The Chinese financial system in the age of globalisation: marketisation, structural balance and stable development

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I. International context of globalisation

Since the 1980s and the emerging international context of globalisation, the Chinese financial sector, and the commercial banking sector in particular, has undergone successive reorganisation. These reorganisations had the following results::

First, financial institutions have more room for internal manoeuvres due to changes in the following policies: less government control over interest rates; reduced state intervention in banks' credit policies; fewer restrictions imposed on financial institutions, competition encouraged in the financial sector; the robust development of direct financing.

Second, with fewer capital and exchange rate controls, the external environment in which financial institutions operate has been increasingly liberalised. Similarly, currency — one of the main activities of financial institutions — has undergone a remarkable transformation as far as stability and its international positioning are concerned. Moreover, capital controls are less restrictive due to factors such as world imbalances and pressure to revalue the yuan.

II. Management and operation methods shift towards marketisation

Financial institutions have undergone sweeping reorganisation of their operational objectives, management methods and the way in which they function, to order to conform to marketisation objectives. Two typical examples are state-owned banks (SOB) quoted on the Stock Exchange and fewer barriers between separate financial activities.

1. Quotation of state-owned banks on the stock exchange

Since the beginning of the free market reforms, the state-owned banking system has lagged behind in terms of innovations necessary for the changing economy and the external environment. This situation has affected the competitiveness of SOBs and to the ability of the financial system as a whole to deal with risk. As China faces pressures resulting from its WTO membership and the competitive challenge of foreign banks, SOBs have successfully responded to the challenges by going public and reforming their shareholder structure in a context where the right to majority control is retained by the StateBy being listed on the stock exchange they not only expanded their sources of financing, but also clarified property rights and improved the administrative structure and efficiency of both management and operations.

2. Trend towards fewer barriers between financial activities

The economy is becoming increasingly financial and finance is becoming increasingly market-oriented due to the force of globalisation and marketisation. Following successive economic and financial structural reorganisations, the organisational forms of the financial sector have undergone further modifications, and cross-pillar activity among various financial institutions is becoming more frequent. In addition to formal collaboration between banks and investment companies, insurance companies and investment funds, the financial holding structure whereby a single company controls the shareholders, but is legally subdivided into several companies, has won over many financial institutions. Currently, a relatively large number of such holding companies have been created in China, but the potential risks of these holdings must not be neglected.

III. Micro and macro risk-management

1. Changes in financial institutions' balance sheets

From a capital standpoint, funds from savings make up the most stable portion of financial institutions' equity. The stability of sources of capital of thee financial institutions will be tested by population aging. The proportion of doubtful assets also remains relatively high, which seriously tarnishes the image of the financial institutions and the stability of their activity. Risks of maturity and currency mismatching have also begun to develop in the balance between assets and liabilities.

2. Macro risk management

There are many macro risk management techniques. These can be divided up into three main categories:

1) Creating macro policies that can absorb economic shocks and reinforce financial stability.

At present the main sources of financial instability lie in the excessive price fluctuations of financial assets and in world economic imbalances. This is why, from this point on, monetary policy should focus on eliminating these two risk factors. Cautious budgetary policy and stable public debt policy are also important instruments to protect against risk.

2) Optimisation of the financial market and financial asset structure

In order to actively develop the corporate bond market it is necessary to: clarify who is responsible for the cost of risk and create institutional investors; form intermediary bodies; perfect the bond rating system; improve trusteeship structures and bond settlements; reinforce the coordination between regulatory structures such as the Ministry of Finance, the National Development and Reform Commission, the People's Bank of China and the China Securities Regulatory Commission; apply functional regulations.

The reform of the shareholder structure and the fund management system have allowed the Chinese Stock Exchange to take a strategic step forward. In the future, strategic change will mainly concern the following: a radical shift in the sources and structure of finance; strategic reorganisation of capital sources and shareholder structure in order to promote the creation of a group of "star" securities.

3) Optimisation of the regulatory system and the reinforcement of means to enforce the system

In order to increase the financial sector's ability to withstand risk, the system must go from a purely cautious regulatory system to a regulatory system that combines risk management and conformity with prudential rules. This kind of risk management-based concept would be a step towards the creation of a complete system based on scientific, rational indicators to regulate external risks, bring together the regulatory model and a risk management system that would offset gaps in the regulations and smooth over any shortcomings. In short, the regulatory method of the future would be a global process that focuses on imperatives and is capable of managing diversity in the regulatory context — which implies the use of internal and external regulatory models.

3. Micro risk management

Pursuing corporate governance reforms

As companies go public and ownership rights are clarified, it is necessary to establish an optimal system with clear incentives and restrictions that meet free market criteria. It is also important to improve corporate governance efficiency by: greater personnel management reforms, a rational recruitment and senior management selection system; creating an incentive-based system; resolving the problem of cheap voting rights. It is also necessary to find the best way to enable management to protest against the decisions of their superiors, to create an annual salary grid, a stock option system and the possibility of management buy-outs, which would resolve any contradictions between short and long term incentives. Other measures would include: improving and perfecting the internal control system to prevent management induced moral hazards; reinforcing control, surveillance, audit and evaluation of operational activities; improving communication among top managers; verifying the completion of top managers and directors' assignments during and at the end of their mandates; reinforcing surveillance and verification; severely punishing actions that break rules, discipline standards or laws; promoting the marketisation of the distribution system; creating jobs inside the company in line with market principles and matching salaries with professional merit through the use of fair and transparent public evaluation mechanisms. Finally, a healthy corporate governance structure in the banking sector must also have an excellent public relations/communications department to make the bank's activities as transparent as possible in line with Basel Committee requirements.

The efficiency of the corporate governance structure applied to Chinese SOBs continues to be influenced by many restrictive factors such as the operational and legal environment, the state's reputation, the stage of development of the financial markets and the People's Bank of China regulations. Coordination with macro policies is therefore essential.

Creation of a global risk management framework

This framework is based on, and implemented around, three main poles. The first concerns the evaluation of funds necessary for specific strategic activities. This is carried out by banks according to their risk preference. The second consists of establishing a credit quota system corresponding to the funds required and ensuring that activity-related risk remains within the preferential framework set by the bank. These quotas must then be controlled and enforced. The third consists of performance evaluation and adjustments for each activity according to the risk involved, as well as estimating and improving the results of the risk strategy in order to balance the relationship between risk, profit and growth.

The organisation, process, instruments and risk management system should work together to accomplish risk management goals. In order to achieve this it is necessary to establish a vertical risk management structure ; set up a firewall to protect human resources, communications and the business functions; reinforce internal control; develop diverse tools and risk evaluation systems; create an efficient structure for communicating risk-related information to superiors in the corporate hierarchy, etc.