Enhancing Risk Management and Governance in the Region's Banking System to Implement Basel II and to Meet Contemporary Risks and Challenges Arising from the Global Banking System

Training Program ~ 8 – 12 December 2008
SHANGHAI, CHINA

Session 6.3/4

How to Implement the Operational Risk Management Proposal under Basel II

Dr Zhao Xian Xin
Shanghai Pudong Development Bank

Ho to Implement the Operational Risk Management Proposal under Basel II ?

Some Viewpoints of China Banks

Zhao Xianxin
zhaoxx@spdb.com.cn
Shanghai Pudong Development Bank
Tel：86-21 61616006
13817578236

Outline of This Presentation

I. An Overview of China Banking Industry

II. Challenges for Operational Risk Management

III. Implications of Basel II Proposal for Our Operational Risk Management

IV. China’s Regulatory Guidelines for the Capital Requirement under Basel II

Structure of Banking Industry in China

- Four-layer Structure of China Banking Sector
- First layer : Big 5, in the past, it was called Big 4

  Up to date, ICBC, BOC, CCB, ABC, and CBC account for two thirds domestic market share.
- Second layer: 12 share holding commercial banks.
- Third layer: Foreign Banks' domestic operation.
- numerous newly licensed commercial banks
- ICBC, BOC, CCB, CBC have been listed in Shanghai and Hong Kong stock markets, ABC is preparing for going public. However, China central government still keeps the major share.
- For the rest commercial banks, except for the foreign banks, local governments keep the controlling right and have direct influence on them.

Governance of Banks as Enterprises

- There are so called “Three New Committees vs. Three Old Committees”
- Three Old Committees:

  -Committee of Communist Party (CCP), Labor Union, and Employee Representative Committee

  -Under traditional regime in the past, the three old committees, especially the CCP played critical roles in banking governance.
- Three New Committees:

  -Shareholders Representative Committee, Board of Directors, and Board of Supervisors.

  -According to Corporate Law in China, the three new committees should stay in the center of the power.
- A compromise status quo: CCP in charge of senior management nomination, whilst the three new committees function in the fields of daily operation decision and areas not so important.

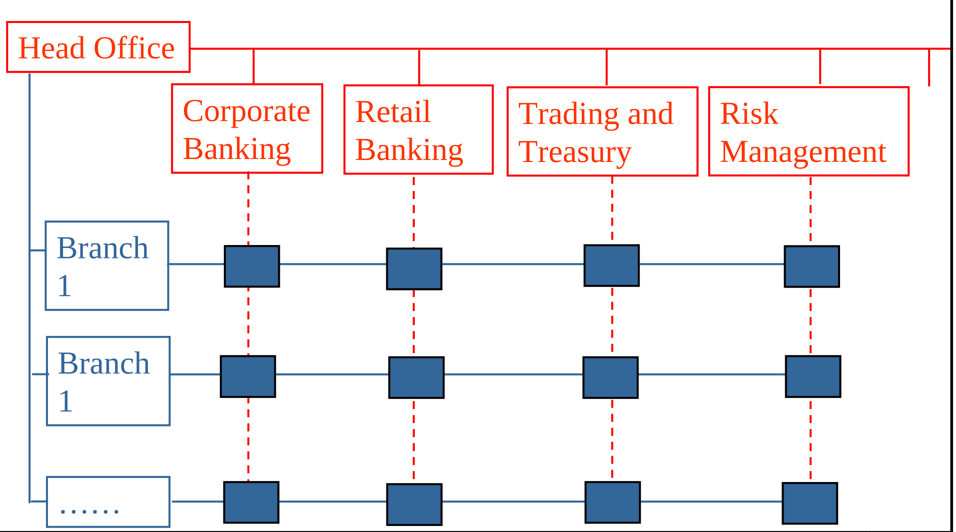
Typical Organization of China Banks

- Head Office with multiple branches
- The whole bank is viewed as a unified legal person which is represented by the Head Office.
- The branches are *de factor* profit centers, which makes them look like independent smaller banks.
- Management functions of various business lines at Head Office are relatively weak:

  -They are not responsible for operating result in terms of performance;

  -They have no direct influence on business operation at branch, instead, they focus on giving directions and guidelines to business at branch level.

Chart of Organization Structure



Regulation on Banking Industry

- China has been adopting a strict financial law which is very much similar to Glass- Steagall Act in the US since 1995, insisting separation of bank types according to their business (commercial and investment banking).
- According to *Law of the People's Republic of China on Commercial Banks*, Chapter IV, Article 43 No commercial banks shall undertake the businesses of trust and investment and securities dealing business, nor shall they invest in the non-self-use real property or non-bank financial institutions and enterprises, unless it is otherwise prescribed by the state.

