Banking

Beyond Basel III: The future of high performance in Chinese banks
By Albert Chan, Ying Wan, and Jacky Yang

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Executive Summary

While Asian banks were not seriously shaken by the global financial crisis, the downturn and greater competition did push many to explore new markets. This has led to banks taking on more risk in operational areas, such as political risk in new markets; overcoming cultural challenges; and managing local governance. Asian banks also increased systems integration risk as they sought to increase efficiency.

To date, Basel III has had little impact on the relatively closed and successful Chinese financial system. Chinese commercial banks have in fact witnessed an improvement in asset quality in recent years due to the country’s booming economy. They also enjoy increasingly solid capital reserves. However, the rapid development of China’s banks has depended heavily on income from net interest margins averaging almost 2.5 per cent. This ‘spread’ (the difference between the interest banks pay on deposits and the rate they offer to customers) has been high by international standards due to government protection. In addition, this type of growth has required significant capital, which means banks face increasing pressure due to Basel III’s stricter capital supervision rules.

Another source of pressure for Chinese banks is declining savings rates caused by inflation rates exceeding interest rates offered by banks. This will exert liquidity pressure on banks as they implement Basel III.

The combination of these factors will put long-term pressure on China’s banks to broaden their income sources and better manage risk by transforming their operating models. The challenge will be finding ways to save capital to meet Basel III requirements. At the same time, many banks are grappling with developing quality corporate clients, expanding their retail business, and expanding high-end financial services. These goals are posing challenges in their own right, including: identifying quality clients; developing accurate pricing strategies; measuring the contribution made by clients and products to profit; determining how to accurately calculate risk exposures; and accruing sufficient capital reserves.

Against this backdrop, Accenture recommends China’s commercial banks focus on developing a broader business portfolio of products via strengthening their retail and SME businesses; and improving their ability to quantify risk and monitor performance. This is achieved by building an integrated risk and performance management system, which enables banks to more effectively manage their client and product portfolios, better manage risks, and reduce costs.

These actions would form a solid foundation for Chinese banks seeking strategic transformation; increased effectiveness and efficiency.
Basel III and its Global Impact

Introduction to Basel III

The 2008 global financial crisis moved the preparation of the New Basel Capital Accord, known as Basel III, higher up on the global regulatory agenda.

In September 2010, regulators from major countries around the world approved and released Basel III. At the Seoul Summit in November 2010, the G20 discussed collaborative risk management and agreed, in principle, on the Basel III regime.

Compared to Basel II, Basel III includes the following changes:

• Enhanced quality, sustainability, and transparency of capital composition
• Enhanced capital coverage and greater capital requirements for securitized positions, trading accounts, and derivatives
• Use of a simple leverage ratio index to reduce the risks caused by errors in models and risk measurement
• Efforts to reduce “pro-cyclical” and increase “counter-cyclical” capital buffers
• Introduction of a unified minimum liquidity criteria to cover liquidity risk that was not addressed by Basel II
• Requires SIFIs to increase capital and liquidity, and implement additional supervision policies to curb the “external effect” those institutions have on the global economic system when they are in trouble.

Western banks under pressure

Stricter supervision

Although the international community has not officially approved Basel III, the profound impact of the financial crisis has led Western governments to start implementing stricter supervision measures. Many of these measures are based on the guidelines and rules set out in Basel III.

In the United States (US), the government has promulgated the Dodd–Frank Wall Street Reform and Consumer Protection Act, committing itself to creating a more solid and rigorous supervision system. Regulatory bodies in European countries have also taken measures to increase supervision. Swiss regulatory bodies put in place a more conservative capital requirement than that regulated in Basel III. This is called the Swiss Finish and has been introduced even though Swiss banks have more capital than their European peers.

Proactive on reform

Having learned a bitter lesson from the 2008 financial crisis, many Western banks are proactively making changes in line with Basel III.

