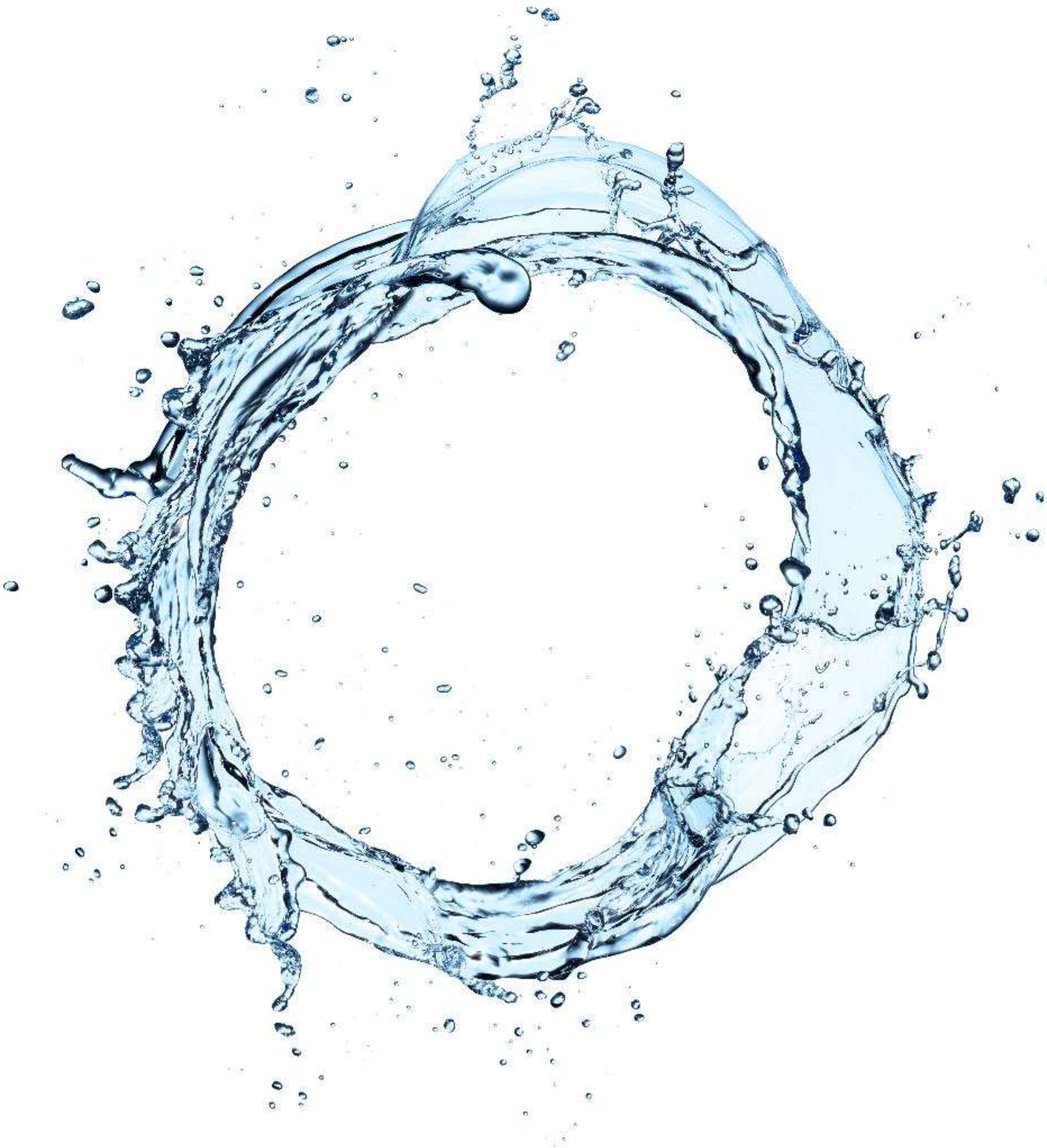


Research Report on the Corporate Governance Practices of China's Big Six Commercial Banks (2019)

March 2019

Contents

I. Introduction

As early as 2013, Chinese President, Xi Jinping put forward the initiative of "building a community with a shared future for mankind". In today's world, each country has its own political, economic and social systems, as well as distinct cultures, traditions and values. Undoubtedly, a deep understanding of these differences between countries, forms the basis for peaceful development and construction of a "community with a shared future for mankind".

Keeping this concept in mind, we use the corporate governance practices of China's Big Six Commercial Banks, as a research example through observation, interview, analysis and recommendation, to display an objective picture for the world. This study aims not only to help the world better understand the governance practices of China's Big Six Commercial Banks, but also to improve the efficiency and quality of the governance practices and to contribute to the progress of the banking industry in China.

From the perspective of China's economic and financial systems, the Big Six commercial banks, namely, Industrial and Commercial Bank of China (ICBC), Agricultural Bank of China (ABC), Bank of China (BOC), China Construction Bank (CCB), Bank of Communications (BOCOM), and Postal Savings Bank of China (PSBC) (hereinafter referred to as "China's Big Six Commercial Banks" or the "Big Six Banks") play an essential role as "market stabilizer" in the Chinese economy. China's Big Six Commercial Banks have experienced monopoly during the traditional planned economy period, and have completed revolutionary changes in the modern market economy. The shareholding reform in 2004 pushed the Big Six Banks towards establishing a modern corporate governance system. Over the past 15 years, China's Big Six Commercial Banks have continuously explored and gradually established their corporate governance framework that are well recognized by the international capital market. From June to October 2017, China's Big Six Commercial Banks had completed the task of incorporating the overall requirements of "Party Building Work" into the company's articles of association, and established the corporate governance framework of "Four Meetings and One Management", namely the Party committee, general meeting of shareholders, board of directors, board of supervisors and senior management. The corporate governance practices of China's Big Six Commercial Banks have their distinctive characteristics whilst also sharing certain similarities with their international peers, which have attracted extensive attention and discussion.

With the increasing trend of economic globalization, the effectiveness of the corporate governance of China's Big Six Commercial Banks has a significant impact on the world economy. In recent years, ICBC, ABC, BOC and CCB have been listed by the Financial Stability Board (FSB) as the global systemically important banks (G-SIBs), representing their increasing importance in the global economic system. As a result, the corporate governance requirements of these banks have become more stringent. The Basel Committee on Banking Supervision pointed out in its 2015 new edition of "*Bank Corporate Governance Principles*" that effective corporate governance is critical to the operations of the banking industry and the economic system as a whole. From a macro perspective, good corporate governance of commercial banks is the basis for strengthening financial regulations and preventing systemic financial risks. From a micro perspective, effective corporate governance is the cornerstone of sustainable development for the banks. For China's Big Six Commercial Banks, especially for the global systemically important banks, there are still many pressing issues as to how to conduct corporate governance more effectively and ensure the healthy development of the banking industry and the financial industry as a whole.

This research project was led by Mr. Chen Caihong, a distinguished professor of Zhongnan University of Economics and Law, with the joint efforts of experts and scholars from the International Finance Corporation (IFC) of the World Bank Group and the Corporate Governance Research Center of Deloitte China. In the course of the research, the project team focused on observing, discussing and analyzing corporate governance based on the annual reports of China's Big Six Commercial Banks and other publicly available information. The project team also reviewed and summarized relevant literature on corporate governance, conducted in-depth interviews with directors and executives of China's Big Six

Commercial Banks, experts from professional organizations, and drafted the *"Research Report on the Corporate Governance Practices of China's Big Six Commercial Banks (2019)"* (hereinafter referred to as "the report"), which was released at Boao Forum for Asia 2019.

II. Achievements of the Big Six Banks in Corporate Governance

In the late 1990s, the Big Six Banks were "technically bankrupt" and were dependent on implicit financial support from the government for their survival[1]. Since the Big Six Banks started their shareholding reform focusing on corporate governance in the early 21st century, they rapidly raced out of "technical bankruptcy" and caught up with, or even outperformed their international counterparts, in terms of scale, asset quality, capital adequacy, profitability and risk control. As a result, China's banking industry was less impacted by the 2008 global financial crisis. BOC, ICBC, ABC and CCB were included in the list G-SIBs by the Financial Stability Board (FSB) for the first time in the years 2011, 2013, 2014 and 2015 respectively. In 2018, ICBC, CCB, BOC and ABC were on the top of the list of 1000 world largest banks, as published by the British magazine "*The Banker*". Effective corporate governance is critical in helping the Big Six Banks to expand in scale, improve asset quality, increase overseas network and maintain steady performance of stocks in both domestic and foreign capital markets.

2.1 Establishment of a corporate governance system recognized by the international capital market

The Big Six Banks have completed the shareholding reform[2] and have been listed in domestic and foreign capital markets since 2004. Establishing a corporate governance system in line with internationally recognized principles, is not only the basic requirement stipulated by regulators and stock exchanges for listing stocks, but also forms the premise for shares to be subscribed by domestic and international investors. The Big Six Banks have established a "Three Meetings and One Management" governance structure comprised of general meeting of shareholders, board of directors, board of supervisors and senior management. Their governance structures do not directly replicate any existing corporate governance models, but follow the basic corporate governance principles, i.e., separation and check and balance of governance bodies in decision making, supervision and execution, equal treatment of all shareholders and transparent information disclosure, which provide assurance to investors (especially foreign strategic investors) to buy and hold their shares.

The board of supervisors in the "Three Meetings and One Management" governance structure set up by the Big Six Banks is an apparent reference to the corporate governance models in Germany and Japan. However, the board of supervisors does not have the same authority in appointing, dismissing and genuinely supervising directors, as those in Germany and Japan. The board of supervisors has overlapping functions with special committees under the board of directors, such as audit committee. The corporate governance structure of the Big Six Banks is similar to the British and American models both in form and essence, which place the board of directors in the central position of corporate governance. Following such models, independent directors are deployed to balance executive directors representing senior management, and equity directors representing major shareholders. Various special committees are established to improve the efficiency of decision-making and discussion. Besides, independent directors chair audit, remuneration, nomination, related party transaction and other special committees to avoid potential conflicts of interest arising from the control of major shareholders or senior management over these committees. The Big Six Banks have fully implemented international best practices in terms of shareholding structure diversification, board

[1] The description of the "technical bankruptcy" of the banks in the late 1990s applies only to ICBC, ABC, BOC and CCB.

[2] BOCOM completed the shareholding reform on 1 April 1987 and became the first national joint-stock commercial bank. It went public on the Hong Kong Stock Exchange in 2005 and the Shanghai Stock Exchange in 2007.

composition diversification, board decision-making process standardization, and information disclosure transparency.

2.2 Diversification of shareholding structure and improved corporate governance practices

Shareholding structure is the foundation of corporate governance. In the early 21st century, the most fundamental change in the corporate governance of the Big Six Banks was the transformation of the ownership from 100% state-owned to state-controlled and the diversification of shareholding structure realized by introducing strategic investors, especially overseas strategic investors. For example, CCB, ICBC, BOC, BOCOM and PSBC drew investments from Bank of America, Goldman Sachs, Royal Bank of Scotland, HSBC and UBS respectively. After the initial public offering, the shareholding structures of the Big Six Banks were further adjusted to be state-controlled (BOCOM is slightly different and relatively controlled by the state), with a large proportion of shares held by state-owned legal persons and foreign capital, and certain shares held by the public. As the representative of state-owned capital investors, the Ministry of Finance (MOF) and Central Huijin Investment Ltd. (hereinafter referred to as "Central Huijin") held the responsibility of preserving and enhancing the value of state-owned capital of the Big Six Banks. They have played an active role in corporate governance by appointing equity directors to protect the interests of major state-owned shareholders and committed not to interfere in the specific operations and management activities of the Big Six Banks.

The modernization of corporate governance of the Big Six Banks started with the introduction of strategic investors and the diversification of the shareholding structure. It was these "outsiders" that pushed the Big Six Banks to deliberate on balancing and coordinating the interests and concerns of different stakeholders through corporate governance, and hence realize genuine corporate governance practices "from form to substance". In order to protect their rights and interests, strategic investors nominated directors to participate in the decision-making and supervision of the board of directors, which have set up an effective check and balance mechanism. They also sent experienced professionals to help the Big Six Banks improve their corporate governance structures by providing technical assistance. For example, after buying shares of BOCOM, HSBC not only provided strong support on staff training, but also sent an executive vice president, a director and some department managers to BOCOM, which played significant roles in the construction of BOCOM's IT system and risk management mechanism. The diversification of the shareholding structure partly addressed the problem of absence of owners and the dominant state-owned major shareholders for the Big Six Banks, triggering fundamental transformation in corporate governance and improving its quality.

2.3 Exploration of the corporate governance practices with Chinese characteristics of the Big Six Banks and the "Four Meetings and One Management" governance structure

Based on China's political and economic systems, state-owned commercial banks have adapted their corporate governance models to China's conditions. Prior to the shareholding system reform, the Big Six Banks were operated under the "old three meetings" governance structure which had the Party committee, workers' congress and the trade union as their main corporate governance bodies, primarily requiring the banks to implement national, economic and financial policies as well as protect the rights and interests of employees. After the implementation of the shareholding reform, the new statutory corporate governance bodies of the Big Six Banks included general meeting of shareholders, board of directors and board of supervisors. They protected the interests of state-owned shareholders, other shareholders and stakeholders including depositors and taxpayers. Meanwhile, the "old three meetings" co-existed with the "new three meetings", where the role of Party committee in corporate governance was substantially strengthened, and certain responsibilities of workers' congress and trade union such as protecting the rights and interests of employees were transferred to the board of supervisors.

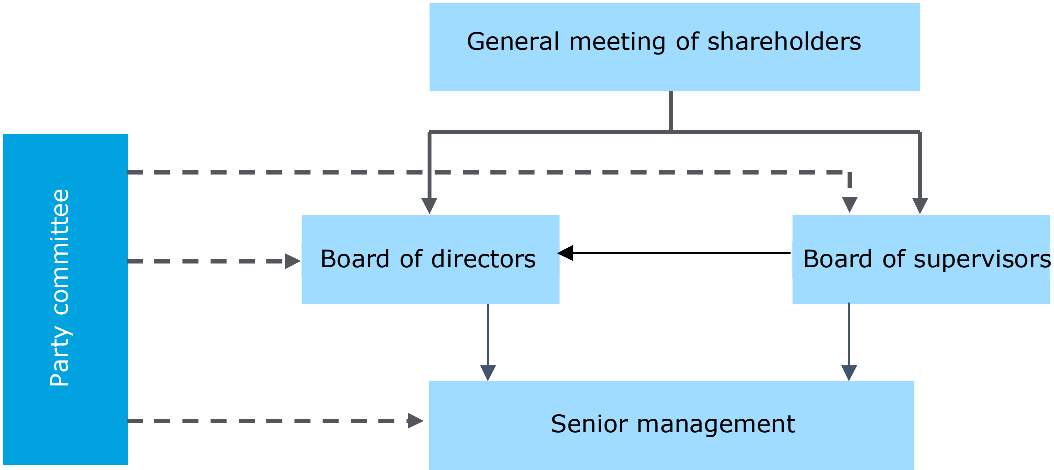
In 2017, the Big Six Banks completed the revision of their articles of association, which defined the legal position of the Party organization in corporate governance and built a corporate governance structure of "Four Meetings and One Management." The corporate governance structure comprises the Party committee, general meeting of shareholders, board of directors, board of supervisors and senior management (see figure 1). This structure may be the most comprehensive and complex corporate governance arrangement. The governance role of the Party organization is the most distinct part with

Chinese characteristics in the corporate governance structure of the Big Six Banks. It plays a key role in understanding their corporate governance structures.