  Adopted at the 13th Session of the Standing Committee of the Eighth National People's Congress on May 10, 1995, and amended according to the Decision on Modifying the Law of the People's Republic of China on Commercial Banks as adopted by the Sixth Session of the Standing Committee of the Tenth National People's Congress on December 27,2003

- Since then, there has been calls from banking industry for deregulation
- Before the amendment in 2003, Article 43 stated that 43?A commercial bank shall not engage in trust investment or stock business, or invest in real estate not for its own use within the People's Republic of China.
- Now, in the shadow of current crisis, these calls should be revalued.

Challenges for Operational Risk Management

- Insider Control due to insufficient monitoring from head office.

  -How to increase risk transparency at branch level?
- Product Complexity.

  -How to ensure the quality of products and services;

  -How to control the inherent risk?
- Process Complexity

  -How to make process more transparent and henceforth to reduce process related risk?
- System Failure

  -How to keep hazard rate of IT system under control?

Challenges for Operational Risk Management -cont'd

Market Evolution and Threats of Disintermediation

- Stock markets are becoming increasingly important in meeting financing needs of companies.
- Threat of disintermediation trend

  -On the lending side, commercial banks have to compete with stock market to attract qualified borrowers.

  -On the liability side, commercial banks need to provide competitive return to abstract depositors.
- Challenges of Interest rate liberalization.

  -The 1970s of the US was considered bankers' "3-6-3" time. Up to date, Chinese bankers have been enjoying this kind of time.

  -Time is in fast change.

Challenges for Operational Risk Management -cont'd

Crime Waves: Internal Theft and Fraud

- Following the economy and society transition, internal crime incidence is increasing.

  -Before 1999, crimes within banking industry were merely connected to loan business: taking bribery or kickbacks from borrowers were once very common.

  -After 1999, internal crimes take new forms: Stealing money from clients' accounts become a new trendy problem. eg. Bank of China suffered a huge amount of losses due to internal money theft.
- Following the rapid commercialization of banks, operational risk related to people emerges:

  -Higher turn over rate of staff,

  -Inappropriate incentive caused by improper compensation package, short sightedness of client manager.

Challenges for Operational Risk Management -cont'd

Crime Waves: External Theft and Fraud

- Retail banking market is growing at fast pace. Unfortunately, there are no effective ways to screen customers.

  -In mortgage lending business, there is so called "Three Fakes" problem; In credit card business, defaults are increasing.

- Safety of IT system.

  -How to guarantee the security of online banking

- It's increasing hard to manage public relations in the time of internet, in particular when some bad news about your bank begins to circulate.

Transformation of the Banking Sector

- Banking business in China is en route from traditional model to modern model.
  - Business lines will play more critical role in daily operation management. More power will be expected to be transferred from branches to Head Office.
  - In line with centralized monitoring and reporting, heavy investments have been put into IT system.
  - New risk management culture: streamlining the process of credit business.
  - New Accountability Culture: separating operational risk from credit risk.
  - Deposit based banking, rather than asset based banking.

Strengths of Basel II Proposal for Operational Risk Management

- Increased transparency both at branch level and business line level will help to control operational risk.
- Risk tolerance level could be set.
- Implementation of Basel II will facilitate the transformation process of banking operation.

  -Management functioned by business line will be strengthened;

  -Give incentive to improve operational risk management and henceforth to reduce operational losses.
- Encourage banks to allocate more sources to strengthen their operational management.

China Version of Guidelines for the Implementation of Basel II

- Three approaches recommended by CBRC

  -The Standardized Approach in China Version

  -The Alternative Standardized Approach

  -The Advanced Approach

- No detail about AMA, reflecting low expectation for implementation.

The Standardized Approach of CBRC

The total capital charge can be expressed as

$$K_{TSA} = \frac{\sum_{j=1}^{3} \max\left\{\sum_{k=1}^{8} GI_{jk} \times \beta_k , 0\right\}}{3}$$

No Big Difference!

Standardized Approach Beta Factors	
Business Lines	**Beta Factors**
Corporate Finance	18%
Trading & Sales	18%
Retail Banking	12%
Commercial Banking	15%
Payments & Settlements	18%
Agency Services	15%
Asset Management	12%
Retail Brokerage	12%
Other Business	18%

The Alternative Standardized Approach of CBRC

Two Choices under CBRC ASA

One is the same as ASA under Basel II, the other is pretty much a short version.

ASA Beta Factors	
Business Lines	**Beta Factors**
Retail Banking	12%*3.5%*alo
Commercial Bankin	15%*3.5%*alo
Other Business	18%

Advanced Measurement Approach

Should be No Difference!