

# Private Sector Opinion

## Guanxi, Mianzi, and Business: The Impact of Culture on Corporate Governance in China

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Before taking advantage of the growing opportunities of the Chinese market, investors will do well to understand the strong influence of Chinese culture on the way businesses operate, how they govern themselves, and how they interact with each other. David Smith identifies two key cultural and sociological issues of particular interest—guanxi (relationships and networks) and mianzi (face). He analyzes their most common implications for investors in areas such as related-party transactions, board composition and deliberations, and shareholder engagement.

### Foreword

One of the more difficult intellectual problems in corporate governance research is assessing the degree to which culture is, or should be, a factor in determining the behavior of companies. Conventional wisdom suggests that cultures vary markedly from country to country, that there's no "one size fits all" when deciding which best practices to implement, and that emerging markets differ fundamentally from developed markets. Such instinctive conclusions are fair to draw, yet they fail to tell the whole story. For example: How do cultures change and adapt in the face of regional and international economic integration? Are all companies in a particular market really the same from a cultural perspective (surely some are more open and transparent than others)? And if one size doesn't fit all, why is there such strong demand for global standards in accounting, auditor regulation, voting by poll, and board independence, among many other areas?



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The process of corporate governance reform in almost any market is invariably an interplay between, on the one hand, the need for new international standards that facilitate transparency and trust, and on the other hand, an equally strong desire to maintain established customs and institutions. Culture is not the only determinant of behavior, but it clearly does matter. Successful communication with companies and individuals across borders, therefore, requires a nuanced understanding of the way people think and how they like to interact in social and business relationships.

This paper by David Smith provides an excellent and helpful entree into the world of guanxi and mianzi in China. Guanxi means “connections or relations” and is sometimes seen mechanistically as the network of contacts an individual has managed to develop. The higher and more important your contacts, especially among senior officials, the better your guanxi is said to be. David shows that guanxi implies a great deal more: it is about “the building and maintaining of deep, complex interpersonal relationships and bonds between individuals.” A key element is that “relationships are developed and nurtured over time, in many cases without a specific ‘need’ or ‘use’ for that relationship.” The message is, don’t wait to develop a relationship until you have a problem—take a longer view and build a group of friends who can help you in the future if necessary, and you them.

Mianzi is translated as “face” and is often interpreted as both the showing of respect (“giving face”) and ensuring you do not offend people (causing them to “lose face”). Although variations of this idea can be found in almost every culture, one difference in China is the linking of mianzi to a “sociological desire to retain social stability, hierarchy, and respect.” Indeed, you not only need to think about your friends, but strangers as well. And, in a business setting, it is important to conduct yourself in a way “that all business partners retain face—as opposed to giving face only to those in positions of seniority.”

David’s paper is a stimulating, thoughtful, and insightful introduction to the complex world of guanxi and mianzi in China. He concludes with some good and timely advice to global shareholders wishing to engage with Chinese companies: do your best to understand the intricacies of culture when analyzing corporate governance in China; many of the rules and best practices may look familiar, but the way they play out may well be significantly different from what you expect.

One final thought: be patient and persistent. China is the master of incremental reform and will proceed at a pace that largely suits its own needs, not those of outside forces. You need to develop an appreciation of how “corporate governance with Chinese characteristics” is different in some fundamental respects from systems found in the West and even in developed Asia. Not all capital market rules in China are in written form. It is often hard to fathom government policy intentions from official sources. And, through an institution called the “Party Committee,” the ruling Communist Party of China plays an important role in the governance of listed state enterprises and even some private companies. A saying about doing business in China is apt in this context: “If you can’t deal with ambiguity, don’t do business in China.”

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# Guanxi, Mianzi, and Business: The Impact of Culture on Corporate Governance in China

David Smith<sup>1</sup>

## Introduction

The *principles* of corporate governance may know no borders, but its practice continues to be subject to cultural influences. National models persist despite increasing integration of global capital markets, greater harmonization of securities rules and laws, and a globalized approach to corporate governance. Even where systems and institutions of corporate governance are similar, the interplay of those institutions can differ markedly from country to country (Matoussi and Jardak 2009; Kar 2011). China is an excellent example of this phenomenon.

