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Corporate Governance and Property Rights Infrastructure: The Experiences of Hong Kong and Lessons for China

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1. Introduction

This is one of a series of papers by the authors examining how China can reform its financial markets by drawing lessons from the experiences of Hong Kong and other market economies. One of the papers examined the development experiences in the Asian economies. Another paper analysed the property rights disputes in China from the perspectives of new institutional economics, emphasizing particularly the role of property rights infrastructure in resolving property rights disputes and commercial crimes (Sheng, Xiao and Wang 2005). This paper, revised from conference presentations in Beijing and Shanghai in 2004 reviews China’s need for a property rights infrastructure as a pre-condition for efficient capital market development and good corporate governance, drawing particularly on lessons from Hong Kong’s experience. An unpublished paper examines the historical reasons why China did not evolve its own property rights infrastructure (Sheng, Xiao and Wang 2004). An overview of the role of property rights infrastructure and the function of efficient markets was presented recently in Beijing (Sheng 2004).

Using Hong Kong’s experiences, this paper examines how corporate governance is closely related to capital market development in particular and property rights infrastructure in general. Good corporate governance is achieved through self-discipline, regulatory discipline and market discipline. Capital market discipline is critical. The role of the capital market is to provide low cost financing to well-performing firms, while rejecting finance to poor-performing firms. A well-functioning capital market requires clear delineation, efficient exchange, and effective enforcement of property rights. These functions rely heavily on an array of supporting institutions, or as defined in this paper, on the property rights infrastructure (PRI).

A major task of the transition from a planned economy to a market economy is to build a strong and well-functioning PRI. Good corporate governance and a competitive market economy can only be built upon a strong PRI. We argue that China’s economic reform has now advanced to a stage in which more attention should be turned towards developing an integrated property rights infrastructure so as to derive lasting benefits to the economy. Hong Kong, which has a well functioning PRI, could serve as a live knowledge base for building and maintaining a modern PRI in China.

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2. Corporate Governance as Self, Regulatory and Market Disciplines

Corporate Governance is defined as “the system of checks and balances that ensures that corporate management, including boards and board committees, senior corporate executives, auditors and corporate advisers, all carry out their fiduciary responsibilities owed to those they represent.” The checks and balances in the corporate governance can be summarized as comprising three disciplines: self discipline, regulatory discipline and market discipline. The three disciplines are usually implemented in three different institutional settings: ethics for self discipline, process for regulatory discipline and structure for market discipline.

Let us use Hong Kong’s experiences to examine how these different dimensions of checks and balances work to ensure that enterprises follow the established ethics and rules as they compete for profits in the markets.

Self Discipline through Ethics

For self-discipline to work, the ethics of the persons involved in each level of corporate structure must act to protect the interests of the company as well as minority shareholders and the public interest. The ethics required for self discipline on the part of corporate insiders would bring rewards to them in the long run through reputation effects, but could diverge from their self interest in the short run. This is why self-discipline alone can rarely work to ensure good corporate governance. However, self-discipline is an essential ingredient in good corporate governance.

Under Hong Kong company law, the company is a legal entity with a unitary board that is responsible for its management. In other words, all directors, irrespective whether executive or non-executive, are equally liable for the affairs of the company. By convention, the board appoints the senior managers, including the CEO and the auditors. It also sets and oversees the implementation of its agreed policies. The board, through the CEO, is responsible for putting in place all the internal controls that prevent fraud and misconduct, including internal audits, dual controls and other checks and balances. The external audits are required by law, but paid for by the company. The board can also appoint external lawyers or specialists to advise the board on all major contracts and decisions. In general, the Company Secretary is the chief compliance officer, responsible to the board for ensuring that due diligence and compliance with the company law are achieved. Clearly, high ethical standards for the top executives are essential for good corporate governance because of their large discretionary power in running their company.

