International Journal of Economics, Commerce and Management
United Kingdom Vol. III, Issue 4, April 2015
http://ijecm.co.uk/ ISSN 2348 0386

INTERBANK BUSINESS OF COMMERCIAL BANKS AND RISKS CONTROL

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Abstract

In recent years, interbank business of commercial banks benefited from high leverage, light regulation characteristics, has rapid developed in China. However, due to the rapid development, interbank business has exposed many risks, such as liquidity risk and market risk, which were became the potential risks in commercial banks operation. The paper dissects the major trading patterns of bank-bank cooperation and bank-trust cooperation of China, and concludes that credit risk, operational risk and liquidity risk are particularly prominent in these patterns by analyzing the key risk points of each specific pattern. At last, in view of the risks of interbank business, the paper put forward some risks control countermeasures from the angle of the bank. Concretely, establish a bank customer access and evaluation system can help banks to strengthen credit risk control. Strict authorization and normative accounting, fine management and complete supervision system are particularly effective for the control of operational risk. Moreover, banks can reduce liquidity risk by adjusting the scale and the proportion of assets and liabilities, using effective risks mitigation tool and strengthening cooperation.

Keywords: Banks, interbank business, risks control, credit risk, operational risk, liquidity risk

INTRODUCTION

Interbank business is all kinds of business cooperation between commercial banks and other financial institutions. It can be divided into two categories; financing business and non-financing business. On the one hand, with the development of China's capital market and the promotion of interest rate liberalization, spreads narrowed cause significant damage to traditional commercial banks' profit model. On the other hand, with the tighter regulation of banking loans from regulators, credit assets of commercial bank are restricted by credit index. Furthermore,

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given the development of external direct financing market and the increase of financial products, banks also have the intrinsic motivation to improve their business innovation ability. Based on the external and internal factors above, interbank business got explosive growth in China. By the end of 2014, the asset size of interbank in China reached 39.2 trillion Yuan.

The rapid growth of interbank business, in essence, is to circumvent the loan size limit and interest rate controls, so there are a lot of risks. In June 2013, “money shortage” event indicated that the price of money in the interbank market volatility easy and the liquidity risk of individual institutions would be triggered at any moment. Apparently, strengthen interbank business risks control has become the urgent need of banking in China. Based on this, in order to make banks more healthy development, this paper reveals the risks that exist in specific pattern by analyzing the trading patterns of interbank and proposes appropriate risks control strategy for banks.

LITERATURE REVIEW

There have been some scholars put forward countermeasures on how to control the risks of commercial banks. Treacy WF and Carey M (2000) pointed out that the establishment of internal credit rating system of banks plays an important role on the control of credit risk by analyzed credit risk of banks in America, and the liquidity comprehensive evaluation model can control liquidity risk more effective(Cao, 2013). Rajan(2006) argued that the profit-driven mechanism of bank——borrow short and lend long——will cause banks to engage in high-risk business which make loans restricted companies to obtain loans more easily. That will increase the risks of the financial system. Wagner(2007)’s research has shown that the instability of banks will increase when the liquidity of assets increase by expanding interbank assets. Distinctly, interbank business is exposed to credit risk, liquidity risk and operational risk(Xu, 2013; Liang, 2013). Zhuang(2013) suggest that bank regulators should adjust their strategy to strengthen liquidity risk management by discussing the driving factors and risks of interbank business expansion. Bu (2014) analyzed the highly leveraged business model of interbank and proposed some policy recommendations that regulatory agencies should strengthen the approval process for financial institutions by learning de-leveraging experience from Europe and America and other countries.

As can be seen, scholars proposed solutions mostly from the angle of regulators, however, rarely from the angle of bank. The potential risks of interbank business are mainly from its complex trading patterns and covert operations. Therefore, through the analysis of interbank business, only control the risks from the source, can us reduce the risks and make interbank business healthy development.

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THE TRADING PATTERNS OF INTERBANK BUSINESS & RISKS ANALYSIS

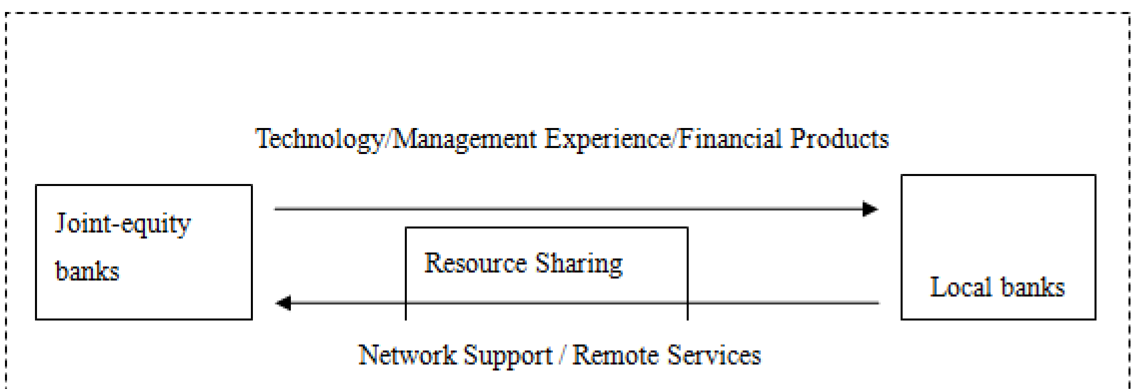
The main trading patterns of interbank business