Banks are reviewing their trading operations and de-leveraging their business to meet the new accord’s higher capital requirements. New limits on securitization techniques have also barred large American and European banks from packaging and selling loans in ways designed to avoid supervision.
US banks examine their models

A survey by Accenture showed that after the Dodd–Frank Wall Street Reform and Consumer Protection Act was approved, 66 percent of American financial institutions believed changes in supervision would force them to examine their current business models. Key reform areas included:

- Reflecting the result of risk management on performance management
- Improving the automatic production of financial and supervision reports
- Building more accurate pricing models
- Creating products that reflect changes in customer risk appetite to better adapt to the new economic and regulatory environment
- Analyzing risk exposure and risk level of counterparties more thoroughly to avoid the "domino effect" seen in the financial crisis.

Basel III in Asia

The 1997 Asian financial crisis raised the importance of risk management, leading Asian banks to avoid holding large exposures that can arise from structured products. This action protected Asian banks during the global financial crisis and today major banks typically hold more capital than required by Basel III. Even so, Asian banks face new risks arising from innovations in business development and technology.

Banks from developed Asian economies (Japan, Korea, and Singapore) are seeking to overcome business saturation at home by expanding their geographic footprints. Many traditionally conservative Asian banks are also attempting to enter the capital markets business as they seek new sources of revenue. However, they lack experienced financial professionals required to operate and manage risk in this area. This has stalled their business expansion plans and increased their risks of further domestic business saturation pressures.

Furthermore, Asian banks have generally under-invested in technology, exposing them to higher operating risks. Many banks are still operating old IT platforms with substantial functional overlaps, creating significant systems integration challenges.
Major Changes in Basel III

1. Adjustment in capital composition

Basel III adjusts the definition of capital composition, making it more transparent and stringent. The biggest impact of Basel III is that it significantly elevates banks’ primary capital adequacy ratio requirements, stipulating that Tier 1 capital must be composed of common shares or retained earnings. The ratio of Tier 1 capital has been raised to 6 percent. The composition of Tier 2 capital has been simplified and increased to 8 percent. There is no longer a requirement for Tier 3 capital (Figure 1).

Due to significant changes in the capital composition standard, the Basel Committee has outlined a timetable for the banks to meet the supervision requirements, with full compliance required by 2018, allowing banks small incremental increases on an annual basis. Figure 2 outlines the timeline for changes in capital composition requirements.

2. Enhanced risk coverage

In terms of credit risk, Basel III amends the current framework to simplify large exposure limit requirements and introduces the concept of risk exposure limits.

On securitization risks, Basel III strengthens supervision over securitized credit. Compared to other forms of securitization, Basel III imposes higher capital requirements on re-securitized positions to reflect the higher risk of unexpected losses. Moreover, Basel III toughens disclosure requirements for securitized positions. In future, disclosure should not only include risks of securitized positions in bank accounts but also related position risks in trading accounts.

With regard to market risk, Basel III raises capital requirements for counter-party credit risks involved in trading account positions, derivatives, repos (sales and re-purchases of highly liquid collateral), and bonds.

3. Introduction of “Leverage Ratio”

Basel III introduces the concept of a “Leverage Ratio” – the ratio between Tier 1 Capital and Total Capital Exposure – and sets the upper limit for this ratio at 3 percent. Tier 1 capital refers to the Tier 1 capital defined by the new accord. Total Capital Exposure refers to total capital without consideration of any kind of credit mitigation.

By introducing this relatively simple indicator, one solely based on total exposure, Basel III establishes a measure for additional risk calculation. This measure is designed to reduce risk from modeling and calculation errors to establish a bottom line for leveraged operation by different bank departments.

4. Reduced “Pro-cyclicality”

The Basel Committee is introducing a series of measures to increase banks’ capital buffers when times are good to make them more resilient during periods of economic downturn. These measures include:

- Introduction of the “Through-the-Cycle Provision” concept
- Adjustment of factors for internal rating, including adoption of a longer timeframe to calculate the probability of default (PD), or adoption of PD estimates for economic downturns.

While Basel II “suggested” the use of estimates of the loss a bank experiences at default (LGD), Basel III requires the use of these estimates

5. Determination of the liquidity standard

The Basel Committee is introducing minimum liquidity standards for all banks, including the 30-day Liquidity Coverage Ratio (LCR) and the long-term structural Net Stable Funding Ratio (NSFR), which requires:

- The LCR to be higher than 100 percent. In other words, financial institutions must ensure they have adequate, high-quality current assets to support operation for one month during severe conditions.
- The NSFR must be higher than 100 percent, so that, under structural economic pressure, a financial institution can provide stable financing sources to provide funding for its operation over one year.

