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Capital Management in Australian and Chinese Banking Systems:

Capital Allocation – for diverse financial activities

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Based on the BASEL Capital Accord, the Banking Regulatory Commission of China introduced the implementation of “Regulations Governing Capital Adequacy of Commercial Banks” in 2004. The Regulators have since played a proactive role in promoting economic capital management in commercial banks.

During the reform of the Chinese banks, capital management is becoming a more important part of the overall bank management with most of the commercial banks having established a capital management framework that is focused on economic capital. After in-depth inquiries and due diligence, the four major state owned banks are now in the phase of putting the study into practice. Other second tier banks have also been making significant improvements in this area by restructuring their internal capital allocation to make it in consistency with the regulatory requirements. The above developments reflect that within the scope of regulatory compliance, the Chinese banks have started pursuing new strategic directions and management models which consist of a core function of capital allocation constraint.

Following I wish to share with you these developments from a broad market perspective which will also address the theoretical environment that has led to the above developments. To conclude, I will touch base on some capital allocation practice at ICBC.

1. Research and Understanding

Until very recently, the concept of “Capital” refers to a basic accounting formula which is “Capital = Assets – Liabilities”. Under such a formula, capital is regarded as the equity holders’ “Residual Claim” over the corporate value. Different to the above is a new approach that looks at the function of capital from a risk perspective. One basic rule of market economy is that any loss to a corporate must be firstly taken by the shareholders’ capital. Capital is given a constraint role to undertake the risk before a loss occurs, and to

provide funding sources to absorb the loss after it has occurred. In this regards, capital is the aggregate of risk a corporate is capable of taking. Also called “Risk Capital”, Economic Capital is the funds to be set aside for the unexpected loss of a corporate.

When it comes to financial institution management, the concept of “Economic Capital” is of even higher importance. This is due mainly to that under this concept the issues of risk management, capital structure and capital budget combine to form the key strategic management of a financial institution, making it a more specialized identity of operating and managing risks. The combination of risk management and capital structure characterizes the capital adequacy issue. That is, whether or not the financial institution has adequate economic capital in place to withstand its overall risks. On the other side, the combination of risk management and capital budget concerns about how economic capital will be distributed between each region, business unit and product to realize a most efficient use of the limited capital resources. In another words, we are in here dealing with a capital allocation issue.

Technically economic capital allocation is about RAROC based investment and risk decision. The economic capital we are talking about in here is the risk contribution to the financial institution as a result of the investment project, which can be further determined as the consequential increase in the overall value at risk of the financial institution. The idea of RAROC is to consider the return and its resultant risk as a whole when evaluating an investment decision. What RAROC measures are for each unit of risk taken, or each unit of economic capital allocated, the expected return. In another words, it measures the additional risk brought in by the investment and the efficiency of capital utilization. When RAROC is applied on capital budget, the RAROC of the investment being evaluated is compared with the hurdle rate. A RAROC above the hurdle rate is an indication of a satisfying risk and return tradeoff thus the investment under evaluation is likely to gain approval. Another alternative of using economic capital for investment decision making is risk pricing. This is a process of transferring the cost of risk, which is in the form of capital charge, into the product pricing so that the financial institution is appropriately compensated for the risk taken when offering a risk product, such as a loan.

Working together, the economic capital allocation mechanism, internal control procedures and hedging techniques provide a platform for a modern risk management framework that supports operation of a financial institution.

2. Current Developments in the Chinese Banking Systems

The Chinese banks tend to develop new capital management systems with a view to overcoming the following issues in their practice of implementing economic capital allocation reform:

- The establishment of economic capital budget is on the basis of risk identification and quantification. The characteristics of this include:
 - Allocating capital in line with the amount of risk undertaken by each unit;

- Promoting a dual function mechanism of economic capital which will constrain overall risk taken and in the meantime, induce value creation;
- Enhancing efficient utilization of the available credit resources and financial resources;
- Strengthening the structural optimization in relation to business, assets, products and clients; and
- Providing economic capital quantification for special business strategies to suite the specific risk appetite.

The credit ceiling system established on the basis of quantified economic capital has its new function that by executing the system, the business risk is confined within the risk appetite of the commercial bank.

