

**World View's Community College Symposium
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**A talk by Professor Robert Bushman
The Forensic Accounting Distinguished Professor
Kenan-Flagler Business School
The University of North Carolina at Chapel Hill**



The **State of Capital Markets in China**



How to handle a *burnt* investor

21 April 2005, The Wall Street Journal

BEIJING -- As dusk fell one day in late January, a Chinese investor apparently upset at his stock-market losses doused himself with gasoline outside the headquarters of the Chinese securities watchdog and set himself on fire.

Regulators responded by placing a gag order on the Chinese media and putting a fire extinguisher near the building's entrance.

China is a long way from Kansas!!!

Stock Markets: Classes of common shares of Chinese public companies

A-shares represent the largest class of Chinese shares. However, these shares trade in the currency of China, the Renminbi, and are available only to Chinese residents and Qualified Foreign Institutional Investors (QFIIs). QFIIs are typically large investment houses which must conform to strict QFII requirements - including a minimum one-year holding period before repatriation of funds.

B-shares are incorporated in China and trade on either the [Shanghai or Shenzhen Stock Exchanges](#). They are quoted in US dollars on the Shanghai Stock Exchange and HK dollars on the Shenzhen Stock Exchange. They can be traded by non-residents with appropriate foreign currency dealing accounts.

H-shares are incorporated in China and trade on the Hong Kong Stock Exchange. They are quoted in HK dollars. There are no resident restrictions on who can trade H-shares.

N-shares are incorporated in China and trade on the New York Stock Exchange. They are quoted in US dollars. There are no resident restrictions on who can trade N-shares.

Red Chip shares are incorporated in Hong Kong and traded on the Hong Kong Stock Exchange. They are quoted in HK dollars. Red Chip companies are substantially owned directly or indirectly by the Chinese government and have the majority of their business interest in mainland China. Like H- shares, there are no resident restrictions on who can trade Red Chip shares.

ICBC Makes Strong Debut in Hong Kong, Shanghai

28 October 2006 The Wall Street Journal

Note differences in performance of the IPO between Hong Kong & Shanghai!

Shares of Industrial & Commercial Bank of China Ltd. made a strong debut Friday in Hong Kong and Shanghai, showing investors' continuing appetite for the country's lenders.

The initial public offering, **which raised 19.1 billion U.S. dollars**, was world's largest IPO and the first simultaneous Hong Kong and Shanghai listing.

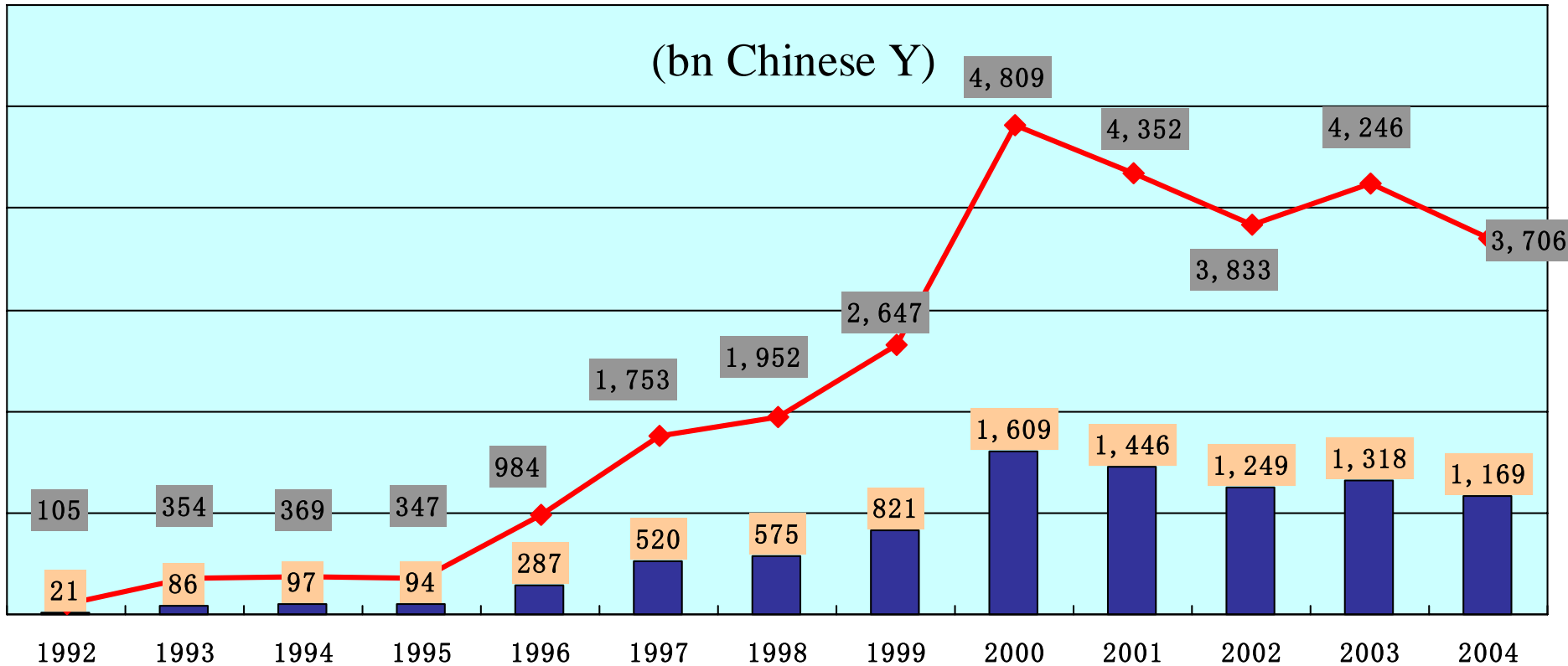
ICBC shares rose 15% in Hong Kong in line with analysts expectations, but they made a weaker-than-expected debut in Shanghai, gaining only 5.1%. Analysts had expected the shares to rise as much as 10% to 15% for the domestic debut.

