalin and Weisbach, 2003). An effective board has become increasingly important for Chinese banks. Driven by various reform efforts, bank managers have obtained greater control over business decision-making, as government intervention has declined and the banks' ownership structure has diversified. But the market for corporate control is still underdeveloped. Hence, the board of directors might be a key mechanism to monitor and advise bank managers.

Third, this study updates the Chinese banking literature. We extend a stream of existing research that documents the impacts of governance mechanisms, mainly ownership structure, on Chinese bank behavior. More importantly, we explore the most extensive time series of data on bank governance in China. The majority of previous literature studies a sample period ending in 2004. However, several significant reform efforts were implemented or completed after 2004, such as the remarkable transformation of the "big four" state-owned banks to joint-stock commercial banks through recapitalization and IPOs. Accordingly, this paper explores a sample period of 2003–2010, reflecting new developments in the Chinese banking sector. Furthermore, the types of Chinese banks under examination in this study span a wide range, including state-owned commercial banks (SOCBs), joint-stock commercial banks (JSCBs), city commercial banks (CCBs) and rural commercial banks (RCBs), which differs from earlier studies.

Finally, this paper provides new evidence on the impact of political connection on bank performance in a transitional economy. Most of the previous literature focuses on non-bank firms and the political connection of top management (e.g. Fan et al., 2007; Wu et al. (2012); Xu et al., 2011). In this paper, we examine the relationship between the politically connectedness of bank boards and performance. The empirical results show that banks with politically connected board have poorer performance and asset quality.

Section 2 provides background information on the banking reform in China. Section 3 reviews the related literature on bank corporate governance and develops the main hypotheses. Section 4 presents the data on Chinese banks and the empirical methodology. Section 5 discusses the empirical results. Section 6 concludes.

2. An overview of Chinese bank governance reform

The Chinese banking system has experienced fundamental structural changes and reforms along with China's comprehensive economic reforms since 1978. The aim is to transform the sector from being state-owned, monopolistic and policy-driven to a multi-ownership, competitive and profit-oriented system. The reform process can be divided into four periods: initial institutional restructuring (1979–1984); establishing four big state-owned commercial banks (1984–1994); reforming these state banks (1994–2003); ownership reform and foreign competition from 2003 onwards.

Since 2003, several banking reform efforts have dramatically accelerated the transformation of the corporate governance system in the Chinese banking sector. First, a milestone of the bank governance reforms is the establishment of the China Banking Regulatory Commission (CBRC) in April 2003. The CBRC was put into force to fill the need for the specialized regulation of an increasingly complex banking system. The CBRC is responsible for formulating regulations for the banking sector, enforcing the banking laws, supervising the banking sector and encouraging good corporate governance. The CBRC takes a top-down legislative approach to enhance the corporate governance system in the banking sector based on the modern corporate governance practices in the Anglo-American systems.

Second, the "big four" banks, Industrial and Commercial Bank of China (ICBC), China Construction Bank (CCB), Bank of China (BOC) and Agricultural Bank of China (ABOC), have successfully transformed from wholly state-owned banks to shareholding companies through recapitalization and IPOs. They are currently referred to as "state-owned commercial banks" (SOCB) and have emerged to be among the biggest banks in the world. ICBC became the largest bank in the world by pre-tax profit at the end of 2010. In addition, the China's Bank of Communications (BOCOM) was officially included as the SOCBs by the China Banking Regulatory Commission (CBRC) in 2007, given its large size. Furthermore, financial liberalization started through gradual deregulation of government driven allocation of credit and interest rate control, and most of the urban credit cooperatives and rural credit cooperatives have been restructured and consolidated into city commercial banks and rural commercial banks. During the restructuring process, new corporate governance mechanisms are put in place such as shareholder's meetings, the board of directors, and top management oversight operations. The joint-stock commercial banks (JSCBs) also made improvements in corporate governance to be in line with newly adopted laws and governance rules.

Third, there are an increasing number of Chinese banks going public. The traditional "big four" state-owned banks have

[1] Our sample banks account for over 80% of the total assets in the Chinese banking sector in 2003. Although this ratio has declined in 2010, they still account for over 60% of the total assets.