Regulatory Discipline through Processes

For the regulatory discipline to work well, it is necessary to develop good regulatory processes (or procedures), which could ensure that shareholders, management and staff perform in accordance with the ethical codes, rules, regulations and law. If any party violates the rules, the regulatory processes can be initiated. At the centre of the regulatory processes are the regulators, the judicial system and the police, which rely on the established regulatory processes to enforce the rules. To guard against abuses of regulatory, judicial and police power, the processes need to be transparent and cover mechanisms for resolving disputes not only among private parties but also between the private parties and the enforcers. In Hong Kong, such reviews are conducted by

Corporations in Hong Kong are subject to a considerable amount of regulatory checks and balances. Board members, who are ultimately responsible for the affairs of the enterprise, are subject to the Companies Ordinance and a variety of other legal responsibilities and duties. The first is the fiduciary duty to do their best. For negligence in their duties, they could be barred from holding future positions as directors of companies. They could be brought to court if they participated in any criminal or civil breaches of the law. Alternatively, according to the review of the Hong Kong company law that is being currently carried out, company directors could be sued by minority shareholders or by the regulators through derivative action suits.

If companies are listed, they are subject to a whole array of regulatory oversight by the stock exchange and other regulators through the listing rules, the securities law, and the taxation law and criminal legislation. Furthermore, the lending bankers to the companies have considerable influence on their financial discipline. The banks provide independent confirmation of balances of the deposits and credit position of the borrowers to their auditors, thus facilitating reliable auditing of the borrowers’ accounts. If banks fail to fulfil their duties in exercising credit discipline over borrowers, they would not only be subject to their own internal audit, but also sanction by their regulators. Each part of the regulatory functions serves to reinforce the delineation, exchange and protection of property rights. In Hong Kong, good credit culture exercised by the banks help reduce non-performing loans and prevent companies from weak credit and payment practices.

Market Discipline through Structures

For market discipline to work, it is necessary to develop internal and external institutional structures that influence the behaviour of the corporations. The internal institutional structures include the arrangements for the board, the board committees, and various units for internal control, risk management and compliance. The external institutional structures cover not only the competitive environment for the traditional product, labour and equity markets, but also the more sophisticated markets for executives, corporate control and corporate information disclosure. These internal and external institutional structures define the competitive market pressures on the corporations. Under a competitive market environment with high transparency, it is difficult for poor corporate governance to perpetuate itself through state protection, monopolistic powers or poor access to information. Cases like Enron in the U.S. demonstrate that poor corporate governance will be exposed sooner or later in a market environment.

Market discipline is enforced mainly through competition and transparency. But competition relies heavily on accurate, timely and readily accessible information for creditors, competitors, investors and analysts to assess risks and make decisions. The quality of information depends on the accounting standards used (e.g. International Accounting and Auditing Standards), the disclosure and transparency rules (such as disclosure requirements in Listing Rules), and the quality of audit. Having good information enables investors, creditors, regulators and other market participants to make crucial investment and investment protection decisions, such as buying, selling, holding or even engaging in legal suits to protect their interests. Moreover, good disclosure enhances accountability and checks and balances against abuses, such
as misconduct or incompetence of corporate managers and corruption or incompetence of public officials.

Mandatory disclosure of information with enforcement by the regulators is important and useful in ensuring access to reliable and comparable information. However, a free and knowledgeable media is an important supplement to the costly regulatory disclosure. The market is able to generate and use information that is much richer than the mandatory disclosure. Hence a free market for information is indispensable for healthy capital market and good corporate governance. This is not to deny that the market occasionally produces misleading information through herding and mania. The analyst scandals that occurred during the tech bubble remind us that market discipline and regulatory discipline are complementary to each other and both are indispensable to enable a market to function efficiently.

With good information disclosure, market discipline on corporate behavior can be achieved through competition policy. Property rights would be corroded if economic rents were allocated through monopoly or oligopoly arrangements. The only way to reduce such economic rents is through open and transparent market competition. One of the lessons of the Asian crisis is that even though Asia relied significantly on self and regulatory disciplines on corporate behavior, the lack of market discipline due to heavy protection of certain industries weakened their capacity to compete under globalization and market liberalization. Protection creates vested interests that seek further rent-seeking behavior and also resist change. Consequently, the most important and complex market discipline is capital market discipline, which deserves more discussion.