The lender's Hong Kong shares opened at 3.60 Hong Kong dollars (46 US cents), up from the IPO price of HK\$3.07, and traded between HK\$3.49 and HK\$3.63. They closed at HK\$3.52. ICBC shares in Shanghai opened at 3.40 yuan (43 US cents), up from the IPO price of 3.12 yuan and closed at 3.28 yuan.

Market Capitalization

Note the large difference between floating and gross market cap:
Driven by non-tradable shares

■ floating ◆ gross



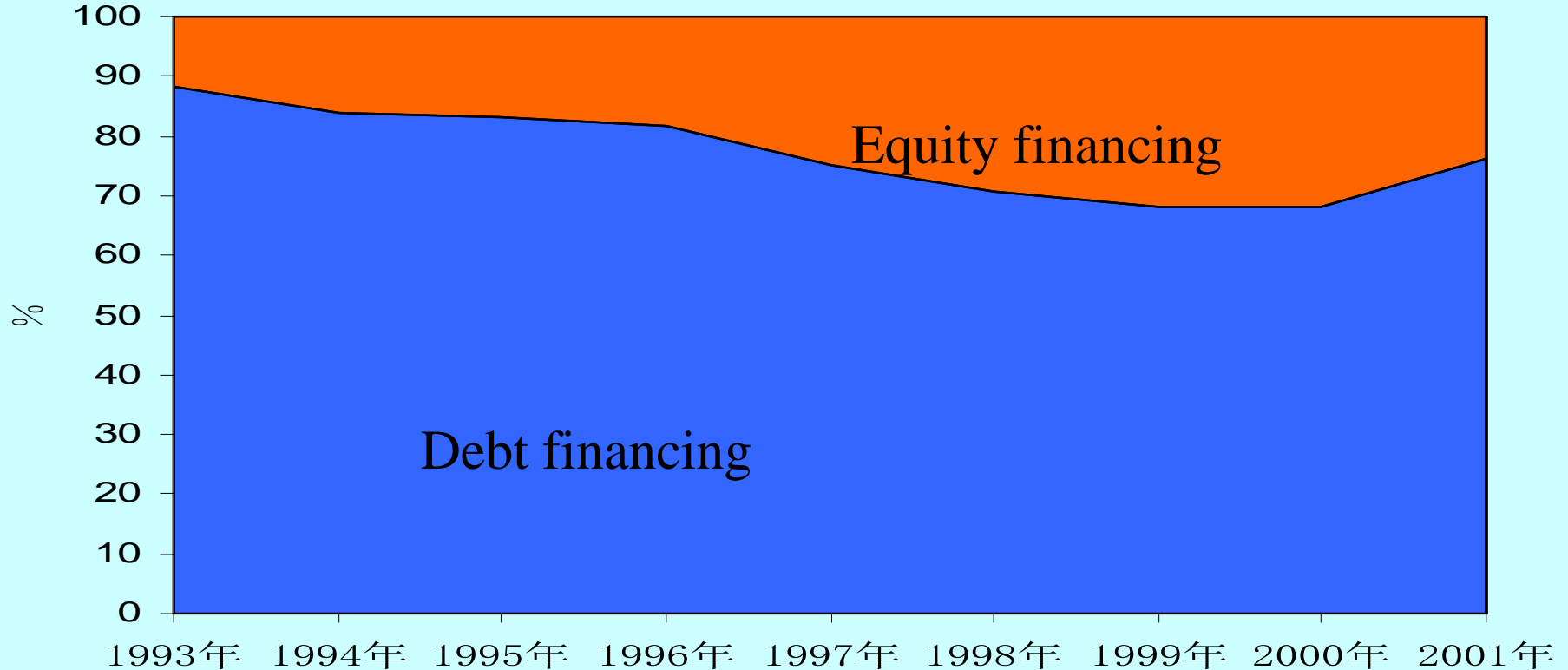
Importance: Market Cap./GDP

Market	MC/GDP
Hong Kong	449%
Malaysia	166%
Singapore	166%
UK	137%
New York+ NASDAQ	130%
Japan	70%
South Korea	57%
Germany	45%
China(Gross MC)	36%
China(Floating MC)	11%

Equity / Debt Financing

Only 10 to 20% of the total fund raised from securities market.

Although that is starting to change with many large IPOs

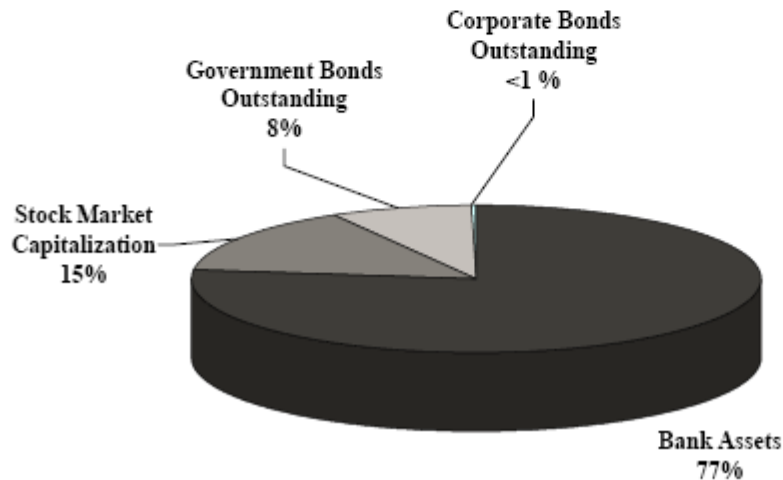


China's Financial System

China operates what is clearly a bank-centric financial system. Banking assets comprise nearly 80 percent of the nation's entire financial asset pie. Based on the market capitalization of equities listed on China's Shanghai and Shenzhen stock exchanges (the only two in the country), stocks rank a distant second to the value of bank assets, accounting for only 15 percent of all financial assets. About two-thirds of China's listed shares, moreover, are government-owned and thus not tradable. Bonds, in terms of their value outstanding, rank last at a mere nine percent. The percentage of external funds raised by firms through the issuance of bonds, moreover, is even more minute: less than one percent.