Externally, the governance role played by the Party organization satisfies the requirements of the ruling Party (i.e., the Communist Party of China) and the government that the Big Six Banks should be positioned as the ruling Party's economic and political foundation. Internally, the Party organization not only directly plays an important role in governance, including decision-making on major matters and the appointment and dismissal of major personnel, but also helps facilitate the operation of the "Three Meetings and One Management" structure through "double entry, cross offices"[3].

While there could be challenges to existing corporate governance theories and principles, the corporate governance structure of "Four Meetings and One Management" could be a feasible institutional arrangement to effectively balance the political demands of the ruling Party and the economic demands of stakeholders of the Big Six Banks in China's current political and economic context.

Figure 1. Corporate governance structure of "Four Meetings and One Management"



Note: The solid arrow in the figure indicates the supervisory relationship stipulated by the Company Law and the dotted arrow represents the impact of the Party committee on the operation of "Three Meetings and One Management" through "double entry, cross offices".

2.4 Establishment of a legally compliant and multiple-channel communication mechanism with the stakeholders

Being fully-informed is essential to exercising their rights effectively. Timely and transparent information disclosure and communication is a basic condition to protect the rights and interests of investors, enhance market confidence, and maintain the safe and stable operation of banks. It is also the focus of capital market regulators. As listed companies and systemically important financial institutions, the Big Six Banks follow stricter standards and requirements in information disclosure and communication. Combined with investor relationship management, the Big Six Banks have generally set up complete and diverse channels for information disclosure and communication, including the statutory information disclosure channels such as periodic reports and announcements of major events, as well as diversified forms of information communication such as investor relationship webpages, results briefings, road shows, investor and analyst meetings, investor hotlines and emails. In order to ensure the high quality of information disclosure, the Big Six Banks have established a comprehensive information quality assurance system composed of market discipline, government

[3] The term "double entry, cross offices" means that eligible Party committee members can enter the board of directors, board of supervisors and management through legal procedures and eligible members of the board of directors, the board of supervisors and the management may enter the Party committee in accordance with relevant regulations and procedures. A Party committee member may have a dual role. For example, the Party secretary and the chairman of the board of directors can be served by one individual.

regulations, external audit and internal control. Among listed Chinese companies, the Big Six Banks have set a good example in terms of the compliance, transparency and adequacy of information disclosure and communication.

The Big Six Banks have more complexities than ordinary listed companies and ordinary commercial banks in terms of the types, composition and information demands of their stakeholders. Government authorities, regulators, large state-owned shareholders, institutional investors, medium and small shareholders, rating agencies, securities analysts and news media have different information demands with their own focuses and varying requirements on information communication channels and methods, which bring a great challenge to provide equal access to information for different stakeholders, and prevent non-compliant information disclosures such as early access of some stakeholders to sensitive information or access to information unavailable to others. According to the information disclosure regulations of the China Securities Regulatory Commission (CSRC) and stock exchanges, all the Big Six Banks meet the requirements of "direct channel for information disclosure"[4], making it easier for these banks to balance the information disclosure and information confidentiality and make decisions on the time and content of information disclosure at their discretion, especially the exemption scope of information disclosure. At the same time, it also brings challenges to the Big Six Banks on how to assure the authenticity, integrity and accuracy of information disclosure, serve the market target of corporate governance and facilitate the proactive and voluntary disclosure. In general, with the guarantee of both external supervision and internal control, the Big Six Banks provide high quality information disclosure that is recognized by investors.

2.5 Initial formation of culture and values in corporate governance, risk management and internal control throughout the banks

Culture and values are strong determinants of corporate governance effectiveness and the most difficult to replicate. As the structure, system and mechanism of corporate governance of the Big Six Banks are built on the basis of corporate governance international best practices, they are not completely compatible with Chinese cultures and traditions. For example, the concept of hierarchy emphasized in traditional Chinese culture, conflicts with the equal consultation and democratic decision-making advocated by modern corporate governance. Building a modern corporate governance system based on local cultures and traditions has become another challenge for the Big Six Banks as it relates to corporate governance. It should be noted that the values of science, democracy, equality, transparency, prudence, robustness and compliance have become the "tone from the top" of the Big Six Banks. These values have been embedded into the operating principles and codes of conduct of the Big Six banks.

As commercial banks are essentially running risk business, risk management and internal controls are crucial to their corporate governance systems. By drawing on international experiences, the Big Six Banks have established sound and comprehensive risk management and internal control systems, including establishment of risk management committee and audit committee under the board of directors, appointment of chief risk officer and chief audit executive, building of vertical and independent risk management and internal audit organizational structures. The banks have established direct reporting lines from risk management department to the risk management committee and from internal audit department to the audit committee of the board of directors. The risk management and internal control systems of the Big Six Banks can not only identify, measure, evaluate and respond to credit risk, market risk and operational risk in an accurate and timely fashion, but also generate quantitative risk information to support the strategic decisions of the board of directors and the investment decisions of investors. When it comes to risk management and internal control, the Big Six Banks have successfully built the organization, technology, method, system and raised the risk and control awareness of managers and employees at all levels. The Big Six Banks have developed a stronger sense of prudence, legal compliance and risk-benefit balance in risk management and internal control.

[4] It means that the Big Six Banks can make their own decisions on the time and content of information disclosure on designated media in accordance with relevant laws and regulations. The exchanges do not review in advance.

III. Observations on Corporate Governance Practices of China’s Big Six Banks

3.1 New corporate governance practice of “Four Meetings and One Management”

The core role played by Party organizations (the Party committee or Party group) in corporate governance is the most distinct feature with Chinese characteristics in China’s state-owned enterprises (SOEs). As the General Secretary Xi Jinping pointed out, the Chinese characteristics of modern enterprise systems in SOEs should incorporate the Party’s leadership into each part of corporate governance, embed enterprises’ Party organizations into the corporate governance structure and clarify the legal status of Party organization in the corporate governance structure. The core governance role of the Party organization satisfies the requirements of the ruling Party to effectively control large commercial banks and hence, enhance its economic and political bases to maintain its ruling position.

From the emergence of the People’s Republic of China, the Communist Party of China (CPC) has been the most important governance body in the social and economic organizations, including SOEs. The main governance structure was the “old three meetings” with Party committee being the core component, before the large commercial banks started their shareholding reform in the early 21st century. After the reform, these banks have established the “new three meetings”, thus generating an independent and interrelated governance structure between the “old three meetings” and “new three meetings”. The effective connection between the “old three meetings” and “new three meetings”, especially the division of authorities, responsibilities and functions between Party organization and the board of directors, has been a major issue to be addressed for the large commercial banks.

Since the 18th CPC National Congress in 2012, the role of Party organizations has been more evident and in the forefront, referring to the SOEs’ definition of the role and function of Party organizations in their articles of association as “Incorporating the Party Building Work into the Articles”. It has changed the Party organization’s usual behavior pattern of “doing without saying”, which has aroused widespread attention from domestic and foreign capital markets. On 1 December 2015, the Organization Department of the CPC Central Committee and the State-owned Assets Supervision and Administration Commission (SASAC) held a symposium of central SOEs on Party building, which formally launched the progress of "Incorporating the Party Building Work into the Articles”. On 25 May 2017, MOF issued the "*Amended Guidelines for Central Financial Institutions to Put Party Building Requirements into the Articles of Association*" (hereinafter referred to as “*Amended Guidelines*”).The *Amended Guidelines* require the central financial institutions to complete the amendment of the decision-making procedure of corporate governance in the articles of association by the end of October 2017. They also form the basis and provide an example for the Big Six Banks to follow. ICBC, ABC, BOC, CCB, BOCOM and PSBC completed the approval procedures for “Incorporating the Party Building Work into the Articles” at their general meetings (see Table 1) from June to October 2017. The Big Six Banks promised investors that “Incorporating the Party Building Work into the Articles” would not harm shareholders’ interests or disrupt the practices of the board of directors. At the general meetings of the Big Six Banks, a majority of attendees voted for the proposal and the banks’ share prices remained stable during the amendment process, without abnormal fluctuations.

Table 1. The Big Six Banks' key timelines of amending articles of association

Event	ICBC	ABC	BOC	CCB	BOCOM	PSBC
Announcement of the resolution approved by the board of directors to amend articles of association	9 Jun 2017	9 Jun 2017	9 Jun 2017	27 Apr 2017	24 Aug 2017	12 Sep 2017
Approval at the general meeting	27 Jun 2017	28 Jun 2017	29 Jun 2017	15 Jun 2017	27 Oct 2017	27 Oct 2017
Approval by the China Banking (and Insurance) Regulatory Commission	25 Sep 2017	8 Nov 2017	27 Nov 2017	13 Mar 2018	8 Apr 2018	21 Jun 2018

The completion of "Incorporating the Party Building Work into the Articles" marked the creation of a corporate governance structure of "Four Meetings and One Management" by China's large commercial banks. What role does the Party organization play in corporate governance of large commercial banks? How do the Party committee and the board of directors define their roles and responsibilities and coordinate their functions during the decision-making process? How to protect the rights of the board of directors to appoint directors and senior management under the principle of "Party supervising leaders"? Should the Party organization disclose its basic information and decision-making process as "Three Meetings and One Management" do? All these major issues are concerns of domestic and international regulators and investors. These are the focuses of our research as well.

3.1.1 Roles and responsibilities of the Party organizations in the corporate governance of the Big Six Banks

The core governance role of the Party organization is decision-making

According to the official documents, the Party organization is positioned as the "core leader", but it is not a corporate governance concept that specifies authorities and responsibilities. While the board of directors, board of supervisors and senior management are responsible for decision-making, supervision and execution respectively, the Party organization takes the responsibility of leading other governance bodies. This suggests that the Party organization has a higher power as compared to the other governance bodies when it comes to decision making, supervision or execution. BOCOM summarizes the role of the Party committee in "Four Meetings and One Management" as "core leadership of Party committee, strategic decision-making by the board of directors, lawful supervision by the board of supervisors, and operation with full authority by the management". The *Amended Guidelines* clarify that the Party organization should conduct research and discussion on major issues, which is the "ex-ante procedure" before the board of directors makes decisions. The role of research and discussion is to facilitate the decision-making, however, the Party organization has the authority to decide whether major issues should be submitted to the board of directors for review. In practice, proposals approved by the Party organization after its research and discussion have rarely ever been vetoed by the board of directors. Both literature researches and interviews indicate that the Party organization is the decision maker when it comes to major issues and it plays the most significant role in governance structure.

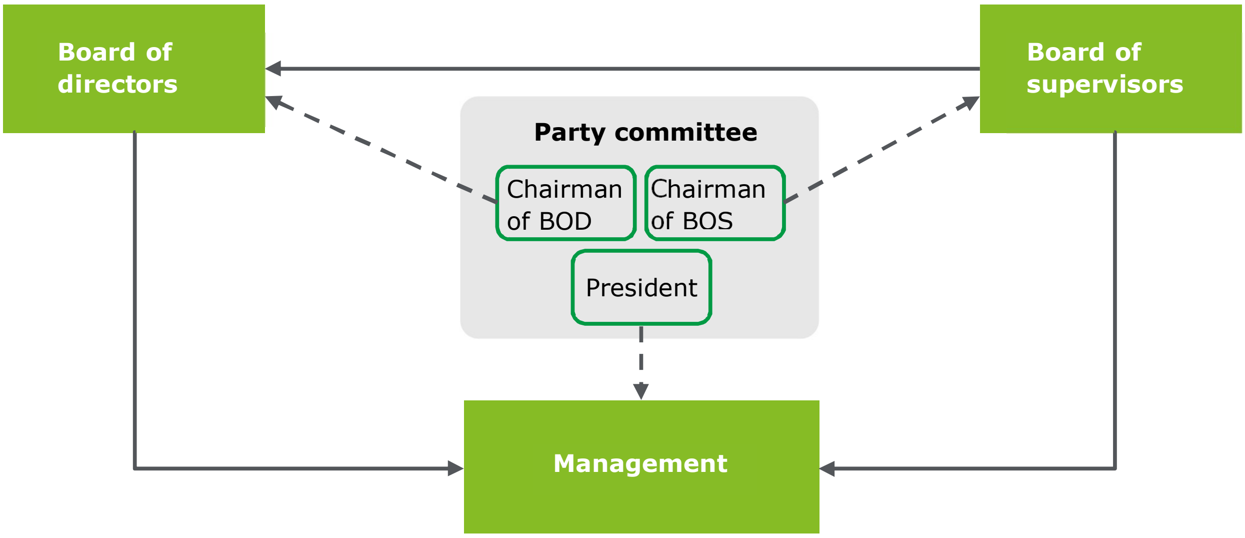
The governance objective of the Party organizations is to follow the political direction and serve for the fundamental policy on national economy and finance

As part of the ruling CPC organization, Party committees of the Big Six Banks should adhere to the directions, guidelines and policies set by CPC and follow CPC's principles and disciplines. The Party committee has roughly the same goal as the "Three Meetings and One Management" in facilitating the Big Six Banks to improve their operations, management, risk prevention and control abilities, market competitiveness, management efficiency and shareholder returns. Given the important position of the Big Six Banks in the economy, the ruling Party requires the banks to assume greater social responsibility in maintaining financial and social stability, boosting economic development and improving people's livelihoods. The Party committee's emphasis on macro policy goals and social objectives can restrain the Big Six Banks from excessive pursuit of economic benefits and risk-taking and push them to perform their social responsibilities for stakeholders. However, this weakens the economic attribute of commercial banks and could conflict with the goal of the commercial banks to pursue economic benefits and shareholder returns. Under these circumstances, the Party committee needs to play its core governance role in coordinating the interests of all parties, balancing internal and external objectives as well as building consensus.

Party committees coordinate the operation of "Three Meetings and One Management" through "double entry, cross offices"

As Party organizations were incorporated into the "Three Meetings and One Management" governance structure as a core governance body, the Big Six Banks faced an increasingly complicated corporate governance and growing operational costs. To facilitate the smooth operations of "Four Meetings and One Management" and reduce governance costs, large commercial banks adopted the "double entry, cross offices" system (see Figure 2) between Party committee, board of directors, board of supervisors and senior management. For example, the chairman of the board of directors serves as the secretary of the Party committee, the president of the bank and chairman of the board of supervisors serve as the deputy secretary of the Party committee and the vice presidents of the bank serve as the Party committee members. The system of "double entry, cross offices" helps reduce the possibility of differences in goals and enhance communication between the Party committee and "Three Meetings and One Management". The system also helps lower the governance costs arising from numerous governance bodies and coordination difficulties. However, this system could also affect the independent operation and checks and balances of "Three Meetings and One Management", especially the supervision of the board of supervisors over the management. From top to bottom in the Party committee are secretary, deputy secretary (also serving as bank president), deputy secretary (also serving as chairman of the board of supervisors) and other members. Due to the positioning of the Party committee where the president is at a higher level than the chairman of the board of supervisors, it is difficult for the chairman of the board of supervisors to effectively exercise its supervisory duties over the president, and more difficult over the chairman of the board of directors.

Figure 2. Governance arrangement of "double entry, cross offices"



Note: The solid arrow in the figure indicates the supervision relationship stipulated by the Company Law and the dotted arrow represents the impact of the Party committee on the operations of "Three Meetings and One Management" through "double entry, cross offices".

