PIONEER
ACADEMIC PUBLISHING LIMITED

Journal of World Economy
ISSN 2709-3999
www.pioneerpublisher.com/jwe
Volume 2 Number 2 June 2023

Corporate Governance of Small-and-Medium Sized Commercial Banks in China

Ziwen Yin[1]

[1] Qujing Vocational and Technical College, Yunnan, China
Correspondence: Ziwen Yin, Qujing Vocational and Technical College, Yunnan, China.

doi:10.56397/JWE.2023.06.07

Abstract

Small-and-medium sized commercial banks have developed significantly along with China's economic development, but in this process, there are often problems; the fundamental reason lies in need for a severe internal governance system and governance capacity of small-and-medium sized commercial banks. Given this situation, this paper focuses on the study of corporate governance of small-and-medium sized commercial banks. Then it takes targeted optimization measures to address its shortcomings to enhance the comprehensive governance level of small-and-medium sized commercial banks, improve their market competitiveness, and lay a good foundation for their long-term sustainable development.

Keywords: corporate governance, small-and-medium sized commercial banks

1. Introduction

Large commercial banks, joint-stock commercial banks, urban commercial banks, private banks, rural commercial banks, and foreign banks are all types of commercial banks in China. In addition to large commercial banks and joint-stock commercial banks, there are small-and medium-sized commercial banks. The assets of small-and-medium sized banks will have reached 42% of the total assets of the banking institutions by June 2021. Therefore small-and-medium sized banks play an essential role in China's financial system.

For small-and-medium sized commercial banks, they must focus on maximizing shareholder wealth. Risk of small and medium-sized commercial banks carried out frequently in China. On the surface, it is a problem of non-performing asset ratios but fundamentally a problem of insufficient corporate governance models. The main stakeholders of the bank are the government, regulators, owners, depositors, and operators. A good corporate governance model requires these five stakeholders to balance each other. Small-and-medium sized banks have specific areas for improvement in business philosophy, risk control, internal management, operational capabilities, personnel quality, and governance ability, resulting in the absence of balance among significant stakeholders. This article explores how to create a standardized and efficient corporate governance mechanism for small-and medium-sized banks while also examining the issues with small-and medium-sized banks' corporate governance.

2. The Difference Between Corporate

Governance in Banks and in Other Types of Businesses

In general, the same corporate governance issues in non-financial companies, which relate to the separation of ownership and control, also apply to financial institutions. Corporate governance of financial institutions also depends on the legal protection of investors, which is only sometimes sufficient (Shleifer & Vishny, 1997). And the standard solutions proposed to coordinate the interests of managers and outside investors are also applicable to banks. These include concentrated ownership, managers' incentive contracts, hostile takeovers, significant creditors, etc. However, financial institutions have unique attributes that will exacerbate common governance problems and limit the effectiveness of corporate control. (Corporate Governance, 2013)

There is a large amount of literature studying corporate governance in banks and its differences from non-financial enterprises. (Becht et al., 2011; Hopt, 2013; Laeven, 2013)

First, banks' leverage ratio is generally high, while the leverage ratio of enterprises varies from high to low. Numerous studies have shown that it is not uncommon for banks to have leverage ratios of more than 90 percent. Gornall & Strebulaev (2018) (Gornall & Strebulaev, 2018) show that the average leverage ratio of banks measured by asset-liability ratio is between 87-95 percent, while that of non-financial enterprises is between 20-30 percent. According to the "China Financial Stability Report (2020)" released by the People's Bank of China, by the end of 2019, the total assets of the banking financial institutions were 290 trillion yuan. The total liabilities were 265.54 trillion yuan, which shows the large scale and high leverage of the creditor's rights financing of the Chinese banking industry. The high debt determines that the bank's risk control is only a high probability choice, and there must be certain risks in the bank's operation. The operation law of high risk and high return makes bank operators more motivated to take risks.