In examining cultural factors in China and their link to business practices and corporate governance, this paper explores the effects of both guanxi and mianzi. Many people are at least familiar with the concept of guanxi and the place of *relationships and networks* in the conducting of business in China. The concept of mianzi—and the business implications of individuals' saving, giving, or losing face—is significantly less understood.

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Understanding both of these concepts, and their importance in business relationships in China, is of manifest importance. It is possible to spend years developing a business network by applying a good understanding of guanxi, only to spectacularly fail because of a misunderstanding of mianzi. Seemingly minor issues, such as pointing out errors in presentations, turning down dinner requests from a business partner, or not examining a name card in enough detail, can have profound repercussions.

In a society where a lack of public disagreement is found alongside a culture of related-party transactions, implications for investors are significant. In tying together the concepts of guanxi, mianzi, and corporate governance, this paper does the following:

- Examines some key factors of corporate governance in China, identifying structural developments and characteristics of the Chinese model;

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- Considers ways in which cultural issues—including guanxi and mianzi—affect corporate governance (for example, how the importance of interpersonal and, in particular, familial relationships may perpetuate the existence of related-party transactions); and
- Considers ways in which the cultural aspects of Chinese business may influence the development of models of investor engagement in China.

## Corporate Governance in China—Development and Structure

The Chinese corporate governance environment is one that couples a relatively nascent capital market (the Shanghai and Shenzhen stock exchanges were established in 1990 and 1991, respectively) with highly concentrated ownership of corporations (Qiao 2006). Individuals, families, or the state typically hold large and controlling positions in corporations, while the financial institutions (such as pension funds and mutual funds) that play a central role in corporate governance in many developed capital markets play an important, yet emerging, ownership role. Mutual funds and securities companies are the most common (nonstate) owners of equity, with commercial banks barred from directly owning stakes in listed companies (Yuan, Milonas, and Xiao 2006).

The state retains control over large parts of the economy. A recent report prepared for the U.S.-China Economic and Security Review Commission on the role of the state in the Chinese economy found that in 2009 the private sector accounted for 38.5 percent of gross industrial output and just 20.1 percent of rural and urban employment, concluding that “. . .by 2009 nearly half of China’s economic output could be attributable to either SOEs [state-owned enterprises], SHEs [state-holding enterprises], and other types of enterprises controlled by the SOEs indirectly” (Szamoszegi and Kyle, 2011). At the same time, SOE reform in the past 25 years has seen the state gradually relinquish absolute control, moving toward a model referred to as “socialism with Chinese characteristics.” As part of this SOE reform, the state moved away from being the *only* owner of enterprises and toward being a majority owner of enterprises through a process of partial privatization, thus allowing foreign and domestic capital to coexist as investors.

The SOE reform and, in particular, the opening up of capital markets through initiatives such as the Qualified Foreign Institutional Investor plan (a 2002 program allowing foreign investors to invest directly in the Chinese mainland A-share market, subject to approval and receipt of an investment quota) were designed with corporate governance reform in mind. In particular, the state sought to harness public market monitoring expertise as a means to improve the governance and operating performance of SOEs (Bai et al. 2004). At the same time, it is worth noting that there is room for improvement in getting minority shareholders’ voices heard in the context of state-owned enterprises in China.

## Guanxi and Relationship-Based Business

Chinese society, according to Hay and coauthors (2010), exhibits high levels of collectivism and uncertainty avoidance. Perhaps the best-known, and most often misunderstood, facet of Chinese culture within this collectivism and uncertainty-avoidance framework is that of *guanxi* (关系). Often thought to be a Chinese version of networking, *guanxi*—meaning connections or relations—has more to do with the building and maintaining of deep, complex interpersonal relationships and bonds between individuals. Vanhonacker’s (2004) comment, “In the West, relationships grow out of deals. . . .In China, deals grow out of relationships,” is a simplified but useful way to understand what *guanxi* is about. At its simplest level, *guanxi* is a network of interconnected individuals, based on mutually exchanged trust and respect.

