Zhou Xiaochuan: Switch to a new way of thinking and steadily experiment with cross-sector operation in the financial industry

Speech by Mr Zhou Xiaochuan, Governor of the People's Bank of China, at the BoCom-HSBC Forum, Beijing, 15 June 2006.

*   *   *

Distinguished guests,
Ladies and Gentlemen,

The topic of today's Forum is integrating the Chinese and Western cultures and creating a world brand. Centering around this very broad topic, let me talk about piloting cross-sector operation in the financial industry. I know that Chairman Jiang Chaoliang cares a lot about this subject. In our discussion with Mr. Stephen Green, Vincent Cheng and Peter Wong of the HSBC group yesterday afternoon, we touched upon HSBC's expertise and experience in this area. This subject has something to do with integrating the Chinese and western cultures. It also has a bearing on the competitiveness of China's financial industry.

With the evolution of the domestic and international economies, and out of consideration for enhancing competitiveness, the Chinese policy has changed on how the operation of different sectors in the financial industry should be arranged. The 5th Plenum of the 16th CPC Central Committee formally proposed that piloting cross-sector operation should be promoted steadily. Around that time, relevant financial legislations were also revised to leave some space for such piloting efforts. The pilot operation has been on track.

I. A system of segmented operation of banking, securities and insurance was proposed in connection with the change of mentality in the transition from a command economy to a market economy.

In the early days of reform and opening up in 1980s, the different sectors were not segmented in the Chinese financial industry. At that time, commercial banks had their own trust and investment companies and securities companies. The Bank of Communications and the Pacific Insurance were affiliated. Later on, some disorder occurred in the financial industry. As for how to analyze and look at the situation, one mainstream opinion then was that the disorder and risks were caused by cross sector operation. Gradually, the different sectors were segmented with the support of legislations. A strict separation of the three sectors was established.

In my personal view, such a philosophy of segmented operation and supervision has something to do with the change of mentality in the transitional process. In the command economy, emphasis was put on separating sector and sub-sectors. Some drew an analogy to slicing a potato, where one usually cut the potato into pieces before further cutting them into smaller slices. Many industries were arranged and regulated along this line. For example, in the auto industry, a truck maker only produced trucks whereas a bus maker made buses only, and car maker manufacture just cars. Furthermore, in the truck sector, production of heavy-duty trucks, light trucks and agricultural trucks were separated. If an enterprise wished to operate beyond one sub-sector, approval was needed, which was in fact very difficult to get. This was also true for foreign trade. In order to prevent competition and pricing problems among the more than a dozen state-owned trade companies, the trade business was carefully divided among them. For example, the national trading companies in China were established to specialize respectively in machinery, instrument, chemical products, textiles, silk, medicine, minerals, metals, edible oil, cereals and foodstuffs import and export. As the economy evolves, such segmentation increasingly became out of place in a market economy, nor was it contributing to competitiveness.

In the financial sector, market demand for financial products has also changed. If we divide the financial business too much, this will affect the growth of financial institutions, and their ability to satisfy customers' need. Of course, this may be convenient for the supervisors, because one supervisor only need to know one sub-sector. Yet, regulation and supervision should develop with the times, along with economic growth.

II. In order to create a favorable environment to promote cross-sector operation, one need to properly understand the current situation and history.

It is not easy to properly understand history. For example, in the aftermath of the Great Depression in the U.S., the 1933 Securities Act were adopted to provide for separate operation of the securities, insurance and banking sectors. But many years after that, efforts of revisiting the Great Depression found many other explanations of the crash. One of the conclusions is whether the financial sector was divided was not a fundamental factor contributing to the Great Depression, and consequently, the 1933 Securities Act was an misinterpretation of the history. Indeed, those who have undergone the situation might not be able to properly understand it. There are both superficial reasons and deep rooted reasons for explaining the occurrence of an incident. Sometimes, superficial reasons and deep-rooted reasons are very different. Furthermore, many economic problems are counter-intuitive. How to properly understand and interpret history will always be a challenge for economists and policy makers alike.