A large staffing overlap between the Party committee and the management may increase agency costs of large commercial banks

It is a basic goal of modern corporate governance to mitigate conflicts between shareholders and managers, in order to prevent "insider control" in enterprises, where the ownership and management are separated. On average, more than 70% of the Party committee members of the Big Six Banks serve as senior management members. Strictly speaking, amongst the Party committee members, only the chairmen of the two boards are not senior management members[5]. As over two thirds of the seats of the Party committee are occupied by the senior management, the Party committee may be predisposed to protect the interests of senior management in its deliberations on major issues. As a result of the absence of restrictions, there may be chances of "insider control". Additionally, the management members serve as the executor of the decisions made by the board of directors, but the Party committee, which is mainly composed of senior management, follows the "ex-ante procedure" of research and discussion before the board of directors make decisions. This may in turn have an influence on the decisions of the board of directors, and result in failure to effectively separate the functions of decision-making and execution.

Suggestion 1:

- ***The Party committee should stick to its political stand, and primarily be responsible for checking on major issues and maintaining the right direction from a political perspective. The Party committee should have the veto power for decision-making matters related to politics and should only exercise the right of suggestion for economic rationality and feasibility of decision-making matters. The board of directors should take charge of making decisions from an economic perspective and exercise the right of decision-making or veto right in view of economic rationality and feasibility.***

- ***The Party committee should focus on coordinating the interests of all parties, balancing internal and external goals and building decision-making consensus, to prevent overemphasis on a single objective and ignoring other aspects of large commercial banks.***

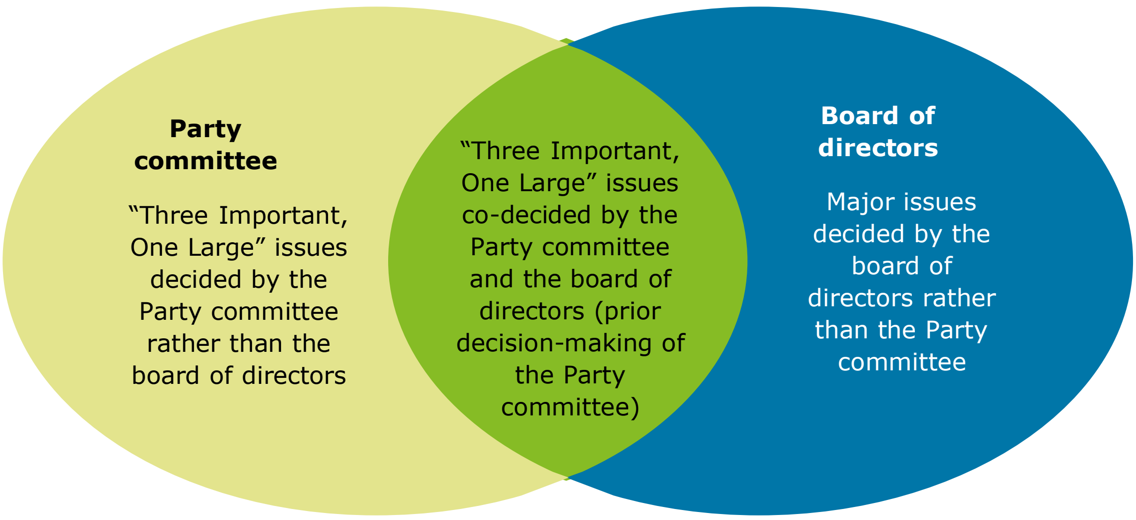
[5] Relevant regulations stipulate that the secretary of the discipline inspection committee should perform duties independently and should not serve in operational and management roles at the same time. But the Big Six Banks include the secretaries of the discipline inspection committee into the management.

3.1.2 Coordinating the decision-making functions of the Party organization and the board of directors on major issues

"Three Important, One Large" issues discussed and decided by the Party committee are largely overlapping with the decision-making scope of the board of directors (see Figure 3)

The "*Opinions on Further Promoting the Decision-Making System for 'Three Important, One Large' issues of SOEs*" (hereinafter referred to as the "*Opinions*") issued in 2010 by the General Office of the Central Committee of the CPC and the General Office of the State Council specifies that SOEs' decision makers, including Party committee (Party organization), board of directors, and management teams (in the case of no board of directors), should conduct group discussions to decide the "Three Important, One Large" issues based on their own responsibilities, authorities and rules of procedure. "Three Important, One Large" issues include decision-making on important issues, appointment and dismissal of important leaders, arrangement of important projects, and the use of large amounts of funds, covering almost all issues that are discussed by the Party committee and the board of directors. The Party committee can make decisions on some issues that are not in the scope of the board of directors, such as Party affairs, appointment and dismissal of presidents and vice presidents of provincial branches, heads of overseas entities and subsidiaries, and department heads at the headquarters. The board of directors can also make decisions on some issues that are not in the decision-making scope of the Party committee, including those related to the operations of the board, such as the rules of procedures of the board of directors and its special committees and directors' reports, or those related to some statutory duties of the board, such as the selection and appointment of external auditors and communication with regulators. Most of the "Three Important, One Large" issues fall under the overlapping decision scope of both the Party committee and the board of directors, for which the Party committee initiates the research and discussion and makes decisions which will then be submitted to the board of directors for review and approval to make legally effective decisions. After "Incorporating the Party Building Work into the Articles", issues that could be decided by the board of directors and the bank presidents' executive meetings instead of the Party committee were sharply reduced, while the decision-making scope and the workload of the Party committee expanded greatly.

Figure 3. Decision-making scope of the Party committee and the board of directors



There are significant differences in decision-making goals, scale, composition, organization structure, and rules of procedure between the Party committee and the board of directors

In terms of decision-making goals, the Party organization focuses more on the implementation of the economic and financial policies set by the ruling Party and the government than the board of directors. The Party committee has around 7-12 members, which is smaller than the average scale of the board of directors. In terms of the composition, the board of directors usually consists of executive directors, non-executive equity directors, and non-executive independent directors with a larger proportion of non-executive directors than executive directors. At the same time, there is greater emphasis on diversity in age, gender, region, education and working experience in the board of directors to ensure that it can fully consider diversified perspectives and views to make decisions. Party committee members are mainly bank executives and diversity is not a requirement. For example, there were no women at all in the Party committees of the Big Six Banks at the end of 2017. The absence of external representatives for small and medium shareholders and other stakeholders in the Party committee makes it hard to prevent the control of controlling shareholders and senior management over decisions. In terms of organization structure, the board of directors sets up various special committees to improve decision-making efficiency. In order to resolve potential conflicts of interest, the special committees on nomination, remuneration, audit and related-party transaction are required to be led by independent directors. Although the Party committee can make a wide range of decisions, it does not set up any special committee to improve the decision-making efficiency, nor formal mechanisms to prevent conflicts of interest, such as stakeholders' withdrawal from voting. In terms of rules of procedure, the board of directors follows the rule of "one person one vote" and approves matters based on a simple majority (more than half) of board members or by an absolute majority (more than two-thirds) of board members depending on the importance of the issues whereas the Party committee adheres to the so-called "democratic centralism" of the ruling Party and emphasizes on reaching consensus through discussion and negotiation. As a result of the hierarchy in the Party committee, the opinions of the Party secretary may influence significantly the decision-making results of the Party committee. SOEs, including large commercial banks, have been facing challenges on ensuring effective supervision and checks and balances on Party secretaries who serve as top leaders, to guarantee the scientific and democratic decision-making of the Party committee.

The Party committee fulfills the duty of substantive decision-making and the board of directors is responsible for the supervision and consultation on decision-making

The Party committee and the board of directors are two decision making bodies in large commercial banks. From the process point of view, the "research and discussion" of the Party committee on numerous major issues is the "ex-ante procedure" for the decision-making of the board of directors. Before making decisions, the Party committee needs to study and listen to all parties including the board of directors. Major issues are submitted to the board of directors for statutory approval after being discussed and approved by the Party committee. Party committee members leverage their past experience of leading important businesses or functions to make decisions more efficiently than the board of directors, as they have a better understanding of matters in relation to the operations and management of banks. Since the substantive review and evaluation are conducted by the Party committee, the decision-making efficiency of the board of directors has greatly been improved. It only takes 3-5 minutes for the board of directors to discuss and approve regular proposals. Theoretically, proposals approved by the Party committee can be vetoed by the board of directors, yet this rarely happens in practice. Through the personnel arrangement of "double entry, cross offices", the Party committee members sitting on the board of directors are responsible for conveying views and decisions of the Party committee and sharing feedback of the board directors with the Party committee. Moreover, the Party committee also communicates with directors on major sensitive issues through informal meetings. Controversial issues are solved by bridging differences through detailed communications, and the submission of the issues to the board of directors are suspended if the differences still exist. Based on such communication and coordination mechanisms, there has never been a single negative vote by the board of directors of the Big Six Banks in the past 5 years. Some independent directors think that casting a negative vote in the board meeting is of no constructive use, as there are plenty of opportunities for different opinions to be expressed before the board meeting. Though it is an international practice to measure the independence of the board of directors through the number of dissenting votes by independent directors, it cannot accurately assess the genuine independence of the board of directors in China. According to our interviews, many non-executive directors talked seriously about related proposals at the directors' communication meetings or the board special committee meetings, including raising lots of questions to the bank executives and giving pertinent opinions and suggestions with their expertise. Although the decision-making function of the board of directors in the Big Six Banks partly overlaps with the "ex-ante procedure" of the Party committee, the board of directors performs supervision and consultation of the decision-making, which is a crucial and an indispensable process for making final scientific and reasonable decisions.

Suggestion 2:

- ***The key to the division of responsibilities and the coordination of functions between the Party committee and the board of directors lies in the clear definition of "Three Important, One Large" issues for the Party committee. We would suggest that the relevant Party organizations at higher levels and government authorities take the lead in formulating basic standards and operational guidelines on the "Three Important, One Large" issues for large commercial banks.***

- ***Given the "ex-ante procedure" in decision-making, the Party committee should seek and take advice from various parties, including the directors. We would suggest institutionalizing and formalizing the various irregular communication meetings, coordination meetings and seminars to establish regular coordination channels and mechanisms between the Party committee and the board of directors.***

3.1.3 Enhancing the recruiting power of the board of directors under the principle of the Party supervising cadres

Limited role and power of the board of directors in recruitment, nomination and remuneration committees

The Big Six Banks are key financial institutions that are administered by the Central Committee (including ruling CPC Central Committee and the central government). As a result, the members of the Party committee or senior management, including secretary and deputy secretary of the Party committees, Party committee members, chairman and vice chairman of the board of directors, president, vice president, and chairman of the board of supervisors, are officials directly governed by the CPC Central Committee. The Organization Department of the CPC Central Committee is responsible for their appointments and dismissals, as well as evaluations management. The non-executive equity directors in the board of directors are appointed, dismissed and evaluated by representatives of the state-owned shareholder, such as Central Huijin. As a result, the board of directors has no substantive authority on the selection, appointment and dismissal of the executive directors (chairman, vice chairman, etc.) and non-executive equity directors in the board and the president and vice president in the senior management. Additionally, the appointment of independent directors and some market-recruited executives usually reflects the influence of major state-owned shareholders and senior management. Further, the presidents and vice presidents of provincial branches, heads of overseas entities and subsidiaries and department heads at the headquarters are appointed and dismissed by the Party committee at the headquarters rather than the board of directors. Due to the "salary limit regulation" on most senior management in the Big Six Banks, the nomination and remuneration committees of the board of directors also have a limited role to play.

Strengthening the power of the board of directors to recruit directors and senior management according to the law can help the board of directors take substantive responsibility for the bank's strategy and performance

The premise for the board of directors to take responsibility for the bank's strategy and performance is that the board of directors should have the power to select directors, and select, appoint and dismiss presidents and other senior management members. In the case of Big Six Banks, directors and senior management members are mainly selected through the Party's organizational system and approved by the board of directors in line with the principle of the Party supervising cadres. As a result, the responsibility taken by the board of directors for the bank's strategy and performance is mainly a "formal responsibility" or "procedural responsibility". The board of directors select directors and senior managements based on strategic demands and performance, which is consistent with the requirements of the Party on operational and management capabilities of the bank officials. Hence, a moderate enhancement of the power of the board of directors to appoint directors and senior management will help the board of directors take substantive responsibility. It will also enable the nomination and remuneration committees of the board of directors to play their professional roles better by selecting excellent directors and senior management members from a market perspective.

Suggestion 3:

- ***Effectively protect the power of the board of directors to select, nominate and evaluate independent directors. Use the cumulative voting system when voting for candidates for independent directors at the general meetings of shareholders to ensure that the selection of independent directors is not controlled by major shareholders and senior management.***
- ***Protect the power of the board of directors to nominate, appoint and dismiss senior executives, which includes the chief risk officer, chief information officer, chief auditing executive, chief financial officer and board secretary, through market-oriented recruitment.***
- ***When recommending directors, presidents and vice presidents to the board of directors, the Party organization may give the board of directors the power to choose from multiple candidates on a pilot basis. For instance, if one vice president is to be selected, the Party organization can recommend two candidates for the board of directors to choose from, in order to select the right person from the professional view of governance.***
- ***The board of directors should be responsible for evaluating the competence and performance of directors and senior management and should provide evaluation results as a reference for the Party organization to appoint and dismiss directors and senior management.***

3.1.4 Enhancing the market's confidence in the Party organizations' role in corporate governance through proper information disclosure

Proper information disclosure can help the market better understand the corporate governance structure of "Four Meetings and One Management"

Party organizations have been involved in the corporate governance of China's large commercial banks for years and have cooperated with "Three Meetings and One Management". Despite the increased complexity and operating costs in the banks' corporate governance, the Party organizations' engagement in governance can be beneficial. Domestic and foreign capital markets may have concerns on the Party organizations' involvement in the governance of large listed commercial banks, owing to their political nature and their non-transparent operations. Nowadays, large commercial banks have clarified and formalized the Party organizations' core role in governance in their articles of association. Making appropriate information disclosure, just like the board of directors, the board of supervisors, and senior management, can help avoid misunderstanding in the market of the Party organization's nature and function. Additionally, proper information disclosure can incentivize the Party committees of the Big Six Banks to focus more on markets, develop a better understanding of operations from the banks' perspective, and build a harmonious relationship with the board of directors.

Proper information disclosure by the Party organization will not result in a high disclosure cost

Although the Big Six Banks have not disclosed information on the membership of their Party committees to date, the arrangement of "double entry, cross offices" makes it possible to infer that information from the list of directors, supervisors, and senior management in their annual reports (see Table 2). The deputy secretary has defined titles, namely president and chairman of the board of supervisors. Additionally, if any deputy secretary is appointed to assist the secretary in building the Party's capabilities, it will be the chairman of the board of supervisors. Since the Big Six Banks have already indirectly disclosed the titles and background information of all Party committee members, having a direct disclosure would demystify the Party organization's engagement in governance without any additional costs. It would also show the confidence of the ruling Party. More importantly, as domestic and foreign investors have an increasing understanding of the Big Six Banks' actual operations, the disclosure of some basic information will gain popularity, recognition and help clear up the confusion about the roles and functions of Party committee secretary and secretary of the discipline inspection commission, thereby enhancing market understanding of the Big Six Banks' governance.

Suggestion 4:

When appropriate, the Big Six Banks can establish an information disclosure system for the Party organization and selectively disclose the composition, scope of discussion, rules of procedure, annual work reports and other information of the Party committee which concern the market. This will help in maintaining consistency and coordination with the information disclosure of the board of directors. Issues decided by the Party committee and voted by the board of directors could be disclosed in the announcement of the board of directors specifying "This issue has been discussed and approved by the Party committee of the bank".

