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The Governance of China's Finance

Katharina Pistor

1.1 Introduction

This chapter discusses the governance of China's finances. It starts from two basic premises: first, that governance of finance can take multiple forms; and second, that the adoption of governance techniques that are common elsewhere does not necessarily imply that they will replace alternative modes of governance already in existence or designed to complement such techniques. Instead, adopting widely accepted governance techniques may serve to signal compliance but disguise the real allocation of control rights and their usage. Distinguishing between real and nominal governance requires closer inspection of governance regimes that transcends formal checklists, and instead probes more deeply into the configuration of power and influence and the channels through which such power is exercised.

This contribution suggests that China has largely mimicked formal governance regimes common in Western market economies. However, this regime remains largely incomplete as control rights that flow from equity positions are partitioned among different stakeholders. The chapter therefore explores an alternate mode of governing finance, namely human resource management (HRM), which uses control rights over the career path of top-level financial cadres. The importance of HRM for governing China's economy, including its financial system, is well understood within China. Outsiders,

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however, are more focused on governance structures that resemble those they are familiar with. Therefore, these are the primary addressees of this contribution. To document the extent of HRM in China's system of financial governance, this chapter makes use of a newly created database of current and previous top-level administrators and board members in key financial organizations to suggest that their career path through China's financial system is far from random; instead, financial cadres tend to be extensively groomed at different financial organizations within the state apparatus before they were appointed to financial intermediaries with greater formal autonomy, such as commercial banks. Based on secondary sources the chapter asserts that HRM is conducted by China's Communist Party (CCP) and that its reach and sophistication has increased rather than decreased over time. Indeed, one could argue that HRM has become a substitute to direct state control, which was still pervasive in China until the end of the 1990s, and a complement to the new rule-based formal mechanisms of control. The CCP's control over HR management intensified as the state apparatus loosened its direct control over the financial system, separated out different regulatory functions from the central bank's unitary system of control, and sold important stakes in formerly state-owned banks to nonstate, including foreign, investors. The HRM appears to work effectively for China's domestic system as a means for maintaining control over and stabilizing the financial system. Yet, it remains to be seen how effective it can be employed for governing China's exposure to global finance.

The chapter is organized as follows. Section 1.2 describes the formal changes in China's financial system over the past decade and asks whether the system of controls thus established has given rise to a coherent governance regime. Section 1.3 describes an alternate governance regime, one that relies less on formal mechanisms of control and instead uses controls over the careers of individuals who serve in the financial system, both in government agencies and in prominent financial intermediaries. It uses secondary sources to sketch the evolution of this system over the same period during which China introduced legal and regulatory means of governance. This evidence suggests that it would be wrong to assume that the withering away of direct state control of China's finances has set the country on a path toward convergence with standard formal governance regimes found in the West. Against this background section 1.4 presents data on patterns of China's human resource allocation within China's financial system. The data are comprised of information on 155 persons who occupy positions as top administrators at regulatory agencies, including China's central bank, as well as positions on the management or supervisory boards of major financial intermediaries. The chapter employs simple network analysis to show that most of these office holders either occupy important positions at other financial organizations concurrently or have held such positions prior to their current one. The pattern of affiliation that emerges from these personal ties differs from the pattern of hierarchical control rights that follows from the formal lines of authority. Network analysis reveals the centrality of organizations and individuals within China's HRM governance regime. However, our data also suggest that the number of people occupying management or supervisory board seats at major financial intermediaries relative to nonaffiliate board members is declining at intermediaries with more diversified ownership structures and greater exposure to global markets. This raises the question whether China will be able to rely on HRM as a key component for governing its financial system as more entities diversify globally—a topic that will be discussed in section 1.5. Section 1.6 places China's governance of finance in comparative perspective by drawing parallels, but also distinctions, to France and Japan. Section 1.7 concludes with some normative considerations about this particular regime of financial governance.

1.2 The Formalization of China's Financial System

China has been widely criticized for postponing reforms of its financial sector until well into the late 1990s—with some observers arguing that this failure might derail the success of China's economic reform project (Lardy 2002). However, over the past decade China has made major strides in overhauling its financial system. Today the financial sector's formal governance regime resembles in many aspects that found in developed Western market economies and can be described in conventional functional terms as follows: the Peoples' Bank of China (PBOC), China's central bank, is charged with monetary and exchange rate policies. Several new regulatory agencies were established, such as the China Banking Regulatory Commission (CBRC), which exercises oversight over China's banking sector; the China Securities Regulatory Commission (CSRC), which overseas stock exchanges and regulates the issuance and trading of securities on these changes; and the China Insurance Regulatory Commission (CIRC), which overseas the insurance sector. Formally, the PBOC and the three major regulators are subordinate to the State Council, the country's executive with the top officers at each of these entities having vice-ministerial status in China's bureaucratic hierarchy. As elsewhere, a single bank can simultaneously be subject to oversight by more than one regulatory agency: the PBOC window guidance policy, the CBRC for prudential supervision, and the CSRC's enforcement of securities regulations. China instituted these changes before the problems of a functional division of labor among different financial regulators became apparent in the context of the global crisis.[1] Notably, China had an intensive debate about whether carving out functional regulators from the unitary

1. For an overview of this debate and related reforms in the United Kingdom, but not the United States, see Schooner, Mandanis and Taylor (2003, 317).

structure of the PBOC was the right way to go[2] before CBRC was established in 2003, or whether it would be preferable to retain consolidated oversight and control over the financial system. In fact, PBOC has continued to be involved in key areas of banking supervision, not the least the preparation of BOC, CCB, and ICBC for their initial public offerings in 2005 and 2006 (ACFB 2007)—and presumably in other strategic decisions as well.

China has also begun an ownership transformation of the largest banks in the country, including three of the "big four" (ABC, BOC, CCB, and ICBC) as well as of other banks, such as the Bank of Communications (BComm), and China Development Bank (CDB). Cumulatively these banks control about 70 percent of China's bank assets (ACFB 2007). However, none of these banks have been fully transferred to private ownership. Table 1.1 details the stakes held by the five largest owners of those banks that are publicly traded and for which, therefore, ownership data are publicly available. Consistent with the capital structure of these banks, equity stakes are designated as A or H shares indicating whether they are traded on the Hong Kong Stock Exchange (H shares) or on one of the major domestic exchanges (A shares).

As can be seen, government ownership is fairly centralized in the hands of Central Hui Jin Investment Ltd. (hereinafter Hui Jin) and the Ministry of Finance (MoF) as the largest blockholders. Hui Jin and MoF are by no means the only state entities with substantial ownership stakes. Others include the National Council of the Social Social Security Fund (NCSSF), which holds as much as 15.3 percent in H shares in ICBC. Moreover, several state-owned enterprises hold sizable stakes in these companies.[3]

The role of more than one state or state-controlled entities as the dominant owner of China's banks is noteworthy, because their coexistence obfuscates the state's use of ownership as a means of controlling them. For wholly state-owned enterprises in the nonfinancial sector the new Law on State Owned Assets (SOA Law)[4] resolves the potential conflict among several state-controlled entities in the exercise of ownership rights, such as the election of management and supervisory board members by delegating this task to a single agent: the State-owned Asset Supervision and Administration Commission (SASAC). However, this law does not apply to financial companies. Instead, for the financial sector China has invented a new version of the famous separation of ownership and control first described by Berle and Means (1932); namely, the separation of the right to appoint the officers

2. See http://business.sohu.com/20090106/n261587587.shtml (in Chinese).

3. HKSCC does not represent another blockholder; the acronym stands for the Hong Kong Securities Clearing Company, which serves as a street name for other investors, each of which is likely to hold a much smaller stake than the combined shareholding of HKSCC indicated in the table.