- Allocation of economic capital to each business division will have little meaning without accurately identifying the risk and the subsequent modeling and quantification of the risk. Issues related to identifying and quantifying risk include:
 - Risk identification requires a prior differentiation of risks relating to core business and non-core business.
 - Quantifying market risk requires techniques such as risk matrix, VaR, stress testing and scenario analysis.
 - Quantifying operational risk requires techniques such as basic indicator, standardized approach, internal measurement, loss distribution and extreme value theory.
- For those banks that are yet to develop an internal rating based system, the BASEL II Standardized Approach has become a main foundation to design their economic capital measurement. Furthermore, some IT systems are still not 100% supportive of the assets classification under the Standardized Approach, making it difficult to effectively acquire the customer rating and risk mitigation data. In order to overcome the limited ability in risk modeling in the transition period, some banks have started to adopt an “Internal Factor Approach”. This is an approach relatively easy to work with under the current systems and is compatible in the current accounting and statistical environment. By making reference to the risk weighting classification recognized by the domestic and international regulators, and to combine it with the regulatory policy direction and the individual assets distribution, it simply allocates an “Economic Capital Factor” to each of the business categories.
- The planning of the economic capital increment for future allocation involves the following processes:
 - In accordance with the “Regulations Governing Capital Adequacy of Commercial Banks”, to determine the incremental scale of the regulatory capital which will be mainly sourced from retained earnings, IPO and

subordinated debt issuance;

- To determine the total economic capital to total regulatory capital ratio by making reference to this year's total economic capital required and regulatory capital held;
 - To estimate next year's economic capital increment for allocation;
 - To ensure the economic capital allocation is planned with full consideration of the capital adequacy and a balance between the business plan and earnings projection; and
 - Any adjustment to the initial allocation plan will be subject to a consolidated assessment of the current level of allocation, the return on economic capital and any proposed variation in the business structure.
- The combination of RAROC and EVA is to be taken as a key performance indicator and a key basis for resources allocation. This will hopefully change the traditional method for performance review where management concentrates on the book value of the profit with the risk measurement being absent from most of the review. Under such a direction, each business division will have the incentive to prioritize the resources allocation among the low risk and high return business. This will in turn initiate new business culture within the whole organization to reduce risk and improve efficiency, which will undoubtedly drive an organic growth. More importantly, with these tools managers have never been so confident in managing the interrelations between the rerun and risk, which has always been a top priority issue in any banking organizations.
- IT management is the area you cannot do much without in a modern commercial bank. Many large banks from developed countries have shown their experience in advanced IT management. How they manage the development of economic capital systems for internal capital allocation is obviously worth learning. This requires consolidation of and data exchange between the assets and liabilities management system, the funds transfer pricing system, the financial accounting system and the internal rating system. IT works will also include some necessary data adjustments in order to achieve a true reflection as to whether or not the bank capital has been utilized for targeted growth and maximizing shareholder value.

3. ICBC Case

ICBC is proud of being one of the few who have gone in front of the other Chinese banks in the capital management reform.

ICBC has used economic capital management instruments since 2005. Economic capital management includes three major procedures: measurement, allocation and evaluation. Economic capital indicators include economic capital (EC), risk adjusted return on capital (RAROC) and economic value-added (EVA).

ICBC's economic capital management has been comprehensively applied in various aspects, including credit resource allocation, operation planning, expense allocation, performance assessment for branch presidents, limit management, product pricing and etc., which has improved the Bank's efficiency of capital utilization and brought into full display the restricting and guiding functions of economic capital for business expansion and risk scale. The leading role of economic capital allocation data and assessment indicators has become prominent.

In a broader range of capital management ICBC implements a comprehensive capital management system, including measurement, planning, allocation, monitoring, evaluation, operation and other management activities with capital as target and instrument, for capital adequacy ratio management, economic capital management, book capital management and aggregate capital and structure management. The objective of capital management is to improve capital utilization efficiency, restrict the expansion of risks and maximize the capital return for shareholders on a stable and sustainable basis whilst maintaining capital sufficiency.

In order to achieve the objectives above, ICBC carries out the following strategies for capital management:

- Establishing a reasonable capital adequacy objective to restrict the expansion of risk assets under the condition that the capital adequacy ratio meets the regulatory requirements;
- Taking into consideration the risks, income, scale and growth with economic capital as the theme, optimizing resource allocation in order to meet the shareholders' requirements of investment return and capital coverage for risks;
- Making reasonable use of various capital instruments, optimizing the aggregate amount and structures of capital and reducing financing costs

ICBC has the ability to work out the capital management plan with regard to its risk appetite and business development and realize the allocation and dynamic monitoring of capital in various risk areas, regions and products via the economic capital allocation system, restrict the expansion of risk scale, optimize and guide resource allocation, and achieve the objectives of capital return and capital adequacy ratio.