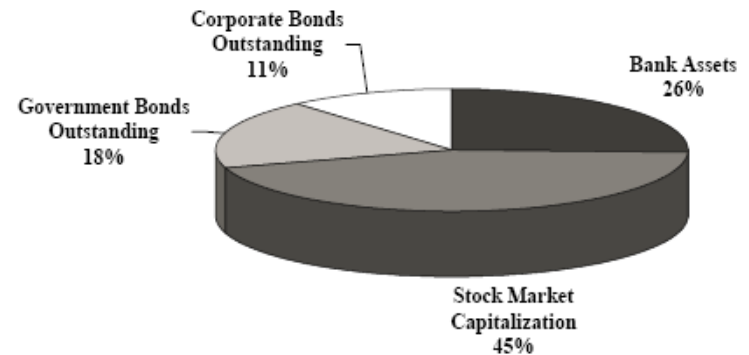
Size and Composition of China's Financial System – 2002

Total = \$3.1 Trillion



Size and Composition of United States' Financial System – 2002

Total = \$24.7 Trillion



Challenges for Corporate Governance In China

China has adopted a gradual process of privatization in contrast to Russia's big bang

Historical Hangovers Left by SOE Restructuring:

- Most Chinese listed companies evolved from state-owned enterprises (SOEs). The spin-offs are often incomplete
- Serious interest clashes between the listed companies and their parent companies, tramping upon the legitimate interests of the minority shareholders.
- Misappropriation of corporate funds by controlling shareholders and related parties is a significant concern.

Privatization involves the initial public offerings of a minority portion of state shares, while the majority of shares are held by various layers of governmental agencies and parent state enterprises. State Asset Management Bureaus (SAMB) at central and local levels are founded to supervise firm operation representing the state's interests.