4. The law was promulgated by the National People's Congress on October 28, 2008 and became effective on May 1, 2009.

Table 1.1 **Ownership of China's largest banks**

	Five largest shareholders by stake (% of all outstanding shares is given in parentheses)				
	1	2	3	4	5
Agricultural Bank of China Limited (as of January 2009 when ABC completed its reorganization and incorporated in form of stock company under the Company Law of the PRC)	Ministry of Finance 50.00	Hui Jin 50.00			
Bank of China Limited (H share Code 3988; A share Code 601988) (updated as of June 30, 2009)[a]	Hui Jin 67.53 (A shares)	HKSCC Nominees Limited 24.64 (H shares)	National Council for Social Security Fund PRC 3.30 (H shares)	Li Ka Shing[b] 1.21 (H shares)	Asian Development Bank 0.20 (H shares)
Bank of Communications Co., Ltd. (H share Code 3328; A share Code 601328) (updated as of June 30, 2009)[c]	Ministry of Finance 26.48 (6.12 H shares; 20.36 A shares)[d]	HKSCC Nominees Limited 21.91 (H shares)	HSBC 18.60 (H shares)	Capital Airports Holding Company SOE[e] 2.01 (A shares)	State Grid Asset Management Co. Limited SOE[e] 0.92 (A shares)
China Construction Bank Corporation (H share Code 939; A share Code 601939) (updated as of June 30, 2009)[f]	Hui Jin 57.08 (57.02% H and 0.06% A)[g]	HKSCC Nominees Limited 26.34 (H shares)	Bank of America 10.95[h] (H shares)	Baosteel Group[e] 1.28 (H shares)	Reca Investment Limited 0.34 (H shares)

(*continued*)

Table 1.1 (continued)

	Five largest shareholders by stake (% of all outstanding shares is given in parentheses)				
	1	2	3	4	5
Industrial and Commercial Bank of China Limited (H share Code 1398; A share Code 601398) (updated as of June 30, 2009)[i]	Hui Jin 35.4 (A shares, subject to selling restrictions)[j]	Ministry of Finance 35.3 (A shares, subject to selling restrictions)	HKSCC Nominees Limited 15.3 (H shares)	National Council for Social Security Fund PRC 4.2 (H shares)	Goldman Sachs 3.9 (H shares)

[a]The total number of outstanding shares is 253,839,162,009, of which the 76,020,251,269 shares are H shares, and 177,818,910,740 shares are A shares (listed at Shanghai Stock Exchange).

[b]Li Ka Shing is a famous HK billionaire, wealthy individual.

[c]The total number of outstanding shares is 48,994,383,703, of which the 23,064,468,136 shares are H shares, and 25,929,915,567 are A shares (listed at Shanghai Stock Exchange).

[d]Out of the 12,974,982,648 shares that MoF owns, all the 9,974,982,648 A shares are subject to selling restrictions.

[e]SOE denotes state-owned enterprise.

[f]The total number of outstanding shares is 233,689,084,000, of which the 224,689,084,000 are H shares, and 9,000,000,000 are A shares (listed at Shanghai Stock Exchange).

[g]In July 2009, Jianyin (Hui Jin's wholly owned subsidiary) transferred all of the H shares it originally owned to Hui Jin for free, and thus increased Hui Jin's shareholding percentage in CCB by 8.85 percent (i.e., 20,692,250,000 H shares subject to selling restrictions).

[h]Bank of America cannot sell those shares without CCB's written approval until August 29, 2011.

[i]The total number of authorized shares is 334,018,850,026, of which the 83,056,501,962 shares are H shares, and 250,962,348,064 are A shares (listed at Shanghai Stock Exchange).

[j]The "selling restrictions" refer to the restrictions imposed on the shareholders for reselling these shares on the market. These restrictions were imposed as part of the "share reform," which was launched in 2005 in China with the purpose of converting the nontradable state-owned shares in public companies into tradable shares, though subject to certain selling restrictions. Typically these restrictions impose certain lockup periods.

and board members of financial intermediaries from the economic costs and benefits associated with holding shares in such entities.

For purposes of illustration, take the example of Hui Jin, which next to the Ministry of Finance is the most important shareholder of China's dominant banks. Hui Jin was established in 2003 as a subsidiary of the State Administration for Foreign Exchange (SAFE), which in turn is an administrative agency subordinate to the PBOC. Hui Jin was authorized by the State Council—that is, by China's executive—to make "equity investments in major state-owned financial enterprises, and . . . , to the extent of its capital contribution, [to] exercise the rights and perform the obligations as an investor on behalf of the State in accordance with applicable laws."[5] In 2007, Hui Jin, which is organized as a limited liability company, became a wholly owned subsidiary of China Investment Corporation (CIC), China's newly established sovereign wealth fund. To this end, MoF issued special treasury bonds that were used to acquire Hui Jin from PBOC; subsequently Hui Jin was transferred to CIC for a price of US$70 billion; that is, almost one-third of CIC's initial capital of US$200 billion (Martin 2008). As the parent and sole shareholder of Hui Jin one would expect CIC to control the appointment of Hui Jin's management and supervisory board members. This, however, is not the case. Instead, Hui Jin's charter stipulates that the State Council exercises these rights[6]—irrespective of the fact that the State Council never held any shares in Hui Jin and CIC is now its parent.

This separation of control rights from ownership suggests that ownership is not conclusive in determining who actually exercises control rights over a state-owned entity. Indeed, even the contents of Hui Jin's charter is misleading in this regard, because ultimately the CCP appoints top officials to financial entities—including regulators, wholly and partially state-owned entities. The CCP's powers are not mentioned in Hui Jin's or any of the banks' charters; however, neither would it be appropriate to relegate them to "informal" means of control.[7] Within China the CCP continues to be recognized as an integral part of a dualistic power structure, with the state apparatus and the CCP forming two separate yet interlinked hierarchies that use different mechanisms of control (Naughton 2008). Whereas the state is associated with control rights exercised by way of ownership and administrative lines of control, the CCP controls the career paths of individuals in

5. See the statement on Hui Jin's web page available at www.huijin-inv.cn.

6. See excerpts from Hui Jin's articles of incorporation available at its website at http://www.huijin-inv.cn/hjen/governance/governance_2008.html?var1=Governance (last visited August 24, 2009).

7. A tradition has evolved in the new institutional economics literature to distinguish between formal and informal institutions depending on whether they are promulgated by the state or not. See North (1990). This distinction, however, can be misleading when applied to countries such as China with more complex power relations. For a critique of the formal-informality divide see Pistor (2006).

the party, the state, and in organizations that are critical to the party or the state (Huang 1996; Shih 2008).