Table 2. Composition of "Four Meetings and One Management" of the Big Six Banks at the end of 2017

Bank	Party committee	Board of directors	Board of supervisors	Management
ICBC Party committee members	Yi Huiman Gu Shu Zhang Hongli Wang Jingdong Wang Lin Qian Wenhui Hu Hao Li Yunze Tan Jiong	Yi Huiman Gu Shu Zhang Hongli Wang Jingdong	Qian Wenhui	Gu Shu Zhang Hongli Wang Jingdong Wang Lin Hu Hao Li Yunze Tan Jiong
Non-Party committee members		Cheng Fengchao Zheng Fuqing Fei Zhoulin Mei Yingchun Dong Shi Ye Donghai Or Ching Fai Hong Yongmiao Anthony F Neoh Yang Siu Shun Sheila C Bair Shen Si	Zhang Wei Hui Ping Huang Li Qu Qiang Shen Bingxi	Wang Bairong Guan Xueqing
ABC Party committee members	Zhou Mubing Zhao Huan Wang Wei Guo Ningning Gong Chao Zhang Keqiu	Zhou Mubing Zhao Huan Wang Wei Guo Ningning		Zhao Huan Wang Wei Guo Ningning Gong Chao Zhang Keqiu
Non-Party committee members		Zhang Dinglong Chen Jianbo Hu Xiaohui Xu Jiandong Liao Luming Wen Tiejun Yuen Tin-fan Xiao Xing Wang Xinxin Huang Zhenzhong	Wang Xingchun Liu Chengxu Xia Zongyu Li Wang Lv Shuqin	Li Zhicheng
BOC Party committee members	Chen Siqing Ren Deqi Wang Xiquan Zhang Qingsong Liu Qiang Fan Dazhi Gao Yingxin	Chen Siqing Ren Deqi	Wang Xiquan	Ren Deqi Zhang Qingsong Liu Qiang Fan Dazhi Gao Yingxin
Non-Party committee members		Zhang Xiangdong Li Jucai Xiao Lihong Wang Xiaoya Zhao Jie Nout Wellink Lu Zhengfei Leung Cheuk Yan Wang Changyun Zhao Anji	Wang Xueqiang Liu Wanming Deng Zhiying Gao Zhaogang Xiang Xi Chen Yuhua	Pan Yuehan Xiao Wei Geng Wei

Bank	Party committee	Board of directors	Board of supervisors	Management
CCB Party committee members	Tian Guoli Wang Zuji Pang Xiusheng Zhang Gengsheng Guo You Yang Wensheng Huang Yi Yu Jingbo Zhu Kepeng Zhang Lilin	Tian Guoli Wang Zuji Pang Xiusheng Zhang Gengsheng	Guo You	Wang Zuji Pang Xiusheng Zhang Gengsheng Yang Wensheng Huang Yi Yu Jingbo Zhu Kepeng Zhang Lilin
Non-Party committee members		Feng Bing Zhu Hailin Li Jun Wu Min Zhang Qi Hao Aiqun Fung Yuen Mei MC McCarthy Carl Walter Chung Shui Ming Murray Horn	Liu Jin Li Xiaoling Li Xiukun Jin Yanmin Li Zhenyu Bai Jianjun	Liao Lin Huang Zhiling Xu Yiming
BOCOM Party committee members	Niu Ximing Peng Chun Yu Yali Hou Weidong Song Shuguang Shou Meisheng Shen Rujun Wu Wei	Niu Ximing Peng Chun Yu Yali Hou Weidong	Song Shuguang	Peng Chun Yu Yali Hou Weidong Shou Meisheng Shen Rujun Wu Wei
Non-Party committee members		Wong Tung Shun Wang Taiyin Song Guobin He Zhaobin Wong Pik Kuen Liu Hanxing Luo Mingde Liu Haoyang Chen Zhiwu Yu Yongshun Li Jian Liu Li Yeung Chi Wai Woo Chin Wan	Gu Huizhong Zhao Yuguo Liu Mingxing Zhang Lili Wang Xueqing Tang Xinyu Xia Zhihua Li Yao Chen Qing Du Yarong Fan Jun Xu Ming	Du Jianglong Guo Mang Wu Zhaoan
PSBC Party committee members	Li Guohua Lyu Jiajin Zhang Xuewen Yao Hong Chen Yuejun Qu Jiawen Xu Xueming Shao Zhibao Liu Hucheng	Li Guohua Lyu Jiajin Zhang Xuewen Yao Hong	Chen Yuejun	Lyu Jiajin Zhang Xuewen Yao Hong Qu Jiawen Xu Xueming Shao Zhibao Liu Hucheng
Non-Party committee members		Han Wenbo Tang Jian Liu Yaogong Chin Hung I Liu Yue Ding Xiangming Ma Weihua Bi Zhonghua Fu Tingmei Gan Peizhong Hu Xiang	Li Yujie Zhao Yongxiang Zeng Kanglin Guo Tianyong Wu Yu Li Yue Song Changlin Bu Dongsheng	Du Chunye

Source: annual reports of the Big Six Banks in 2017

3.2 Directors' competencies

After the listing of the Big Six Banks, their board of directors have gone through the initial stages of listing and have now entered a relatively stable growth stage. Building a mature board of directors compatible with the size and importance of the Big Six Banks should be the focus in the next phase of corporate governance, with improving the competencies of directors being the top priority.

Composition of the board of directors of the Big Six Banks

According to their 2017 annual reports, the average number of board of directors of the Big Six Banks is 14.8, which is slightly larger than the board of directors of large international banks[6] (14 on average). Executive directors, non-executive directors (excluding independent directors) and independent directors account for 22.5%, 41.6% and 35.9% respectively of the board of directors.

Table 3. Composition of the board of directors of the Big Six Banks

	ICBC	ABC	BOC	CCB	BOCOM	PSBC	Average
Number of directors	16	14	12	15	17	15	14.8
Number of executive directors	4	4	2	4	3	3	3.3
Percentage of executive directors	25.0%	28.6%	16.6%	26.7%	17.6%	20.0%	22.5%
Number of non-executive directors	6	5	5	6	8	7	6.2
Percentage of non-executive directors	37.5%	35.7%	41.7%	40.0%	47.1%	46.7%	41.6%
Number of independent directors	6	5	5	5	6	5	5.3
Percentage of independent directors	37.5%	35.7%	41.7%	33.3%	35.3%	33.3%	35.9%
Number of female directors	2	2	3	3	3	2	2.5
Percentage of female directors	12.5%	14.3%	25.0%	20.0%	17.6%	13.3%	16.9%

Source: annual reports of the Big Six Banks in 2017

According to our research on the board of directors with Chinese characteristics, directors' competencies have three key elements. Firstly, the ability to make business decisions, which means that the directors should be able to make reasonable and timely decisions on major business issues of the company. Secondly, the ability to do strategic research, which means that the directors should be able to raise questions on the matters with long-term objectives as it relates to strategy, risk, talent and should have the ability to develop solutions. Thirdly, the ability to understand and implement the procedures of corporate governance, which means that the directors should be able to fully understand, comprehend and apply corporate governance principles, rules and processes to make operational decisions and strategic research by following procedures, and give their own opinions.

In this section, we study directors' competencies by analyzing their background, composition and evaluation and provide relevant suggestions accordingly.

[6] "Large international banks" in Section 3.2 refer to HSBC, Citi, Bank of America, Goldman Sachs, Wells Fargo and JP Morgan.

3.2.1 Appointing more directors with operational and managerial experiences

Insufficient directors with operational and managerial experiences

In 2017, the Big Six Banks had 89 directors in total, out of which, 35 had served in government agencies for more than 10 years, accounting for 39% of all directors. In the board of directors of large international banks, the proportion of directors who have served in government agencies is about 8.6%. Directors of large international banks are mainly the chairmen or chief executives of companies in other industries, among which 71.4% have operational and managerial experience, while only 43.8% of the directors of the Big Six Banks have operational and managerial experience (including executive directors). As more than half of the directors of the Big Six Banks have no experience in running and managing enterprises or commercial banks, the banks' senior management may need to spend more time (through the board office) to explain key issues to these directors. Furthermore, due to lack of expertise and practical experience, some directors may not be able to put forward professional and systematic suggestions at the board meetings which could partly affected the decision-making efficiency of the board meetings.

Figure 4. Backgrounds of directors of the Big Six Banks

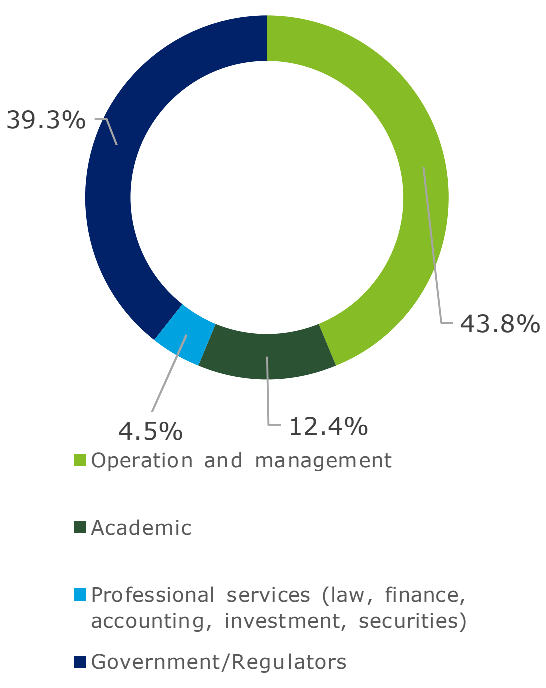
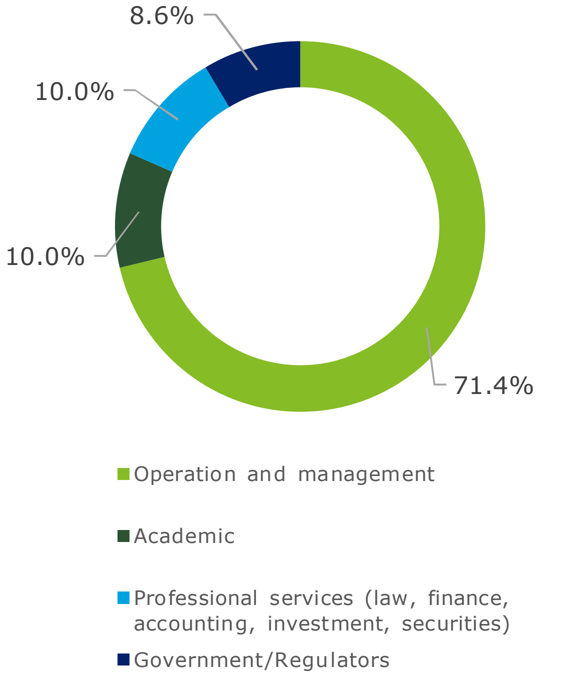


Figure 5. Backgrounds of directors of large international banks



Limitations of directors without operational or managerial experience

Our interviews with bank executives indicate that directors with government background have a good understanding of the bigger picture and can provide high-quality advice in strategy development and direction controlling, but are weaker in business related decision-making, less experienced in supervising senior management and making decisions on commercial issues. Although the non-executive directors appointed by Central Huijin are based in the banks, this method can only solve the problem of time allocation of those directors and their easy access to bank information while not able to address the challenge of their lack of experiences in commercial banking business. Therefore, directors need to proactively learn and as a result, their learning abilities are particularly important.

Learning-oriented governance talents

We have learned from the Big Six Banks that some non-executive directors with main background in government entities have quickly become familiar with the businesses and mechanisms of commercial banks. Non-executive directors and independent directors of the Big Six Banks are selected and assessed at many levels. As each of them has their own area of expertise, they often demonstrate strong competence and provide high-quality advice to the board of directors if they have a good knowledge of banking business. Therefore, the director selection process should particularly focus on the continuous learning enthusiasm and learning ability of candidates, while emphasizing on academic qualifications and working experience. Learning enthusiasm and ability is more valuable for directors to perform their duties than existing knowledge and experience. The requirement of learning-oriented governance talents should be the primary criteria for selecting directors.

Relatively balanced backgrounds of independent directors

The independent directors selected by the Big Six Banks have strong track records, including professors from top international universities, former senior government officials, and former executives of large international financial institutions. These directors who have joined the board of directors of the banks have enhanced their decision-making efficiency. About one-third of independent directors are executives with management experience, another one-third are scholars from universities and the remaining one-third are from professional service providers or have a background in the government or the regulators. In terms of the composition of independent directors, the board of directors of the Big Six Banks generally considers geography, gender and expertise. As the Big Six Banks are listed companies with many overseas investors, they also take into account the representative jurisdictions of their investors. For example, when considering representative jurisdictions of independent directors, Bank of China primarily takes Hong Kong, Europe and North America into account. Gender is also one of the considerations. If there are no women executive directors or non-executive directors, special consideration will be given to female candidates. In terms of independent directors' expertise, finance and accounting top the list, followed by law, investment and financing. At present, 37.5% of all independent directors in the Big Six Banks have commercial operation and management experience, whereas the 68% of the independent directors in large international banks have such experience. Obviously, there is still a shortage of operation and management talents among independent directors.

Table 4. Professional background of independent directors in the Big Six Banks

Professional background of independent directors	ICBC	ABC	BOC	CCB	BOCOM	PSBC	Total	Proportion
Operation and management	2	1	1	3	2	3	12	37.5%
Academic	1	4	2	-	3	1	11	34.4%
Professional services*	1	-	1	-	1	1	4	12.5%
Government/regulator	2	-	1	2	-	-	5	15.6%
Total	6	5	5	5	6	5	32	100%

* Professional services refer to law, finance, accounting, investment, securities, etc.

Academic elites acting as independent directors resulted from the shortage of director talents

There have been different opinions from the field of governance regarding the role of academic elites as independent directors in large companies. Academic elites are criticized for lacking knowledge of companies' operations and therefore being too idealistic or having no distinctive views. However, some experts believe that the academic elites' filling the vacancy of independent directors at current stage is a market-driven result as China's large banks face a shortage of talents in director candidates. Ideal independent director candidates should be management talents from enterprises of the same scale and complexity. However, most counterparts of the same scale with Big Six Banks in China are state-owned enterprises, whose incumbent staff are supervised and managed by the state and cannot take on part-time directorship appointments. Retired SOE executives are also subject to restrictions which do not allow them to serve as directors within certain cooling-off periods. As a result of the shortage of talent, academic elites are preferred by the board of directors because of their good social reputation and excellent expertise.

Restrictions on retired executives of state-owned enterprises to serve as independent directors

As required by the Organization Department of the CPC Central Committee, current Party and government leaders, as well as former Party and government leaders who have retired recently have a cooling-off period of three years before they can serve as independent directors in listed companies. As executives of large SOEs are not allowed to serve as independent directors after retirement, other large SOEs (including the Big Six Banks) have no access to the extensive experience of these excellent executives. Despite a valuable treasure of these executives' lifelong experience, such experience cannot be fully leveraged in the most valuable period right after retirement. Therefore, there needs to be a balance between the disciplinary restrictions on officials and talent utilization. For example, administrative officials and companies' executives could be treated differently, or the "cooling-off period" for serving as independent director after retirement could be shortened from three years to one year.

Exploring the diversification of independent directors candidates

Private companies in China have made tremendous progress in the past decade, resulting in the emergence of a number of excellent entrepreneurs. Some private entrepreneurs act as independent directors in joint-stock commercial banks and provide pragmatic governance practices to the boards of directors. The Big Six Banks can also explore the opportunity to attract well-known private entrepreneurs from non-financial industries into the board, making full use of their strong decision-making competence, strategic views and learning ability to enhance the performance of the board. Concerns on whether the private entrepreneurs acting as independent directors of banks will provide favorable financing for private enterprises can be addressed by the governance rules and banks' risk management mechanisms.