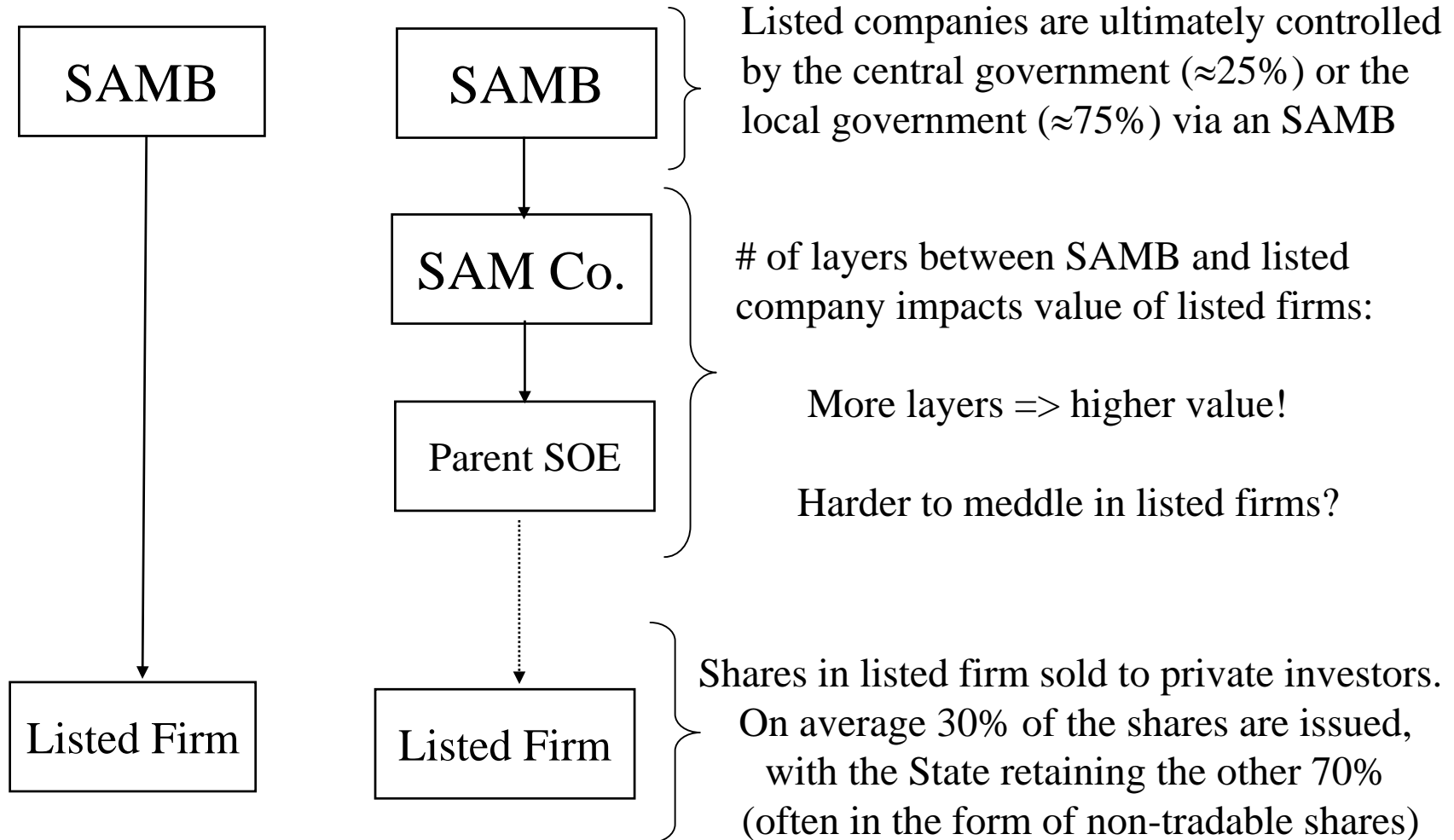
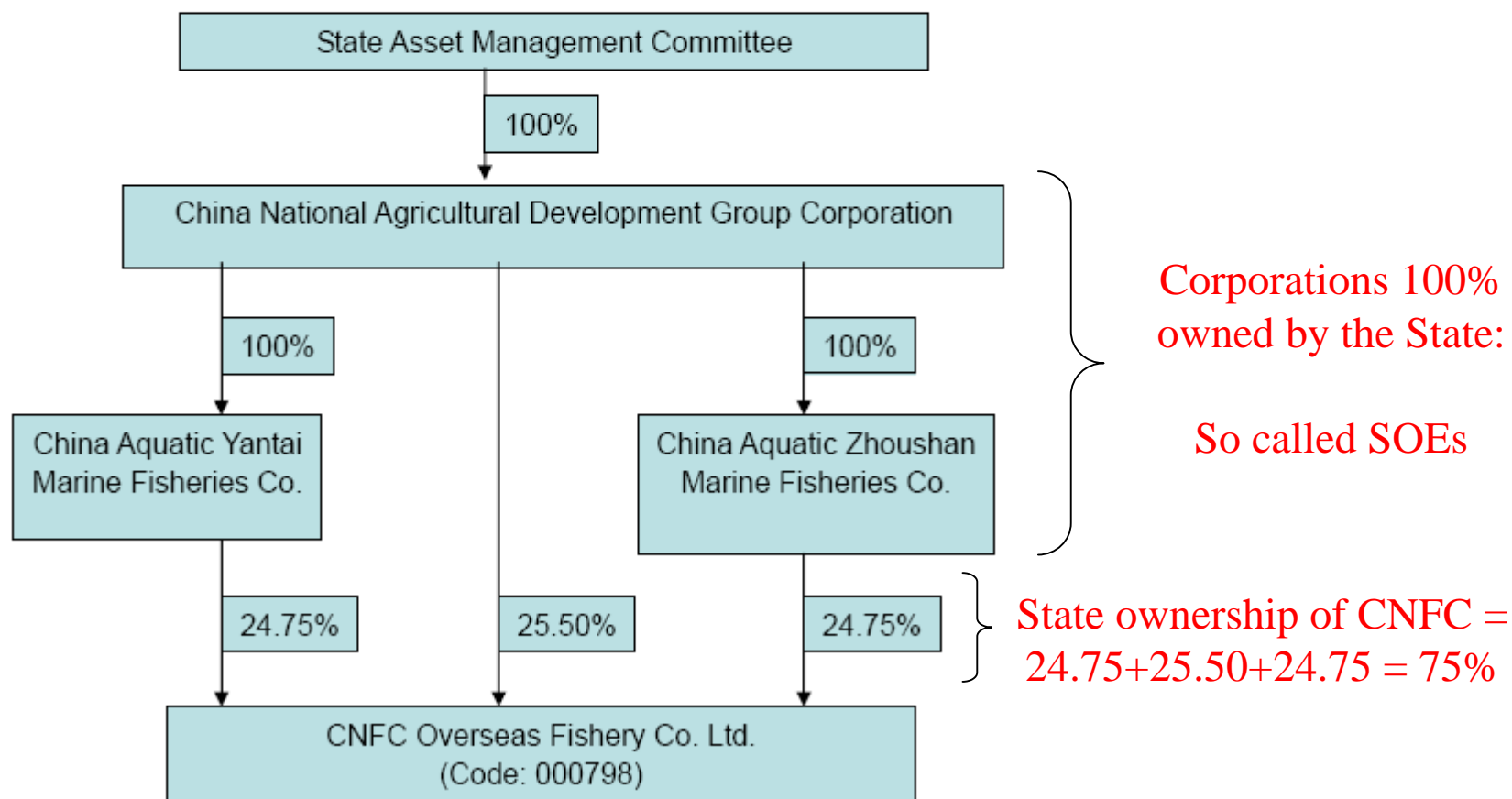


Figure 2 Ultimate controlling structure of CNFC Overseas Fishery Co. Ltd.

(000798)

Source: The 2004 annual report of CNFC Overseas Fishery Co. Ltd. (000798)

The CNFC Overseas Fishery Co. Ltd. (000798) is a state-owned listed company, which is ultimately controlled by State Assets Management Committee that report to the State Council. The SAMB controls the listed company through three solely SOEs: China National Agricultural Development Group Corporation, China Aquatic Yantai Marine Fisheries Corporation and China Aquatic Zhoushan Marine Fisheries Corporations.



State control over IPOs creates incentives to act opportunistically

The opportunity to raise capital on stock exchanges has created strong incentives for state enterprises to engage in opportunistic activities.

- It has been documented that state enterprises manage earnings to boost their chances of being selected for IPO, since bright-line earnings performance is a government stated criterion for listing (e.g., return-on-equity targets).
- The parent or holding company often injects valuable assets to its listed subsidiary in order to boost earnings. Also, the parent company or other group-members may absorb unprofitable units from the listed company prior to listing. In return, the holding company expects future payoffs by siphoning profits or cash back from the listed company.

Related party transactions

There have been many examples of looting of firms by managers or controlling shareholders using related party transactions during the emerging markets crisis of 1997-1998. Through related party transactions, earnings of troubled firms in a group can be manipulated upwards, while cash and profits can be diverted away from other group Members (often called tunneling).

Related party transactions have become an increasingly important issue in China. Since 1997, the Ministry of Finance and China Securities Regulatory Commission (CSRC) have issued several accounting rules and regulations regarding related party transactions.

According to the 2001 annual reports of all the listed firms, 90% of them are involved in different degrees of related party transactions. Anecdotal evidence indicates that the current corporate governance system in China fails to constrain controlling shareholders from manipulating earnings and expropriating minority shareholders through related party transactions.