1.3 China's Other Governance Regime: The CCP's Human Resource Management

A critical component of financial governance in China is the CCP's management of human resource. The CCP controls key positions in government, administration, and government-controlled sectors in the economy. This function has evolved over time and has been exercised via different channels. Critically, and perhaps counterintuitively, given China's economic rise and embrace of market mechanisms in many aspects of economic organization, it has not diminished in recent time. Indeed, the CCP's power of the financial sector by way of HRM seems to have increased arguably as a way of ensuring continued control over finance given its central role to economic, social, and political stability.

The role of the CCP in controlling key personnel is well established; in an attempt to bolster its legitimacy in China's evolving governance structure, the CCP has made some of its operations more transparent and has promulgated a set of "Regulations on Selection and Appointment of Party and Government Leading Cadres" (Bo 2004; Burns 1994). These regulations are not published, but are widely circulated among administrators and managers in government, and in practice they operate as binding rules. Neither the corporate law nor the charters of the major banks refer to these rules. Nonetheless, the CCP rules explicitly state that the CCP selects and appoints the chairman, vice-chairmen, president and vice presidents of the Bank of China and the equivalent positions at the other banks, as well as top management at CIC, China's sovereign wealth fund (established in 2007).

In order to understand the importance of CCP's HRM as a means of governing China's finance it is useful to analyze how the CCP's governance of human resources has coevolved with the formal changes in China's financial system just described. At the end of 1998 the basic governance structure of China's finances had not changed much from 1980 (Shih 2008). Consistent with the coexistence of state and party structures linked by the general oversight of the Standing Committee of the Politburo, state and party governance formed two partly overlapping vertical governance regimes: the State Council formally controlled the PBOC, which in turn controlled the four state banks; they in turn oversaw their own. There were no specialized regulators so that the PBOC acted as lender, regulator, and de facto owner in one. Parallel to this structure, the CCP imposed its own control mechanism in the form of Central Discipline and Inspection Commission (CDIC), which was subordinate to the Central Committee. It gained control over staffing the members of the disciplinary party committees found at each of the state-owned banks; local party committees exercised similar powers over local branches of the major banks. In addition to disciplinary supervision, the CCP appointed the PBOC's key management personnel and the PBOC in turn appointed the leadership at the major banks (Shih 2008).

This structure optimized centralized control of the CCP but did not easily accommodate a more differentiated division of labor among various functional regulators (such as the CBRC), which were established in China over the past decade; nor could it easily fit an ownership structure that included nonstate owners, including foreign investors. The latter was deemed important for China to comply with the opening of financial services under the General Agreement on Trade in Services (GATS), but also to impose greater financial discipline on the banks and expose them to foreign expertise (Allen 2005; Leigh and Podpiera 2006).

The East Asian financial crisis served as a wake-up call to those concerned with the governance of finance around the world, including politicians and party leaders in China. China was not directly affected by the crisis, because it had insulated itself from global markets by capital controls, tight exchange rate management, and a state-controlled financial system. Nonetheless, leaders in China quickly recognized the risk of financial destabilization to the Chinese economy and by implication, to the stability of the political regime,[8] and sought to address these concerns at the same time as they were embarking on reforming the financial system, which had seriously lagged behind institutional and governance reforms (Lardy 2002).

In response to these challenges, the CCP began to tighten its control over the financial sector (Heilmann 2005). The vehicle for this strategy was the Central Financial Work Commission (CFWC), a newly established body that was directly and exclusively answerable to the CCP's Central Committee. Wen Jiabao, vice-premier and Politburo member, served as its chairman. The changes implied that the CCP gained direct control over appointing and dismissing key personnel at China's four largest banks—powers that previously had been vested with the PBOC. Now, key personnel were nominated by the banks and approved by the CFWC (Shih 2008). In the words of Heilmann, who conducted numerous interviews in China to establish the role of the CFWC:

> After the establishment of the CFWC, the appointment procedures and authority relationships changed fundamentally. Thereafter, the CFWC, in cooperation with the financial institution and state regulatory body concerned, actively investigated, appraised and appointed financial cadres who were deemed loyal to the Party centre and professionally qualified to take leading positions. The headquarters of financial institutions still recommended persons to become senior managers. But they now had to submit and justify their choice to the CFWC for approval. The final deci-

8. The intimate connection between financial, economic, and political stability was forcefully demonstrated by the case of Indonesia during the East Asian financial crisis. It let to riots and brought down an autocratic regime under President Suharto.

> sion rested with the CFWC. . . . Moreover, the CFWC installed vertical leadership authority by newly established full Party committees between the national and subnational management levels. (Heilmann 2005)

These powers did not make the CFWC a hands-on manager; its own rules prohibited it from taking up such a role. However, by appointing all members of the newly created supervisory boards of banks and other financial intermediaries that were corporatized at the time, the CFWC was able to place 200 members it had selected on sixteen newly established supervisory boards in 2000 alone (Heilmann 2005, 12).

The CFWC's control over human resources extended also to key regulators. Between 1998 and 2003 the CFWC controlled the appointment of senior executives across all key institutions in finance, including regulators, administrative agencies, and banks (see table 1.2).

The CFWC was disbanded in 2003 and its more regulatory functions were transferred to the newly created bank regulator, the CBRC—formally a spin-off from PBOC. However, its operation has left a decisive mark on the management of China's financial sector. First, CFWC was deeply involved in the establishment and staffing of CBRC and the new banking supervision law was prepared by it (Heilmann 2005). Indeed, of the CBRC's sixteen new departments within CBRC, only five were transferred from the PBOC, while eleven had previously been housed inside the CFWC (Heilmann 2005). Similarly, the newly appointed top officials at CBRC had all previously been members of CFWC.

More generally, the formal dissolution of CFWC—or perhaps rather its transformation into a regulatory body—did not put an end to party control over HRM in China's financial sector. Instead, CFWC's HRM functions were transferred to the CCP Central Organization Department (COD)—much to the critique of China's financial press.[9] The COD now exercises the power to appoint senior executives at China's national state supervisory organs (PBOC, CBRC, CSRC, CIRC) and ten national financial companies under central administration, including the big four national commercial banks, the three policy banks, Bank of Communications, Everbright Group and CITIC Group (formerly the China International Trust and Investment Corporation) (Heilmann 2005), and more recently CIC. Appointment powers for top cadres at the PBOC and the three functional regulators were delegated to CCP committees at these organizations. Moreover, the appointment of lower level appointees at these organizations' regional branch offices were transferred to corresponding local party committees (Heilmann 2005, 18). Interestingly, the administrative heads of the three regulatory agencies no longer combine the roles of party secretary and state or bureaucratic leader; instead a greater functional division was implemented, whereby the "number 1" at these agencies with the power to exercise overall strategic lead-

9. Heilmann quotes Caijing, China's leading financial paper, as bemoaning the lack of profound reform reflected in this decision. See Heilmann (2005, 17, fn. 59).

