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International Responses to Current Financial Turbulence:
China's Experiences in Enhancing Governance Standards

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First, the macro-prudential framework: We agree that bank regulators should always watch out for weak fundamentals in the macroeconomic environment, and take appropriate preventive action with changing times. We know from experience that bankers are prone to pro-cyclical behaviour, being over-bullish in lending that fuels the boom, and over-cautious when markets are down. When the Chinese economy was enjoying high growth and booming property and stock markets in 2005/2006, the CBRC was already taking counter-cyclical action to prevent the banking system from over-extending its risks. In the equity market, we rigorously stopped bank lending to finance speculation in shares and monitored carefully the amount of stocks held as bank collateral. In the property market, we initially applied moral suasion to the banks to be aware of risks of overheated property markets. As the real estate market continued to rise, we applied three specific measures. First, we insisted that the banks impose a minimum 40% down payment on mortgages for second homes. Secondly, we raised the benchmark lending rate by 10 percent. Thirdly, we tightened overall bank credit in 2007 and early 2008 to prevent the market from overheating and carefully monitored the use of bank funds to avoid the financing of speculation in stocks and real estate. This is the main reason why the 60% drop in share prices and current correction in the real estate market in China have not so far impaired the resilience of the banking system.

Second, given its stage of financial development, China still maintains the principle underlying Glass-Steagall - the fundamental separation between the banking system and the capital market in order to guard against the risk contagion between money market and capital market. As we have seen, the money market and capital market serve as two engines driving economic growth. Because traditional banks are custodians of public deposits and maintain the payment system, collapse of the capital market could have serious consequences on the banking system if there is no firewall between these two markets. What we have observed is that it is through the area of financial innovation of securitization, origination and distribution that has eliminated the firewall between the two markets. But it is also clear to us that this has gone too far, because traditional

commercial bankers have found difficulty in understanding where the risks have gone to, since assets and risks have moved off-balance sheet, so that no one is clear exactly where the excess leverage is building up.

It is precisely because we maintain the separation between the banking and capital markets that we have to regulate financial innovation, something that is strange to many bank regulators who think that regulating financial products is to over-regulate. We regulate financial innovation because we realize that commercial bankers are still learning the process of transferring their risks to capital markets through innovative products. But the greater reliance on securitisation and other risk transfer mechanisms, the faster the disappearance of the firewall and the higher requirements on banks' capacities to manage their exposure. Indeed, we are also aware the average bank depositor and investor are also learning and often do not appreciate the risks arising from financial innovation, hence the need for more investor education. Financial derivatives are risky precisely because they are not transparent, they embed high leverage and since no one follows their evolution, no one understands when the new product has become toxic. Consequently, as prudential supervisors, we encourage banks to innovate and explore new business, but only if they have the proper governance, risk management and IT infrastructure to support such innovation. Moreover, we intend to examine financial products on an end-to-end basis, looking at the product evolution from origination, distribution and final change, to ensure that during the product innovation stage, there are no toxic risks that are embedded in the system. This, in essence, is preventive regulation, like the duties of public health authorities on the issue of new drugs to the public.

Third, as China is still an emerging market, we must watch very closely the Quality, and not just the Quantity of Banking. By this I mean the Quality of Bank Governance, their ethical and moral values, and the quality of their information and risk management. What the CBRC tries to achieve is to have an overall assessment of such qualities. We rate the banks and conduct peer-group comparison analysis using a CAMELS+ methodology, including not only the fitness and properness of management, but also the shareholders and the board of directors. We are particularly watchful over connected lending and transactions, and have strengthened supervision on banks' credit concentration on big complex conglomerates. Having installed an off-site surveillance system, we are now complementing this with on-site examination procedures, using statistical tools, that tries to analyze the cost of bank activities and identifying bad practices in good time to take corrective action.

Fourth, we are great believers in higher transparency. Part of an effective risk-focused approach is the promotion of market discipline as the first line of defense whenever possible. Market discipline is enhanced whenever regulators take positive steps to ensure that banking institutions understand and can manage their risks. In addressing the information integrity issues, ever since the founding of the CBRC five years ago, we have always set priorities to the improvement of supervisory information system and also the disclosure framework for banks. Our work on more consistent, sustained and comprehensive supervisory information, which has helped our work, has also propelled the banking institutions tremendously to improve their data quality and disclosure.

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As many of you are aware, we have already encouraged the major banks to adopt Basel II, and also asked the listed banks to completely adopt International Accounting Standards. We were the first to ask our banks to disclose their exposures to sub-prime securities. Unfortunately, the adoption of fair value accounting and current international practices of loan provisioning do not allow us to take a longer view in terms of dynamic provisioning practices. Philosophically, I believe that banks should undertake dynamic provisioning, because the evolution of market prices, particularly in the property market, may take a cycle of more than 2 to 3 years, whereas current Loss Given Default takes into consideration known losses within one year of balance sheet date.

Fifthly, I have to address the vital importance of the incentive structure for financial stability. Even the Institute of International Finance has agreed that current flaws in the design and practice of bankers' compensation have inadvertently produced short-term risk-taking behavior at the expense of long-term shareholder value and financial stability. It is clear that what is adequate compensation for traditional commercial bankers are not adequate for investment bankers and so large universal banks have lost control over their risks that arise from the distorted incentive structure. But the incentive structure is not just about rewards, but also the proper sanctions against bad behaviour. Here, I believe it entirely appropriate for supervisors, as part of our general assessment of systems and controls, to be interested in compensation and incentive structure, and to adjust our assessment of prudential requirements for a bank accordingly, just as we take other aspects of a bank's control philosophy and practice into account. We have started to review the senior and executive management compensation of our banks, to make sure that those are heavily based on the performance of the bank as a whole. We try to ensure that bankers do not sacrifice bank and system-wide stability for high risk and high volatility lines of businesses.