The non-tradable share issue: A Headache for the State

- Promoters' shares owned by the state and other entities or individuals have been classified as non-tradable for various reasons since the beginning of the capital market in China in early 1990s.
- By the end of 2004, 64% of shares of listed companies are earmarked as non-tradable. Among these non-tradable shares, 74% are owned by the state.

The non-tradable share issue

- Under the approval from the State Council, the CSRC started a campaign to solve the non-tradable share issue.
- While change is critical for bringing stock trading more in line with market principles, China's investors have long lived in dread that any move to make all stock tradable would flood the market with supply and further depress prices. Official figures show 64% of the \$448.1 billion in market capital at the end of last year was non-tradable.
- Basically, the holders of non-tradable shares have to pay consideration to the holders of tradable shares to get tradable statute for their shareholding. The level of consideration will be determined through negotiation between the two group of shareholders.

Fissures Appear In China Revamp Of Equity System --- Baosteel Plan to Parcel Out Government-Owned Shares Draws Boardroom Dissent 11 August 2005 The Wall Street Journal

HONG KONG -- A rare boardroom dispute has broken out over the way a big Chinese company is dealing with the thorny issue of how to move massive piles of government-owned equity into the public share market.

The board of Baosteel, as the Shanghai company is known, in June approved a plan that would parcel out the nontradable shares to existing shareholders.

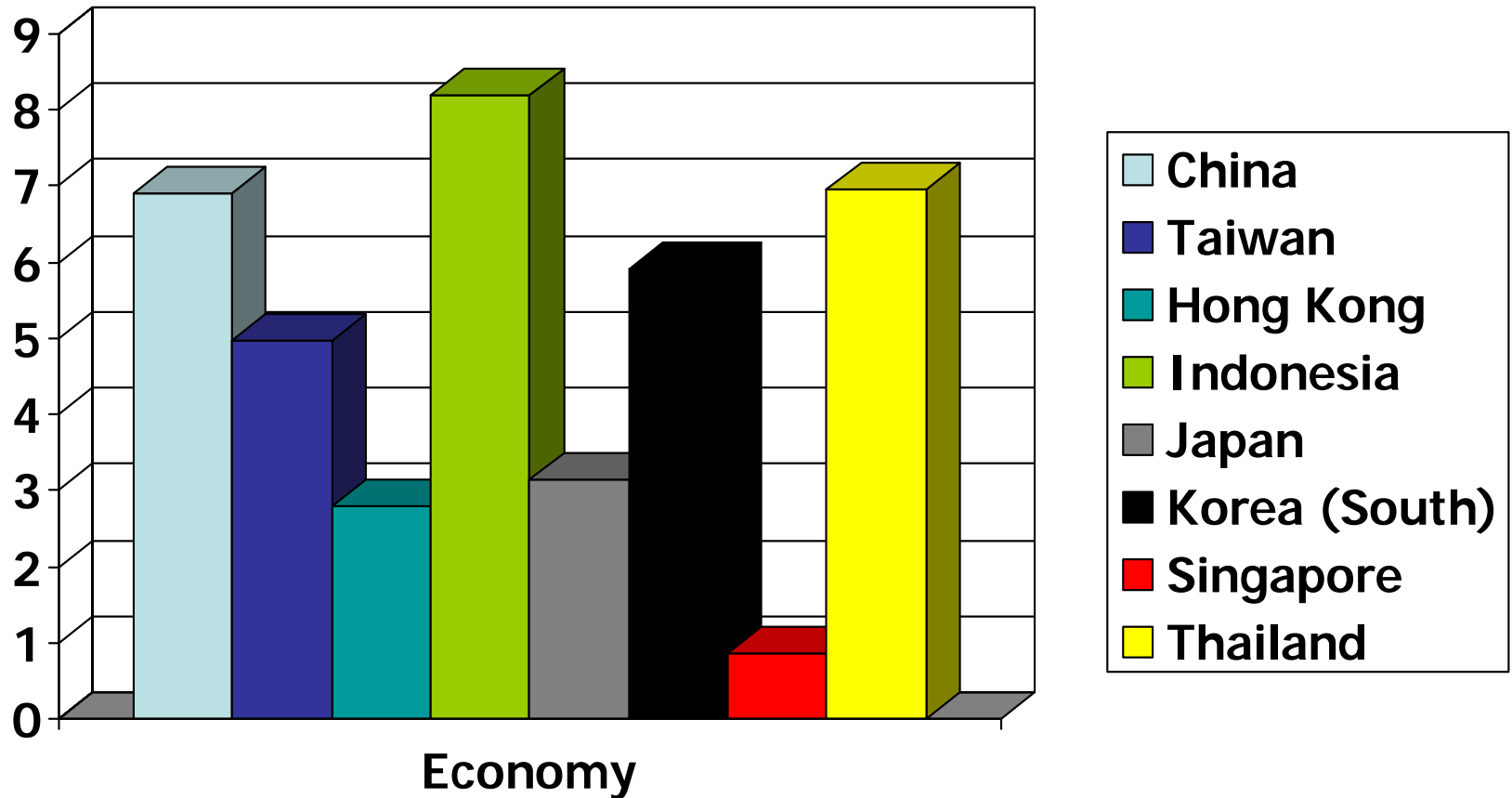
An independent director at Baosteel has made an unusual public objection to the company's proposed solution. In a sharply worded letter to Baosteel's board, Weijian Shan, an executive in Hong Kong for U.S. private-equity group Newbridge Capital Ltd., warned that the plan would harm the company's long-term financial stability and ultimately hurt its shareholders.

Baosteel's conversion plan would distribute 2.2 non-tradable shares for every 10 publicly traded shares, so an investor with 100 shares would receive 22 new ones for free! This will increase their percentage holdings of the firm's total equity.

Mr. Shan voted against the plan, arguing that giving away shares interferes with the market mechanism of setting prices according to supply and demand. While propping up Baosteel's share price in the short term, the plan will encourage public investors to lock in artificial gains by selling those shares later on, he said.