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What is important to understand about *guanxi* is that relationships are developed and nurtured over time, in many cases without a specific “need” or “use” for that relationship. Many businessmen new to China wait to develop relationships until they are faced with a problem; then they proceed to develop relationships to help with that particular problem. Or, if they recognize the importance of *guanxi* and establish relationships with appropriate individuals, they fail to maintain and cultivate those

relationships. Both of those approaches miss the essence of *guanxi*: it *must* be cultivated over time. We might liken it to having a partner who spots a roadblock a mile away—not one who helps make an emergency stop.

*Guanxi* involves the cultivation and maintenance of relationships with individuals—with both parties recognizing that, as part of the developing relationship, a personal obligation is also developing. This obligation is reinforced when one party makes “use” of the relationship. By “using” the individual with whom one has *guanxi*, the moral code of reciprocity means that the user is likely to be called upon at a later, unspecified date to assist the other party. However, a moral code associated with *guanxi* does prevent an individual from exercising such obligations excessively. Constantly calling on others to assist in a manner disproportionate to that individual’s own contributions runs contrary to an unwritten code of *guanxi*.

The liability is that business is conducted predominantly between people who are part of a *guanxi* network—a supplier might help with a supply problem, someone connected with local government might help with certain business operation issues, and a banker might aid in financial matters. Essentially, *guanxi* “serves as a form of insurance in an otherwise risky business environment” (Chua and Morris 2006).

Obviously, relationships matter everywhere, but Chinese (and on a broader note, Asian) business is driven to a much greater extent by relationships and connections than is business in many other economies. This relationship-based approach to business has a number of ramifications for investors and businessmen. For example, a lack of *guanxi* is a fundamental barrier to entry. Establishing the right *guanxi* with the right people can help an individual (and his or her business) tremendously—although having the right *guanxi* does not necessarily mean that success is a given.

## Mianzi (Face) and Social Norms

A related issue, *mianzi* (面子), or face, is equally important within Chinese social settings and therefore of significant importance in a business context. With its roots in Confucianism and social harmony (Dong and Lee 2007), face is a sociological manifestation of a desire to retain social stability, hierarchy, and respect, a need to be respected by others and not be embarrassed in social interactions (Hwang, Ang, and Francesco 2002).

Face is perhaps less understood than *guanxi*, because it is less widely commented on from a business perspective by non-Chinese media and research. Face can be given (*gei mianzi*), gained (*zengjia mianzi*), or lost (*diu mianzi*). As a consequence, a significant level of importance is given to “saving” face (*liu mianzi*), since losing face can “affect one’s ability to function effectively in society” (Ho 1976).

Although other cultures have similar sociological constructs, the importance of face in China is such that a misunderstanding can have serious consequences for an individual or business. Fundamentally about perception, respect, and appropriate deference, face is perhaps best described as being “the respect, pride, and dignity of an individual as a consequence of his/her social achievement and the practice of it” (Leung and Chen 2001). Significantly, face is of equal importance in relationships with people of greater seniority, of similar seniority (peers), and of a junior standing. Face has been characterized as a Chinese businessperson’s “most precious possession” (Brunner and Wang 1988), and so it is important in conducting business to ensure that *all* business partners retain face—as opposed to giving face only to those in positions of seniority.

Giving face involves an act that communicates an appropriate level of respect. Examples might include accepting an invitation to the wedding of a business partner’s eldest son, stressing the accomplishments of a business partner in a social setting, avoiding direct conflict, and generally ensuring compliance with expected norms of etiquette. Although western cultures place importance on social norms of behavior and etiquette, eastern societies place even greater emphasis on such behavior. Perhaps the difference is best explained through Edward Hall’s (1976) theory of high-context/low-context social dichotomy: Low-context societies (including, for example, Australia, the United States,

and many European societies) are typified by high levels of explicit communication and by the verbal and written communication of rules and norms. High-context societies (such as China, Japan, and Korea) are characterized as much by what is *not* said as by what *is*. Whereas in low-context societies business interaction often includes forthright and explicit discussions of differences during negotiations, in high-context societies “Life revolves around human relationships rather than what are seen as universal rules of logic. Because there is no independent standard by which to resolve conflicts, it is important not to give offense in the first place. . . .But when dealing with business associates with whom one must maintain working relationships, it is necessary to preserve harmony through deference, courtesy, and indirection” (Hooker, 2012).