- Introduction of Capital Conservation Buffer, with a ‘standard’ set at 2.5 percent
- Introduction of Counter-Cyclical Buffer, with the ratio increased from nil to 2.5 percent.
Figure 1: Basel III capital composition requirements

<table>
<thead>
<tr>
<th>Tier 3 Capital</th>
<th>Tier 2 Capital</th>
<th>Tier 1 Capital</th>
<th>Pre-Basel III capital ratio</th>
<th>Basel III capital ratio</th>
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Figure 2: Basel III capital composition requirements

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<td>Leverage ratio</td>
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<td>% of minimum common shares</td>
<td>3.5%</td>
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<td>Capital conservation buffer</td>
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<td>Gradual deduction from CET 1</td>
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<td>DTA, MSR and the upper limit</td>
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<td>Minimum Tier 1 capital</td>
<td>4.5%</td>
<td>5.5%</td>
<td>6%</td>
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<td>Minimum total capital</td>
<td>8%</td>
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<td>Minimum total capital and</td>
<td>8%</td>
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<td>8.6%</td>
<td>9.3%</td>
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<td>retained earnings cushion</td>
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<td>Liquidity coverage</td>
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<td>Net stable funding ratio</td>
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Source: Bank for International Settlements
Basel III and China’s Commercial Banks

Limited short-term impact

Since the Asian crisis of the late 1990s, Chinese banking regulators have focused on improving the quality of banking assets. The nation’s commercial banks have in turn made progress in terms of both asset quality and capital adequacy. Today, the capital structures at Chinese commercial banks are very healthy from a Basel III perspective, because they mainly comprise share capital and subordinated debt. Even the subordinated debt is not seen as significant, which means Basel III has had a limited impact on China’s commercial banks. Figure 3 lists capital adequacy ratios for major Chinese listed banks.

Long-term implications

Despite the limited short-term impact of Basel III, China’s commercial banks cannot relax. As economic growth slows and structural adjustments increase, the Basel III accord presents commercial banks with some tough challenges.

Figure 3: Capital adequacy ratio for major Chinese listed banks

<table>
<thead>
<tr>
<th>Commercial banks</th>
<th>Capital adequacy ratio (%)</th>
<th>Core capital adequacy ratio (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industrial and Commercial Bank of China (ICBC)</td>
<td>12.27</td>
<td>9.97</td>
</tr>
<tr>
<td>China Construction Bank (CBC)</td>
<td>12.68</td>
<td>10.40</td>
</tr>
<tr>
<td>Bank of China (BoC)</td>
<td>12.58</td>
<td>10.09</td>
</tr>
<tr>
<td>Agricultural Bank of China (ABC)</td>
<td>11.59</td>
<td>9.75</td>
</tr>
<tr>
<td>Bank of Communications (BoCom)</td>
<td>12.36</td>
<td>9.37</td>
</tr>
<tr>
<td>China CITIC Bank</td>
<td>11.31</td>
<td>8.45</td>
</tr>
<tr>
<td>China Everbright Bank</td>
<td>11.02</td>
<td>8.15</td>
</tr>
<tr>
<td>China Merchants Bank (CMB)</td>
<td>11.47</td>
<td>8.04</td>
</tr>
<tr>
<td>Pudong Development Bank (PDB)</td>
<td>12.02</td>
<td>9.37</td>
</tr>
<tr>
<td>China Minsheng Bank (MSB)</td>
<td>10.44</td>
<td>8.07</td>
</tr>
<tr>
<td>Shenzhen Development Bank A (SDB A)</td>
<td>10.19</td>
<td>7.10</td>
</tr>
<tr>
<td>Huaxia Bank</td>
<td>10.58</td>
<td>6.65</td>
</tr>
<tr>
<td>Industrial Bank</td>
<td>11.22</td>
<td>8.80</td>
</tr>
<tr>
<td>Bank of Beijing</td>
<td>12.47</td>
<td>10.75</td>
</tr>
<tr>
<td>Bank of Nanjing</td>
<td>10.48</td>
<td>9.51</td>
</tr>
<tr>
<td>Bank of Ningbo</td>
<td>10.91</td>
<td>9.18</td>
</tr>
</tbody>
</table>

Source: Listed commercial banks’ 2010 annual reports.
Capital adequacy pressure

According to statistics from the People's Bank of China, China's central bank, over 80 percent of China's economy is funded via indirect financing channels. A key factor is the nation's high savings rate.