Suggestion 5:

- ***About 43.8% of directors of the Big Six Banks in China have operational or managerial experiences, a large gap in comparison with large international banks. In practice, the board of directors face the challenges by insufficient decision-making ability. We suggest that the proportion of directors with operational or managerial experiences in the board of directors should be increased from 43.8% to 60%, at the minimum, and special attention should be paid to directors' learning ability while selecting directors.***

- ***Due to a shortage of directors, about one third of the independent directors of the Big Six Banks are academic elites. In order to make full use of the extensive experience of retired executives in large SOEs, we suggest relaxing restrictions on SOEs' retired executives serving as independent directors and exploring the possibility of private entrepreneurs entering the boards of the Big Six Banks in China.***

3.2.2 Increasing the proportion of independent directors

Establishment of independent directors primarily for compliance purpose

At present, the average proportion of independent directors in the Big Six Banks in China is 35.9%, slightly higher than one third. The proportion of independent directors of Bank of China is 41.7%, which is the highest among the Big Six Banks.

Unique roles of independent directors

Compared with other directors, independent directors are less involved in the interests of the senior management and major shareholders. Independent directors are mostly experts in finance, accounting and marketing. Combined with their personal reputations, increasing the representation of independent directors will strengthen the independence of the board of directors and enhance the expertise in decision-making.

Overwhelming majority of independent directors in the board of directors of large international banks

The proportion of independent directors on the board of directors of large international banks is about 89.3%. The overwhelming majority of independent directors enables the board of directors of large international banks to balance the power of senior management, pay attention to long-term strategic objectives and supervise senior management. At present, independent directors of the Big Six Banks account for only about one third of the board of directors. In practice, these independent directors play a limited role, partly due to their small number and low proportion. If the proportion is increased to 50% or above, along with the proposal in the next section for a "Lead Independent Director", the board of directors can play a more balanced and coordinated role in governance, thereby enhancing the confidence of international and domestic capital markets in the governance structure of the Big Six Banks.

Lead Independent Director

The international practice of appointing a "Lead Independent Director" can be used to help independent directors play a better role. The "Lead Independent Director" system is widely adopted in the United Kingdom, Singapore, Hong Kong and the United States. US companies are leading in setting up the independent director system. Post the Enron incident, US companies realized that different professional backgrounds and decentralized power of independent directors could lead to insider control if independent directors cannot communicate and reach consensus in a timely manner. The responsibilities of the "Lead Independent Director" in the United States include: 1) setting a time schedule for meeting independent directors individually and presiding over independent director meetings, 2) helping the board of directors and senior management understand and coordinate the boundaries of their responsibilities, 3) convening board meetings in case of company crisis, 4) organizing interviews with director candidates, and providing guidance and assistance for new independent directors, and 5) ensuring smooth information flow within the board of directors, especially beyond the board meetings.

Suggestion 6:

- ***Independent directors of the Big Six Banks account for about one third of the board of directors, a sharp contrast to the overwhelming majority of independent directors in large international banks. Considering the unique roles of independent directors, we suggest that the proportion of independent directors should be increased to 50% or more of the board of directors, so that the independent directors can help balance governance to boost the confidence of international and domestic capital markets.***

- ***In order to strengthen the role of independent directors, we suggest setting up the "Lead Independent Director" system on a pilot basis in the Big Six Banks, by drawing lessons from the developed markets.***

3.2.3 Drawing on the strengths of equity directors

Equity directors with Chinese characteristics

In contrast to the large international banks whose boards of directors mainly consist of independent directors, non-executive directors take up the largest proportion of the board of directors in the Big Six Banks in China, reaching 41.6%. Most non-executive directors are deployed by representatives of state-owned stake (i.e. equity directors). This arrangement is the result of China's banking reform. In December 2003, the State Council established Central Huijin Investment Co., Ltd. (hereinafter referred to as "Central Huijin") to invest in banks and exercise the rights and obligations of investors on behalf of the state. Central Huijin sent equity directors to ICBC, ABC, BOC and CCB. Unlike non-executive directors of other listed companies who are only present at the board meetings, these equity directors work full-time in the banks. This arrangement of Central Huijin, deploying full-time non-executive directors to its invested banks is known as "Huijin model" in China. The model is designed to enable non-executive directors to be better informed about their banks. The directors deployed by Central Huijin are remunerated by Central Huijin instead of the banks, and their performance evaluation, appointment and dismissal are all decided by Central Huijin. As a result, these directors are independent from bank executives.

Equity directors are mainly from government agencies

Among the four largest banks of China: ICBC, ABC, BOC and CCB, 86% of the equity directors from Central Huijin, are former government officials. A considerable proportion of directors sent by Central Huijin are former administrative officials from MOF and the central bank (People's Bank of China), China Securities Regulatory Commission (CSRC), the former China Insurance Regulatory Commission (CIRC) and the former China Banking Regulatory Commission (CBRC) (the latter two were merged recently). Central Huijin also recruits directors from the market. There is a complete list of criteria and procedures to be followed for market-oriented selection of directors. However, as the selection criteria for director candidates from MOF, the central bank, CSRC, CIRC and CBRC is not well defined, some positions are exclusively for certain officials. Despite the six-year tenure requirement of equity directors, the MOF sometimes shortens the tenure of some equity directors who are transferred within six years, which causes challenges to the operations of the board of directors. As the equity directors selected by Central Huijin from the market are more stable and professional, Central Huijin can consider moderately increasing the proportion of directors recruited from the market, and focus on selecting directors with operational experience.

Table 5. Professional background of non-executive directors

Professional background of non-executive directors	ICBC	ABC	BOC	CCB	BOCOM	PSBC	Total	Percentage
Operations and management	1	-	-	2	3	4	10	27%
Academic	-	-	-	-	-	-	-	-
Professional services*	-	-	-	-	-	-	-	-
Government/regulator	5	5	5	4	5	3	27	73%
Total	6	5	5	6	8	7	37	100%

* Professional services refer to law, finance, accounting, investment, securities, etc.

Equity directors should focus on improving decision-making and research ability

Most of the equity directors of the Big Six Banks deployed by Central Huijin (about 73%) are former government officials or regulators. They have extensive experience in policy formulation or regulations but need to learn and understand the banks' businesses and the competitive market environment. They are also weak in business management and need to enhance their strategic research ability.

Equity directors play a more supervisory role than a decision-making role

As employees of Central Huijin, equity directors are committed to the capital operations objectives of Central Huijin. They sometimes confuse the differing roles of directors and shareholders when performing their duties and often supervise the management from the perspective of shareholders, without giving enough importance to the governance principle that requires directors to prioritize banks' interests on top of others. In addition, although non-executive directors do not perform a management role, they still need to work full-time in the banks, and thus sometimes they confuse the roles of directors and managers. Some non-executive directors provide improvement recommendations to the banks in the form of research reports, which are neither board resolutions nor authorized by management, and do not meet the procedural requirements of governance. Therefore, it is difficult to implement these recommendations even if they are valuable.

Advantages of equity directors

The Huijin model pioneers the model of non-executive directors working full-time in companies, which enables equity directors to have sufficient time and energy to perform their duties as directors. Equity directors can devote their time and leverage their government background to conduct strategic research, thereby providing in-depth strategic thinking for the long-term development of banks.

Autonomy of equity directors

Central Huijin has a clear mandate for its equity directors. Equity directors have autonomous voting rights. According to the Central Huijin, about 84% of the board’s proposals are voted by the equity directors themselves. Central Huijin provides voting recommendations for the equity directors only on matters that require approval by more than two-thirds of the board and that may affect sponsor interests, such as the appointment and removal of executives, profit distribution, and capital planning, etc. Although these recommendations are not legally mandatory, directors still need to decide whether to adopt them and have to assume legal responsibility for their decisions. However, since the equity directors are paid, assessed and replaced by Central Huijin as its own employees, their voting rights are in fact restricted to a certain extent. According to the general governance principle, equity directors should be paid by the banks, but at present all of them are paid by Central Huijin. This can be interpreted, from the accounting perspective, as a subsidy from Central Huijin. However, such subsidies are not necessary. Although, this arrangement guarantees the independence of equity directors from the executives, it makes equity directors dependent on major shareholders and limits independent voting rights and discussion capability. In addition, according to the new regulations of the MOF in 2019, equity directors should strictly follow the voting instructions and requirements of the shareholders which nominate the directors in voicing and voting on major issues (i.e., proposals need to be submitted to the general meeting of shareholders for approval, proposals need to be agreed by more than two-thirds of the directors, and proposals related to major interests of sponsors, or those that may have a significant impact on financial institutions). After the implementation of this regulation, the autonomy of equity directors may be further restricted.

Non-controlling equity directors

The composition of non-executive directors of BOCOM and PSBC is different from that of China’s four largest banks. In addition to the three non-executive directors nominated by the major shareholder Ministry of Finance, BOCOM also has non-executive directors nominated by some of the strategic investors, namely HSBC, the National Council of Social Security Fund and Capital Airport Group. In addition to the four non-executive directors nominated by the major shareholder China Post Group, PSBC also has three non-executive directors nominated by the strategic investor UBS Group, and cornerstone investors, namely China Shipbuilding Industry Corporation and Shanghai International Port Group. These directors nominated by non-controlling shareholders are different from the equity directors nominated by Central Huijin. These directors represent the interests of strategic investors and increase the power of checks and balances at the board level from the perspective of governance.

Suggestion 7:

- ***It is suggested that the power of state-owned capital representatives in selecting equity directors should be entirely delegated to Central Huijin, in order to avoid administrative appointments, and ensure that directors have the ability to perform their duties.***

- ***Currently, less than 30% of existing equity directors have operational or managerial experiences, and the remaining 70% have a government background. It is suggested that Central Huijin increase the proportion of market recruitment, add directors with operational and managerial experiences, and improve the professionalism of equity directors to enhance the independence of equity directors from executives.***

- ***At present, Central Huijin is paying the remuneration to the equity directors appointed by Central Huijin. It is suggested that those directors should be paid by the banks so that they would have the equivalent duties, rights and responsibilities in accordance with the international best practices.***

3.2.4 Regular evaluation of the directors and the board of directors

The bank's evaluation of the directors

According to the requirements of the former CBRC, the board of supervisors of the bank is responsible for the annual evaluation of all directors. However, in practice, the evaluation of the directors is rather homogeneous and formal without proper supervision or dismissal of unqualified directors. In addition to the evaluation by the board of supervisors, the nominators of the directors also assess them. Executive directors are assessed by the Party committee in accordance with the requirements of Organizational Departments of the Party, and the assessment is mainly done on the basis of the operational performance of the banks, rather than the performance of the directors. The current mechanism is flawed, as there is only a selection mechanism for directors but no removal mechanism. All parties, including the former CBRC, the board of supervisors and others are considering to improve the director evaluation mechanism. However, they have not been able to find a proper solution.

Central Huijin's evaluation of equity directors

Compared to the banks' evaluation method for assessing directors' performance, the multidimensional evaluation method adopted by Central Huijin seems more comprehensive. Central Huijin requires the chairman of the board of directors, chairman of the board of supervisors and the president to grade and evaluate the equity directors, which have a weighted proportion in the multidimensional evaluation. In addition, Central Huijin conducts on-site visits to the banks to investigate the performance of the equity directors. Additionally, in terms of the evaluation criteria for directors, Central Huijin does not prioritize the operational performance of the bank, which helps avoid focusing on the short-term performance by the directors. Instead, it focuses on encouraging the conscientiousness of equity directors. However, in practice, the appraisal and compensation of the equity directors generally do not account fully for the differences in the responsibilities of directors.

Lack of evaluation on the overall effectiveness of the board of directors

At present, the evaluation of the directors by the Big Six Banks, generally focuses on individual performance, rather than the effectiveness of the board as a whole. As a collective decision-making body, the board's efficiency, procedures, structure, and the working mechanism, all affect the effectiveness of banks' governance. In fact, the international practice is more and more to focus on the evaluation on the effectiveness of the full board. A report issued by the Financial Stability Board (FSB) suggests that the financial regulators should establish detailed guidelines for financial institutions to conduct board evaluation, especially for risk management and remuneration practices. Large international banks evaluate the overall performance and effectiveness of the board every year. HSBC and Wells Fargo had also engaged independent third parties to evaluate their boards.

Suggestion 8:

In accordance with global practice, it is suggested to engage independent third-party consulting firms to conduct annual evaluations on directors and the board. This will not only improve the individual capabilities of directors, but also provide improvement suggestions to enhance the overall work of the board. It will help in identifying any deficiencies in the working processes of the board, facilitate the removal of unqualified directors, and improve the screening criteria for new directors. The criteria for determining the directors' performance should be improved and the operational performance of the bank should be regarded as an important basis for board evaluation.

3.2.5 Succession plan and board diversity

Succession plan

At present, the nomination of directors of the Big Six Banks involves multiple parties. The executive directors are selected and nominated by the Organization Department of the upper-level Party organizations, whereas the equity directors are nominated by MOF and Central Huijin, and the independent directors are decided by the board of directors of the bank. This leads to ambiguous accountability, which is the most fundamental problem in corporate governance. The main question to be answered here is whether the nominated directors should be accountable to the nominator or to the board of the bank. Although a nominated director needs to be appraised by both the nominator and the bank, the appointment and removal of executive directors and non-executive directors is primarily determined by their nominators. As a result, they report to the nominator first and then to the board of the bank. In reality, without changing the nomination rights of any party, the nomination committee of the board should conduct substantive reviews on the candidates nominated by all parties, propose the requirements for the director candidates best suitable for the development of the bank combined with the results of the appraisal by the board, and form a succession plan. The nomination committee should regularly analyze the capability portfolio of the board and propose a list of additional capabilities that the board needs as a basis for selecting directors and developing a succession plan.

Gender diversity of the board of directors

The proportion of female directors in the Big Six Banks is 16.9%, whereas the average proportion of female directors in large international banks is 30.9%. However, it is not clear that the proportion of female directors is positively correlated to the efficiency and effectiveness of the board of directors. At present, the practice of the Big Six Banks guarantees women representation in the board, but does not overemphasize the importance of gender. This is believed to be the most pragmatic approach as of now.

Relatively high threshold for minority shareholders to nominate directors

At present, the minimum shareholding ratio to nominate directors is 3% (1% for nominating independent directors). As the threshold is so high, even some of the top ten shareholders cannot meet this requirement, which limits the ability and motivation of small and medium shareholders to nominate directors. In the United States, Australia, Singapore, Japan, Germany and other countries, there is no requirement on shareholding proportion to nominate directors.

Suggestion 9:

- ***China's Big Six Banks have a multi-party nomination mechanism for directors. It is suggested that the nomination committee of the board of directors should play a substantive role in the nomination process and evaluate the directors (including executive directors and non-executive directors) from a professional perspective, focusing on how they perform their duties. They should also provide opinions and suggestions for the selection of directors in accordance with the capability portfolio of the board. Additionally, the board diversity should be taken into consideration and a succession plan should be developed.***

- ***In order to encourage multilateral governance and increase the representation of other governance entities, it is suggested that the threshold for nominating independent directors be lowered to 0.1% or nomination rights should be granted to all top ten shareholders.***

3.3 Roles of state-owned shareholders

At the beginning of the reform, the Big Six Banks were entirely owned by the state. After the restructuring and listing, the state-owned shares were diluted, but the state shareholders continued to be the controlling shareholders. Currently, the state-owned shares directly or indirectly held by MOF or Central Huijin in the four largest banks (ICBC, ABC, BOC and CCB) exceed 50%. As far as the Bank of Communications (BOCOM) is concerned, MOF is the single largest shareholder, with a shareholding ratio higher than the shareholding ratio held by HSBC (18.70%), which is the second largest shareholder. The direct controlling shareholder of PSBC is China Post Group, which is 100% controlled by the MOF. This section focuses on how the state-owned shareholders exercise their shareholders' rights and perform their duties and how to transform their roles from governmental authorities to shareholders.

