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DEVELOPMENT AND TREND OF BANKING RISK MANAGEMENT IN CHINA

by

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Ladies and Gentlemen,

I am very pleased to address the 4th Forum for Asian Insolvency Reform (FAIR) organized by the OECD, the World Bank, and the ADB. I believe this forum hosted by the Ministry of Finance and the Ministry of Company Affairs of India is of great importance to sustaining a safe and sound economic and financial development in Asia. To contribute to the forum, I would like to first provide you an overview of banking industry reforms in China and then share with you China's experiences in improving banking risk management.

I. An overview of banking industry reforms in China

Prior to the launch of economic reform and opening-up in 1978, the banking system in China was known as the mono-banking system with the People's Bank of China (PBC) being the only bank serving both government and business customers. Starting from late 1970s, four state-owned specialized banks were established successively, which were named as Industrial and Commercial Bank of China (ICBC), Agricultural Bank of China (ABC), Bank of China (BOC) and China Construction Bank (CCB). The year 1984 witnessed the shaping of a two-tier banking system in China when the PBC began to function as the central bank. Later on, with a view to promoting the transformation of four specialized banks into state-owned commercial banks, three policy banks, namely China Development Bank, Export-import Bank of China and Agricultural Development Bank of China, were created in 1994 to take over the policy-natured businesses from the four specialized banks. Also since 1980s, other types of banking institutions have been developing by leaps and bounds and have become an important component of the Chinese banking sector. These institutions are joint-stock commercial banks, city commercial banks, rural credit cooperatives, trust and investment companies, finance companies and asset management companies, etc..

After two decades of reforms and evolution, a comprehensive and multi-layered banking system is developed in China, in which the state-owned commercial banks play a dominant role, and, together with other banking institutions of various types, provide a full range of products and services to the economy. As of end-September 2004, the Chinese banking sector consisted of 35,013 institutions, including four state-owned commercial banks, three policy banks, twelve joint-stock commercial banks, four asset management companies, 112 city commercial banks, tens of thousands of rural credit cooperatives, 203 foreign banks'

operational entities, 224 foreign banks' representative offices, 59 trust and investment companies, 74 finance companies, twelve financial leasing companies, and four auto financing companies. The assets possessed by these banking institutions amounted to RMB30.1 trillion, which made up more than 90 per cent of the total assets of all financial institutions in China.

In a bid to enforce effective bank supervision and secure the safety and soundness of the banking sector, the Chinese government created a new agency in April 2003 named China Banking Regulatory Commission to assume the responsibility of supervising and regulating banking institutions, a duty previously performed by the PBC.

II. The evolution of banking risk management in China

Along with the growth of banking system was the evolution of the banking risk management in China.

Under the mono-banking system, there was no banking risk management in its real sense. At that time, the Chinese economy was operating under a planned system, where the supply and use of funds were mostly pre-arranged, and the PBC, being the only bank, was mainly engaged in allocating funds according to the government instructions.

Subsequently, as the four specialized banks were transformed into state-owned commercial banks, they were obliged to make loans more often than not on a commercial basis. Since then, credit risks have increasingly become a major concern for banks and bank supervisors as their strong influence on banks' business development and management performance has gradually unfolded. In response, banks began to work out various techniques and methodology to manage their risks, and today, the banking risk management has evolved into a systematic practice. Nevertheless, partly because of the limitations in the institutional set-up, a number of obstacles are still existing in further improving the banking risk management in China.

The first obstacle is the huge amount of NPLs accumulated during the course of rapid development of the banking system. Because of the rapid expansion of banks, the average NPL ratio of the Chinese banking sector reached a level higher than 25 per cent before 1998.

The second obstacle is the banks' weak corporate governance, which has impeded banks' efforts to establish an effective risk management system and improve their risk management capacity.

The third obstacle lies in the absence of a deposit insurance scheme. Currently, the closing of commercial banks is handled mainly through administrative means, and the legislation dealing with bankruptcy of financial institutions is not yet in place.

Recognizing these challenges, the Chinese government and the CBRC are taking a series of measures to improve the banking risk management by way of fostering a sound external environment and carrying out deepened bank reforms.

In the first instance, efforts have been made to deal with the accumulation of banking risks. In 1998, the Chinese government injected RMB270 billion into the four state-owned commercial banks to replenish their capital. Between 1999 and 2000, four asset management companies were established to acquire from the four state-owned commercial banks RMB1.4 trillion worth of NPLs that were resulted from the past mandated lending activities. All these efforts have paved the way for the banks to be developed into modern financial enterprises operating on a truly commercial basis and accountable for their own operational decisions and the related losses.