In contrast to high funding costs incurred by foreign counterparts, China’s savings ratio and the state's control of interest rates have enabled China's commercial banks to harvest substantial income from interest-rate spreads. According to their 2010 annual reports, the average net interest margin for China's listed commercial banks was as high as 2.46 percent and banks' net interest income accounted for 80 percent of their total income. The interest rate spreads and high reliance on loan interest income, coupled with Chinese companies' limited use of other financing channels, has pushed the country's banks to continue seeking growth in assets and, in turn, book profit. However, this type of expansion will create enormous supervisory capital pressure under Basel III and the wider international regulatory system. This is especially true for large domestic Chinese banks, which face higher supervision requirements from the China Banking Regulatory Commission than the capital adequacy ratios stipulated in Basel III.

Apart from meeting capital requirements, banks must ensure they possess sufficient capital to respond to losses from economic fluctuations or mismanagement.

The rapid increase in China’s credit assets and changes to its economic structure are exposing banks to higher risks, which will require them to hold more capital than is required by regulatory authorities. However, as the banks’ retained earnings won't provide enough capital to meet even their regulatory requirements, banks will need to turn to the market to address this capital shortage.

Over the past few years, regardless of their public promises, many commercial banks have sourced funds via the capital markets, thereby increasing stock volatility. Witnessing such changes in the market, bankers feel keenly the dual pressures from regulatory bodies and investors making it even more difficult for banks to acquire capital smoothly and promptly in case of capital shortage.

Liquidity pressure

In addition to amending capital adequacy ratios, the Basel Committee included a related requirement on liquidity in the new capital accord. This update has major implications for Chinese banks; it arose as a result of the liquidity challenges faced by major financial institutions in Europe and the US.

According to the figures disclosed in the 2010 annual reports of China's listed banks, although overall loan-to-deposit ratio of listed banks satisfied the 75 percent benchmark, after years of rapid expansion, national joint-stock commercial banks reported an average loan-to-deposit ratio of 73.4 percent, indicating a heightened liquidity risk.

On the other hand, the transformation of China's economy has driven up inflation. Despite the central bank increasing interest rates, the benchmark one-year deposit rate is still only about 3 percent. By comparison, domestic consumer prices rose 5.3 percent in the year to April 2011.

This means the actual savings interest rate has been negative, leading to a slowdown in the growth of savings. This slowdown in savings growth not only threatens banks’ lending business but also their profits as they offer higher interest rates to win business. Figure 4 illustrates growth rates of savings and loans for five large state-owned Chinese banks.

Figure 4: Growth rates of savings and loans for five large state-owned banks 2009 – 2010

![Figure 4: Growth rates of savings and loans for five large state-owned banks 2009 – 2010](source: Commercial banks' 2010 annual reports)
**Business transformation directions**

Faced with greater challenges in terms of capital adequacy ratios and liquidity, China’s commercial banks have looked to the experience and array of product used by their Western counterparts. As figures 5 and 6 illustrate, world-leading banks are vigorously developing capital-saving products and growing non-interest-related income to contribute more than half of their total incomes.

**Figure 5: Business composition of large international banks**

![Business composition chart](image)

Source: Banks’ 2010 annual reports

**Figure 6: Income composition of large international banks**

![Income composition chart](image)

Source: Banks’ 2010 annual reports
Learning from leading foreign banks

Based on the practices of leading foreign banks, China’s commercial banks are adjusting their product and income structures creating capital-saving business models. This often involves focusing on retail lending, lending to small and medium enterprises (SMEs), offering intermediary services and entering the capital markets business.