*Treating name cards with respect is a central element of face—looking at the name card, commenting on the individual’s job, and treating the item with respect all give face to the individual.*

The desire to save face is common in many business environments, yet it is of manifest importance in China. Situations in which an individual might lose face include open and public criticism by a peer or manager, or an open display of anger. One example of causing a counterparty to lose face illustrates the issue better than most: A friend recalled bringing his chief executive officer to China to discuss business with senior management of a large Chinese

company. The chief executive officer thought the meeting had gone well but, on leaving the meeting, had left all the Chinese delegation’s name cards on the table in the meeting room—a move that had not gone unnoticed by the Chinese hosts. Treating name cards with respect is a central element of face—looking at the name card, commenting on the individual’s job, and treating the item with respect all give face to the individual. Leaving the name cards in the meeting room, however, does not.

It is perhaps worth bearing in mind that, to some extent, these cultural norms may be affected over time by the dynamics of globalization, in particular the emergence of a new generation of Chinese businesspeople who may be influenced by exposure to other cultures through, for example, study abroad and social networking tools such as the Internet and Facebook.

## **Culture and Related-Party Transactions**

The facet of business most commonly associated with China is the related-party transaction. One reason for the large numbers of related-party transactions is the method of listing of SOEs that was developed with the reform period of the 1980s and 1990s, whereby the profitable parts of SOEs were carved into distinct business entities and listed on stock exchanges (Aharony, Lee, and Wong 2000). A parent entity retained the unprofitable parts of the business (sometimes with the aim of incubating business units into profitability) along with majority ownership of the listed entity. This “wrapper” (or financial packaging,

*cai wu bao zhuang*) method has given rise to large numbers of related-party transactions. These transactions might involve the trading of goods (for example, the sale of inputs by the parent company to the listed entity), services (such as the provision of ancillary services around a factory), or assets (such as the sale of a business unit by the parent company to the listed entity).

But, related party-transactions also occur between nonstate companies. These transactions take place between entities or individuals related by blood or by business associations, and they are as common as transactions between state companies.

In a market where agency issues exist not only between owners and managers but also between majority and minority shareholders (Zhang 2006), concern has been raised over the potential for tunneling, whereby majority shareholders or managers extract private benefits via related-party transactions (Cheung et al. 2007). For example, tunneling might involve paying too much for inputs sold by the parent company or selling a business unit to the parent company for too little.

How might culture contribute to related-party transactions? Consider three key issues: 1) social networks are important to business; 2) “related” in a *guanxi* context does not necessarily equate to “related” in a *regulatory* context; and 3) the concept of face may decrease the likelihood of boardroom challenge to such transactions.

*First*, given the close interpersonal relationships that are developed within China (*guanxi*), business is often conducted between a set of individuals who share a very close bond or relationship. Chua and coauthors (2003) suggest that Chinese business is “characterized by trust in family-like relationships,” and “reliance on another person depends greatly on his or her embeddedness within one’s network.”

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To solidify such bonds, these individuals enter into business arrangements, form joint-ventures overseas, and may take ownership stakes in each other’s businesses. As a result of these formalized business relationships, many subsequent transactions with these individuals are by definition related-party transactions. For example, two property developers with cross-shareholdings might exchange property assets. Or, two brothers might form an overseas joint-venture.

In another example, a supplier to a listed company may acquire some part of the listed company’s business based on the manager’s dual need to sell that business unit and to sell it to a trusted business partner. A conversation over tea and dim sum might see the manager of the listed company lament that he is not sure how to turn around the business unit,

only for the supplier to offer to take the unit off his hands. This exchange cements the *guanxi* and deepens the bond between the individuals (and hence the businesses). This act of support creates reciprocity and obligation. Over time, investors should not be surprised to see money from the listed entity used to support the supplier in times of need, either through the extension of a loan or through acquiring assets to provide financial assistance.