Table 6. Shareholding proportions of state-owned (relative-controlled) shareholders in the Big Six Banks

	ICBC	ABC	BOC	CCB	BOCOM	PSBC
Ministry of Finance	34.60%	39.21%	-	-	26.53%	-
Central Huijin Investment Ltd.	34.71%	40.42%[1]	64.83%[2]	57.11%	-	-
China Post Group Corporation[3]	-	-	-	-	-	68.92%
Total	69.31%	79.63%	64.83%	57.11%	26.53%	68.92%

Note:
[1] Including 0.39% shares held by Huijin Asset Management Co., Ltd.
[2] Including 0.61% shares held by Huijin Asset Management Co., Ltd.
[3] MOF is the state-owned asset management authority of China Post Group.

3.3.1 Enabling Central Huijin to continue to play its constructive role

Establishing the role as a representative of state funder

The establishment of Central Huijin solved the problem of the absence of national stake owner in the large commercial banks. Before the reform, no single entity was able to exercise full ownership of the Big Six Banks on behalf of the state. Upon its establishment, Central Huijin clearly defined its role as the representative of the state funder, including its independence from government authorities, its commitment to operate in a market-oriented way, and its duty to exercise the rights and fulfill the obligations of a funder on behalf of the state.

Following the governance principles and playing the shareholder's role well

Central Huijin has committed to two principles: not to engage in any commercial business activities other than investment holding and not to interfere with the daily operations of the invested companies. In line with these principles, Central Huijin participated in the revision of the articles of association of the four largest banks (BOC, ABC, ICBC and CCB), the formulation of the rules for meetings of the board of directors and the board of supervisors, the development of the authorization system, and the formulation of the policy that defines the powers and responsibilities of "Three Meetings and One Management". As a shareholder, Central Huijin promoted the changes in the corporate governance structures and processes of the four largest banks, and strongly supported their capital diversification and marketization. However, Central Huijin has no influence over the Party Committees of its invested companies.

Innovating with the "equity director" model and establishing a professional system for the selection, appraisal, training and support of directors

As mentioned above, Central Huijin's initiative to nominate designated "equity directors" in invested institutions is an important contribution under the "Huijin Model". The equity directors are nominated by the Central Huijin and do not receive compensation from the financial institutions. They are appraised and remunerated by Central Huijin, which has a comprehensive system for the selection and evaluation for these directors. The directors are subject to a unified examination before the appointment, and have to go through a multidimensional annual evaluation afterwards. Central Huijin also provides systematic and multidimensional training to the equity directors, especially on the professional aspects of finance, law and corporate management, which is based on their director roles. In addition, Central Huijin's equity management department has set up a specialized team to provide support for these directors in helping them fulfil their duties. The members of this team have diverse backgrounds, which include finance, law, risk and management.

Actively exercising the rights of a shareholder

At present, according to the basic institutional arrangements for state-owned shareholding, Central Huijin cannot make profits by selling state-owned stakes in financial institutions or from large amounts of dividends. This arrangement limits its profitability as a company, since its primary business is capital management. In our interview with Central Huijin, we learned that it is constrained from voting with its feet therefore it focuses on the process management of its invested banks, including proper communication with the banks prior to important events. It also exercises its shareholder rights actively and participates in strategic and risk-related decision making. In addition to deliberating and voting on shareholders meeting proposals, Central Huijin creatively uses the "two letters and six guidelines" approach to exercise its shareholder rights. The "two letters" refer to the "*Risk Warning Letter*" and "*Management Suggestion Letter*" issued by Central Huijin to the financial institutions, which provides risk warning and management suggestions based on actual conditions. The "six guidelines" refer to the guidelines issued by Central Huijin for the financial institutions, which covers six main aspects: strategy, authorization, business planning, capital status, risk and the performance of the board of directors, the board of supervisors and senior management. The goal of the guidelines is to help Central Huijin better fulfill its responsibilities as a funder, by clearly stating Central Huijin's views on the systems and the process-related arrangements required for promoting the work in the six areas. The main challenge for Central Huijin is to carefully distinguish between the shareholder's right to make suggestions and involvement in a company's day-to-day business operations.

Improving the efficiency of administrative communication

Two of the Big Six Banks, ICBC and ABC, are jointly held by Central Huijin and MOF. At present, the MOF authorizes Central Huijin to nominate directors on its behalf. However, in the decision-making on key issues, these two institutions still need to coordinate and form complementary opinions. In practice, the MOF is mainly concerned with overarching issues when formulating public policies, whereas Central Huijin, as a shareholder, needs to make decisions in accordance with the specific situations of the companies. Hence, the two entities need to coordinate with each other. According to banking professionals, since Central Huijin has taken the role of the state-owned shareholder, the banks have greatly improved the efficiency of their administrative communication with state shareholders, as compared to the situation prior to the reform. Some interviewees suggest that all the state-owned shares held by the authority should be transferred to Central Huijin, which can then act as the sole agent for exercising shareholders' rights.

Suggestion 10:

- ***Central Huijin initiated and developed the "Huijin Model", under which it assumes responsibilities as a representative of state-owned shareholder, nominates full-time directors, actively exercises shareholder's rights and undertakes administrative communication. Central Huijin's professionalism as a shareholder has also been widely recognized. It is suggested that Central Huijin should continue to play its positive role and other state shareholders should strive to learn from its experience and strengthen their role as representatives of state shareholders.***

- ***Central Huijin should continue to follow market practices in nominating directors, introduce a competition mechanism, enrich the candidate pool of directors, nominate directors based on the differentiated needs of banks, and continuously improve the competence of nominated directors.***

3.3.2 From “playing the shareholder’s role well” to performing as a “good shareholder”

At present, apart from Central Huijin, MOF and China Post Group (hereinafter as “China Post”) are the other state-owned shareholders of the Big Six Banks. In the process of reform and listing of the Big Six Banks, state-owned shareholders have played a positive role. The focus of the next phase of reform should be to advance from “playing the shareholder’s role well” to performing as a “good shareholder”.

Drawing a clear line between the duties of a shareholder and a director

A director's responsibility is to serve the company and work for the company's interests. The management of the nominated directors should follow the principle of good governance and grant them adequate autonomy in voting. Shareholders delegate powers to the board of directors through general meetings of shareholders and should exercise their shareholder rights through appropriate governance mechanisms. Shareholders cannot and should not directly interfere in the day-to-day business operations of the company.

Transforming from an authority to a shareholder and replacing administrative management with corporate governance

As representatives of the state-owned capital shareholders, state shareholders should focus on capital operations to preserve and increase the value of state-owned stake, and not pursue separate administrative or commercial interests. However, some state shareholders of the Big Six Banks have not completely left their previous roles as authorities, and still adopt an administrative management style that is not conducive to improving the operating efficiency and market orientation of the banks.

Coordinating social and economic objectives

Unlike the decentralized ownership structure of the large international banks, state-owned shareholders can play a leading role due to their concentrated ownership in the Big Six Banks. As a result, when the social and economic agendas are difficult to reconcile, the state-owned shareholders have a big advantage in leading the banks to achieve the social goals. Studies have shown that coordinating the social and economic objectives is an important factor for the sustainable development of banks. According to the social responsibility reports issued by the Big Six Banks, they are at the forefront of the industry in fulfilling social responsibilities, which is consistent with their position as the state-controlled banks. However, according to banking professionals, the contingency mechanism of state-owned shareholders still needs to be improved in order to serve the public good in times of emergency (such as donations in response to major natural disasters).

Focusing on long-term development

Unlike individual shareholders who seek to maximize short-term returns, state-owned shareholders are more capable of focusing on the long-term development of banks. For the banks’ sustainable development in the long run, the state-owned shareholders should consider the capital requirements for the long-term development of banks in the dividend policy, and strike a proper balance between shareholder dividends and retained capital for long-term development.

Complying with regulations, abiding by the rules of information disclosure and following the principle of fairness

Financial and capital market regulations require shareholders to be subjected to oversight. The state-owned shareholders of the Big Six Banks should ensure compliance with regulations and disclose relevant information. The shareholders, regardless of their shareholdings, are equal under the corporate governance structure. Although, Central Huijin represents the state funder, it should enjoy the same shareholders' rights as the other shareholders do under the rules of the capital market, especially in terms of information rights. The state-owned shareholders should avoid obtaining internal information of banks other than publically disclosed information.

Suggestion 11:

- ***The state-owned shareholders should further reduce the administrative management of the banks. It should be further clarified that the Big Six Banks are regarded as independent market players, and therefore the state-owned shareholders should avoid replacing the governance process with administrative orders.***
- ***The state-owned shareholders should be able to play to their advantage in coordinating the banks' social and economic goals, and provide more support to banks to fulfill their social responsibilities.***
- ***The state-owned shareholders should adopt a long-term view and strike a proper balance between shareholder dividends and the bank's retained capital.***
- ***The state-owned shareholders are not exempt from regulations and need to abide by the rules of information disclosure.***

3.4 Remuneration of directors and executives

3.4.1 Cultivating professional bankers with market-oriented incentive mechanism

3.4.1.1 The remuneration of executive directors and executives of the Big Six Banks is lagging behind the market

Low average remuneration of executive directors in Big Six Banks as compared to their counterparts in joint-stock commercial banks

Due to the government's "salary limit regulation", the remuneration of the executive directors in the Big Six Banks has dropped from an average of RMB1.1 million to RMB0.58 million in the three years since 2015. According to the 2017 annual reports, the remuneration of executive directors of some joint-stock commercial banks was nine times higher than their counterparts' in the Big Six Banks.

Low remuneration as compared to global peers

According to the 2017 annual reports, the total remuneration of the chairman of Bank of America was about RMB142 million, and those of other executives was invariably above RMB65 million. The chairman and CEO of Citibank was paid about RMB116 million. The chairman of Goldman Sachs was paid around RMB144 million and other executives were paid about RMB108 million. The former chairman of HSBC, Douglas Jardine Flint, who stepped down in September 2017, was paid RMB14.13 million, while the three executive directors' remunerations were RMB53.4 million, RMB29.3 million and RMB29.1 million respectively. During the same period, the chairmen of the Big Six Banks were paid only RMB0.6 million to RMB0.7 million, whereas the average compensation of executives was merely RMB0.6 million, well below the averages at global peers.

Low remuneration of the market recruited executives

At present, the Big Six Banks recruit certain key executives from the marketplace, including the chief risk officer, board secretary, chief auditor, chief financial officer, etc. The compensations for these positions are not subject to the "salary limit regulation" and are nearly two times the remunerations of the chairmen and presidents. However, there is still a big gap when compared with the same positions in other listed banks. For example, the board secretary at CMBC had the highest pay of RMB3.8 million before tax in 2017, followed by the board secretaries of CITIC Bank and Ping An Bank, who got remunerated at RMB3.1 million and RMB2.9 million, respectively. On the other hand, the highest paid board secretary at the Big Six Banks received RMB1.2 million before tax (the figures don't include deferred payments), which was merely one third of the pay of the board secretary at CMBC. As a further example, the annual compensation of the chief risk officer at CITIC Bank was RMB3.2 million before tax in 2017. In contrast, the chief risk officers at the Big Six Banks were paid between RMB0.8 to 1.2 million before tax, with the chief risk officer at BOC being paid the highest amount at RMB1.2 million, which was only one third of the pay of the chief risk officer at CITIC Bank.

3.4.1.2 The dual remuneration system blurs the boundaries between the government and the market

The dual remuneration system

The executives of the Big Six Banks (except PSBC) are divided into two categories: the "Central Supervised Cadres (supervised by Organization Department of CPC Central Committee)" and the "market recruited" executives. The "Central Supervised Cadres" include the Party secretary, deputy Party secretary, Party Committee members, secretary of the discipline inspection commission, chairman, president, chairman of the board of supervisors and the vice president[7]. The remuneration of these cadres is subject to the pay limit. Additionally, besides these centrally supervised positions, the five largest banks are allowed to recruit executives from the market, and their compensation is not restricted by the government. This leads to inequality among executives at the same level. The structure of unequal pay for similar work is not conducive to personnel stability. Many market-

[7] The scope of the "Central Supervised Cadres" of PSBC is slightly different from the other five banks.

recruited executives choose to leave after a short time, which can be explained by the above stated reason.

Blurred lines between officials and executives impede the growth of professional bankers

Before the "salary limit regulation" was implemented in 2015, even though the remuneration of the "Central Supervised Cadres" was lower than that of the same positions in the joint-stock banks, market factors still played a role. Since the "salary limit regulation" was implemented, the remuneration of the cadres in the central financial institutions has been at a unified level of about RMB0.6 million. This universal application of the salary limit emphasizes discipline but ignores incentives. The executives of the Big Six Banks are bankers, and at the same time Party cadres. As a result, they can be transferred to other positions, including the administrative official positions in the government, whenever necessary according to the needs of the Party. For instance, the recent three chairmen of CSRC were all former chairmen of the Big Six Banks. The executives at or above the vice-president level in the Big Six Banks also have the opportunity to be transferred to positions in local governments or central governmental bodies. To some extent, the current talent management and remuneration system have encouraged the executives of the Big Six Banks to seek promotions within the government system rather than pursuing a career in the banking industry. The government-centered appraisal system does not facilitate the development of professional bankers.

The sustainable development of the large commercial banks depends on a team of professional bankers

The "salary limit regulation" was issued to promote economic growth and the fairness of social wealth distribution, by restricting the remuneration of executives of some state-owned institutions. Due to the nature of the shareholding structure of the large commercial banks and protection by national policies, the large commercial banks are less exposed to market risks than other banks. All other things being equal, it is not fair for the executives of large commercial banks to receive the same remuneration as their peers in other financial institutions or private enterprises. However, faced with fierce market competition and the challenge of incentivizing and retaining talent, large commercial banks also need to be competitive in the financial market as they need professional bankers to make professional judgments on business, strategy and risks. Since the reform of the large commercial banks in 2004, the improving market orientation and capitalization of the banks have contributed to a growing number of professional bankers. They have helped China's financial industry survive in the international financial crisis and ensured continued development. Facing the changes in the international market, the increase in business complexity and diverse risk mechanisms of the financial institutions, it is necessary to have a new generation of professional bankers. However, it may be difficult to promote this process if the dual roles as "government officials and bankers" remain.

3.4.1.3 Deficiencies of the current remuneration system

Brain drain

Among the senior, middle-aged and junior bankers, the senior generation, who are approaching retirement have the highest acceptance of the salary limit, whereas the middle-aged generation has a lower acceptance of this restriction. This shows that the rising stars among the professional bankers are more willing to accept market-based incentives and constraints rather than administrative management. At present, the young generation of talent has not yet been selected to the centrally supervised team, but they have already expressed concerns about the salary limit. Some are even willing to forgo promotion to senior management. The bankers who do not intend to pursue administrative promotion can choose to join joint-stock commercial banks for a higher pay. Additionally, although the salary limit for executives is limited to the "Central Supervised Cadres", the upper limit of remuneration in some functional departments of the head office and branches is also capped by this ceiling in practice. This low remuneration level leads to brain drain.