Britain’s Barclays Bank provides an example of a model, that many Chinese and foreign banks aspire to emulate. Figure 7 shows the various sources of the bank’s income.

Challenges for Chinese banks

A challenge for China’s domestic, commercial banks is continuing to develop their corporate banking businesses amid growing competition.

For historical reasons, the majority of Chinese commercial banks’ loan business are corporate loans contributing over 70 percent of banks’ business and generating larger spreads than retail products. However, corporate loans have a higher risk of default compared to retail loans, thus eroding the higher net interest margin gained via credit loss.

These trends are driving China’s commercial banks to shift their strategic focus from corporate to retail banking. However, this does not imply banks will cease providing corporate loans given they still provide the majority of income.

The key challenge therefore, is how to devote their limited resources to secure the most profitable clients in both the corporate and retail markets. They are also asking detailed questions about profitability at a per-customer level, such as how much income do specific high-quality customers deliver, and whether customers with huge savings and corporate loans are truly profitable.

Improving retail and SME business

In its 12th Five-Year Plan, released in March 2011, the Chinese Government committed to increasing the nation’s household wealth, and vigorously supporting technological innovation and independent innovation. This will create enormous opportunities for the development of retail and SME lending businesses.

Compared to corporate business, risks from retail credit business are more systematic and can be mitigated through quantitative risk management techniques. Banks also have greater pricing power in retail and SME credit, enabling them to better accommodate risk and other factors to reach higher profit levels.

Figure 7: Income breakdown at Barclays Bank: 2008 – 2009

<table>
<thead>
<tr>
<th>Profitability analysis by business lines</th>
<th>U.K. retail banking business £m</th>
<th>Barclays commercial banking business £m</th>
<th>Barclays card business £m</th>
<th>GRCB – Western Europe business £m</th>
<th>GRCB – Emerging market business £m</th>
<th>GRCB – Asia Pacific business £m</th>
<th>Barclays capital £m</th>
<th>Barclays global investment business £m</th>
<th>Barclays wealth management £m</th>
<th>HQ and other department expenses £m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net interest income</td>
<td>2,624</td>
<td>1,741</td>
<td>2,723</td>
<td>1,182</td>
<td>743</td>
<td>1,300</td>
<td>1,598</td>
<td>43</td>
<td>504</td>
<td>(507)</td>
</tr>
<tr>
<td>Fees and commissions</td>
<td>1,225</td>
<td>926</td>
<td>1,271</td>
<td>438</td>
<td>232</td>
<td>943</td>
<td>3,001</td>
<td>1,757</td>
<td>802</td>
<td>(418)</td>
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<tr>
<td>Trading income</td>
<td>-</td>
<td>(26)</td>
<td>22</td>
<td>123</td>
<td>68</td>
<td>123</td>
<td>7,021</td>
<td>98</td>
<td>20</td>
<td>(325)</td>
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<td>Net insurance contract premium</td>
<td>198</td>
<td>-</td>
<td>44</td>
<td>544</td>
<td>-</td>
<td>294</td>
<td>5</td>
<td>-</td>
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<td>92</td>
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<td>Other income</td>
<td>6</td>
<td>112</td>
<td>2</td>
<td>8</td>
<td>2</td>
<td>60</td>
<td>-</td>
<td>5</td>
<td>7</td>
<td>1,186</td>
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<tr>
<td>Total income</td>
<td>4,053</td>
<td>2,753</td>
<td>4,062</td>
<td>2,295</td>
<td>1,045</td>
<td>2,720</td>
<td>11,625</td>
<td>1,903</td>
<td>1,333</td>
<td>28</td>
</tr>
</tbody>
</table>

Note: GRCB refers to Global Retail & Commercial Banking.
Source: Barclays Bank 2009 annual report.
To date, the majority of retail business for China’s commercial banks has been housing loans. These loans have been a key driver in the rapid development of the nation’s prosperous – and unprecedented – real estate market. However, banks are being forced to reconsider their development strategies as more severe bubbles arise in the real estate market, and as the Chinese Government introduces policies designed to curb the growth of housing prices.