The most widely cooperation in interbank business are bank-bank cooperation and bank-trust cooperation. Innovation and development of cooperation between other financial institutions are also based on the structure of these two types trading patterns. Thus, the cooperation of bank-bank and bank-trust can be summarized as follows:

The main trading patterns of bank-bank cooperation

The new way of consociation in bank-bank is platform cooperation. This cooperation is usually between joint-equity banks and local banks. Joint-equity banks output technology, management experience and financial products to local banks. Local banks use their geographical advantage to provide network support and remote services for Joint-equity banks. This win-win cooperation is shown below (figure 1). Joint-equity banks can cooperation with many local banks. As the cooperative local banks increase, joint-equity banks become a backbone, local banks become branches, this two form a sales and services network covering the whole country, as shown in figure 1.

Fig. 1 Platform cooperation pattern



The main trading patterns of bank-trust cooperation

Bank-trust cooperation is developing from bank-bank cooperation and it is the most complex one in interbank business. With the tight regulation, interest rate marketization and financial disintermediation, bank-trust consociation has become a new way to satisfy the need of real economy loans.

The cooperation of bank and trust companies experiences several stages. At present, the most widely trading pattern is buying and return sale. As shown in figure 2.

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Fig. 2 Buying and return sale pattern

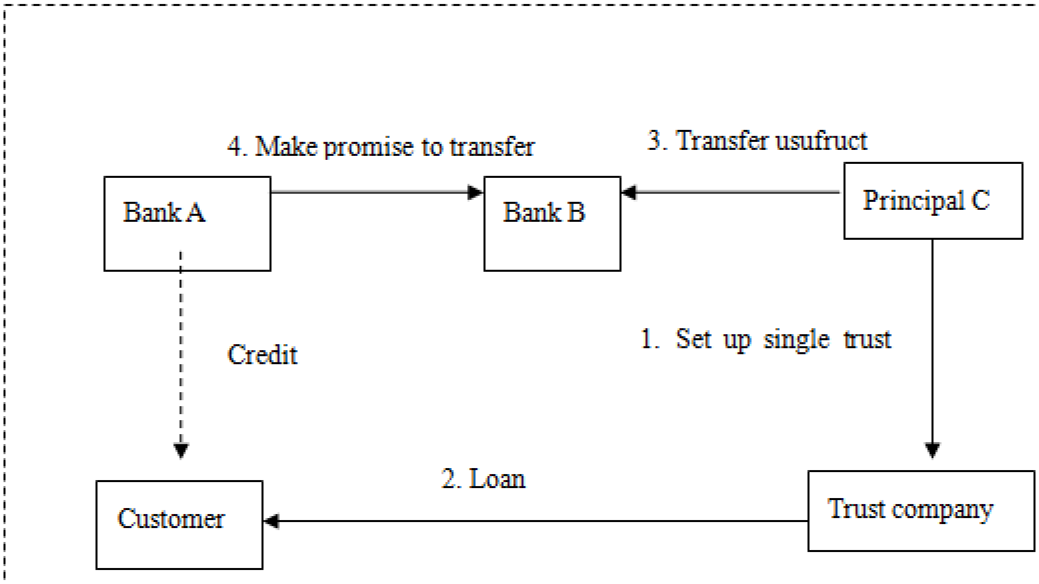

Figure 2 is a standard tripartite cooperation pattern of buying and return sale. As a bridge, C set up a single trust plan to loan to the customer of bank A through the trust company. bank B transfers the usufruct from principal C as an actual investor. At the same time, as a real risk taker, bank A promises to transfer bank B's usufruct before the expiration of trust plan. Bank B also can resell to other banks, such as bank D, E, F, and the last bank will undertake the risks of the entire trust plan. In fact, this trading pattern is bank A loans to his customer by using the money of bank C.

Risks analysis

Credit risk

In the cooperation of bank-bank, as they share platform each other, customer's information may divulged thus cause credit crisis. In the cooperation of bank-trust, risks come from all parties of cooperators. Bank A lending indirectly through a trust company to the enterprise, which will transfer in-balance sheet loans to off-balance sheet, so that bank can use a lower risk factor to measure loans. However, the risks of bank A undertakes is the same as general loan.

Operational risk

In bank-bank cooperation, local bank use joint-equity bank's advanced information system to set up a vast network channel to sharing resources. However, the operator may operate illegally for their own sake. In bank-trust cooperation, the complex transaction process and large number of

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operation data may increase the operational risk. As routes, bank C and bank B may face greater operational risk. In practice, since the final repo bank(Bank A) often secretly guaranteed the underlying assets make use of the transaction structure, bank B or C in the same industry who may review the terms of the contract are not strict. Therefore, the possibility of operational risk will increase.