Table 1.2 CFWC's Human Resource Management (1998–2003)

National Financial Institutions, from vice-ministerial level (formally appointed by COD) down to the deputy bureau chief level	National commercial financial institutions with control over senior executives and supervisory board members	National commercial financial institutions with control over senior executives only
PBOC	BOC	Minsheng Bank
CSRC	CCB	Minsheng Securities
IRC	ICBC	Minsheng Life Insurance
	ABC	Merchants Bank
	CDB	Sci-Tech Securities
		Minzu Securities
	China Import Export Bank	Galaxy Securities
	4 AMC	Government Securities Depository Trust & Clearing Co.
	CITIC Group	Chung Mei Trust & Investment
	Everbright Group	
	Bank of Communications	
	People's Insurance	
	China Life Insurance	
	China Reinsurance	
	China Export & Credit Insurance	

Source: Heilmann (2005).

ership is now appointed by a CCP committee, but does not operate simultaneously as the representative of the party within the organization. Instead, this function is exercised by the "number 2" with the mandate to conduct human resource management (Naughton 2008). Rather than indicating a diminished role of the CCP at these entities, it can also be viewed as a sign for the increasing importance attributed by the party to HRM.

The continuing pervasive role of the CCP in China's financial system by way of controlling HRM should leave its marks on appointment patterns and promotions of key individuals. We will explore this in the following section, which introduces a new data set and brings to bear basic network analysis to explore the governance of China's finances.

1.4 Scale and Scope of the CCP's HRM: Empirical Evidence

This section presents empirical evidence on the scale and scope of the CCP's management of human resources over China's finances. To this end we have collected data on the key positions in management and supervision at China's major regulators and financial intermediaries. For each person who was identified as a current top-level administrator at a regulatory entity (PBOC, CBRC, CSRC, etc.), or as a member of either the management board or the supervisory board of a financial intermediary (BOC, CCB, ICBC, ABC, etc.), we recorded his (and occasionally her) concurrent position at other entities as well as positions that person has held previously. These data were hand collected using information made available on the websites and annual reports of the organizations in question.[10] The database includes 155 people and a total of 41 entities or organizations with which they are or have been affiliated. Initially, we included thirteen entities in the analysis: PBOC, SAFE, CBRC, CSRC, CIC, Hui Jin, BOC, CCB, ICBC, ABC, Import Export Bank (IEB), BComm, and China Development Bank (CDB). We coded all top-level executives and board members at these entities and traced their current and previous ties to other entities throughout China's financial system. Indeed, we also included other important government positions, such as governor or vice-governor of a province. However, we did not include in our data set previous postings at multilateral institutions, such as the World Bank or the Asian Development Bank.

We use this database to establish the imprint of HRM on the governance of China's finances. As posited earlier, HRM can be regarded as an alternative governance regime to the formal control structure that China has established over the past decade. In order to establish the relation between formal control structures rooted in legally and administratively established lines of authority on one hand, and the scope of HRM within China's financial system on the other, we compare the governance structures of these two alternative regimes. Figure 1.1 depicts the governance regime that emerges from the analysis of formal lines of control; that is, ownership relations and lines of administrative or regulatory authority. It includes the largest owners of the banks listed in table 1.1 (except for HKSCC) as well as regulatory and supervisory authorities embedded in China's legal infrastructure.

The picture that emerges is a bifurcated governance structure headed by the State Council and divided into monetary and exchange rate policy represented by PBOC and SAFE on one hand (at the far right side of the figure) and financial intermediation, represented by banks and their regulators on the other. The central role of Hui Jin as a major owner in China's "big 4" is readily apparent. Contrast this picture with the one found in figure 1.2, which depicts the relations among the same entities, but this time the ties among entities are not determined by ownership or administrative lines of authority; instead, they depict interlocking positions held by senior executives or board members at two or more entities.

Unlike the first picture, the PBOC now takes a much more central role as a result of its many interlocking senior positions with the CCP Committees,[11] SAFE, CBRC, and CSRC, as well as CIC. Hui Jin remains a central

10. The full database names and affiliations, including explanations for the role of different organizations, is on file with the author.

11. Note that all top level officials at PBOC concurrently serve on PBOC's CCP Commission. In other words, the division of labor between strategic and human resource management described earlier is absent at the PBOC.

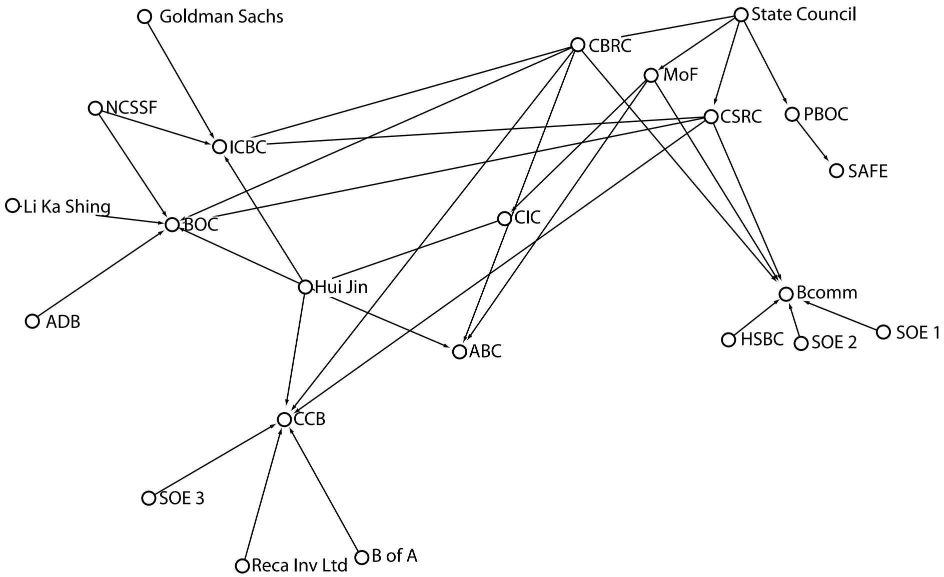

Fig. 1.1 Formal governance

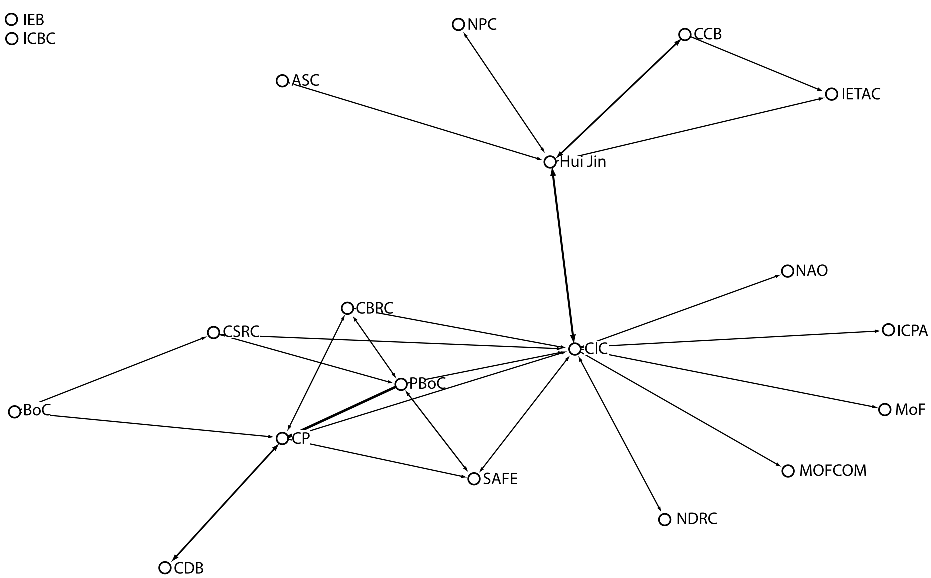

Fig. 1.2 HRM—Concurrent entity affiliations

player, less because of its ties to major banks—although it does have concurrent board seats at CCB—but instead, because members of its boards concurrently hold positions within the National People's Congress (NPC), the Accounting Society of China, as well as CIC, and indirectly (via interlocking board members at CCB) with China's International Economic Arbitration Commission.

