

Financial supervision in China: framework, methods and current issues

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Current supervision framework and methods in China

Financial supervision in China is conducted according to the laws and regulations in force. With the enactment of the Law on Securities at the end of 1998, the three major supervision authorities, namely, the People's Bank of China (the PBC), the Insurance Regulatory Commission of China and the Securities Regulatory Commission of China, now supervise the three types of financial institutions and their business activities based on the Law of The People's Bank of China, the Law of Commercial Banks, the Law of Insurance and the Law on Securities respectively. The financial institutions adhere strictly to the principle of segregation of financial business. Banks in China cannot engage in trust, insurance or securities business, nor can they invest in trust or investment companies; while the securities and insurance institutions cannot be involved in banking and trust business. As to the supervision of commercial banks in China, both the supervision system and the framework are designed strictly in line with the requirements of the Basle Accord.

In the past, the financial system in China was established in line with the administrative structure, as was the PBC system. Therefore, there was segregation in the supervision of financial institutions, which meant that supervisory bodies supervised the commercial financial institutions at the same administrative level while being ignorant of the overall situation of a commercial bank confronted with risk. In consideration of the existing financial risk in China, especially the changes in the international financial environment and the lessons from the South-East Asian financial crises, the method of financial supervision in China is now changing towards risk evaluation of the legal person of a commercial bank and the resupervision of the management structure inside every financial institution. Based on the Basel Core Principles, the supervisory

measures have been enhanced in some aspects, such as the design of some indicator systems and the monitoring of the risk situation of financial institutions, especially non-performing assets and the risk faced by medium- and small-sized financial institutions. In addition, procedures for the exit of problem financial institutions were introduced in China in 1998. Viewed from the market angle, this is an issue which requires further research. Since the financial system in China is undergoing transition from a planned one towards a market one, we could not deal with everything perfectly overnight. However, attention has been paid to the market issue. In 1998, the PBC closed down the Guangdong International Trust and Investment Corporation, more than 20 urban credit cooperatives and one shareholding commercial bank, Hainan Development Bank. Dealing with these problem institutions is unavoidable in the process of development.

As to the supervision methods, one of the main problems confronting us is the examination of the qualification of staff in financial institutions and dealing with unqualified staff. The low quality of some staff is really a problem. The PBC is therefore gradually improving its supervision and examination of the management of financial institutions, and has removed some unqualified bank managers from their positions. Many problems in financial institutions are caused not solely by economic factors, but mainly by the behaviour of senior managers. If all the senior management of financial institutions fulfilled their duties according to the rules and regulations previously enacted by the PBC, the situation of many institutions would not have been as bad as it is today. The problems caused by factors outside the financial system, such as staff and management, can only be solved by correcting the behaviour of staff, which is essential to ensure the soundness and development of the institution.

Risks confronting China's financial institutions and the problems in financial supervision

As Governor Dai pointed out before, a stable supervision system should be based on a sound economic and financial environment. Apart from external factors such as the intervention of government agencies and the imperfection of the legal framework, there are currently four major problem areas in financial supervision:

1. The supervised entities (i.e. financial institutions) are undergoing the transition from a planned economy to a market economy, and with the reform and opening-up, therefore, their behaviour needs to be improved accordingly. In this context, the financial institutions themselves have to gradually come to understand the market and risks. The fundamentals of the financial institutions operating on the market now are not very solid. Once I asked some supervisors who had just returned from a study trip abroad what was the most difficult part in China's financial supervision. They said that the most difficult part of supervision was the behaviour of the supervised entities and the unsound internal governance mechanism. Let me take the health of a child as an example to illustrate this: if a child is born disabled or unhealthy, how should one bring him up to be a healthy man through supervision? This is a very difficult issue, and finding a solution is time-consuming.

