Promoting a Better Balance Between Financial Innovation and Regulation: China’s Experience

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### Some Theoretical Thoughts on Financial Innovation

<table>
<thead>
<tr>
<th><strong>Bounded rationality</strong></th>
<th>Market participants are rational, but to a limit; The more complex and unpredictable the markets are, the more risks and uncertainties we have.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Fallacy of Composition</strong></td>
<td>What holds true for part of a system does not hold true for the whole system.</td>
</tr>
<tr>
<td><strong>Principal-Agent Problem</strong></td>
<td>High degree of information asymmetry; The market players tend to bear excess risks for higher return without proper arrangement</td>
</tr>
</tbody>
</table>
# Financial Innovation: A Double-edged Sword

## Pros
- Creating new processes, new instruments, new markets and new institutions
- Managing individual risk
- Reducing transaction cost
- Discovering price and promoting resource allocation
- Providing market liquidity
- Broadening investor choices, etc.

## Cons
- Creating Information asymmetry
- Incentivizing regulatory arbitrage
- Provoking rent-seeking
- Declining marginal utility
- Creating unexpected systemic risks, etc.
Over-innovation is like over-speed driving

**Over-innovation**
- Easy credit
- Excessive leverage
- Complexity

**Over-speed driving**
- Step on the gas to accelerate
- Shift to higher gears
- Enlarge compressor displacement

- Bankruptcy
- Financial instability
- Kill yourself
- Hurt innocent others
Balance Between Financial Deepening and Excesses

A road to growth

Financial Deepening

Financial Innovation

Regulation & Supervision

Traffic rules and speed limits

Going too fast

Financial Excesses
Good or Bad Financial Innovation

**Good Financial Innovation**

- Able to effectively distribute the risks to the one who has the ability and willingness to take.

**Bad Financial Innovation**

- Always ends up with risk-mismatches, or accumulates excessive risks through over-innovating which goes far beyond the needs of the real economy.
1970-1990 price increase from 1.80 to 40 dollars per barrel
Sep. 2004 exceeded 50 dollars impacted by Iraq War
Jun. 2005 exceeded 60 dollars
2005 8 exceeded 70 dollars hit by Hurricane Katrina
12 Sep. 2007 exceeded 80 dollars
2 Jan. 2008 exceeded 100 dollars
5 May 2008 exceeded 120 dollars
21 May 2008 exceeded 130 dollars
16 Jun. 2008 hitting new high at 139.89 dollars
3 Jul. 2008 exceeded 145 dollars
17 Jul. 2009: 62 dollars
10 Apr. 2009 80 dollars
Citic Pacific Ltd’s HK$15.5 billion loss on AUD/USD currency option trading.

- What did it do: Bought one call, sold two puts
<table>
<thead>
<tr>
<th>Stage</th>
<th>Description</th>
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<tbody>
<tr>
<td>One</td>
<td>Banks emerge</td>
</tr>
<tr>
<td>Two</td>
<td>Securities markets come into being</td>
</tr>
<tr>
<td>Three</td>
<td>Development of fixed income market</td>
</tr>
<tr>
<td>Four</td>
<td>Derivatives and securitization</td>
</tr>
</tbody>
</table>
Financial Innovation: China’s Experience

- Rapid developments of financial innovations in Chinese banking industry
  - Fast growing in bank credit card business
  - Increasing demand for wealth management
  - E-banking services improve continuously
  - Green lending being encouraged
  - Cross-sector activities
Financial Innovation: China’s Experience

Fast Growing in bank credit card business

![Graph showing the cumulative number of credit cards issuance and transaction value (rhs) from 2007 to 2009.]
Increasing demand for wealth management

- Number of wealth management products
- Balance (rhs)

RMB Billion

<table>
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<tr>
<th>Year</th>
<th>Number of Products</th>
<th>Balance</th>
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<tbody>
<tr>
<td>2007</td>
<td>2000</td>
<td>300</td>
</tr>
<tr>
<td>2008</td>
<td>5000</td>
<td>800</td>
</tr>
<tr>
<td>2009</td>
<td>7000</td>
<td>1000</td>
</tr>
</tbody>
</table>
E-banking services improve continuously

- Number of clients for internet banking
- Transaction value through internet banking (rhs)

- Million
- RMB Trillion

- 2007
- 2008
- 2009
A bird’s eye view on cross-sector activities

- 8 banks established their own fund management companies
- 3 banks invested in insurance companies
- 7 banks hold shares of financial leasing companies
- 2 banks become major shareholders of trust companies
- ........
Financial Innovation: China’s Experience

Factors in boosting the future demand for financial innovations

- Developments in urbanization
- Developments in financial infrastructure and financial market
- Rise in households disposable income

What new products do we need?

- Securitization
- Wealth management products
Although China is at the early stage in terms of financial innovation and financial deepening, we still believe that imprudent innovation can create unexpected risks for an individual institution, increasing the vulnerability of the whole financial system.

Much attention has been given to define the boundary of the financial innovation. If new products and activities are within the boundary, they can be offered, otherwise, they will be banned.
Future cash flow and its uncertainty

- Risk: Can you manage its future cash flows and uncertainty?
- Pricing: Can you calculate and allocate its present value?
- Transparent: Can you let customers understand its structure?
## Basic Principles of Financial Innovation

### What we do
- Rule of “simple, basic and transparent”
- Integration of behavioral and prudential supervision
- Coordination of quantitative metrics and professional judgment

### What they do
- Good corporate governance
- Know your business, know your customer, know your risk, know your counterparty
- Consumer protection
- Quality first and speed second
- Services first and profit second
Supervisory Practice: Derivatives Strictly Regulated

Supervisors’ concern: taking excessive risks

- Subject to prior approval by the CBRC
- Guidelines and risk notices issued by the CBRC
- More economic capital and provisioning for proprietary trading
- Provisioning for counterparty credit risk in market making activities
- Firewalls between proprietary trading and market making
- Monitoring overall credit quality of counterparts
- Be cautious about selling products you cannot understand or price
- Retail customer fit and proper test before selling
- Quality control of marketing process
- Timely, adequate information and risk disclosure
- Violation of rules resulting in civil penalty and license revoke
Supervisory Practice: Off Balance Sheet Activities Closely Watched

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<th>Supervisors’ Concern: regulatory arbitrage to avoid capital and provisioning requirements</th>
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<td>➢ Guidelines and risk notices issued by the CBRC</td>
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<tr>
<td>➢ Off balance sheet commitments equivalent to lending</td>
</tr>
<tr>
<td>➢ Loan sale activities closely watched by the supervisor:</td>
</tr>
<tr>
<td>➢ True and clean sale or not? Substance over formality</td>
</tr>
<tr>
<td>➢ Capital and provisioning strictly enforced if not true or clean sale</td>
</tr>
<tr>
<td>➢ Violation of rules resulting in civil penalty and license revoke</td>
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Challenges ahead: within the banking sector

- More banks turn into banking groups
- More activities across the markets.
- Quality of people, process and data
Challenges ahead: outside banking sector

Rapid growth in private equity and venture capital

PE and VC investments in China (1999-2009)

Source: www.chinaventure.com.cn
What matters is not innovation, but useful innovation.
You’d better do nothing with your money than do anything you could not understand.

—— Liu Mingkang, chairman of CBRC

Thank you!

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