Liquidity risk

Liquidity risk usually occurs in bank-trust cooperation. The bank loans to his customers through the bridge companies and the time of recouping will be very long, even more than one year. For most banks, the main source of funds comes from high mobility of interbank funding and the term for these funds is less than three months. Hence, it may create a severe maturity mismatch. Once the market funds become tight, financing banks will face liquidity risk. It’s more likely to trigger a “Domino” effect, spreading risks to elsewhere. Therefore, both sides of the trading pattern have liquidity risk.

RISKS CONTROL STRATEGY FOR COMMERCIAL INTERBANK BUSINESS

Control strategy for credit risk

According to the defect of credit risk control system of commercial interbank business, banks can establish a customer evaluation system to control the credit risk effectively.

Due diligence

Before the cooperation, banks should investigate and record customers’ information, such as funds, shareholder back ground, operations, and credit records, and included in the system.

Strict access and credit condition

Banks can establish a quantitative access standard for customers and businesses. Although the beneficial right of trust is one of the interbank businesses, banks should manage it according to the management level of credit assets. In the process of cooperation, banks must enforce relevant provisions strictly, confirming a reasonable credit scheme.

Classification management

For key customers and businesses, banks can conduct the real name system and differentiated management. For example, in resale business, banks should examine the authenticity of the financing business background and the condition related to the implementation of credit and

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other guarantors. At the same time, the obligations and rights in the fiduciary contract should be arranged very clear.

Control strategy for operational risk

In order to reduce the operational risk, banks should change operators' attitude, paying attention to the operational risk.

Strict authorization and normative accounting

Concentrate the authority on the head office of the bank, avoiding bank branches financing illegally for their own sake. On the other hand, banks can record assets data synchronously, preparing the work for the risks in advance.

Fine management

Banks should establish the industry sector in each branch and produce a set of clear principles for interbank businesses. Before signing a contract, banks should verify the investment project and due diligence. At the time of signing, banks should check the contract carefully by at least two staffs. Prior to draw funds, fund transfer department should identify that the risks of the proposed investment projects department has reviewed and agreed to set aside funds. After that, banks should ensure that whether funds reach the designated account.

Complete supervision system

In order to control the operational risk, banks also can implement a "online monitoring-focus on monitoring-monitoring afterwards" system. This system can be divided roughly into three parts. At first, for the sake of reducing the starting point of operator's illegal operations, banks can use real-time video monitoring to supervise operators. Secondly, complex business should be focused particularly. At last, banks can carry out a sample survey on the interbank business to make sure the information of the parties is complete.

Control strategy for liquidity risk

With the purpose of reducing the liquidity risk, banks can take the following methods:

Reasonable arrangement of assets and liabilities

In order to avoid the liquidity risk causing by the large maturity mismatch, banks should adjust the scale and the proportion of assets and liabilities according to the change of the market. First of all, banks should consolidate sources of general deposit and maintain their stability. Then,

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banks should improve their term management by changing single interbank demand deposits gradually to sources of high rate and long term funds. Finally, strengthen business innovation, expand sources of deposit and reduce the debt concentration also conducive to control liquidity risk.

Effective risk mitigation tool selection and use

Banks should select and use some effective risks mitigation tools to achieve risks compensation. Especially for resale businesses, banks should investigate further the repayment ability of the second repayment source.

Strengthen cooperation and achieve mutual benefit

Different banks have different access conditions, causing that some banks have customers but can't get the business, however, some banks can get the business but lacking customers. Therefore, banks can enhance the cooperation between the industries so that they can achieve win-win situation.

IMPLICATIONS AND LIMITATIONS

Interbank business, which provides a new way for banks to avoid regulation, has rapid development in recent years in China. With interbank business size, type expanding, some corresponding problems and risks are exposed. The paper analyzes the main trading patterns of bank-bank cooperation and bank-trust cooperation, concludes that credit risk, operational risk and liquidity risk are particularly prominent in these patterns. Banks should establish a bank customer access and evaluation system to strengthen credit risk control. For operational risk, strict authorization and normative accounting, fine management and complete supervision system would help banks to strengthen the operational risk control. Finally, banks can reduce liquidity risk by adjusting the scale and the proportion of assets and liabilities, using effective risks mitigation tool and strengthening cooperation.

Both the implications and limitations of the study suggest many topics for future research. For instance, although interbank business has similarities in patterns, there are differences for specific banks. Therefore, banks should take different control strategy to reduce their risks according to special business. In addition, we propose countermeasures to strengthen risks control, in practice, banks may also encounter a lot of details that need to be further studied and improved. Interbank business is a new pattern that rapid developed by banks in recent years. With each bank to carry on the business, risks control measures should be changed according to the new environment, new conditions. Future research may also introduce new risks control measures according to the new trading patterns.

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