When commercial banks extend into other retail lending areas such as credit cards, consumption loans, and car loans, as well as SME loans, banks will find they are poorly prepared to operate in these new areas. The danger is ending up with a high non-performing loan (NPL) rate due to a lack of capacity to manage these products, which are more lucrative but also more complex than housing loans.

In the face of an increasingly prosperous retail loan market, banks must consider whether to continue vigorously expanding their housing loan portfolio and, if so, how to do it more effectively. Where they do decide to enter riskier and potentially more profitable product areas, they must also consider how to accurately price products with different risk levels to secure adequate profits.

**Accelerating capital markets business**

Apart from being the most capital-saving area, intermediary services offer banks a distinct way to leverage their huge franchises and financial expertise. China’s commercial banks do offer a large range of paid services, but have failed to deliver adequate added value and have been criticized in the media. Having also learned from Western experiences, China’s commercial banks are recognizing the path to success in the intermediary arena lies in agency commissions and service-fee income from selling high-end capital market services. Figure 8 compares the income composition of intermediary services for domestic and foreign banks. Income from capital market services forms a major revenue stream for leading international banks. In fact, more than half of the investment income at many banks is derived from their capital market business. Although structured products such as derivatives brought huge losses to Western banks during the global financial crisis, banks can profitably engage in this business by using enhanced risk management and product screening techniques.

However, to vigorously develop their capital market business, China’s commercial banks must work within rigorous regulatory controls and solve a range of other challenges. These include deciding how to accurately price or value advanced capital market products, and how to accurately calculate risk exposures as well as set and control limits. When calculating regulatory capital, they must also decide how to accrue adequate capital reserves in time to achieve compliance with Basel III.

**Figure 8: Comparison of income composition of intermediary services: One China Bank and Bank of America**

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<th>Source: Listed banks’ 2010 annual reports</th>
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<tr>
<td><strong>One China Bank</strong>&lt;br&gt;Non-Interest Income</td>
<td><strong>Bank of America</strong>&lt;br&gt;Non-interest Income</td>
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<tr>
<td><strong>Card Income</strong>&lt;br&gt;Settlement Service Charge&lt;br&gt;Agent Service Charge&lt;br&gt;Consulting Service Charge&lt;br&gt;eBanking Service Charge&lt;br&gt;Commit Charge&lt;br&gt;Brokerage service&lt;br&gt;Other Income</td>
<td><strong>Card income</strong>&lt;br&gt;Service charges&lt;br&gt;Investment and brokerage services&lt;br&gt;Investment banking income&lt;br&gt;Equity investment income&lt;br&gt;Trading account profits (losses)&lt;br&gt;Mortgage banking income&lt;br&gt;Insurance income&lt;br&gt;Gains on sales of debt securities&lt;br&gt;Other income (loss)</td>
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Accenture’s Recommendations: Securing the Future

The challenges outlined in this paper are not solely confined to China. From the Basel Capital Accord to the New Basel Capital Accord III, banks have witnessed increasingly strict risk supervision.

At the same time, senior managers within banks have been looking beyond risk and asking how they can:

• Accurately estimate capital demand in future years
• Address increasingly serious liquidity issues and increases in funding costs
• Identify quality customers that will increase their profitability
• Differentiate pricing strategies for different customers
• Price and value complex financial products in complicated markets.

To meet the developing regulatory requirements presented by Basel III and to address the challenges arising as China’s commercial banks extend beyond corporate and residential housing-focused banking, Accenture recommends Chinese banks consider:

1. Strengthen capabilities in quantitative risk analysis to meet the demand of risk supervision and regulation
2. Develop a broader business portfolio
3. Build up a platform that integrates the management of risk and performance to meet the requirement for highly efficient banks.

1. Strengthen quantitative risk analysis

The deepening and detailing of regulatory requirements around the world shows that governments and regulatory authorities are becoming more aware of risk management within financial institutions. In turn, banks must improve their quantitative risk analysis capabilities.

The key to true risk calculation and management is consistent improvement in data collection and the use of quantitative techniques to facilitate the transformation from regulatory capital measurement to economic capital measurement.