In order to formally establish the relative importance of these various entities in the web of financial relations, we calculate the centrality of these different organizations based on *betweenness.* It measures the relation of a given actor to other actors in the system by calculating its position relative to other pairs of actors. The idea is that an actor that links multiple pairs of related actors confers power on that actor. The coefficient for betweenness increases with the number of geodesic paths to which it is linked; i.e. in our case the coefficient increases as a single entity is linked with each additional pair of organizations. According to this measure, CIC occupies the position of highest centrality for concurrent interlocking positions followed by the CCP.[12]

Figure 1.3 depicts the same affiliations, but this time we have included not only concurrent positions, but also the positions senior executives or board members had previously held at other entities within China's financial sector. The number of entities has increased and so has the complexity of the network. Visually it is apparent that CIC, Hui Jin, and the CCP, as well as the PBOC, occupy central positions within this network; in other words, each of them is linked to many other institutions by way of positions held by their top level financial cadres either concurrently or sequentially. However, the numerical analysis reveals that three of the "big 4" banks outperform CIC and PBOC on the centrality measure of betweenness[13]—even though CIC, the CCP, as well as the PBOC are close followers on this measure and outrank other state entities.[14] This suggests that they are more deeply embedded in the HRM governance regime as a result of previous appointments executive and supervisory board members at these entities have held than is apparent from analyzing only the current interlocking positions they occupy. It is also worth noting that whereas ICBC and IEB lack ties with other organizations in the financial system by way of current interlocking positions, many of their board members previously occupied such positions. Again, this suggests that they may in fact be less autonomous than their concurrent affiliations indicate.

Network analysis allows us not only to identify the centrality of different organizations in China's financial system, but also the centrality of individuals. The more positions a person occupies in a system, and the more other

12. The coefficient for CIC is 0.389 and for the CCP 0.283.
13. The coefficients for BOC, CCB, and ICBC are, respectively, 0.192, 0.252, and 0.244.
14. CIC 0.181, CCP 0.149, and PBOC 0.155.

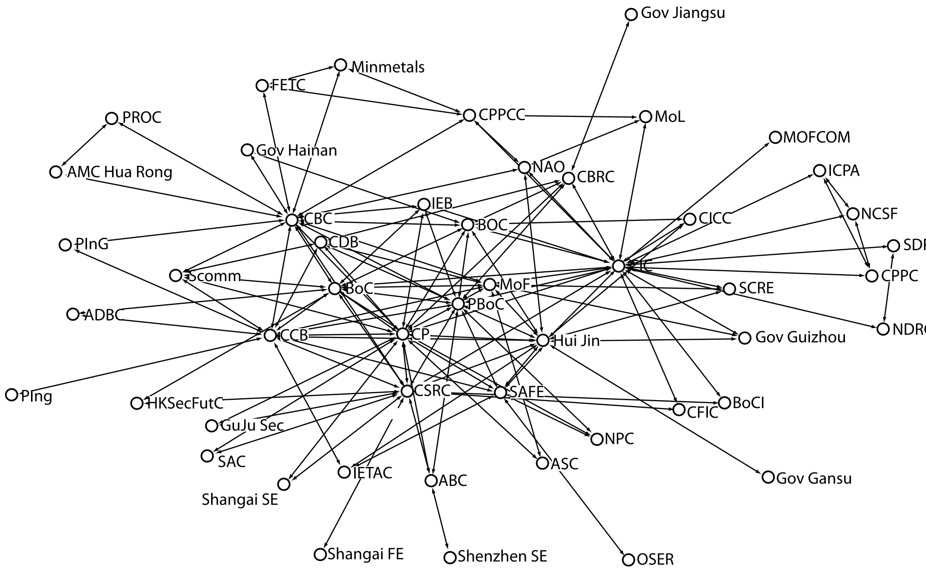

Fig. 1.3 HRM—Previous and concurrent entity affiliations

individuals are tied to it by holding positions at entities with which that individual is affiliated, the more powerful such a person is. Figure 1.4 reveals the relation among the 155 individuals in our database via organizations with which they are currently affiliated. The picture clearly insulates the people currently holding positions at ICBC and IEB from the rest of the financial cadres who maintain many ties with multiple entities throughout financial system by way of concurrent affiliation.

The measure we use to assert their centrality in this case is the degree of centrality, which measures how many ties a given node (here a financial cadre) has. In contrast to the betweenness measure used earlier, measuring centrality by degree is less concerned with how many dependency relations that individual intercepts. On this measure, three individuals, all affiliated with CIC, score the highest: Lou Jiwei, the chairman of CIC; Jin Liqun, the chairman of Hui Jin who also serves on CIC's board; and Cui Guangqin, also a concurrent board member of CIC and Hui Jin.[15] While perhaps not all personal ties should be given equal weight, because they do not necessarily confer the same level of influence in the governance of CIC, it is still remarkable how closely CIC is intertwined with other entities in China's financial system.

15. All three share the same score of 7.723. Note that for the purpose of this analysis we have excluded individuals that are only linked to ICBC or IEB as their score indicates relations to a much smaller network.

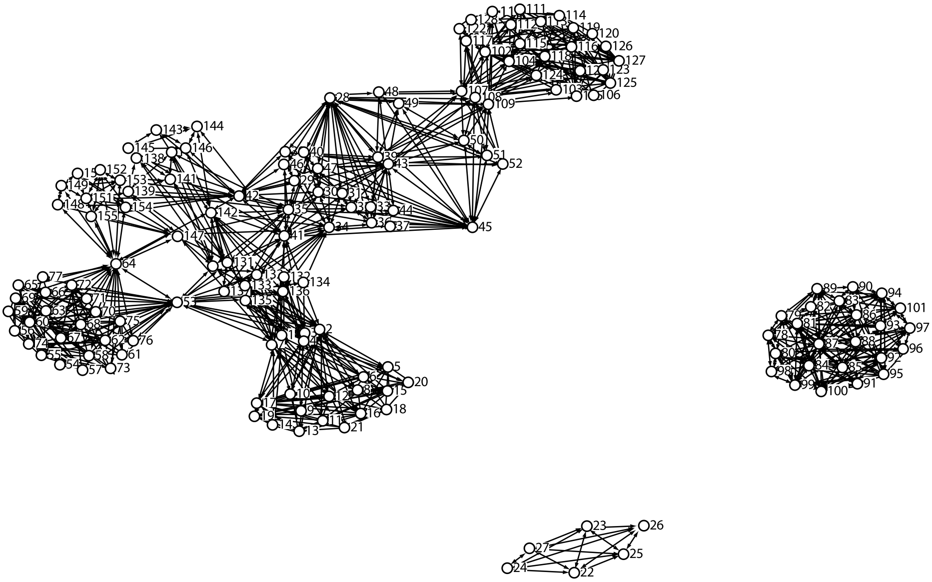

Fig. 1.4 Current personal affiliations

In practice, CIC portrays itself as an autonomous actor—an ordinary financial intermediary whose task it is to maximize financial returns on its assets without a political agenda or much explicit political interference. Yet, CIC has on its supervisory board representatives from virtually every important government entity within China's financial system and its executives previously served on important posts in other financial entities—including the PBOC, the MoF, and the CSRC.

