

Executive Roundtable and Professional Placements

2 – 10 October 2008 • Melbourne, Canberra and Sydney

Session 6, Part 2

Capital Management in Australian and Chinese Banking Systems: Capital Allocation – for group consideration

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Capital allocation is fundamentally what a banking institution is all about. For a banking group, this issue becomes more complex as consolidation concerns management as well as regulators. Senior management is essentially deciding how to allocate the institution's scarce capital resources among a portfolio of businesses including usually retail and commercial banking, corporate banking, investment management, insurance and other financial services.

There are many factors influencing capital allocation among group entities. The starting point for an effective and efficient capital allocation is the accurate measurement to attribute risk and associated capital requirement to individual businesses or divisions. However, the theory and practices of quantifying various types of risks are not mature enough today to give a confident description of a diverse institutions' risk profile. A recent paper on economic capital by the Basel Committee on Banking Supervision lists a number of issues of risk aggregation techniques. Typically, economic capital is calculated using an approach that first assess individual risk components, and then proceeds to aggregate these risk components up to the level of the entire bank.

Bargaining power of business leaders is another factor. Managers who have more bargaining power within a group can get a larger part of capital for their own business units. Bargaining power is usually measured by looking at the tenure of division CEOs and whether or not they were members of executive board of the group. Senior management should realize that business managers have the incentive to bargain by wittingly or unwittingly claiming "unfair treatment" in order to keep the capital charge to their individual business as low as possible. So it is ultimately important for senior management to align reward incentives to the institution's strategic objective and risk appetite in such a way that the eventual capital allocation does not induce "misbehaviours" of individual businesses, such as overly aggressive risk-taking or intentional information hiding from senior management.

Last but not least, the strategy of a group is also a factor determining capital allocation among group entities. Usually, the business unit which operates in a market where the group

strategy focuses on gets more favour.

One should be mindful of the fact that capital allocation, as it is practiced today in the industry, is largely an art rather than science. Many so-called sophisticated banking institutions do not even allocate capital beyond the subsidiary level.

Given the lack of methodological consensus on risk aggregation and capital allocation in a diverse financial institution, senior management should establish a comprehensive enterprise-wide risk management framework to address capital allocation and many other risk management issues instead of relying on mechanical calculations only. Such an enterprise-wide framework should exert real and effective influence on the institution's execution of business and risk management policies. A recent study has found that a key differentiator of those banks who fared better than others during the recent credit market turbulence is the "degree to which senior management encouraged a firm-wide approach to risk management and enhancement of control structures to keep pace with the growth of risk taking. In addition, it was critical for firms to have risk management functions that are not only independent, but also have sufficient authority within the organization."

There has been a wide consensus in the industry that significant investment on IT and information systems should be made in the area of risk management in addition to the area of transaction processing. Basel II implementation has given a major boost to this effort in the banking industry so the next challenge is to leverage the significant hardware investment for effective risk information integration and reporting.

To conclude, I would like to say a few words about regulators' concerns. Banking is one of the most important sectors of an economy. Given the complexity of banking industry and the methodological deficiency of any set of "sufficient statistics" for risk information, outsiders would not be able to know what is going on inside unless there is total informational transparency. Total transparency does not mean processing of every piece of information generated in every processes of a banking institution. That would be impossible by definition. Instead, the possibility that regulators' review of any part of an institution's operations would itself exert such a pressure so that the institution affected would self-correct any mismanagement behaviours concerning risk-taking and risk-management issues. In parallel, some regulators, such as Federal Reserves and OCC in US have invested significantly on acquiring quantitative talents on their staff in order to engage the industry in this ever-evolving area.

Cooperation and coordination among home and host regulators is important. Host regulators usually like to see more capital injected into the subsidiaries they supervise as more solid capital base usually means stronger risk-resistant capability. However, capital allocation is generally decided at the group level. Taking foreign-funded banks in China as example, risk models are mostly designed at the group level. Therefore, validation of risk models needs international consultation to see whether they are acceptable and locally adapted. In addition, the approaches toward implementation of new capital accord also vary by economies and institutions. Cooperation among regulators in terms of on-site examination is also helpful for on-going supervision of internationally active banking groups.