Secondly, the stakeholders of banks are different from companies. Generally, the main stakeholders of a company include shareholders and operators. Shareholders are naturally the main stakeholders. They have inherent incentives to maximize shareholder value due to their control of the company's residual claim rights, thereby having sufficient motivation to maximize company value. The ownership and management rights of the company are divided as a result of the enterprise-scale expansion, and all shareholders select qualified operators to be in charge of carrying out the company's mission. Therefore, operators are also important stakeholders of the bank. Other stakeholders, such as banks, depositors, employees, customers, suppliers, communities, etc., have no decisive impact on the company. Small and medium-sized banks have more significant stakeholders, including shareholders, operators, other banks, governments, central banks, regulatory authorities, and depositors. In addition to shareholders and operators, other banks are the main stakeholders of small and medium-sized banks. Compared to ordinary companies, there are more forces that can influence the operation and revenue of banks. The emergence of other banks, governments, regulatory authorities, and depositors has changed the governance structure of companies, bringing more information asymmetry and principal-agent issues. Generally speaking, companies adopt the principle of "shareholder supremacy" because shareholders are the source of capital and the ultimate risk bearers of the company. However, for banks, creditors and shareholders are both important sources of funds and the top risk bearers. Therefore, when considering the corporate governance of banks, it is not only necessary to consider the role of one party but also to integrate the supervision and incentives of all parties to ensure that the interests of all parties can be protected.

3. The Problems Existing in the Corporate Governance of Small-and-Medium Sized Banks

3.1 Poor Supervision and Management

Adequate supervision and management system is the key to ensuring supervision's independence. For the governance of small and medium-sized commercial banks, there is independence between shareholders and the board of directors. However, considering the actual situation at the present stage, the directors of many small and medium-sized commercial banks do not carry out their work per the principle of supervision and management in the governance process. The presidents of many banks also serve as members of the board of directors or even vice chairpersons. The dual role of the CEO is defined as the practice of a single individual serving as both CEO and chairman (Krause et al., 2014). Banks' opacity, lack of market control, and complexity of agency costs undermine CEO discipline, making the separation of leadership roles in banks all the more critical (John et al., 2016). Moreover, the independence of the supervisory board could be better. According to the Company Law, the Board of Supervisors cannot control the board of directors and managers, and its work is mainly focused on economic and financial business. However, because the Board of Directors decides the individual compensation of the Board of Supervisors, and the Board of Supervisors' job is to supervise the operation of the Board of directors, there are profound contradictions between them. This also leads to the board of supervisors not completing their work per the supervision and management requirements. At the same time, based on the unique characteristics of commercial banks, small and medium-sized commercial banks cannot guarantee operation quality with governance ability like conventional enterprises. In addition, because commercial banks are greatly affected by external factors, the lack of supervision and management based on inadequate governance will also become the main fuse of the financial crisis.

3.2 Poor Institutional Construction

On the one hand, the incentive and constraint system of the board of directors could be better. Currently, for the governance system of small and medium-sized commercial bank companies, there needs to be a scientific analysis of the board of directors' responsibilities in terms of content. Even many bank directors only focus on the chairman in the system implementation and supervision process, analyzing whether they attend the board of directors by regulations. This single situation can make the rights and responsibilities of board members clear. In addition, small and medium-sized commercial bank companies do not have a scientific board responsibility system. Once there are problems in decision-making during the business process, the responsibility of the board members can only be pursued after some time. On the other hand, research has demonstrated the impact of director experience on bank performance. Aebi et al. (2012) (Aebi et al., 2012) investigated whether experience and financial expertise during crises affect the performance of US banks. Their research results indicate that the presence of CROs on bank board positively impacts bank performance during financial crises. In addition, the market competition of small and medium-sized commercial banks has become increasingly severe, and individual decisions and judgments can easily affect the scientific nature of the final decision. For small and medium-sized commercial banks, improving the quality of decision-making means that it is necessary to avoid the insufficient personal abilities of management staff and complete decisions through group suggestions or communication. The independent decision-making of the executive director will directly lead to subjective assumptions in the final decision-making content, which cannot ensure scientificity.

4. How to Optimize the Corporate Governance Mechanism of Small-and-Medium Sized Commercial Banks

4.1 Improve the Enterprise Mechanism

First, we should establish a sound governance structure and formulate an independent and scientific board of directors system by the requirements of the governance system of modern small and medium-sized commercial banks. In the context of the system, it is required that the staff should further play the board of directors' governance function to ensure the shareholders' economic benefits. In addition, the independence of the board of directors should be ensured to form a restrictive relationship between the board of directors and the general meeting of shareholders to check and balance each other's decisions and ideas to ensure that the governance of small and medium-sized commercial banks can meet the expected needs.