Relationships and *guanxi* are useful for business and are a necessary component in building networks. However, one extension of this practice is that corporate money may not be put to best use in the near term, when the manager is focusing instead on the deepening of bonds with an eye on the longer term.

*Second*, *guanxi* between individuals may not mean that a business relationship has been formalized (through the kind of business exchanges discussed above). Therefore, transactions between networked individuals may not qualify as related-party transactions under listing or accounting rules. In such circumstances, corporate monies may not be put to best use. In some cases this shadow related-party transaction can be abusive to the extent that relationships are obfuscated and assets can be expropriated. Investors may think a sale of property is on an arm's-length basis and to an independent third party, and they may assume that the best price was obtained. Where *guanxi* and relationships are not covered by listing rules, asset leakage may occur over time.

*Finally*, and as will be discussed in greater detail in the next section, in both circumstances a need to give face in the boardroom (and by extension avoid conflict) may result in a lack of robust debate within the boardroom during the decision-making process.

## Culture and the Boardroom

China operates a two-tier board system—similar to but distinct from that seen in countries such as Germany. In Germany, a nonexecutive board supervises an executive board; in the Chinese system, a nonexecutive board supervises a board similar to that seen in the United Kingdom, for example, including executive, nonexecutive, and independent directors. This hybrid approach casts the board of directors as the ultimate decision-making body in the company, and it charges the board of supervisors with monitoring the board of directors, financial affairs at the company, and the performance of senior executives of the company (Company Law, 2005).

Of critical importance in any boardroom, however, are robust discussion, debate, and deliberation. Boardrooms can become heated in the process of making the right decision. How might this align with the Chinese concept of face? And, how might *guanxi* affect recruitment in the boardroom?

*First*, the overriding consideration given to face means that in many cases direct conflict is avoided in the boardroom. However, skilled directors can put points across outside the boardroom—and do so in a way seen to be constructive and face-saving. Where a potentially bad decision may be under consideration, alternative routes to a final decision may be extremely important—for example, one-to-one discussions out of the glare of a large boardroom. In many cases, managers are attuned to the difficulties faced in Asian boardrooms, and they use mutually face-saving channels to arrive at the best decision. However, the desire to give face may mean that the inexperienced or unskilled director does not challenge bad decisions or behaviors.

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*Second*, and related to the earlier discussion of relatedness in a guanxi context versus in a regulatory context, dominant chief executive officers in China may tap in to a guanxi network when selecting directors. If business partnerships with individuals have not been formalized to the extent that their relationship would be flagged in a regulatory filing, these individuals may be nominated to the board as independent directors. Once on the board, their relationship with the chief executive officer may mean that debate and discussion are less robust than in other boardrooms.

It would be an oversimplification to say that all directors recruited through guanxi would not challenge in the boardroom or are otherwise poor appointments. However, investors should note that individuals deemed independent by a company may not, in fact, be independent. Investors considering independence must undertake due diligence on individuals, and look not only at current directorships but also at historical ties, including former board interlinks and overlaps, school and university education, birthplace, and so on. Indeed, understanding of the concept of independence in China may differ from the understanding of it in other countries and cultures.

## **Culture and Shareholder Engagement**

Faced with the dual challenge of guanxi and mianzi, how might non-Chinese shareholders engage with Chinese companies? Following engagement strategies adopted in North America and the United Kingdom, for example, may not generate meaningful discussion and change (where change is the desired outcome). Moreover, certain ownership structures may be such that typical modalities of shareholder engagement may not be effective or feasible. Shareholders should adapt engagement programs to recognize the distinct business environment within China, and should consider the following:

*First*, engage early. In the context of guanxi, it is important to cultivate relationships early on and to maintain those relationships. Even where there are no immediate issues,

*As owners, shareholders should seek to develop and cultivate relationships with management of Chinese companies, even where there are no immediate issues.*

shareholders, as owners, should seek to develop and cultivate relationships with management of Chinese companies. If in management's first meeting with an investor the investor raises concerns over company management, governance, or strategy, further discussions may be strained. Early engagements should be aimed at building trust and developing respect and understanding, and these

relationships should be cultivated through regular contact (including discussions outside of a business context). When the time does come for engagement with change as the aim, the store of goodwill that has been developed over time can make that dialogue more effective.