Corruption in Asian Economies

(Source: Transparency International: mean Corruption Perception Index 1992-2000)



As China's Economy Thrives, So Does Graft --- Beijing's Limited Success at Curbing Abuses Could Impede Adoption of Free-Market System

19 June 2006 The Wall Street Journal

Beijing -- RECENT HIGH-PROFILE corruption cases in China underscore the challenges the country's leaders face as they seek to counter the drawbacks of fast economic growth. By many accounts, corruption is worsening as some public officials and private businessmen attempt to take advantage of China's sometimes chaotic market economy.

The linkup of "qian" and "quan" -- or money and power -- in many ways resembles the robber-baron economy of post-communist Russia.

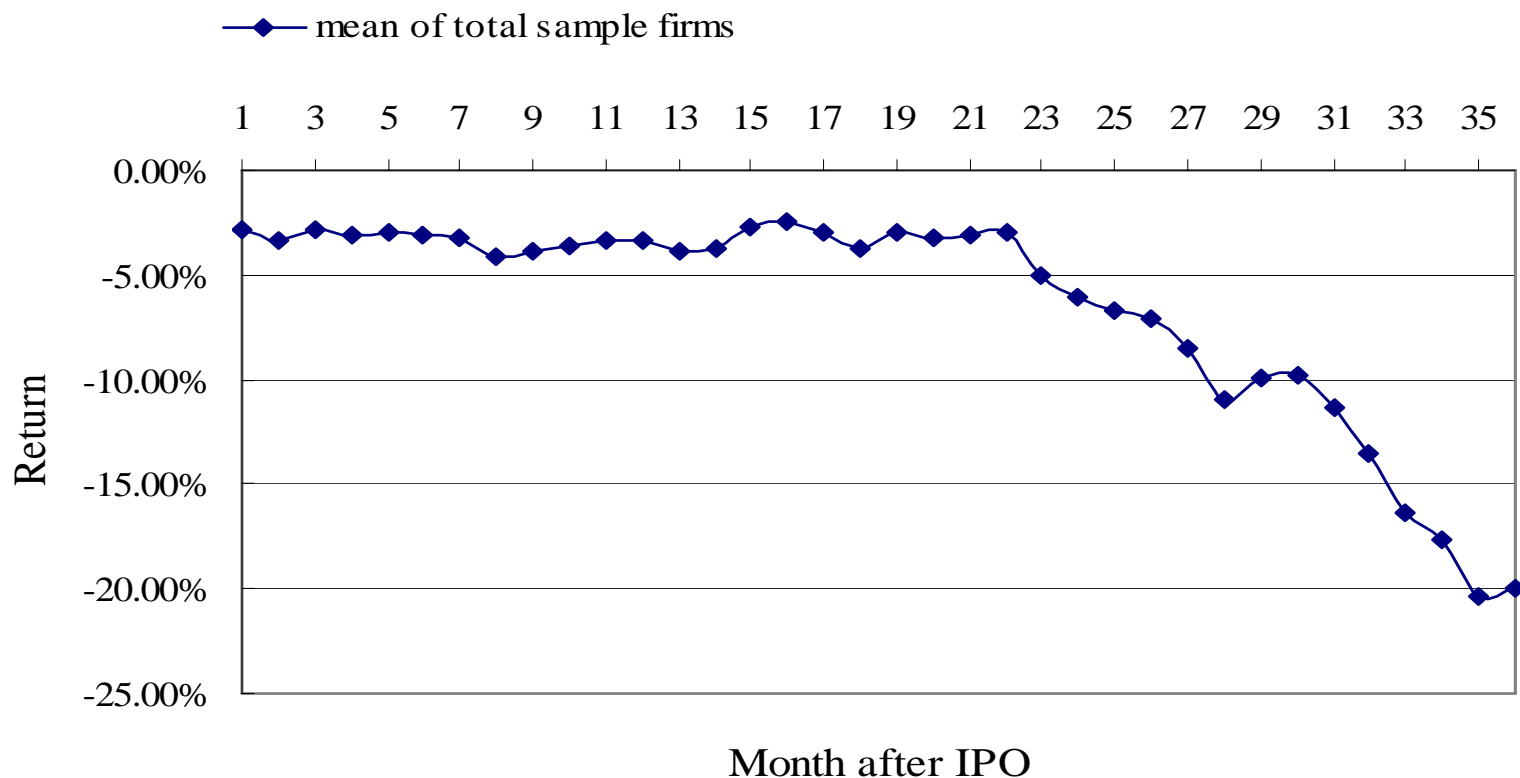
Even during the days of China's strict communist rule, officials enjoyed privileges. Nowadays, the government's extensive control over permits for businesses and assets such as land -- combined with low civil-servant salaries -- creates an incentive for officials to potentially abuse their positions.

At the same time, increasing numbers of successful businessmen are allegedly using their left to secure positions in government or representative bodies, like the Chinese People's Political Consultative Conference, where they can use their influence to benefit themselves.

Political connections hurt performance!