2. There are various problems in the PBC's current supervision of financial institutions. One example is that supervision is relatively weak. The PBC began to perform the sole function of a central bank in 1984. Before that time, the PBC also took deposits and extended loans. Its current function was developed in the process of reform. Therefore, the behaviour and system of the central bank itself needs to be improved gradually according to the market principle and international practice, so as to make it more in line with the requirements of a socialist market economy. This is a long and concrete process. We are now aware of the problem and speeding up our steps to change this situation. For example, in 1998, the PBC underwent organisational restructuring, setting up nine regional branches to replace the original provincial level branches. This appears to be a simple transition, but as a matter of fact it is really a big change and differs very much from the existing structure of the political system in China. This illustrates that a systematic change is taking place and a great effort is being made towards creating a genuine central bank.

3. Information disclosure is also an issue to be solved in supervision, which means to provide the public and investors with necessary information to let them judge the risk of a financial institution. It is not enough just to make information public. For example, listed companies began to disclose their financial statements on the capital market several years ago, but investors did not realise the importance of this practice. Therefore, it is true that information disclosure is an issue to be solved

in China, but what is more important is to enable investors and business people to realise the significance of doing this. This means, through information disclosure, making investors aware of the risk situation of the institution they intend to invest in, and showing them where the risk of their investment lies, and therefore enhancing their awareness of financial risks. What I mean here is that information disclosure is not only a technical issue but also an issue of one's mentality.

4. The market exit of financial institutions is an acute issue. Market exit is not a simple and easy thing to do even in market economies, since it is connected with the interest of investors and the stability of a country and of society. We also see that, after the Asian financial crises, no country is able to deal with problem financial institutions in an easy way. This is also a hard problem for China, especially in the course of its economic development. However, we have begun to incorporate the international experiences into our research on how to deal with problem institutions in consideration of the concrete situation in China.

Solutions to the issues existing in financial supervision in China

It is sometimes said that the problems we are exposed to today have been accumulated during the past 20 years of reform and development in China. In my view, we should look back 50 years, not only 20 years, when thinking of the issues in China. During the 50 years since the foundation of the new China, economic operation and people's way of thinking were much affected by the planned economy. Therefore, the issue we are confronted with today will not be solved simply by principles of market economies. For example, we could make a good judgement about the risks taken by the financial institutions, including the seriousness and types of the risks. We know that the reasons causing those risks are complicated, unable to be handled only on the technical level. When we deal with the issue of financial risk, we will not only solve the problem on the surface but also solve the fundamental problems by improving the mechanism. In the process of improving the supervisory system and resolving the existing problems, we have to make reform the top priority. The meaning of the word "reform" here is different (or more profound) from the same word mentioned before. Here it means that we have to determine clearly how to develop an institution or a

system, and what is its future status. Since we did not have a clear idea about the status and development of some institutions such as the trust and investment companies in the past, they could not achieve soundness and healthy development. For these institutions, we should not only solve their existing problems, but also make their whole system work well and develop. Enhancing competition is not targeted at individual institutions, but to make analysis and judgement based on the linkages among institutions as well as their roles in the market. Currently the issue of establishing the financial supervision system is arduous, but we have found out the way to fundamentally solve the problems after years of experiment, exploration and research.

To be able to better supervise the commercial financial institutions according to market principles, the PBC will need to encourage the financial institutions to improve their internal control systems, to regulate their behaviour and to raise their consciousness of risk prevention.

Raising the quality of the staff engaged in financial business is also part of the task to improve the supervision system. The overall improvement of supervision will be compromised if the problem remains unsolved. In practice, some staff members work very hard, but they have not mastered modern techniques and methods, and they have not realised that banks' exposure to risk is an unavoidable reality facing us with the development of the market. Many of them still try to solve these problems using out-of-date administrative methods which cannot meet the requirements of the modernised market economy.

The study of China's issues should be based on China's concrete situation

China is still in the process of transition from a planned economy to a market economy. Therefore, the public, the management of financial institutions and government agencies should strengthen their awareness of credit and risks. If they hold the view that all deposits are protected by the authorities and the interests of the depositors will not be impaired, investors will never learn to judge the risk of an institution but will rely on the authorities and supervisors. We should therefore make the public fully aware of the importance of financial risk prevention.