3. Capital Market Discipline Critical for Corporate Governance Performance

In addition to the market for products, executive skills, labor and land, the capital market is critical in disciplining corporate behavior. Finance is a derivative of the real sector. A well-functioning financial system promotes efficient development of the real sectors. Defects in the financial sector tend to distort resource allocation and hold back economic development. Conversely, inefficiencies in the real sector will sooner or later be reflected in the weaknesses of the financial sector, through the emergence of chronic non-performing loans in the banking system.

The financial sector has essentially four major functions: resource allocation, price discovery, risk management and corporate governance. At the core of these functions is the capacity to distinguish good firms from bad firms. A well-functioning financial sector should reward good firms by reducing their cost of capital. Conversely, it should impose appropriately high costs of capital for bad firms either through credit rationing or risk provisioning. Through its lending and fund-raising function, the financial sector plays an important role in disciplining the corporate sector and hence is crucial to corporate governance performance.

In the early stages of economic development, strong banks can play a crucial role in developing strong financial discipline and good corporate credit culture. For example, enterprises in Hong Kong were subject to considerable credit discipline when the British trade banks insisted on independent auditing of financial statements and on providing high quality collateral in the form of warehouse receipts and letters of credit before lending to borrowers. Those firms that had poor accounting records and bad payment history were quickly cut off from bank credit and their
costs of borrowing basically went up. On the other hand, the well-performing firms would enjoy relatively low costs of capital through flexible and easily accessible credit. Banks in Hong Kong played an important role of separating the good firms from the bad firms. When the bad firms were largely excluded from the credit markets, the banks in Hong Kong were able to use their interest spreads to cover the relatively low levels of non-performing loans arising mainly from business cycles and other business risks. Even during the recent Asian financial crisis, the ratio of non-performing loans in Hong Kong was very low. The stability of Hong Kong’s banking sector was achieved without a deposit-insurance system and without any controls on capital mobility and interest rates.

Similarly, companies that seek public funds through listing in the stock exchanges in Hong Kong are subject to scrutiny by sponsors such as investment banks, vetting by exchanges, financial analysts and investor choices (as they have the options to shift their investment to other firms and other markets). Regulatory discipline also works through mandatory disclosure of their business transactions and performance and sanctioning on false and misleading disclosure. Like the banks in Hong Kong, the securities market in Hong Kong played an important role in selecting good firms. The costs of capital are made low for well-performing firms but very high for poor-performing firms. Firms that show signs of poor performance or misconduct will suffer higher price volatility, low liquidity and also attract tough investigations of individual and corporate misdeeds by the regulatory agencies.

In the case of fraud and cheating, recent amendments in the Securities and Futures Ordinance and co-ordinated enforcement action by the SFC, Commercial Crime Bureau of the Police and ICAC have begun to sanction back such egregious behaviour.

In summary, a well-regulated and functioning financial system helps enterprises with good corporate governance and performance to raise funds efficiently and cheaply, while rejecting funding to firms with poor corporate governance and performance.

In recent years, information technology and globalisation has also made the functions of financial system more transparent and more competitive. We now know much better how the financial systems define, exchange, and enforce property rights:

- First, a financial system comprises a set of hardware (networks of computers and other platforms) across which participants transact and exchange financial products (e.g. property rights), according to a set of agreed standards and rules of the game (i.e. software).

- Secondly, these financial products are transacted and then settled and cleared through various processes (such as trading software and clearing, payment and settlement software), which used to be paper-based but are now increasingly digital.

- Third, global markets are a network of local market networks. The robustness and efficiency of global markets would depend on the robustness and efficiency of the weakest links in these local networks. In other words, financial systems are subject to local shocks and contagion, which could spread risks across the global networks.
• Fourth, increasingly, the standards and rules relating to operations in financial systems are being globalized and formalized given the competitive pressures on each local market. These include accounting, legal, operational and regulatory standards, such as International Accounting Standards, IOSCO Principles, and Basle Capital Accord Requirements etc.