Post-IPO stock return performance (CAR) of 625 China's partially privatized firms

Figure 1: Cumulative market-adjusted compound stock returns



Post-IPO stock return performance (CAR) distinguished by whether CEOs are politically connected

Politically connected => current or ex-government bureaucrats

Figure 3: Cumulative market-adjusted compound stock returns

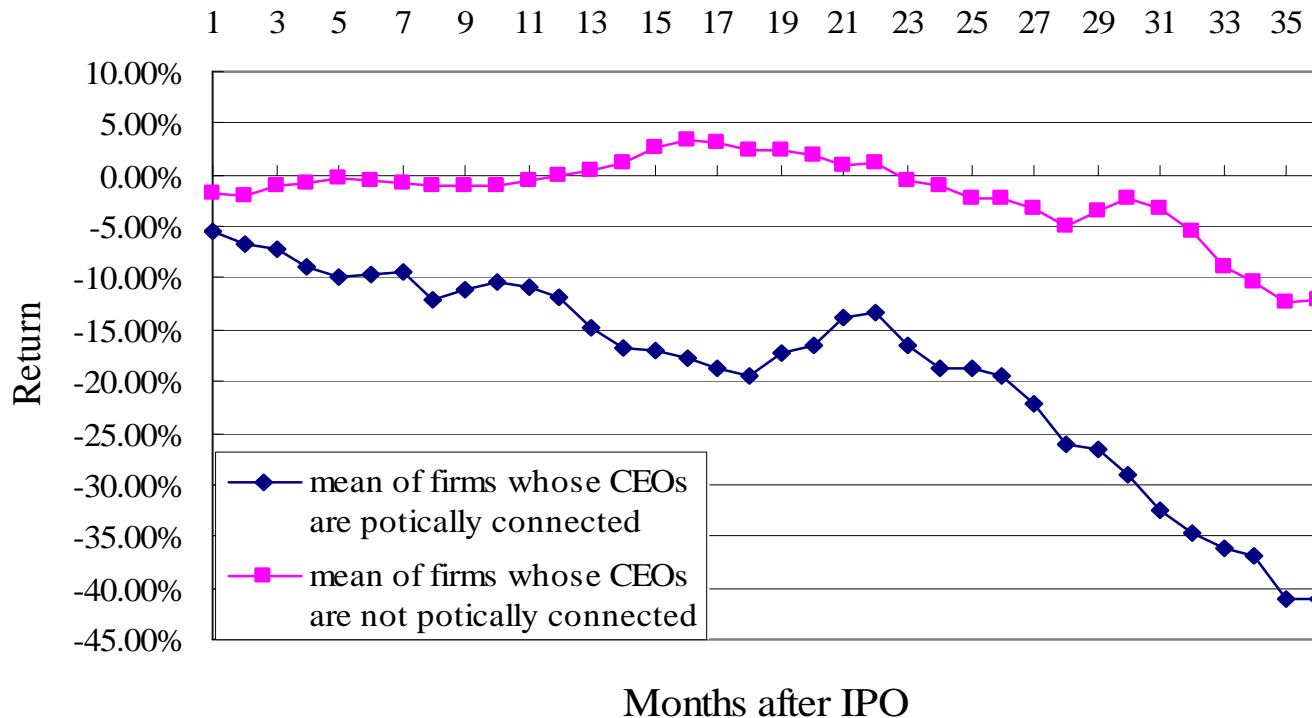


Table 5
Characteristics of the boards of directors of the newly partially privatized firms in China

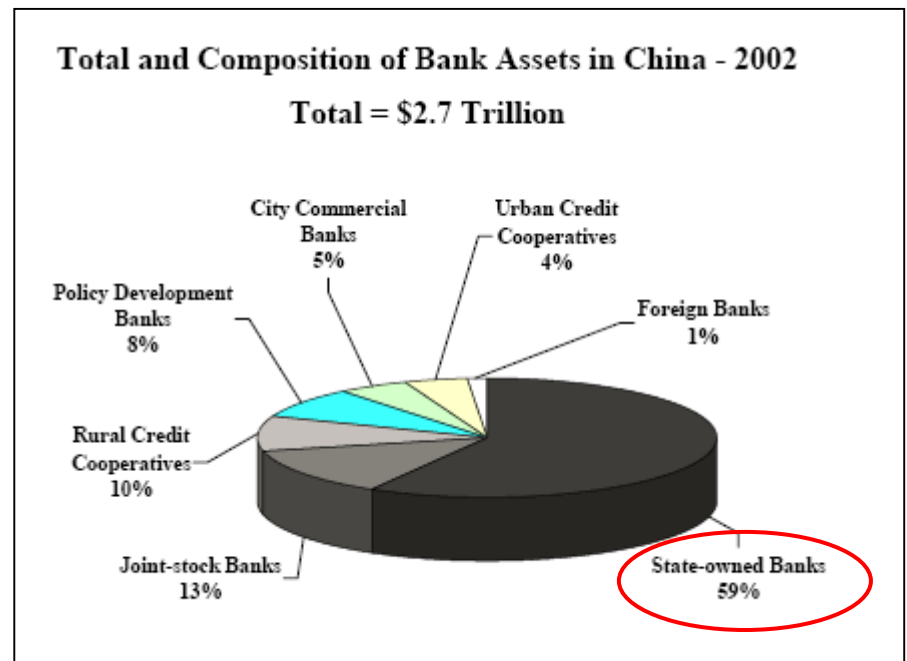
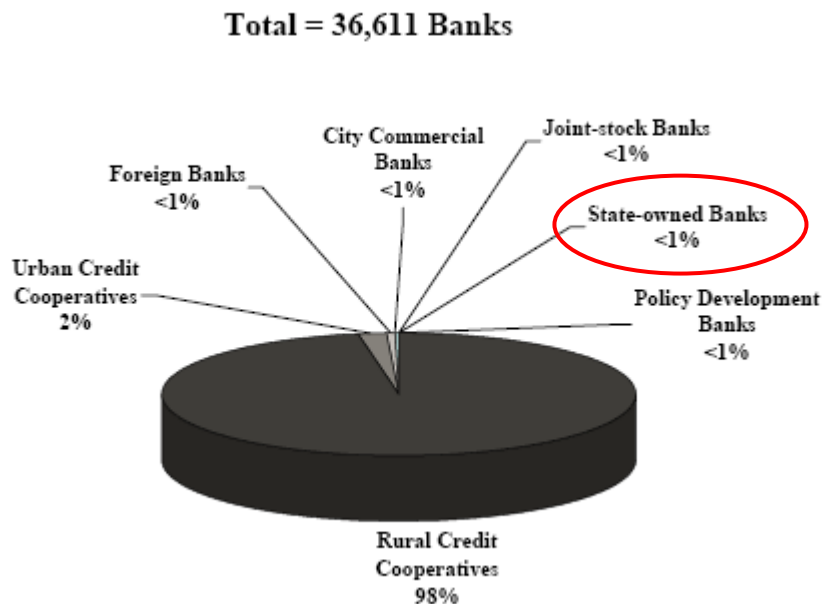
This table reports the mean and median statistics of the board characteristics of China's 625 newly partially privatized firms that went public during 1993 to 2000. The tables also report the statistics for two sub-samples of firms distinguished by whether their CEOs are politically-connected. Director education level is a score ranging between 0 and 4: 4 equals a doctoral degree, 3 a master degree, 2 a university degree, 1 a junior college degree, and 0 representing a degree below junior college. The definitions of the other variables are in Appendix 1. Test statistics for the differences in means and medians are provided. Asterisks denote levels of statistical significance: *** 1%, ** 5%, and * 10%.