Second, improve the independent director selection mechanism. Small and medium-sized commercial banks are required to strictly appoint and remove independent directors by the Guidelines on the Independent Directors and External Part-time System of Joint-Stock Commercial Banks. The most crucial point is that independent directors should be elected under the approval of the general meeting of shareholders to standardize the comprehensive level of directors and ensure their completion of governance.

4.2 Improve the Organizational Structure of the Board of Directors and Strengthen the Relationship

of Mutual Restraint

Banks should improve the business decision-making system and make more independent and scientific decisions. In the concrete work, we should pay more attention to centralized decision-making and give full play to the individual ability and advantages of board members so that the decision-making can become a kind of group reflection to enhance the decision-making level. Secondly, we should optimize the supervision and management mechanism and improve the quality of supervision. Independent directors of commercial banks shoulder the responsibility of supervising the operation and management of banks. To further enhance the supervision quality of independent directors, commercial banks should establish an internal management system and highlight the supervisory independence in internal control. In specific work, a scientific board structure should be established. 40% of the board members should be independent directors to enhance the proportion of independent director (Forbes & Milliken, 1999), ensure scientific decision-making, and prevent major shareholders from influencing the development and governance of the company. In addition, strengthen the status and function of the board of supervisors, specifically by increasing the number of members of the board. Finally, the incentive mechanism should be set up to equal the interests of managers and shareholders. In addition, the audit committee and related organizations under the organizational structure of the board of directors should be established to provide data and opinions for the governance of the board of directors to ensure the scientificity and rationality of decision-making governance. At the same time, the functions of directors should be further refined so that they can make scientific strategic plans based on thoroughly combining the development goals of banks and leading small and medium-sized commercial banks to complete the phased development.

5. Conclusion

Small-and-medium sized banks are very special compared to common companies. Only by improving the adaptability of the internal system can they ensure stable development in the ever-changing financial system. Therefore, in terms of corporate governance, more attention should be paid to enhancing the comprehensive ability and level of managers. In specific work, it is required that company management personnel should start from several aspects such as system, management ability, and supervision system. Then scientifically optimize the commercial banking system based on the actual situation of the company and market changes, creating good conditions for the governance development of small-and-medium sized commercial banks.

References

Aebi, V., Sabato, G., & Schmid, M. (2012). Risk management, corporate governance, and bank performance in the financial crisis. *Journal of Banking & Finance, 36*(12), 3213–3226.

Becht, M., Bolton, P., & Röell, A. (2011). Why bank governance is different. *Oxford Review of Economic Policy, 27*(3), 437–463.

Bushman, R. M., & Smith, A. J. (2001). Financial accounting information and corporate governance. *Journal of Accounting and Economics, 32*(1–3), 237–333.

Corporate governance: What's special about banks? (2013). *Annu. Rev. Financ. Econ., 5*(1), 63–92.

Forbes, D. P., & Milliken, F. J. (1999). Cognition and corporate governance: Understanding boards of directors as strategic decision-making groups. *Academy of Management Review, 24*(3), 489–505.

Gornall, W., & Strebulaev, I. A. (2018). Financing as a supply chain: The capital structure of banks and borrowers. *Journal of Financial Economics, 129*(3), 510–530.

Hopt, K. J. (2013). Corporate governance of banks and other financial institutions after the financial crisis. *Journal of Corporate Law Studies, 13*(2), 219–253.

John, K., De Masi, S., & Paci, A. (2016). Corporate governance in banks. *Corporate Governance: An International Review, 24*(3), 303–321.

Krause, R., Semadeni, M., & Cannella Jr, A. A. (2014). CEO duality: A review and research agenda. *Journal of Management, 40*(1), 256–286.

La Porta, R., Lopez-de-Silanes, F., Shleifer, A., & Vishny, R. (2000). Investor protection and corporate governance. *Journal of Financial Economics, 58*(1–2), 3–27.

Laeven, L. (2013). Corporate governance: What's special about banks? *Annu. Rev. Financ. Econ.*, *5*(1), 63–92.

Shleifer, A., & Vishny, R. W. (1997). A survey of corporate governance. *The Journal of Finance,* *52*(2), 737–783.