As I have said, in late 80s and early 90s, the financial industry was not segmented in China. The disorder financial industry witnessed in early 90s was caused by many reasons, including the lack of legislation, supervision, expertise, internal control and accounting standards. The financial eco-environment then would inevitably give rise to problems. In the first part of 90s, commercial banks were requested to terminate their international business company and credit card company, because many of the disorders were thought to have originated in non-banking companies created by commercial banks. In retrospect, many banks still feel that a separate credit card company to run the business was a meaningful exploration. Later on, problems occurred in the stock market and capital market, leading to the perception that it was a dangerous thing for fund to flow from banks into the stock market. At the same time, in consideration of what happened in the Great Depression, the banking and securities sectors were further segmented.

In 1999??one reason that the four big commercial banks established four asset management companies was that *Provisions on the Management of Asset Management Companies* could provide them with some flexibility in disposing of NPLs, flexibilities that were beyond the reach of commercial banks. For example, asset management companies could do debt equity swap, but commercial banks were not allowed. Other methods of asset disposal by asset management companies were also not allowed in the case of commercial banks. The purpose of establishing asset management companies was to dispose of NPLs in a flexible manner. Of course, large-scale transfer of NPLs out of commercial banks might not be possible in the future; rather, commercial banks will resolve the problem assets on their own. Therefore, if commercial banks are still constrained by the rules of segmented operation in investment, share-holding and asset disposal, their ability to dispose of NPLs will be limited. In addition, asset management companies also hope to further enhance their capability by establishing their own securities companies to put the assets under their management on the capital market. There should be new considerations and arrangements. We are in favour of reviewing and interpreting history in our endeavor while moving forward. This will help us find a correct way of thinking and create a necessary environment for experimenting cross-sector operation in the financial sector as put forward by the 5th Plenum of the 16th CPC National Congress.

III. The experiment with cross-sector operation must proceed steadily, because such operation needs a large pool of high quality talents and risk control capability.

We all know the importance of talents. Risk control has increasingly become the core of financial sector performance as a result of the increasing complexity of financial businesses and products, yet not all people have realized it. In China, many financial institutions have begun to pay attention to risk control only in recent years. Thus, risk control is rather weak. In many large financial institutions abroad, risk control department is very important and powerful, so much as that the Risk Control Officer is in a position to reject what the President has said. Therefore, when we explore cross-sector operation and new cross-sector products, importance should be attached, first and foremost, to talents and risk control. Otherwise, problems of one kind or another might emerge in the piloting operation. Problems are not bad things for experience could be accumulated in the process. But problems in the financial sector usually will slow down the reform and experiments.

IV. In the steady progress of cross-sector operation, not all financial institutions will adopt the pattern of cross-sector operation.

Every financial institution has its own development strategy and features, and needs to consider how to position itself in the market, on the basis of the specificities of its clients and what kind of services to provide to such clients. In many countries, after the restrictions of segmented operation were lifted, especially after the Bank Reform Act was adopted to lift control in 1999 in the U.S., not all financial institutions rushed to expand their business into other sectors. Decisions on whether to conduct cross-sector business or continue to focus on some businesses should be made by a financial institution after careful deliberation, based on its strength, development strategy and the specific characters of operation.

V. Central bank and regulatory authorities face challenges in the piloting cross-sector operation.

First of all, the quality of supervisors should be improved. They need to have knowledge of all kinds of financial businesses. Of course, this will take some time. Second, given the framework of segmented supervision, coordination among the three regulatory agencies should be strengthened, and functional supervision stressed. The agency who gives license to financial institutions should not be the one to approve all the businesses of all financial institutions. Rather, financial institutions should be supervised according to the type of their businesses. Many new issues relating to functional supervision should be studied.

As for the role of central bank, through its payment and settlement system, it provides a platform for various kinds of financial activities; on the other hand, because contagious risks usually come from deposit taking institutions, a deposit insurance system and other mechanisms to protect investors, depositors and the insured will quickly dissolve and reduce the risks as they arise. Finally, the central bank needs to look at the systemic risks in the entire system. When systemic risks do arise, prompt and proper action shall be taken in terms of monetary policy and liquidity based on domestic and international experience, in order to alleviate the damage on the financial industry and the national economy.

In conclusion, when we steadily promote the pilot cross-sector operation in the financial industry, the legislature, central bank and supervisory agencies are faced with new challenges. In the direction set by the 5th Plenum of the 16th CPC Central Committee, we will strive to do a good job in every area to make effective progress and accumulate more experience.

Thank you.