Based on this analysis it seems fair to say that the 155 cadres currently occupying key positions in finance form a thick network, which links important entities and which comprises the core of China's governance regime for finance. The most striking result of this analysis is the contrast between the dense network relations depicted in figures 1.2 through 1.4 with the simple control structure in figure 1.1. While it may be too strong to suggest that personal ties substitute for formal control based on ownership ties, the former appear to dominate the latter. This is nowhere more apparent than in the role of the PBOC. Judging from the formal lines of control alone PBOC occupies a rather marginal place in China's financial system (see figure 1.1). However, based on the personal ties revealed in figures 1.2 and 1.3, there is little doubt that PBOC, or rather the financial cadres serving at PBOC, are central players within China's system of finance. Moreover, as in the early days of China's transition to a market economy, PBOC continues to operate as *the* link between state and party control over China's financial sector.

All of its leading cadres concurrently hold positions at PBOC's party committee and as such exercise HRM controls over key regulators within the system.

Yet our data also indicate that this system is not without vulnerabilities. As indicated in figures 1.2 and 1.4, some entities lack current interlocking ties with other organizations—most notably ICBC and IEB. The ICBC is particularly interesting, as it is traded on the Hong Kong and Shanghai stock exchanges and calls not only private investors, but also major foreign investors, such as Goldman Sachs, among its owners. This raises the question whether HRM as a governance regime can adapt China's increasing role in global finance.

1.5 China's Global Ambitions and the Future of HRM

The transformation of China's financial sector over the past ten years has gone hand in hand with its rapid expansion and its integration into the global financial system. The BOC, CCB, and ICBC, as well as Bank of Communications (BComm) were listed on Hong Kong's stock exchange and sold shares to foreign investors, including important strategic investors, as early as 2005 and 2007 (Pistor 2009a). The ABC followed suit in mid-2010.[16] While some of these foreign investors have shed or reduced their holdings in Chinese banks, mostly because they needed to raise fresh capital during the global financial crisis (Pistor 2009b), the bank's exposure to foreign investors has given them an opportunity to learn from other business models and adapt them to China's circumstances. Representatives of foreign banks served on the boards of China's commercial banks—albeit not in executive positions, giving them access to information on how the Chinese system of finance operates in practice, but also exposing other board members to the views of representatives of foreign financial intermediaries.

China's major banks have also become more active globally themselves. The BOC, which was carved out from the PBOC in 1984, took over the central bank's foreign currency portfolio at the time and has established branches and subsidiaries around the globe.[17] The CCB and ICBC have followed suit more recently and expanded their global operations. The ICBC has moved beyond opening representative or branch offices and has recently acquired a 20 percent stake in South Africa's Standard Bank in 2008. The

16. "Agricultural Revolution–Agricultural Bank's IP," *The Economist,* July 10, 2010, 69. Note that the key strategic investors for ABC were not private financial intermediaries from the West as in the case of the first three banks that went public, but instead were sovereign wealth funds (SWFs) from the Gulf states. This reflects the changing landscape of global finance. See Pistor (2009b) on the role of SWFs in the global financial system.

17. For details on BOC branches in different countries see http://www.BOC.cn/en/about BOC/.

two banks are now cooperating across the African continent in numerous ventures related to mining and natural resource exploration.[18] Last but not least, China established a new sovereign wealth fund in 2007. The CIC has made several widely reported foreign investments, including in the US private equity firm Blackstone and the investment bank Morgan Stanley (Pistor 2009b), and more recently in the natural resource sector.[19] In addition to CIC, the State Administration for Foreign Exchange (SAFE) and the National Security Fund (NSF) are engaging in foreign investments. In contrast to CIC, which has taken substantial minority stakes, SAFE and NSF seem to be taking smaller stakes and maintain a more diversified portfolio that includes both equity and debt securities.[20]

The involvement of foreign investors in China's state-controlled banks, the outward expansion of financial intermediaries, as well as the greater openness of China's financial system to foreign investments (including wholly owned banks and other financial intermediaries), raises questions about the viability of the described HRM governance regime as a long-term governance strategy.

A similar question can and should be asked about any governance regime, including those based on conventional formal mechanisms, such as ownership and regulatory controls. National regulators have only limited reach over their own banks with global operations and have had at best limited success in controlling foreign financial intermediaries operating on their shores. Nowhere has this been more apparent than in the recent global crisis. A good example is Iceland, which had allowed its bank Landsbanki to expand rapidly in foreign markets by using the interbank lending market for its liquidity needs and attracting foreign depositors with high interest rates in Internet retail operations primarily in the United Kingdom and the Netherlands (Turner 2009). When the interbank lending market froze, the Icelandic bank collapsed and Iceland was unable to cover deposit insurance for depositors in the United Kingdom. Legally, Iceland was responsible for insurance as well as lender of last resort functions of the Icelandic bank, because the UK operations were technically branch operations of the parent bank and as such under the jurisdiction of Iceland.[21] On the flip side, the United Kingdom had paid only scant attention to Icelandic's operations in the United Kingdom—after all, this was the responsibility of Iceland's

18. "ICBC cooperates with Standard Bank on 65 projects," *China Daily,* May 26, 2009, available at http://en.ce.cn/Industries/Financial-services.

19. For details on CIC's recent investments see http://www.swfinstitute.org/fund/cic.php.

20. See http://www.swfinstitute.org/fund/safe.php on SAFE. The National Council on Social Security Fund is only beginning to invest globally. See http://www.swfinstitute.org/fund/nssf.php.

21. For Iceland this followed not only from the Basel Concordat, but also from relevant EU legislation, as Iceland is a member of the EEA and as such subject to EU regulations and directives, which follow the Basel model in dividing responsibilities between home and host country regulators and lenders of last resort.

regulators. When that bank collapsed and amidst fears of another bank run,[22] the UK government stepped in to provide coverage and in return froze all assets of Iceland under an antiterrorism law. Similarly, regulators in Austria, Sweden, and other European countries witnessed their banking industry expand aggressively into Central and Eastern Europe (CEE). Again, these banking groups greatly contributed to a rapid credit expansion that proved unsustainable. Unlike the case of the Icelandic bank, the foreign operations usually took the form of wholly owned subsidiaries, which placed them under the jurisdiction of the host countries when it came to covering depositors and offering lender of last resort functions. Most of the CEE countries had tried to stem the flow of credit, but found this to be largely ineffective, because foreign parent banks quickly outmaneuvered them by switching to alternative channels for their continued credit expansion. As a result, most CEE saw themselves unable to rescue their own financial system and ended up seeking help from the International Monetary Fund (IMF) and other multilaterals (Pistor 2012). In short, neither the property rights regime of transnationally operating banking groups nor thirty years of international cooperation in developing common standards for banking supervision within the Bank for International Settlements (BIS) framework and the EU (which largely incorporated the BIS framework) have shielded countries that rely on those governance mechanisms from the prospects of financial collapse.

