Zhou Xiaochuan: Capital Accord II and regional disparities in financial risks

Speech by Mr Zhou Xiaochuan, Governor of the People's Bank of China, at the Seminar on Risk Management and Internal Control of the Commercial Banks, Beijing, 8 January 2004.

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It is a great pleasure to attend and speak at this important seminar. The subject of the seminar is of particular relevance at a time when the State council just took the decision to recapalize the two large state-owned commercial banks. The significance of the capital infusion lies not only with the strengthening of the capital base of the two banks, but also with the important signals it sends to the outside world, indicating banking reform will be accelerated with more decisive actions to improve internal management and corporate governance of the commercial banks. I believe this seminar could make an important contribution to promoting internal reform, in particular the internal control and risk management of the commercial banks.

I will focus my speech on one important aspect of risk management, which deals with Basle Capital Accord II and the regional disparities in financial risks across China. Basle Capital Accord is an important document in terms of banking supervision and the Chinese banking regulatory authority has committed to pushing forward its application in the banking sector. While emphasizing the importance of capital adequacy in the business operations of the commercial banks, the Capital Accord has also set a clear definition for bank capital, leading to the development of such concepts as tier-one capital and tier-two capital, and answered the question on how the asset risks could be properly calculated. In 1988, the Basle Banking Supervision Committee assigned respective weightings to different categories of risks in its first edition of the capital accord, which was quite necessary at that time. Because many banks back at that time could not rely adequately on themselves to identify and measure the risk profiles of different categories of loans. However, it remains disputable as to whether such risk weightings should be assigned based on the status of a country in an organization, i.e., as a member of the OECD or not. Later on, some progress was made and a new capital accord (Capital Accord II) was formed in which more emphasis was put on risk management. Despite different views on its application in reality, Capital Accord II marks an important step forward in strengthening prudent banking supervision. The Chinese banks and the regulatory authority also welcome such a development and vow to actively push for its implementation across the banking sector. Capital Accord II particularly calls for strengthened identification and assessment of risks by the banks themselves, which means each bank should be able to conduct internal risk rating on each category of assets according to its own historical or realistic data. This is what we call "internal rating based approach (IRB)". Such a practice has already been adopted by some Chinese banks. For example, some banks have conducted assessment of credit risks based on classifications of the borrowers. Some based their risk rating on the business size of the borrowing enterprises while others referred to the ownership structure of the borrowers in deciding the risk profiles. What I would like to stress here is that classification of risk profiles by geographical regions also has profound significance. Theoretically speaking, in a country where capital freely moves without any restrictions, there might not be a visible difference in respect of credit risks across different regions, and we have actually seen this situation in many countries. However, in a big country like China, such a regional risk difference is relatively distinct since many of China's provinces are even larger than some of the countries in the world. On the other side, capital has not been able to move freely within China in the transition process from the centralized planning system to the market economic system, which indicates risk differences across the regions could not be neglected. Several years ago when the regional risk difference was at its high level, the NPL ratio in the regions with worst risk profiles could be 10 times higher than that in the regions boasting the best risk performance.

Some experts have made many studies on the reasons behind such a regional difference in terms of financial risks, which could be summarized as follows. First, different degrees of intervention in banking business by the local governments have contributed to regional financial risk difference. Second, different performance of the judiciary system and law enforcement across the regions has led to different protections for the rights of the creditors and support for the financial institutions. For the four asset management companies established in 1999 to speed up the disposal of non-performing assets in the commercial banks, they need support from the judiciary and law enforcement departments in each region in the process of asset recovery. However, due to the difference in support they received from these departments, the recovery ratio of even the same category of assets posed sharp difference among different regions. Third, commercial culture has developed in different ways across the regions. Though only a temporary phenomenon by nature, cronyism or nepotism once heavily penetrated commercial activities in certain regions, contributing to the high stockpile of non-performing loans. Fourth, before the State Council called for a stop in commercial activities by the army and public security forces several years ago, some military units had engaged in such activities and even infiltrated into business operations of the financial institutions. This meant some delinquent borrowers, protected by such special forces, could turn a blind eye to the regulatory pressures and refuse to honor their debt obligations. Although it is no longer the case right now, the associated non-performing assets have yet to be completely disposed of. Fifth, in the past, the commercial banks adopted a credit quota system under which credit funds were allocated to each province and municipality according to a specified quota. In this case, the commercial banks found it very difficult to move fund from one province to another, for the local governments would oppose to such a fund movement. Therefore, fund outflow was not a concern for governments in those areas with high financial risks. Moreover, China's banking regulatory architecture in the past was also built along the administrative structures, which to some extent has obstructed free fund movement within the country.

The reasons behind the regional disparities in financial risks that I listed above may not be complete. With the deepening of the reform, some positive changes are taking place in terms of the overall financial environment. For example, internal control and risk management of the commercial banks are being steadily improved, some banks have started to introduce the internal rating system to assess their credit risks on a pilot basis, and financial resources are starting to flow from the high-risk areas to those areas with low risks. I believe such positive changes will attract the attention of the local governments in China.

As we all know, quite a number of commercial banks have their own internal risk ratings for each province and municipality in China, but they are usually not willing to disclose them to the public. Some rating agencies and credit information companies are trying to peep into these internal rating results. I think such efforts could finally lead to a total or semi transparency of the risk ratings set by commercial banks for different regions. This will further create a pressure on those high-risk areas to improve their financial environment or their "regional financial ecological environment" as some people call it. In order to secure more financial resources from the commercial banks to support regional economic development, many local governments have vowed to further improve their regional financial environment, and some even view the enhancement of local financial environment of the same importance as improving the local investment environment. In one word, this perception has marked a sharp difference from the past. Many people used to hold the view that banking credit was actually confined to local use and the credit risks of the national commercial banks could be transferred to the government. Now I am pleased to see some positive changes. From the perspective of the commercial banks, they are able to move credit fund from the high-risk areas to areas with low risks. They can also float the lending rate to reflect the financial risk difference among various regions. Form the point of the local governments, they now care about not only the local financial environment, but also the quality of the local customers of the financial institutions. That is to say, they stress much about the creation of a sound local credit system under which businesses in the region must fulfill their fiduciary and debt obligation. Apart from that, public listing companies in the region are also encouraged to timely disclose reliable and quality information so as to lay a solid reputation for other companies in the region seeking public offering. In my view, these are important and positive progress which owes much to the efforts of both the local governments and the commercial banks. However, we must recognize that these efforts only mark the beginning of a long process, and the remaining regional risk difference means the internal risk rating will continue to be applied in the foreseeable future.

As the final note, I would like to point out that, despite the above progress, much remains to be done to eliminate the regional financial risk difference in China. Regional segregation and disparity once has been a major obstacle to China's economic reform. But I believe the market forces will finally prevail. With the implementation of the Basle Capital Accord II and the IRB, better microeconomic fundamentals will gradually emerge as the local governments strive to improve the regional financial ecological environment and the interactions between the financial institutions and the local governments further strengthen in a positive way.

I wish the seminar a great success, thank you all.