• Fifth, property rights are described by information. Hence, disclosure and transparency is crucial in making good decisions and ensuring accountability [and hence right incentives] in market systems.

In other words, the institutional structure of financial markets is a complex system of participants trading property rights across a network made of both hardware and software. It is a dynamic system, because behaviour within the financial markets is determined and shaped by the passive rules and regulations as well as by the active behaviour of all participants, including in particular the regulators who carry out enforcement functions.

In the past, Asian economies focused on development through openness to trade and heavy investment in fixed capital goods or hardware. But as the Asian crisis has shown, the weaknesses in the financial system reflected overinvestment in hardware and underinvestment in software, or what this paper calls the property rights infrastructure.

4. The Role of Property Rights Infrastructure in a Market Economy

Corporate governance and capital markets cannot function independently of their political, social, legal, and economic environment. There is a growing literature on the close interaction between the legal and economic aspects of the integrated modern market system as reviewed in Lars Werin (2003). In this paper, we try to make the key point that underlying corporate governance and capital market is the property rights infrastructure (PRI). The PRI comprises the system that delineates, registers, transfers and protects property rights within a legal jurisdiction. If any part of the PRI is defective, corporate governance cannot function effectively.

What most studies on corporate governance have not appreciated enough is that in the real world, an array of sub-systems of supporting institutions have been integrated over time and eventually formed what is collectively called PRI. If parts of the subsets do not function properly, the whole may not be effective. Hong Kong has a complete PRI arising from its history. As a free port, property rights were initially defined through foreign trade and exchange. Goods can be traded and exchanged more efficiently through hard currencies and a mutually accepted set of rules of trade and exchange. Primitive bartering systems are inefficient because of lack of transparency, standards and high transactions costs. The common law jurisdiction under which Hong Kong operated in came with a complete set of property rights infrastructure: land and stock registers, warehouse registers, accounting, commercial and financial law, courts, various specialized tribunals, arbitration centres, free media, stock exchanges, and commercial and financial intermediation services. All of these institutions operate together in an integrated system to transfer and protect property rights in Hong Kong. Property rights in Hong Kong can be transacted with great legal certainty, transparency and accountability and ultimately low transaction costs. The free media, credible judiciary and rule of law are built upon a solid
property rights infrastructure. The integrated economic and legal system as a whole is the reason why Hong Kong is successful as an international financial and trade centre.

Each of the subsystems has evolved through its institutional history. An example is the governance structure of auditors. Accountants evolved like other professionals, through professional associations or self-regulated organisations (SRO). The SRO established its own code of ethics and professional standards of due diligence. If an auditor failed in his duties through negligence or by aiding and abetting corporate misconduct, the SRO would sanction the member. The same would happen in the case of lawyers, which are also subject to discipline by SROs. The conduct of professional bankers or investment bankers would be subject to supervision by respective banking or securities regulator.

The essential elements of a modern PRI include the following institutions grouped by three broad categories:

1. Institutions for delineation of property rights:
   - Central Registry of property right [e.g. land registry, share registry] to officially record property rights. This is crucial in transparency of the property right and reducing the costs of enforcement.
   - Accounting and legal process to define the property rights [annual audits and right to sue to protect property right].

2. Institutions for exchange of property rights:
   - Trading process [such as stock exchange trading platform to enable transparent trading of property rights, and public auctions].
   - Clearing, settlement and payment infrastructure [clearing house and payment system operated by banking system to enable transfers to be cleared and settled in final form through delivery of property right].
   - Regulated intermediaries [intermediaries who help the transfer process should be sanctioned if they do not perform according to rules of the game].

3. Institutions for enforcement and fine-tuning of property rights:
   - Rules of Game: norms, standards, codes, regulations, and law that help protect the property rights of participants against abuses of the system.
   - Enforcement infrastructure: there must exist regulators to enforce the rules but enforcement costs should not exceed benefits to markets.
   - Independent and transparent judiciary to adjudicate disputes over property rights.
   - Transparent media and disclosure regime to ensure that property right is independently verified and accountable [e.g. disclosure rules and mandatory publication of financial statements].