However, it is not possible to improve quantitative risk analysis overnight. First, Chinese commercial banks must clearly understand the China Banking Regulatory Commission’s (CBRC) definition and explanation for related supervision indicators, especially the leverage ratio/liquidity requirement that has been added to the Basel accord. A thorough understanding of these terms will enable banks to complete their regulatory capital measurement in a more efficient and targeted way.

Second, China’s commercial banks need to stay abreast of the latest developments in risk measurement and quantitative models, and choose appropriate approaches based on their specific requirements.

There is a sharp difference in product portfolio, data integrity and risk management cultures between domestic and foreign banks, and even between different domestic commercial banks. The challenge for all banks is to implement risk management systems that are customized for their situations while meeting the CBRC’s industry-wide requirements and wider Basel III obligations. Beyond meeting these regulatory requirements, banks should focus on the ultimate goal of establishing a risk management system that delivers long-term benefits.

Third, Chinese commercial banks should develop their risk analysis capacities in a staged approach. To accelerate this process, they can review international best practice and leverage the knowledge and experience of external parties.

2. Develop a broader business portfolio

The high net interest margins enjoyed by China’s commercial banks will be eroded as competition intensifies and regulatory bodies tighten their requirements regarding bank capital. Recent changes in the way regulators assess deposit ratios is also prompting many Chinese banks to fight harder for customers’ savings.

With reference to the experience of banks in advanced markets around the world, Accenture recommends China’s commercial banks take steps to strengthen their retail and SME businesses. They should also focus on growing their intermediary service businesses, especially financial markets business.

To succeed in the large-volume businesses of Retail and SME, Chinese banks need to increase their efforts in quantitative risk assessment. This will allow their risk management teams to quantify client risks and attain balanced profits and risk-based pricing. Chinese banks should accelerate the development of modern credit management systems to improve customer satisfaction and enhance control over operational risks.
In respect to growing their financial markets business, Chinese banks need to increase their investment in high-end talent and systems to build competence and competitiveness in financial markets services. Based on lessons learned from the global financial crisis, China’s commercial banks should also build internal risk firewalls and implement other risk control measures to protect themselves from losses from structured products. Finally, Chinese banks should consider the higher capital reserve requirements associated with financial market operations, as defined by Basel III.

In short, when determining new and potentially highly profitable business strategies, Chinese commercial banks should carefully review related operational and management challenges. They should also focus on how they can best use their unique resources and advantages, while addressing their individual needs.

3. Integrate risk and performance management

Addressing the tough questions faced by China’s banks will require them to move beyond only developing areas of new business and the ability to calculate risks more precisely.

As indicated by Accenture’s internal research, risk management can assist financial institutions differentiate themselves and achieve excellence in times of financial turbulence. However, this requires that risk management is implemented across all parts of a bank, from corporate culture and incentive plans to business operations, financing, and operational decision making.

As part of Accenture’s Global Risk Management Survey, 85 percent of the individuals surveyed agreed that one of the lessons learned from the global financial crisis is that banks must better combine risk with strategy and performance management. This equates to what Accenture refers to as integrated risk and performance management (IRPM). This approach comprises a series of business processes, methods and techniques. It also gives banks a new perspective for monitoring, controlling, and managing their performance in a way that combines accounting and risk management processes.

To assist improve rates of return among banks after the global financial crisis, Accenture developed five key capabilities: cutting costs, more effective customer management, pricing optimization, more effective risk management, and pursuing inorganic growth. IRPM can contribute to the first four of these capabilities and enable banks to rebuild return on equity as outlined in Figure 9.

Figure 9: Five directions for rebuilding return on equity after the crisis
Unlike frameworks adopted by traditional companies, IRPM is seamlessly embedded into banks’ risk management systems to provide strong support for supervision from a customer’s perspective and overall management of all business units. This is illustrated in Figure 10.

The implementation of IRPM structures into world-leading banks, has delivered the following insights:

- Sufficient integration of risk management with performance is key to achieving real performance targets
- Performance indicators can better support the calculation of economic capital
- A risk-based pricing strategy is only possible if risk and performance are integrated
- An integrated system can transform performance evaluation systems from relying on observation of past behaviors to having the ability to support predictions.

