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# Executive Roundtable and Professional Placements

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## Session 5, Part 1

Managing Banking Risks in Australian and Chinese Banking Systems:  
Liquidity and Market Risks

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It's my honor to share the market risk management experience with the experts coming from China and Australia. A lot of unbelievable events happened in the past one year, more than 20 financial institutions bankrupted, 3 largest investment banks have changed their name or disappeared. We don't know when and where the end is, but we know market risk is very important for a financial institution. I want to introduce CCB first and then discuss the lessons from the crisis.

### **1. The introduction of CCB**

China Construction Bank (CCB) was founded in 1954 as a wholly state-owned bank under the direction of the Ministry of Finance of the PRC. In 1979, CCB became a financial institution under the direction of the State Council. In September 2004, CCB was formed as a joint-stock commercial bank and under the PRC Company Law. On 27 October 2005, the Bank's H-shares were listed on Hong Kong Stock Exchange (Stock Code: 939), and on 25 September 2007, the Bank's A-shares were listed on Shanghai Stock Exchange (Stock Code: 601939).

For the first half of 2008, The Group's total assets grew by 6.96% to USD1,028,820 million, while total liabilities increased by 6.90% to USD962,435 million. The Group recorded a net profit of USD8,556 million, representing an increase of 71.34%. Annualised return on average assets was 1.72%, and annualised return on average equity was 26.36%, with an increase of 0.54 percentage points and 6.56 percentage points respectively over the same period last year. Earnings per share for the period were USD0.04. Assets reached over USD1.02 trillion, and asset quality improved steadily as evidenced by declining non-performing loans in both percentage and amount.

### **2. Risk management of CCB**

Through its restructuring and listing, CCB has gained significant enhancement in risk

management capabilities and achieved outstanding results in refining risk management system, improving asset quality, reengineering risk management processes and upgrading risk management technologies. Consequently, CCB has won extensive approval from investors and its stock price has been rising steadily, so much so that it has become one of the world's largest banks in terms of market capitalisation.

As at 30 June 2008, the Group's non-performing loans were USD11.387 million, with the non-performing loan ratio down 0.39 percentage points to 2.21%. This decline was largely due to the Group's improved infrastructure and risk management, as well as our continued adjustment of loan structure and increased disposal of impaired assets. Adequate allowances for impairment losses were maintained as at 30 June 2008, and the ratio of allowances to non-performing loans rose by 12.82 percentage points to 117.23%. CCB'S Credit Rating increased gradually in recent years. The following form shows CCB credit ratings by Standard & Poor's, Moody and Fitch, on November 2007.

<b>Rating Agency</b>	<b>Long-term</b>	<b>Short-term</b>	<b>Outlook</b>	<b>Financial Strength</b>
Standard & Poor	A-	A-2	Stable	C
Moody	A1	P-1	Stable	D- (Positive)
Fitch	A	F1	Stable	D

However, if CCB were to adapt to the complicated and changing operating environment and continue to maintain an edge in the ever more tightly contested market, it would have to form its core competence in banking. Since becoming effective in 2004, the New Basel Capital Accord ("the Accord", "the New Accord" or "the New Capital Accord") has been drawing enthusiastic responses from many countries and is becoming a new set of operation rules for the banking industry. On careful studying of the Accord and analysis of its own situation, CCB has arrived at the fundamental judgment that implementation of the Accord will further enhance its risk management capabilities, improve its comprehensive risk management system and raise its core competence in all aspects. This will be a key management focus for CCB in the future.

### **3. Lessons from the Sub-prime Crisis**

The sub-prime crisis is one of the most serious crises in the latest 100 years.

Since the bursting on the first half of 2007, sub-prime crisis has lasted for more than one year. Not only the financial institutions, but also the global economy is impacted seriously. The crisis is one of the most serious crises in the latest 100 years. But the reality proof, at the initial stage, the anticipation to the damage of the crisis was not enough. The true damage of the crisis overtops the market participator's anticipation greatly.