In a functioning market, the PRI essentially functions to vet the entry of market participants, ensure that they perform to market and ethical norms and those that damage public interest through inefficiency or misconduct [theft or fraud] exit the market. Each sector of the
economy has different PRI, such as the trading, clearing and settlement system for the securities market. If the PRI is defective, then the property rights are not protected and indeed expropriated by players that are inefficient, loss making and in effect subsidized by the rest of the market.

In his path breaking work, Hernando de Soto (2000) has uncovered six hidden benefits of private property (which is really what we call here property rights infrastructure):

- Fixing the economic potential of assets (efficient use of capital).
- Integrating dispersed information into one system (economy of scale in PRI and standards and low transaction costs).
- Making people accountable (private property as an ultimate guarantee on contract fulfillment or fulfilment of responsibility).
- Making assets fungible (allow convergence of risk-adjusted return on various assets).
- Networking people (increasing the extent of market and facilitate specialization).
- Protecting transactions (low enforcement costs when private property can be used as collateral and reduce transaction costs).

The Latin American experience shows that weaknesses in the PRI gives rise to a system that is not accountable, not fungible, with no network benefits, and little trading. Consequently, there is no credit culture. Ultimately, the poor are disadvantaged because the costs of entry into business is overwhelmingly high for small enterprises and poor people, while large enterprises can engage in regulatory capture to protect their vested interests against competition. When PRI is defective, transactions costs are high due to high risks or rent-seeking activities.

It should be pointed out that PRI is a public good that requires large investment to establish, but it can generate sustained benefits in the form of drastically reduced transaction costs in the economy. This is why the government has a responsibility in building a well-functioning PRI as soon as possible if the society wants a modern market economy. Since PRI is a system to delineate, exchange and protect property rights, the role of the government in the process of establishing PRI can be summarized as follows:

- Setting standards, rules, and legislations for a well functioning PRI;
- Defending property rights of citizens against non-citizens [national defence and foreign affairs functions];
- Enforce and protect private property rights by resolving disputes between citizens and citizens [adjudication and anti-crime functions];
- Creating mechanisms to constrain abuses of state power and resolve property rights disputes between citizens and the state [anti-corruption and human rights protection function].

In other words, the government’s role is to build and maintain a well functioning PRI, across which participants can trade property rights.

Generally, people assume that regulation is efficiency promoting and serves public interest by addressing areas of market failure. But since the government is also an important part of the PRI, it is possible for government failure to generate high costs of operating PRI, which will affect the delineation, exchange, and enforcement of the private property rights of citizens. As the
government is heavily involved in a number of the sub-systems of PRI, the coordination costs among these sub-systems could be very high when the government is weak or when politics dominates economics. Hence, an important and permanent function of the government is to create and maintain mechanisms to discipline itself and to maintain political and macro-economic stability so as the citizens can have a stable political, social, legal, and economic environment and a robust PRI.

Expressed in Coasian institutional economics, the role of government in a market economy is to reduce the total costs, including transaction costs and regulatory costs, of exchanging and protecting property rights. If property rights are subject to huge costs of exchange and protection, such as excessive taxation, corruption, risks of confiscation, theft, and erosion through inflation, then capital flight and prevalence of mafia are likely.

After a quarter of century of reforms, China has reached the stage of economic development where the macroeconomic conditions provide a favourable opportunity for the next stage of reform: construction of a robust PRI to allow more efficient and orderly exchange and protection of property rights. China is no longer short of savings and funds. Indeed, it is arguably suffering from an excess of savings. Without a robust PRI, such savings could be dissipated through NPLs and corruption. What China needs now are experienced people with the right processes and governance structures to ensure that the PRI system is complete and is functioning effectively.

Indeed, the greatest benefit of allowing in FDI is to introduce competition and bring in people, processes and experiences so as the Chinese enterprises and skills could catch up and achieve global standards. Since Hong Kong is already an international financial centre with a PRI competitive and transparent by world standards, Hong Kong can bring in a wealth of market experience in building the PRI to facilitate the Mainland’s transition to a fully competitive market economy that operates on global standards.

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