During the course of the research, we learned that bankers believe that the rapid development of internet finance and economic downturn are the main external factors, whereas the unsound incentive mechanism and remuneration system are the main internal factors for brain drain. More bankers in the Big Six Banks, as compared to their counterparts in joint-stock commercial banks, believe that brain drain has a greater impact on banks and that the Big Six Banks will face more severe consequences from brain drain than joint-stock commercial banks.

Salary inversion

Given the pay limit is only applied to the "Central Supervised Cadres", the Big Six Banks do not restrict the compensation for certain positions such as investment, risk control, science and technology, financial market, etc. The compensation for these positions are based on the market mechanism as the banks need to compete for talents in the market. As a result, salary inversion occurs between the head office and branches of the Big Six Banks, which essentially means that the compensation of the business directors of the branches is higher than the compensation of the executives at the head office. The annual salary of some local branch presidents is as much as RMB2 million, which is far above the compensation received by the president of head office. The salary inversion leads to serious imbalances in the remuneration system, creates inequalities, stimulates the dissatisfaction of executives at the head office and inculcates negative sentiments towards the system, thereby impacting the long-term development of middle management.

Suggestion 12:

- ***It is suggested to narrow down the scope of the "salary limit regulation" and expand the number of roles recruited based on market mechanism. For example, it is suggested to restrict the scope of the salary limit to the cadres who do not undertake specific business tasks, and then gradually allow positions with operational responsibilities (such as vice presidents) to be market recruited and their salaries to be based on market rules.***

- ***In order to attract and retain more professional bankers, the remuneration of market-recruited talent should be increased to a competitive level in the banking industry.***

3.4.2 Enhancing the correlation between remuneration and performance

The uniform remuneration structure

At present, the remuneration system of the Big Six Banks has maintained a traditional structure, namely "basic salary + welfare + bonus", which is dominated by cash incentives and does not involve any new form of remuneration incentives. In 2011, FSB conducted an assessment of the application of the "*Principles for Sound Compensation Practices*" in the global banking industry. The assessment found that equity-related tools are hardly used in the compensation structure of directors and executives in China's banking industry. In contrast, in the UK the proportion of executive compensation related to equity is 80%. In North America, the average proportion of floating compensation for executives is about 81%, of which payment in the form of equity accounts for about 66%. In 2017, about 89% of the total compensation of the chairman of Bank of America, 55% of the compensation of the CEO of Citibank and 62% of the compensation of the chairman of Goldman Sachs were equity-related. Compared to the large international banks, the executive remuneration structure of the Big Six Banks is relatively simple and mainly based on cash payment. There is a huge gap as compared to the multi-level remuneration structure in developed countries which has gone through a long journey of evolution.

Legacy remuneration system of the egalitarian "big pot"

The remuneration of the executives of the Big Six Banks, both the cadres who are subject to the pay limit and those recruited from the market, do not vary significantly within each group. Compensation is largely determined by the administrative rank, rather than the performance or the effectiveness of the businesses managed by the executives. For instance, almost all vice presidents are paid the same, which is obviously not playing any motivation role.

Lack of long-term incentives

Another major problem in the executive remuneration structure of the Big Six Banks is the lack of long-term incentive tools. The remuneration of the directors and executives is mainly paid by cash, and there is no incentive linked to medium-term or long-term performance such as equity. A large number of practical studies have proved that, compared with other forms of compensation, long-term incentives such as options are the best compensation mechanism to ensure that executives consider the interests of the corporate and strive to promote the long-term healthy development of the company. Long-term incentives mainly include long-term cash payments and long-term equity plans, with stock options being the most common one. More than 90% of Fortune 1000 U.S. companies have implemented stock options as a long-term incentive tool. The annual remuneration of the chairman and CEO of the Bank of America was about RMB142 million in 2017, out of which about RMB128 million was related to stock options. The compensation structure of the executive director of HSBC includes long-term incentives related to shares in the form of deferred shares, which are granted for up to seven years. The lack of medium-term or long-term incentive tools in the compensation structure of the Big Six Banks reduces the correlation between compensation and performance, which may lead to lack of motivation for the executives, the pursuit of safety and unwillingness to take risks, thereby impeding the long-term strategic goals of the banks.

Suggestion 13:

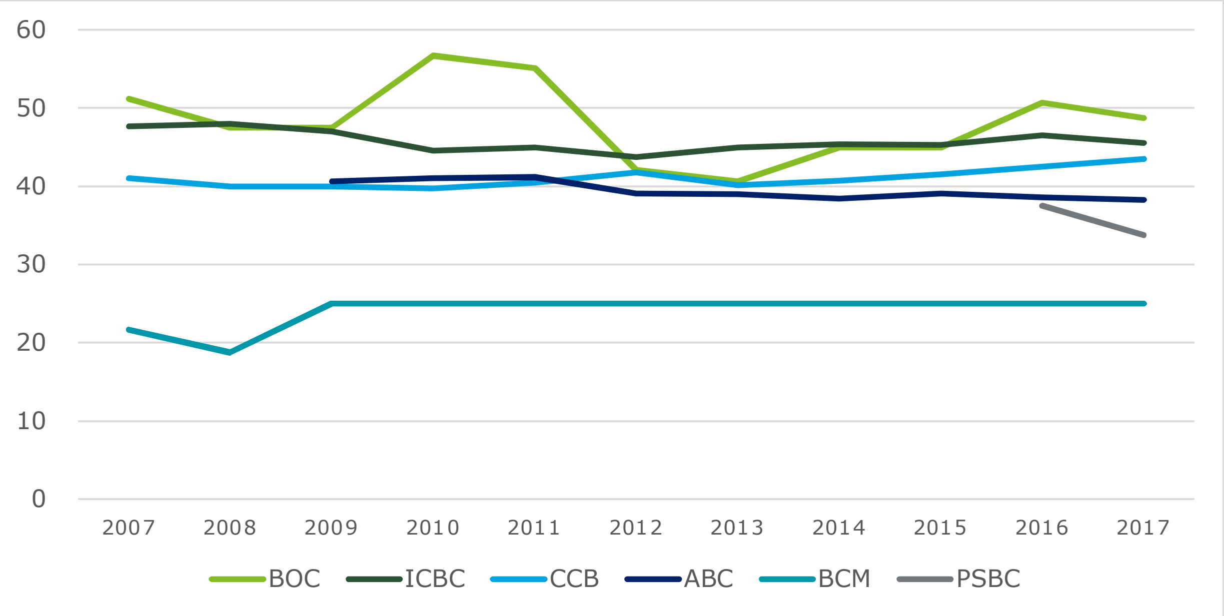
It is suggested that the Big Six Banks optimize the remuneration structure of executive directors and the executives and learn from the experience of the international banking industry. They should pilot incentive tools linked to long-term performance, and gradually establish a mechanism that relates the interests of the executives to the long-term goals of the banks. This will help in striking a balance between the risk-taking appetite and performance of the executives.

3.4.3 Breaking the rigid mechanism of independent director compensation

Constant overall remuneration level of independent directors for a decade

In 2017, among the Big Six Banks, the average remuneration for independent directors was RMB0.4 million before tax, with the highest being RMB0.6 million and the lowest being RMB0.25 million. These figures were not significantly different from those of other joint-stock commercial banks (other than China Minsheng Bank, which was the highest paying bank in the country). The position of independent director has been established since the Big Six Banks went public. Except for slight fluctuations in BOC, the remuneration of independent directors of other banks has remained broadly unchanged over the past decade (as shown in the figure below).

Figure 6. Remuneration of independent directors in the Big Six Banks from 2007 to 2017 (unit: RMB10,000)



Fixed remuneration structure of the Big Six Banks

In general, the remuneration of the independent directors at the Big Six Banks comprises solely a fixed annual salary, whereas the compensation in large international banks is determined by the workload.[8] Additionally, some international banks also grant independent directors shares worth 15-20% of their total annual remuneration, while the payment of these shares is deferred. Independent directors can even choose to be paid completely in shares. The inclusion of shares in the remuneration structure of the independent directors intends to bring more attention to the long-term interest of the bank and the return to the capital market.

A big gap in remuneration of independent directors when compared with large international banks

Compared with the average remuneration of independent directors of large international banks, which ranges from USD300,000 to USD600,000, the figure in the Big Six Banks ranges from RMB250,000 to RMB500,000, which is less competitive. The Big Six Banks not only recruit independent directors in China, but also compete with large international banks for excellent independent directors globally. As the independent directors are responsible for the bank's audit committee, risk committee and other important director positions, which face heavy workload and high career risk, the compensation of

[8] It refers to the data of HSBC, Citi, Goldman Sachs and Bank of American in 2017.

independent directors should be benchmarked to the global level to enhance the international competitiveness of the Big Six Banks.

Suggestion 14:

- ***Reform the fixed remuneration structure of independent directors and instead determine the remuneration according to their relevant experience, workload and performance, and supplement with an equity payment mechanism.***

- ***Improve the remuneration level of independent directors to enhance global competitiveness.***

3.5 Communication with stakeholders

— Confidence comes from transparency

The principal-agent arrangement of modern corporate governance requires companies to disclose information and improve transparency in order to eliminate information asymmetry between shareholders and managers. More banks have realized the positive benefits of effective communication, and as a result, the information disclosure of the banks is evolving from passive compliance-driven disclosure to active communication with stakeholders. For the Big Six Banks, the stakeholders include not only shareholders, authorities, regulators, employees, customers/depositors, but also rating agencies, securities analysts and the public. As systemically important banks, the Big Six Banks are at the forefront of listed companies in terms of information disclosure compliance, which meets the regulators' requirements of "direct channel of information disclosure" and has been recognized by the capital market.

This section focuses on the communication between the Big Six Banks and some of their important stakeholders, analyses the gap between the Big Six Banks and their international counterparts in terms of information disclosure, and puts forward suggestions to increase the effectiveness of information disclosure of these major banks.

3.5.1 Strengthening communication with international stakeholders

As global systemically important banks, ICBC, ABC, BOC and CCB reflect the overall governance level of China's banking industry to a certain extent. The governance level of the Big Six Banks plays an important role in the stability of the global financial system. The Big Six Banks are listed in Hong Kong, with international investors holding between 10% - 47% of their shares (see Table 7). In June 2018, MSCI incorporated 234 Chinese listed companies into the benchmark index of emerging markets for the first time. As a result, international investors are paying more attention to Chinese listed companies. In terms of communication with stakeholders, the Big Six Banks should pay special attention to the concerns of international stakeholders, such as international institutional investors, index suppliers and rating agencies, regarding information disclosure.

Table 7. International institutional investors disclosed by the Big Six Banks (collated according to the 2017 annual reports)

Bank	H-shares/total shares	Major international institutional investors disclosed
ICBC	24.35%	Temasek Holdings (Private) Limited
		BlackRock, Inc.
ABC	9.46%	Qatar Investment Authority
		The Bank of New York Mellon Corporation
		BlackRock, Inc.
BOC	28.41%	BlackRock, Inc.
		JP Morgan Chase & Co.
CCB	37.28%*	Temasek Holdings (Private) Limited
BOCOM	47.15%	HSBC Holdings plc
PSBC	24.51%**	UBS Group AG

* 37.28% of CCB's H shares are foreign listed and held by foreign investors.
** H shares account for 24.51% of PSBC's total shares, including 7.72% restricted shares.

Respond to company engagement activities of international institutional investors

Although the Big Six Banks have routine road shows for foreign investors each year, many large institutional investors prefer to communicate one-on-one with the banks. This helps the institutional investors in building a deeper understanding of bank information through dialogues with the board of directors and executives, which also helps banks in enhancing their financial and social values. Interviews with the Big Six Banks suggested that 10 to 50 international institutional investors proposed to meet individually with the Big Six Banks every year. These international institutional investors are mostly long-term investors who pay more attention to the development strategy and the sustainability of banks. Interviews with international institutional investors suggested that these investors require additional information, beyond what is already disclosed in the annual reports. Some of the areas where the investors require more information include business model, corporate governance, executive remuneration, institutional client's business, project financing, network security, data privacy and artificial intelligence etc. For example, in terms of corporate governance, the international institutional investors encourage banks to disclose information on the Party Committee members and the Party Committee work plans. They also encourage the banks to establish formal and transparent director nomination procedures. In terms of executive compensation, the investors expect to see sustainable remuneration metrics. The investors also have concerns on network security, which includes the background of data security team members, their contribution to bank information security and supervisory measures that the board of directors has implemented to tackle network security issues. According to the international institutional investors, as compared to the large international banks, the Big Six Banks need to proactively prepare and be more open to responding to the concerns of institutional investors.

Feedback on market analysis

On 28 February 2019, MSCI announced that it would increase the inclusion factor of Chinese mainland stocks in its global benchmark index from 5% to 20%. This adjustment was expected to attract more than USD80 billion into the A-share market. The analysis and research of MSCI has an important influence on the international capital market. MSCI conducts ESG (environmental, social and corporate governance) ratings on more than 7,000 listed companies worldwide every year. It has 96 corporate governance indicators in four categories, namely board of directors, remuneration, ownership and control, and audit. MSCI verifies the data with listed companies before releasing the rating results. If the listed companies proactively provide feedback, the accuracy of the analysis will be improved and the factual misunderstandings will be clarified. According to MSCI, as of February 2019, three of the Big Six Banks had provided feedback for verification of the ESG/CSR reports rating. In the interviews with the Big Six Banks, we also learned that some bank staff were completely unaware of this important rating.

"Equator Principle" has not been adopted in international project financing

Nowadays, sustainable development is a hot topic all over the world. In order to establish a sustainable financial system, more than 2,300 institutional investors around the world have signed the United Nations Principles for Responsible Investment (UN PRI), promising to incorporate environmental, social and corporate governance (ESG) factors into their investment decisions, and to encourage investors to disclose ESG-related issues. In recent years, the Chinese government has made a great effort in solving environmental problems, promoting the development of green finance and formulating a series of regulations and policies. On 30 September 2018, China Securities Regulatory Commission (CSRC) released the revised "*China Corporate Governance Code for Listed Companies*". Compared to the 2002 version, the new code includes new sections on stakeholders, environmental protection and social responsibility. As the establishment of a green financial system has become a national strategy, the Big Six Banks are giving more importance to green finance, incorporating environmental risks and benefits, and other sustainable development factors into the lending and investing processes. As a result, the proportion of green credit has risen in all the banks. The disclosure of green finance and green credit by the Big Six Banks is in compliance with China's regulatory requirements. However, the content and quality of information disclosure by the Big Six Banks in terms of environmental risk management, climate change investment and financing lag behind their international counterparts. HSBC, Citibank, JP Morgan and other 97 large commercial banks and financial institutions have adopted the "Equator Principle"[9] to assess and manage environmental and social risks in project financing. The international investors also pay attention to the adoption of the "Equator Principle" in the banks' international project financing and the international project financing policies. However, none of the Big Six Banks in China have adopted the "Equator Principle" so far, and hence fail to meet the expectations of international investors and match the practice of sustainable financing around the world.

Suggestion 15:

The Big Six Banks should pay high attention to their communication with international institutional investors, index companies and other international stakeholders, actively respond to international investors' concerns about company information in order to maintain the soundness of communication channels, adopt international standards such as the "Equator Principles" and strengthen information disclosure in terms of investments and financing.

[9] The "Equator Principle" is a set of financial industry benchmarks used to identify, assess and manage the environmental and social risks involved in financing process. They are used in various industries around the world for project financing advisory services, large project financing, corporate loans and financial products such as bridge loans.