Secondly, efforts have been made to strengthen banks' corporate governance and risk management through deepened reforms. Given the recognition that establishing sound corporate governance is crucial for the improvement of banks' risk management capacity, the Chinese government decided, at the end of 2003, to launch a pilot reform of two selected banks, Bank of China and China Construction Bank, which aimed at building the two banks into modern and internationally competitive joint stock commercial banks within a timeframe of three years. Compared with the RMB270 billion capital replenishment in 1998 and the RMB1.4 trillion NPLs off-load in 1999, the capital injection in 2003 was considered as a part of a general comprehensive reform package designed to boost banks' balance sheet so as to pave the way for the ensuing bank restructuring. Accordingly, this round of reform is focused on building up the banks' corporate governance and operating mechanisms, and thereby improving their overall operating and risk management capacity.

These efforts put the banking risk management practice in a virtuous cycle of development, whereby the improvement of the operating environment through reforms helps enhance the risk management capacity of individual banks, which in turn facilitates an overall strengthening of risk management of the entire banking sector.

III. Prospects of banking risk management in China

Even though Chinese commercial banks have notably improved their risk management capacity over recent years, they are still lagging far behind the internationally active banks in this regard. To further strengthen the risk management of China's banking sector, it is necessary to, along with the deepening of banking reforms, have in place supportive regulations and sound institutional systems for risk management.

For this purpose, the CBRC has, during the process of forging ahead banking reforms, set out ten requirements for good corporate governance and seven performance indicators benchmarked to the top 100

largest banks globally. To put in detail, the ten requirements refer to: (1) having a sound corporate governance structure comprising the general shareholders meeting, a board of directors, a supervisory board and an executive management team with all the necessary checks and balances in place; (2) inviting the participation of domestic and foreign strategic investors to form synergy; (3) setting out clear-cut business strategies; (4) building up sound decision-making process, internal controls and risk management system; (5) adopting reduced layers of hierarchy and streamlined business process and procedures; (6) adopting a market-oriented human resource management system that highlights accountability and motivation; (7) having in place policies and procedures for prudent accounting practices and sound information disclosure; (8) establishing an up-to-date information technology system to ensure quality management and services; (9) underpinning staff training and talents recruitment; and (10) giving a full play to the roles of financial intermediaries in the process of joint-stock restructuring.

The seven performance benchmarks include the net Return on Assets (ROA) ratio, the net Return on Equity (ROE) ratio, the cost/income ratio, the non-performing assets ratio, the capital adequacy ratio, the largest exposure, and the NPL provisioning coverage ratio. In addition, the CBRC has clearly defined the responsibility and accountability for the reforms and put into place a target-driven evaluation system, in which the reforming banks are required to conduct periodical performance evaluation and submit the evaluation reports to the CBRC.

Based on the past supervisory experiences, the CBRC has also developed a number of new supervisory concepts, including: (1) conducting consolidated supervision with the attention focused on the overall risks of each banking institution; (2) staying focused on risk-based supervision that stresses the identification, early warning and control of systemic risks; (3) underpinning strong internal controls at banks; and (4) enhancing the information disclosure both by banking institutions and supervisors so as to underpin transparency.

In line with these new supervisory concepts, the CBRC has, with reference to international best practices, committed itself to enhancing the risk management capacity of the banking sector by taking the following initiatives.

First is to construct a sound regulatory environment. Having in place the needed business rules and regulations is a pre-condition for effective risk-based supervision and for cultivating a sound risk management culture and system. Given this recognition, the CBRC has, in light of worldwide practices and the Chinese realities, promptly issued a series of prudential supervisory rules and regulations covering the areas of capital adequacy, risk control and management, loan classification, NPLs resolution, and due diligence inspection, etc.

Second is to improve the mechanisms for effective supervision. The CBRC has endeavored to (1) improve the off-site surveillance system with the help of modern information technology; (2) make a comprehensive and objective assessment of the overall risks of each domestic or foreign-funded bank by introducing internationally advanced assessment systems and experiences; (3) conduct consolidated supervision with the supervisory oversight covering each bank's local and foreign currency business, domestic and overseas operations and the activities of both the parent bank and the affiliated entities; (4) set stringent qualification criteria for accounting or auditing firms engaged in financial audit activities and highlight their role as external examiners; and (5) strengthen market discipline by setting strict information disclosure requirements for banking institutions.

Third is to learn from international best practices and improve the supervisory expertise. Immediately after its establishment, the CBRC set up a cross-department team to carry out a self-assessment of the Chinese status regarding the implementation of the Basel Core Principles. The assessment team identified the major gaps and deficiencies in the Chinese banking supervisory regime and practices, and on this basis prepared an action plan for further improvements. In addition, the CBRC took the initiative to establish a Council of International Advisors, inviting the internationally-renowned financial supervisory experts to provide professional advice on issues related to the construction of a supervisory legal framework, the improvement of supervisory techniques and practices, etc.

Fourth is to promote financial innovation so as to offer quality services. Financial innovation lies at the root of the vigorous development of the financial industry. Therefore, in conjunction with enforcing effective supervision, the CBRC is also encouraging and guiding the banks to proceed with various innovations, including those of operating and management systems, business products, financial instruments and technology. By so doing, the banks are expected to strengthen their internal controls, reduce their cost, improve their service efficiency and quality, which in turn will lead to the substantial improvement of their risk management and control capacity.

Thank you.