Board characteristic	Mean				Median			
	Total sample	CEO is politically-connected	CEO is not politically-connected	T-statistics for between-group difference	Total sample	CEO is politically-connected	CEO is not politically-connected	Z-statistics for between-group difference
Board size	9.24	9.20	9.26	0.26	9.00	9.00	9.00	0.615
Percentage of directors that are								
senior managers	33.74	33.07	33.99	0.59	33.33	33.33	29.71	1.88*
current or ex-government bureaucrats	25.99	37.60	21.55	9.13***	26.67	37.50	18.18	7.47***
professionals	37.50	28.31	41.02	-5.44***	30.00	25.00	36.36	-3.28***
with accounting, law, or finance background	5.27	3.80	5.83	-2.16**	0.00	0.00	0.00	1.16
with experience in non-affiliated firms	18.34	16.47	19.05	-1.93*	18.18	12.50	18.18	-1.64
with academic background	13.90	8.04	16.14	-4.60***	9.09	6.67	9.09	-0.94
women	5.04	3.26	5.72	-3.64***	0.00	0.00	0.00	-3.08***
Director age	47.00	47.62	46.77	3.85***	46.91	47.64	46.50	3.15***
Director education level	1.61	1.65	1.59	1.49	1.63	1.67	1.60	2.65***

There are 36,611 banking institutions in China. The vast majority (98 percent) operate as mutual institutions known as rural credit cooperatives (RCCs) that are located throughout China's approximately 25,000 townships.

The real money is in China's four enormous state-owned banks. These banks, the "Big Four," represent a 59 percent share of the banking asset pie and operate a vast nation-wide branch network. The Big Four SOBs account for about half of the financial assets of the entire nation. China thus does not merely have a financial infrastructure that is "banking system" dominated but one that is in fact Big Four "bank" dominated.

Number and Type of Banking Institutions in China - 2002



Banks in China: The Big Four

The background to how the Big Four have established their pre-eminence in China's financial system is important to understanding the extent of contemporary changes to the system and the direction in which reforms are heading. The SOBs were born from China's first stage of reforms orchestrated by Vice Premier Deng Xiaoping in 1979.

From 30 years prior to that, in the aftermath of the 1949 Revolution, the new Communist government had incrementally closed down China's patchwork of commercial banks and replaced them with a single People's Bank of China (PBOC). From then on the PBOC played the dual role of both a central and commercial bank. It wielded monopoly power over the banking system, disbursing investment and operating funds to SOEs according to government fiat.

Deng's reforms brought the first break in the PBOC monopoly with the creation of two spinoff entities: the **Agricultural Bank of China** and the **Bank of China**. Within a matter of years the State Council firmly decided to reconstitute the PBOC to serve solely as the nation's central bank and launched a process of gradual reorganization. Its first major initiative along these lines was to transfer the bank's remaining commercial banking functions and certain banking functions from the Ministry of Finance to two special purpose banks: the **China Construction Bank** (formed in 1983) and the **Industrial and Commercial Bank of China** (formed in 1984).

Banks in China: Bad loans

A fundamental problem left unsolved has been that the State Owned Banks have continued lending to inefficient and frequently unprofitable SOEs.

This situation has impeded the development of a sense for a “credit culture”—an appreciation for necessary balance of risk and return considerations—in reaching lending decisions.

Bad Loans May Hurt China Banks 31 May 2006, The Wall Street Journal

BEIJING -- China's financial system could face \$220 billion in losses owing to bad loans, according to a report by Fitch Ratings.

The report said China's banks remain "acutely vulnerable" to an economic slowdown, but overhaul steps have improved the sector, and the government's foreign reserves probably would cushion any fall.

As China's government clamps down on sectors from property to steel to prevent its economy from overheating, China's banking regulator pushes banks to prepare for a rising tide of nonperforming loans on their books by increasing provisions and bad-loan write-offs.

More on the Industrial & Commercial Bank of China Ltd IPO:

Just a few years ago, Chinese banks were riddled with billions of dollars of nonperforming loans. But in 2003, Beijing jump-started a US\$60 billion bailout plan to turn its policy lenders into commercially oriented banks

ICBC received a US\$15 billion injection to clean up its balance sheet last year. Listed peers Bank of China and China Communications Bank each received US\$22.5 billion in 2003.

ICBC and its peers also wooed billions of dollars of foreign investment and tied up strategic investment agreements with U.S. and European banks to help get them on track. In total, foreign investors have sunk US\$18.4 billion into Chinese banks since 2005, according to capital-markets data provider Dealogic.

Goldman Sachs Group Inc., American Express Co. and Allianz AG of Germany together paid US\$3.8 billion for an 8.89% stake in ICBC this year. The IPO will also give the bank an added boost of fresh capital so it is better positioned to compete with better-capitalized foreign banks moving into China.

The banks are beginning to prepare for increased competition later this year, when Beijing begins allowing foreign competitors greater access to China's banking market, in which individual deposits total \$1.9 trillion.