3.5.2 Strengthening communication with authority and regulators to better coordinate information disclosure

The authority and regulators have advantages in acquiring information from the banks

Among the various stakeholders, the authority and regulators have the most influence on corporate governance and information disclosure of the Big Six Banks. The authority of the Big Six Banks is the Finance Department of MOF, which is also a stakeholder with Chinese characteristics. The authority is responsible for state-owned asset management, financial discipline supervision and executive compensation management. The regulators of the Big Six Banks include the People's Bank of China, the China Banking and Insurance Regulatory Commission (CBIRC), CSRC, domestic and foreign stock exchanges etc. From the interviews, we learned that the Big Six Banks should report to the authority on core business data, such as the total assets, asset quality and the profit of the previous year, at the beginning of each year. As a result, the authority should have such information earlier than the official disclosures in the annual report. The regulators also ask the Big Six Banks to provide core business data from time to time. In addition, the authority and regulators also use the key information of the Big Six Banks to develop annual work plans and set their appraisal criteria. The Big Six Banks still report in an administrative manner when they respond to these information requests. According to the principles of the capital market, the board of directors should be the ultimate responsible entity for information disclosure, who should coordinate and control the various information disclosure methods, ensure the confidentiality of information and the fairness of information disclosure to all the shareholders. The Big Six Banks need to clearly define the scope of information provided to the authority and pay attention to the confidentiality while providing such information. Information that has not been disclosed to the market should be marked as "internal information not yet disclosed to the public" when provided to the authority and regulators, in order to alert the relevant parties.

Suggestion 16:

The board of directors should strengthen the communication with the authority and regulators, control the fairness and accuracy of information disclosure. It is suggested to mark "internal information" whenever providing undisclosed information, to alert the authority and regulators on the confidentiality of information while using such information. The authority should use undisclosed information only for administrating the industry and cannot use the undisclosed information to instruct or approve the sale and purchase of shares by state-owned shareholders.

3.5.3 Encouraging and strengthening the initiative of information disclosure, forming competitive advantages of information disclosure

Compliance-driven and lack of initiative in information disclosure

Domestic and foreign researches have shown that increased information transparency can reduce corporate financing costs and enhance the value of corporates. The Big Six Banks have established a comprehensive set of information disclosure programs such as periodic reporting, temporary announcements, roadshows and analyst conference calls. In addition to the mandatory information disclosure such as capital composition, leverage ratio and liquidity coverage information required by the regulators, the Big Six Banks can provide voluntary disclosures through the "management analysis and discussion section" of their periodic reports or through temporary announcements and other channels. From interviews with the Big Six Banks, we learned that the information disclosure of the Big Six Banks is mostly driven by compliance. The banks try to minimize disclosure risks by disclosing as little as possible or not disclosing at all on the ground of business secrets. The main reason for this approach is the lack of motivation for active disclosure. There are three main reasons for the lack of initiative in information disclosure by the Big Six Banks. Firstly, the remuneration of directors and executives of the Big Six Banks is not related to the bank performance and their motivation to manage market value is not strong as the fluctuations in the stock prices have minimal effect on their remuneration. Secondly, the directors and executives are concerned that active information disclosures (such as the bank's forward-looking information) will become a "commitment to future performance", and as result, they choose to adopt a cautious approach and minimize active disclosure. Thirdly, since the investors in China's capital market are mostly individual investors, there is no active push or a positive feedback mechanism for information disclosure in the market.

Homogeneous information disclosure makes it difficult to highlight competitive advantages with insufficient "communication"

Each of the Big Six Banks is unique in its business and corporate governance culture, but these are not reflected in its information disclosure. The information disclosure of the Big Six Banks is "homogeneous", sharing similarities in the form and substance of annual reports, internal control evaluation reports and social responsibility reports which are presented at almost same formatting and lack uniqueness. The report structures and the expressions are very similar. Some banks even have the same definitions of the key risks. The reports are generally not reader friendly and fail to reflect the characteristics of the banks. In contrast, J.P. Morgan's 2017 annual report started with a 45-page letter to shareholders from the chairman and CEO, Jamie Dimon, which comprehensively analyzed the bank's strategy, the key risks, peer comparison, succession issues and how to deal with the bureaucratic problems in large companies. This reader-friendly letter made up one-seventh of the report and address key characteristics of the bank. The letter sets a good example for the Big Six Banks. In general, the annual reports of large international banks pay more attention to communication with stakeholders and actively respond to the stakeholders' concerns. Comparatively, the reporting and style of the annual reports of the Big Six Banks are traditional with insufficient communication with stakeholders.

ESG information disclosure

International institutional investors place great emphasis on non-financial disclosures such as environmental, social and corporate governance (ESG) information. The Big Six Banks disclose ESG information mainly in the corporate social responsibility (CSR) report. Among the Big Six Banks, CCB was the first to disclose a CSR report in 2006, and other banks followed suit successively since 2007. Just like the annual report, the Big Six Banks have a similar style of ESG information disclosure. Upon the request of regulators, the Big Six Banks disclose their green credit policies and achievements, supportive measures for inclusive finance, "Three Rural" economy policies (agriculture, rural areas and farmers), environmental performance indicators and other quantitative data. However, the Big Six Banks focus on social responsibility mainly in terms of poverty alleviation and public welfare, and regard the CSR report as a way to promote corporate culture. In fact, the ESG report is an important tool for the banks to explain their strategies to the stakeholders, communicate their ESG performance, and provide non-financial information that investors care about. For example, nearly half of HSBC's

2017 ESG report focuses on the bank's strategy to enhance the global customer experience with increased customer trust, whereas the other half emphasizes on feedback, training for employees and efforts in achieving sustainable development. HSBC uses its ESG report to communicate its concerns as it relates to customers, employees and society, which sets a good example for the Big Six Banks.

Suggestion 17:

The Big Six Banks should increase their initiative and uniqueness in information disclosure, with a focus on informative content rather than style, and turn communications into a competitive advantage. The Big Six Banks should emphasize on the importance of non-financial information disclosures. The banks should also consider the annual report, social responsibility report and ESG report as communication tools to address stakeholders' concerns.

3.5.4 Strengthening crisis management and communication

Communicating risk events actively and frankly

As the international business environment is becoming more complicated, both domestic and overseas regulators are strengthening their supervision over the banks. Timely and effective crisis management can help avoid the negative impact of risk events on the banks, as well as protect their reputations. We have also noticed that the CSR/ESG reports of the Big Six Banks tend to "report good news only", excluding the banks' analyses and responses to the risk events. In the 2018 ESG report, HSBC frankly disclosed the fine imposed by the US Federal Reserve and the Justice Department, and admitted its misconduct. It developed a series of improvement measures which were clearly stated in the report. The honest communication and proper mitigation measures reflect HSBC's emphasis on professional ethics and corporate culture, thereby promoting its corporate image. The Big Six Banks should develop contingency plans to deal with domestic and overseas non-compliance events, and communicate with stakeholders actively and frankly when the risk events occur. Active crisis management helps to enhance corporate value and form a long-term competitive advantage for the banks.

Insufficient training for directors in crisis management

As the board of directors is the ultimate responsible body for information disclosure, the board should have appropriate crisis management knowledge and capability, including that in an overseas regulatory environment. Based on the statistics of the director training programs disclosed by the Big Six Banks from 2013 to 2017, we found that the Big Six Banks have not included specialized crisis management in their director training.

Suggestion 18:

Given the complex regulatory and business environment, the Big Six Banks should strengthen crisis management and communication, actively and frankly communicate with stakeholders, and enhance crisis management training for directors.

3.6 Internal audit and external audit

The International Association of Internal Auditors pointed out that the board of directors, management, internal audit and external audit are the four cornerstones of corporate governance. Internal audit and external audit, as the two cornerstones of corporate governance, play an important role in the corporate governance of the Big Six Banks. Bringing the role of internal audit and external audit into full play in corporate governance is of great significance for improving the corporate governance of the Big Six Banks. Based on the research, we provide the following observations and suggestions on the internal audit and external audit of the Big Six Banks:

3.6.1 Strengthening the audit committee's function of supporting and supervising the internal audit and external audit

Strengthening the independence of internal audit and external audit

Independence is the core value of internal audit and external audit in corporate governance. Without independence, even the most capable auditors cannot report their audit findings. Communication mechanisms between internal/external auditors and shareholders, industry authorities and regulators should be set up. These will help the internal and external auditors to have more communication channels and a stronger support system, when reporting audit findings under great pressure. In addition, from the perspective of the corporate governance mechanisms of the banks, an independent and professional audit committee and a corporate culture that values audit work, can also provide assurance to the independence of internal audit and external audit.

Enabling the audit committee to play its role in support and supervision

In the corporate governance structure of the Big Six Banks, the audit committee is the most important supporter of internal audit and external audit. An independent and professional audit committee can provide stronger support for internal audit and external audit, supervise their work and help internal and external audit in maintaining independence and improving the work quality. According to the 2017 annual reports of the Big Six Banks, the proportion of independent directors in the audit committee is about 60%, which is lower than their international peers. The chairmen of the audit committees of the Big Six Banks have many years of audit experience and play a core role in the audit committees. However, regarding the overall composition of the audit committee, directors with auditing or accounting background account for a relatively low proportion.

In terms of internal audit, the audit committee should play the following roles:

- Establish an effective constant communication mechanism with internal auditors, so that internal auditors can report major audit findings to the audit committee immediately, and report follow-up communications with the management objectively to the audit committee. This will help the audit committee keep up with the internal audit findings and evaluate the work of the internal auditors better.
- Independently lead the selection, appointment and evaluation of the chief internal auditor, so that the operation of internal audit department could achieve maximum objectivity within the bank's organizational structure.

In terms of external audit, the audit committee should play the following roles:

- Strengthen the communication with the management about external audit findings. During the audit, in addition to closely communicate with external auditors, the audit committee should also communicate with management on the audit findings and ask the management to follow up on the difficulties or audit findings raised by external auditors, and report implementation details. At the audit committee meetings, the management should send a representative to answer the questions of the audit committee and follow up on implementation.
- Consider disclosing the evaluation results of external auditors to the market, when evaluating external audit work and deciding whether to renew their appointment. This disclosure will have a positive effect on the external auditors to maintain their independence and on the quality of external audit work. The external auditor should be evaluated in terms of the ability to audit the extensive and complex business of the bank, resources and knowledge of industry experts, the

quality of communication between the audit committee and the management, independence, the quality of service and efficiency (including resource inputs and effectiveness of professional judgment), reasonableness of audit fees and the tenure of the auditor for the company.

- Review the work scope of external audits to effectively limit non-audit services of the external auditors. This includes prohibiting external auditors from performing non-audit services that affect their independence and strengthen the approval and review of the effectiveness of non-audit services.

Suggestion 19:

In the future, the Big Six Banks should increase the proportion of independent directors with auditing or accounting background in the audit committee, and strengthen the training of all directors in auditing and accounting, so that the audit committee can provide more professional support and supervision for internal audit and external audit.

3.6.2 Building a system of corporate culture and values that attach importance to audit work

Building a corporate culture that values audit

The Big Six Banks should build a corporate culture that respects the independence and professionalism of internal audit and external audit in corporate governance. This will encourage, guide, and coordinate auditing strengths, and better mobilize the initiative of internal and external auditors, to improve the efficiency and quality of audits. Meanwhile, the internal and external auditors should carry out the audits in a diligent and responsible manner to the audit committee and shareholders, maintain professional prudence, continuously enrich theoretical knowledge and deal with various problems in audit practices independently, cautiously and objectively.

Promoting close coordination between internal audit and external audit

Internal audit, as an internal function, has a more comprehensive and in-depth understanding of the bank's internal control and risk management, while external audit can identify risks from a more independent perspective. As these are indispensable parts of the audit committee, internal audit and external audit have different focuses, but can learn from each other. Cooperation between internal and external audits is important to reduce duplicated auditing and improve auditing efficiency and quality. However, in practice, there is not much or insufficient cooperation between the internal and external auditors.

Suggestion 20:

- ***The Big Six Banks should integrate auditing culture into all parts of the banking businesses, enabling all departments to fully recognize the value of audits.***

- ***The management and functions should respect the independence of audits, actively coordinate with auditors, provide more support for audits, show respect to professional results, pay attention to the recommendations made by internal and external auditors, and actively implement the recommendations.***

- ***Under the guidance support of the audit committee, internal and external auditors should establish a joint working mechanism. Internal and external auditors should share their audit plans, risk recognition and auditing materials, which are of great significance for improving auditing efficiency and effectiveness, and also provide convenience for the audit committee to mobilize audit resources comprehensively and flexibly. For example, the audit committee may require internal and external auditors to conduct a joint inspection on certain risk areas when necessary.***

- ***The audit committee of the board of directors should emphasize on the value of supporting internal and external auditors. This can help mobilize auditors' initiative, improve auditing efficiency and quality, and create a good corporate governance culture.***

IV. Research Team, Research Methods and Acknowledgements

4.1 Research team

The project was led by Chen Caihong, a distinguished professor of Zhongnan University of Economics and Law, with joint efforts of International Finance Corporation (IFC), World Bank Group and the Corporate Governance Research Center of Deloitte China. Mr. David Wu, vice chairman of Deloitte China and leader of China Financial Services Industry and Mr. James Christopher Razook, head of Corporate Governance of IFC East Asia and Pacific Region, co-chair the Project Steering Committee. The project team is comprised of Ms. Lin Zhaowen, IFC senior Corporate Governance consultant, Mr. Chen Bo, associate professor and dean of Department of Auditing, School of Accounting, Zhongnan University of Economics and Law, Mr. Jerry Han, associate director of Deloitte Touche Tohmatsu Certified Public Accountants LLP and Ms. Jia Ruo, IFC Corporate Governance consultant.

Professor Chen Caihong, the host of the project, has worked in CCB for more than 30 years and served as the board secretary of CCB. He has extensive practical experience in corporate governance of large commercial banks. Professor Chen Caihong has published many research papers in economics, finance and corporate governance, and also published 12 books and collections.

4.2 Research methods

The research methods applied by the research team mainly include:

• Literature summary

The research team collected research literature related to the corporate governance practices of the Big Six Banks. They reviewed both the academic and professional journals available locally and internationally, and gained a comprehensive understanding and analysis of the relevant theoretical foundations, major research findings and representative viewpoints. At the same time, the team comprehensively collected and compiled relevant documents from the annual reports, announcements, and social responsibility reports of the Big Six Banks, and obtained basic information on the corporate governance of these banks.

• In-depth interviews

The research team conducted in-depth interviews with the board secretaries and independent directors of the Big Six Banks, heads of professional service providers and other insiders (including equity directors, executive directors and executives), and obtained first-hand information on the actual operations of corporate governance in these banks.

• Statistical analysis

The research team has comprehensively analyzed the basic characteristics and operational effects of the shareholding structure, Party committee, board of directors, board of supervisors, audit committee, directors' competencies, the remuneration of directors and executives, and information disclosure of the Big Six Banks.

4.3 Acknowledgements

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Appendix I. Introduction of IFC and Deloitte

1. About IFC

IFC—a sister organization of the World Bank and member of the World Bank Group—is the largest global development institution focused on the private sector in emerging markets. We work with more than 2,000 businesses worldwide, using our capital, expertise, and influence to create markets and opportunities in the toughest areas of the world. In fiscal year 2018, we delivered $23 billion in long-term financing for developing countries, leveraging the power of the private sector to help end poverty and boost shared prosperity. For more information, visit www.ifc.org

2. About Deloitte

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