Occupy Wall Street in Qing Dynasty, China

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What if a banker's family could be taken as slaves to repay losses arising from the banker's malfeasance? This is no fantasy from Occupy Wall Street. Such a system actually existed 200 years ago in the Shanxi banking system.

The possible enslavement of a bank employee's relatives is the most severe instance of policies and operating methods that aligned employee and shareholder interests. Because the principal/agent wedge lies at the heart of corporate governance, Shanxi bank governance has much to recommend to modern banking (well, except for the slavery part).

Bordering Mongolia, Shanxi is a desolate region in central China best known today for coal mining. It is a surprising birthplace for a banking system that served elite citizens and the treasury of the Qing dynasty. Shanxi banks thrived amid wars and pervasive corruption in the merchant economy. They started by providing bank drafts to traveling merchants, but soon established regional branches that took deposits, provided loans, exchanged currencies and recorded peer-to-peer loans, for which certificates were issued.

They had a peculiar class share structure that distinguished between asset ownership, operational control and cash flow rights. "Capital" shares conferred a pro rata ownership stake in the assets of the bank. However, they did not come with a say in how the bank conducted daily operations. Most fascinating of all, a Shanxi bank capital shareholder had *unlimited* liability, in the same way as a Lloyds name.

Therefore, Capital shareholders had to hire carefully and structure thoughtful compensation policies. On "assessment days," Capital shareholders conducted a performance review of bank employees and allocated "Expertise" shares, which came with the right to receive dividends. Expertise shareholders (i.e. employees) had a pro-rata vote in bank operations. The general manager functioned as a one-man board of directors and could ratify or reject recommendations. The general manager was himself periodically re-appointed or replaced, based on a vote of Capital shareholders.

Expertise shareholders who retired or died on the job had their shares converted to "Dead shares," which had cash flow rights, no management vote and a finite term. In this way, the problem of managerial entrenchment was mitigated.

Given the unlimited liability of Capital shareholders, they also relied on cultural and tribal enforcement to safeguard financial interests and mitigate their unlimited liability. Shanxi banks hired from only within the Shanxi province. Job candidate family histories going back three generations were scrutinized. Candidates needed affidavits of personal integrity and a guarantee letter from prominent citizens. No marriage was allowed during a branch tour of duty, and family members were not permitted to accompany the employee during branch postings. Family members of bank employees were a kind of "performance bond," and Capital shareholders liked to keep this collateral nearby.

In return for enduring such conditions, Expertise shareholders, such as employees, enjoyed a stable job with pay for performance, and a handsome pension in retirement. Over the 100 years during which the banks were active, no case of significant employee misbehavior was documented.

By the beginning of the 20th century, the Shanxi bank empire had become the government's banker. So what happened to it? First, political turmoil hurt both loan performance and loan growth. Some of the instability was homegrown and some was introduced by Western intrusion. Secondly, competition intensified among local and foreign banks using telegraphs to dramatically cut operating costs. As if this disruptive technology was not bad enough, the newcomers also operated with limited liability, which translated into bigger balance sheets and less risk aversion. Profitability for Shanxi banks disintegrated as a government banking franchise and its strong reputation were not able to offset a higher cost structure and operational inflexibility.

Chinese banking today is dominated by state-owned enterprises. While they serve an important public utility function of taking public deposits and allocating capital, their struggles with the biggest economic transition in history have been well-documented. The bank sector in countries growing much more slowly have not been immune from the same problems that Chinese banks face. Fast-growing economies present their own set of challenges and dangers for the highly levered bank sector. Compounding these difficulties in China is the sheer geographic, demographic and economic scope of bank operations.

We are certain to see more turmoil in the years ahead, but it is worth keeping in mind that banking discipline and robust corporate governance were once well-established in China, and may yet come again.

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