Similarly, both systems—the formal and the HRM governance regimes—have had their fair shares of rogue traders. For China, the wake up call that HRM might be insufficient for governing personnel located abroad came with the collapse of China Aviation Oil Company (CAO) on the Singapore Stock Exchange in December of 2004.[23] However, other governance regimes have experienced similar failures—one needs only to point to Barings or the more recent case of Société General.

Raising concerns about the vulnerability of HRM in the context of globalization is therefore not meant to benchmark this particular regime against an allegedly superior standard, but to detect the specific strengths and weaknesses of this regime in the global context.[24] China's HRM regime as described earlier is built around the notion that there is a centralized vetting of cadres for the financial sector not only when they first enter the system, but also as they advance through the system. For every major position at the central bank regulators (or financial intermediaries) the CCP or CCP committees at the PBOC or the CBRC vet and ultimately approve the relevant financial cadres. The PBOC also maintains its own training school from

22. The UK Bank Northern Rock failed in 2007 triggering the first bank run in the United Kingdom since 1866. See "The Run on the Rock," Report by the Treasury Committee of the UK House of Commons, January 24, 2008.

23. This case is explored in detail in Milhaupt and Pistor (2008, chapter 7, 125).

24. This approach is explained in greater detail in Milhaupt and Pistor (see note 23).

which people are recruited for important positions within the system.[25] As our data analysis suggests, a substantial number of persons in this universe have held other positions in finance before being appointed to the one they hold currently; moreover, they typically maintain direct and indirect ties to other entities where they served before or hold concurrent positions. The question then is, whether this system can adapt to the global operation of Chinese banks and/or the increase in job opportunities in China's expanding financial system, which includes an increasing number of entities that at least to our knowledge are not part of the CCP's HRM system.

In seeking answers to this question, this part of the chapter examines affiliations of members of management and supervisory boards of only those financial intermediaries that have substantial global operations. The purpose of this exercise is to analyze how deeply these entities are embedded in China's HRM system. This database includes 127 individuals at 18 entities. Twenty-four of the 127 individuals concurrently occupy another position within China's financial system, while the remaining 103 do not. Of those that are currently without interlocking positions, 54 have held positions at other financial organizations prior to their current position and 39 held positions at state entities in finance, such as the PBOC, SAFE, the CBRC, and so forth. The other fifteen individuals occupied positions at another bank—typically at a time when these banks were still an integral part of a state-controlled financial system. Still, this leaves forty-nine individuals without any current or previous affiliations—some of which are other representatives of foreign investors, others "independent" directors recruited, among others, from academic institutions in China.

As can be seen in figure 1.5, the density of current affiliations varies. As already noted, ICBC and IEB have no current affiliations. However, the number of current affiliates at other commercial banks with global operations, including BOC and CCB, is also strikingly low. In part this seems to be compensated by what one may want to call "strong" ties within China's HRM system. Thus, Xiao Gang, the CEO of BOC, is head of the CCP Commission at BOC, and thus closely tied to the party; but this is not the case for CCB's CEO, Guo Shuqing. Guo's future career may still be entirely dependent on the CCP's HRM system and that might suffice to ensure that his interests and the interests of the bank he heads are aligned with those of China's leaders. However, as CCB continues to expand globally, increasing tensions between global opportunities and concerns about China's internal stability may arise and, at least for an outside observer, it is difficult to determine how such a conflict might be resolved.

It may be too strong to assert that some banks with global operations

25. I am grateful to Professor Leonard K. Cheng at Hong Kong's University for Science and Technology for pointing this out.

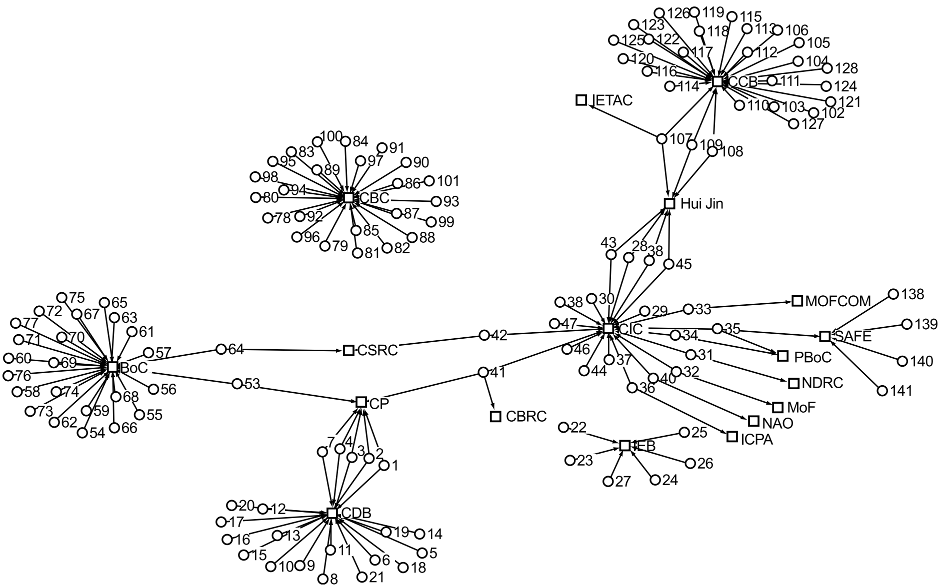

Fig. 1.5 HRM for global players

are "growing out"[26] of the HRM used to govern China's financial system. Nonetheless, the examples suggest that some entities have enjoyed greater leeway in recruiting from a pool of people with fewer ties to the broader network of China's financial cadres. Within China, this is a new experiment. There is little doubt that underperformance of these individuals too would be sanctioned were they to return to the state-controlled financial system. However, today they may well find job opportunities elsewhere. Nonetheless, as long as the flow of people the CCP can recruit into this system is sufficiently large, the fact that some will exit and find jobs in systems that maintain fewer controls over individuals may not lead to its demise. Of greater importance is the size of the financial system under the control of the CCP relative to those parts that escape its control. As mentioned, the CCP controls key positions only at China's largest banks. Today they still account for 70 percent of all bank assets (see ACFB 2007). However, smaller banks are no longer directly controlled by the state and the opening of China's financial system to new entrants, including greenfield establishments, may gradually change the financial landscape. Just as China's real economy has

26. This terminology is borrowed from Naughton's book *Growing out of the Plan* and the accompanying analysis, which suggests that China's path to economic success has been a gradual transformation of economic relations.

"grown out of the plan" (Naughton 1996), so too may the financial system grow out of CCP tutelage. This process, however, is only beginning. If anything, the global financial crisis has strengthened those who believe that a liberalized financial system poses a threat to China's economic success and its political foundations.