Institution's anticipation loss of the sub-prime crisis

<b>Institution (date)</b>	<b>Sub-prime and related securities loss (billion USD)</b>
FED (2007.8)	50-100
FED (2007.11)	150
DBS (2007.11)	400
S & P (2008.1)	265
J. P. Morgan (2008.1)	325
Goldman (2008.3)	460
Chartered bank (2008.3)	500
IMF (2008.4)	565

Source: public data

The above form shows the market participator's anticipation to the crisis. Obviously, as the time boost, the anticipation loss increased gradually. According to IMF, the global loss of sub-prime and related securities approach 565 billion USD, adding with the commercial real asset, consumer loan and corp. loan related securities, the potential loss approach 945 billion USD, equal to 6.7% of USA's 2007 nominal GDP. The following form shows global main financial institutions' loss from the crisis.

**Write Down & Loss of Global Main Bank/Security Company's  
From Sub-Prime and Related Securities**

<b>No.</b>	<b>Institution</b>	<b>Write down &amp; loss (100 million USD)</b>	<b>No.</b>	<b>Institution</b>	<b>Write down &amp; loss (100 million USD)</b>
1	Citigroup	551	11	JPMorgan Chase	143
2	Merrill Lynch	518	12	Deutsche Bank	108
3	UBS	442	13	Credit Suisse	105
4	HSBC	274	14	Wells Fargo	100
5	Wachovia	225	15	Barclays	91
6	Bank of America	212	16	Lehman Brothers	82
7	IKB Deutsche	153	17	Credit Agricole	80
8	Royal Bank of Scotland	149	18	Fortis	74
9	Washington Mutual	148	19	HBOS	71
10	Morgan Stanley	144	20	Societe Generale	68

Source: Bloomberg, August 2008

Looking forward, there are some lessons that we can learn to strengthen market risk management in response to the crisis.

**Lesson 1:**

*Market risk is systematic risk* – With the economic globalization, when crisis occurs, no financial institution can escape.

**Lesson 2:**

*“Too big to fail” is out of fashion* – With the collapsing of Bear Stearns, Lehman and Merrill Lynch, the saying “too big to fail” became past. When economic circle is in depression stage, any financial institution has bankrupt possibility.

**Lesson 3:**

*The crisis is the result of interaction of different risk* – Briefly, the crisis originated from market risk---interest rate increase, the lender can't afford the mortgage and default, this is market risk transferring to credit risk; credit risk spread in the crisis, sub-prime bonds devaluate, this is credit market transferring to market risk; because of above credit risk and market risk, financial institution's liquidity dry up instantly. Then many big institutions bankrupt, such as Bear Stearns, Northern Rock.

**Lesson 4:**

*VaR model can't capture all risk events* – VaR system can't measure extreme market condition, the measurement and management of tail risk need to be strengthened. In addition, facing weak liquidity asset, VaR is insufficient.

**Lesson 5:**

*Credit risk must be considered before an investment* – In financial market business, counter party risk and issuer risk are very important risks. These kinds of credit risks must be taken care of, especially in extreme condition.

**Lesson 6:**

*Operational risk management is the first defend line* – Operational risk affairs occurred many times, shows operational risk management is very important. All policy, limit and other rules are obeyed by person, so the operational risk is the first defend line.

**Lesson 7:**

*Portfolio risk management is the tendency of market risk management* – As the interaction of different risks, the correlation must be considered sufficiently, and this kind of correlation is not less than 1, but greater than 1. And under “Purchase-Originate” mode, the bank's liquidity risk should deal with at portfolio level.

**Lesson 8:**

*Stress test and economic capital are the basic tools of portfolio risk management* – Stress test should be designed to span risks and asset classes, both through the clear definition of bank-wide scenarios and greater interaction between risk and business expert, and iterative discussion loops clarify the numerous hidden linkage between risks. Economic capital can add all kinds of risks together, and can measure risk management performance with RAROC.