*Second*, engagement should be constructive, not confrontational, and with respect for management. Many engagements in China take place in a room packed with company representatives. In our experience, two research analysts are often met by anywhere from four to twelve company representatives of varying seniority (with the most senior usually in the center of the table). The two senior individuals are usually most involved in the discussions, with the junior representatives more often taking copious notes. From time to time, others will be called into and out of the meeting as required, involving a cast of many.

Although this practice can be disconcerting for some non-Chinese participants, and means that meetings often run to two hours or more, it is important to remember that the senior individuals have a vested interest in retaining face in front of colleagues (and, certainly, subordinates). A confrontational or hostile approach to engagement—such as a direct criticism of senior management's decisions or track record—in front of other management team members, or junior team members, would represent a significant loss of face.

This is not an insurmountable hurdle, however. Investors should recognize the reason for this practice and adjust to it, finding ways, for example, to adapt the phrasing of questions to accommodate the culture. Investors can still get answers to their questions, but it is hugely important to ask them in a nonconfrontational way. If the objective is to cultivate a long-term relationship, it will not be achieved by causing a company executive to lose face in front of subordinates. And doing so may have very serious repercussions.

*Third*, if engagement is not as productive as might be hoped, tapping into one's *guanxi* may help uncover the answer. Is the investor speaking to the right person? Who holds the real influence in the company? And, what are those in the company making of the engagement from their perspective? We have heard stories of people having seemingly constructive and useful discussions with mid-ranking individuals at an SOE, then returning from these meetings and reporting that, although things seemed to be going well, not much was being achieved. The reason? The people they talked with were not sufficiently senior to make any useful comments or offer solutions; they could only listen to concerns, offer platitudes, and

agree (under duress) to follow-up meetings. After checking with industry colleagues, these individuals were able to approach and establish dialogue with a more appropriate contact at the company. Such back-channel discussion can be of immense use when developing and implementing an engagement strategy.

## Guanxi versus Corruption

One important—and widely discussed—issue related to business conducted on the basis of close personal bonds, as seen in many markets, is that of corruption. As the Chinese economy grows in size and influence, not only in Asia but also worldwide, it becomes increasingly important that corruption, or perceptions thereof, be addressed effectively. In this context, it is helpful to give careful consideration to the element of guanxi. And, corporate governance has a significant role in addressing this issue, not only for the benefit of the international community but also, perhaps more importantly, for the people of China. They, as well as investors from abroad, must feel comfortable bringing their capital to Chinese companies.

Moreover, the Chinese government speaks of “social harmony,” an important component of which is an appropriate response to corruption—that is, adherence to good practices of corporate governance. This issue is also important for Chinese companies that seek to raise capital in other markets: some Chinese companies listed on NASDAQ, for example, have been perceived as being corrupt or fraudulent, leading to their being de-listed. The business leadership of China, which, as we have seen, functions to an important extent on the basis of relationships, will need to carefully balance this tradition while keeping to practices that are free of the risks associated with corruption.

## Final Thoughts

What does all this mean for shareholders? *First* and foremost, it is important for investors to recognize that cultural institutions are intertwined with commonly held understandings of corporate governance. *Second*, it is critical that they understand the intricacies of guanxi and mianzi when considering China from a corporate governance perspective.

More research on these areas would be of significant value. Case studies documenting engagement experiences, for example, could aid investors in developing their engagement framework. Research on related topics would also be beneficial, such as how Chinese culture might contribute to financial reporting norms and approaches.

Over time, and as China’s corporate governance institutions develop and strengthen, guanxi and mianzi may decline in importance. It is unlikely, however, that the influence of personal relationships or the importance of giving face will ever disappear.

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