In the long run and with the support of competent operational capacity, the integration of risk management and performance management can enable banks to meet regulatory requirements and protect capital. Importantly, it can also improve return on capital and shareholder value performance.

For Chinese commercial banks facing growing pressure in terms of capital adequacy ratios, the establishment of an integrated risk and performance management platform will form a critical foundation for their long-term and healthy development.

**How to build an IRPM platform**

Accenture’s research into risk management® revealed that while many world-leading banks had transformed their operations to adjust to new global regulatory and competitive requirements, the benefits of these changes had been undermined by a lack of attention to the integration of risk management and performance management. Over 80 percent of the bankers surveyed believed improvements were needed, especially in terms of data quality. Poor data quality, ineffective reporting systems and discrete systems were all adding to banks’ operating costs.

China’s commercial banks are in a similar situation. In the past few years, management accounting, balanced scorecard, risk measurement and Basel III-related compliance projects appear frequently in Chinese banks’ technology plans. The banks have poured huge financial and human capital investment into such projects, much of which has yielded positive returns. In particular, much headway has been made in data construction and basic function building. Further, individual business units have developed complete computing and management systems of their own.

However, when they look at the flow of data more carefully, banks find they are highly complicated, overlapping and inefficient. Faced with such complex data networks, banks’ senior executives often struggle to find answers to basic questions such as the capital cost for issuing one loan. The reason is that there are at least three yield curves produced by separate risk management, asset and liability, and accounting functions. Worse, all three curves come from different source data.

Accenture recommends that banks adopt the IRPM framework, which includes:

- Using a universal accounting and risk language
- Centralizing maintenance of computing engines and rules
- Employing powerful data management, standards, and controls, including “metadata” management tools
- Simplifying and optimizing risk and performance management procedures.

Business management procedures. The result is that management can better achieve their goals because they have more effective and reliable data.
Conclusion

The past few years have been a golden age in the development of China’s commercial banks. Alongside the growth of China’s economy, the nation’s banks have also experienced strong growth and increased profitability. China’s five major state-owned banks are now among the largest in the world. However, management skills growth within China’s banks has not always kept pace with the rapid expansion in scale.

Meanwhile, as significant progress will be made in the liberalization of interest rates during the government’s 12th Five-Year Plan, the Chinese banking market is set to become more competitive. Pricing will no longer be mandated through government orders and cost for various resources will go up. Combined with new regulatory pressures, particularly Basel III, China’s commercial banks will need to diversify their products and services through business innovation. They will also need to expand outside of China by opening branches and undertaking other measures.

With such market change and new business opportunities, senior executives at China’s commercial banks should carefully consider how to reform their business models. Drawing on the lessons learned in the Asian and global financial crises, Accenture believes China’s commercial banks should consider an integrated risk and performance management system to ensure their sustainability and profitability in today’s increasingly complex economic environment.

Together with a performance evaluation method that genuinely combines risk factors, such a system can be used to comprehensively review business activities and decision-making processes across banks, from high-level strategic planning to winning individual clients.

Next steps

Banks must establish a viable plan to gradually establish a fully integrated risk and performance management system. This will, in turn, require close cooperation between banks’ chief financial officers (CFO) and chief risk officers (CRO). For example, the accounting function will no longer only be concerned about the book profit, and risk managers won’t be confined to lowering risk levels.

Starting from business planning, the departments of the CFO and CRO need to find a balance between business development and risk control. Further, they need to form effective mechanisms and structures for implementing their collaborative decision making in every business line.

Banks must also start analyzing and integrating their data to establish a solid foundation for the entire IRPM system. This work is not simple – it goes beyond the financial analysis and risk measurement data that CFOs and CROs are typically required to produce. The improvement in data quality should be based on a bank-wide data management and control process that has buy-in from all bank staff involved in data management.

Finally, banks need to consider “smart growth” by using the figures from the integrated risk and performance system. Not all banks are positioned to develop retail banking businesses given that opening new outlets and hiring relevant staff would create financial pressure. Some might also lack the technology required to grow in retail and manage related business risks. However, the implementation of a performance appraisal system that incorporates risk factors would assist management, outside investors, analysts, and others to make effective decisions.
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