1.6 HRM in Comparative Perspective

China's governance of finance may be unique with respect to the central role the CCP plays in vetting cadres for key positions within the system. However, other countries also have a highly centralized elite structure that dominates the key echelons of power in politics, finance, and big business. A comparison of power elites in Britain and France reveals that in both countries elites are highly concentrated, but that the social processes by which elites are formed and the position they occupy on their path to power differ across systems (Maclean, Harvey, and Chia 2010). Maclean et al. identify the top power wielders in both countries by focusing on corporate executive and nonexecutive directorships. They allocate weights to positions in corporate hierarchies these directors hold (whether CEO, chairman of the board, etc.) for a sample of over one thousand agents in each system. They find that in France, 200 directors wield 63 percent of the combined power of the entire sample; and in Britain 54 percent (Maclean, Harvey, and Chia 2010, 336). The formation of this elite occurs primarily in the education system, especially in France. Ninety-five percent of the top 100 directors in France attended a Parisien *lycée* (high school) and virtually all attended one of France's elite schools (*grandes écoles*) for higher education, such as the École Poytechnique, the Institut d'Études Politiques de Paris, or the École Nationale d'Administration (ENA). Education at one of these institutions does not only open the path to top positions in state administration or politics, but also in the private sector. In Maclean's sample, 49 of the top 100 corporate directors in France began their career in government and advanced from there to one of the top positions in the private sector (Maclean, Harvey, and Chia 2010, 339). These findings are consistent with earlier findings that showed that a position at the French Treasury is a critical step in the career path of a future top level manager at one of France's financial institutions (Kadushin 1995). The Treasury is one of the most powerful agencies in France's political system and recruits the top graduates from the *grandes écoles* (Kadushin 1995, 210). Directorships and similar positions with the Treasury are term limited (five years). However, private sector financial institutions recruit their top corporate officers at the Treasury, offering them a multiple of their salaries.

The pattern of career advancement is thus not very different from China's. As suggested in this chapter, top corporate officers of China's largest banks typically served previously either at the PBOC or the Ministry of Finance at earlier stages in their career before advancing to their current position. Interestingly, this pattern of elite formation has not changed after France abandoned direct control over the corporate and financial sectors (Kadushin 1995). Existing literatures say little about whether this form of HRM has gained strength as the state has lost direct control over the corporate sector—a trend that is suggested by the CCP's strengthening of HRM since the late 1990s. At the very least, however, the experience of France confirms that state ownership is not needed for HRM, and that it survives changes of ownership as well as changes in government.

The aforementioned discussion could lead to the conclusion that HRM is more common in countries with a high level of state control over the economy, or in the language of the comparative capitalism literature, in "coordinated market economies" in contrast to "liberal market economies," as represented by the United Kingdom or the United States (Hall and Soskice 2001). In fact, Yoo and Lee suggest that elite networks are complementary to institutions of state dirigisme and associated low levels of social trust (Yoo and Lee 2009).

However, available evidence suggests that liberal market economies too are governed by elites. Thus, Maclean et al. find that in Britain over 88 percent of the top corporate directors attended elite framer schools, such as Eton, Winchester, or Harrow. While the level of higher education is much lower than in France, those with higher education tended to have gone to Oxbridge or Harvard (Maclean, Harvey, and Chia 2010). Moreover, 84 out of 100 corporate directors began their career in the private corporate sector and the remainder in law or similar professions, but not in government service. In the United States, linkages between the corporate and government sectors appear to be more prevalent. The importance of power networks that criss-cross government and business in the United States was first pointed to by Mills in 1956 (Mills 1956). Moreover, anecdotal evidence confirms that links between government and finance are strong, as suggested by the advancement of two former Goldman Sachs top managers to the position of US Treasury in two recent administrations: Paul Rubin in the Clinton administration, and Hank Paulson in the George W. Bush administration. Indeed, a more systematic analysis of elite structures for the 1990s reveals strong interlocks between the corporate, nonprofit, and state sectors in the United States (Moore et al. 2002). Using a newly created elite database, they show that many corporate directors link to nongovernmental organizations as well as to federal advisory bodies. Unlike China or France, however, the movement appears to be less from government into the private sector, but from the private sector into the government sector: "The most central (i.e., the best-connected) organizations in these interorganizational networks are also major corporations" (Moore et al. 2002, 740).

In sum, looking beyond the formal structures, such as ownership or regulatory oversight that are commonly used in economics and law to identify governance structures, serves as an eye opener not only in China, but equally in other countries. Elites are prominent in government and business, and in fact often link government and business. However, not all elites are formed in a similar manner and the dominance of government versus the private sector for elite formation differs across countries. Future research should focus on how these structures help shape the formal structures that govern finance—not only in China, but also in the West.

1.7 Concluding Remarks: HRM and Global Governance

This chapter has shown that governance of China's finances cannot be explained completely using conventional paradigms that rely on ownership and legal or regulatory controls alone. Instead, China's governance regime relies heavily on HRM. The regime evolved and strengthened during the transition from complete state control over finance, which lasted until the early 2000s, to a more diverse system that allows for more diverse ownership patterns, more players within China's domestic financial system, and greater opportunities for Chinese entities globally. Further diversification, in particular the greater job opportunities for financial cadres outside the CCP-controlled HRM system might undermine the logic of this regime; that is, control over future career prospects of financial cadres and the current governance regime needs to adapt to these ongoing changes. The possible direction of such changes can be gleaned from emerging patterns of governance employed by Chinese entities that operate globally. The relation between CIC with Blackstone and Morgan Stanley may serve as an example. The CIC holds over 10 percent in ownership stakes in both entities—in Blackstone, which is a limited partnership in the form of nonvoting "units," and in Morgan Stanley in the form of preferred stock as well as debt instruments. Yet in neither company does CIC hold board positions. While executive positions were excluded in the original investment agreements, CIC had the option to appoint representatives to the board of directors in both companies. The choice not to exercise these options could be interpreted to suggest that CIC has decided to operate as a purely passive investor. This, however, might not capture the whole story. As 10 percent owner and potential future funder, CIC undoubtedly has a voice with the management of these organizations. Moreover, CIC announced that Blackstone and Morgan Stanley have been chosen by CIC to manage hundreds of millions of dollars in new global investments. The Wall Street Journal captured this move with the headline "CIC turns to friends."[27] The move to strengthen personal ties even as financial gains were still outstanding suggests that CIC invested not only, and perhaps not primarily, in financial assets when it invested in these firms, but in relational bonds comprising of human capital. That investment appears

27. Carew and Strasburg (2009).

to be paying off handsomely for Blackstone and Morgan Stanley as they have gained money management opportunities for CIC's investments. It might also point the way toward a different form of HRM in the global context: one that does not rely primarily on controlling future careers, but access to future finance and markets. This would be akin to the world of international finance in the old days when family empires—from the Medici to the Rothchilds—dominated international finance.

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Comment Zheng Song

This chapter is very useful for understanding how the financial system is governed in China. There is a widely held belief that the Chinese government (or the Communist Party of China) has firm control on Chinese financial markets. However, the underlying mechanism through which the Chinese government exercises its controls is far from clear. The problem becomes even more challenging as China has established formal ways of governing its financial sector (mimicking those in developed countries). So, more fundamentally, how can the Chinese government continue to maintain the direct state control given the substantial ownership changes over the past decade? This chapter looks at a data set covering a total of more than 150 top administrators or managers and concludes that human resource manage-

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