

Perspectives on Risk Management from a Chinese City Commercial Bank

An Interview with Mr. Chaoge Zhou, Executive Manager of the Training Unit of the Small Business Finance Department, Baoshang Bank

1. What would you consider to be the three main factors that have contributed to Baoshang Bank's strong micro- and small-enterprise (MSE) lending business?

The first factor, which is very critical, is strategy. Prior to 2005, our customers were large corporate clients and enterprises, which was similar to other banks. However, as competition with other banks increased, we realized that as a city commercial bank, our competitive strength definitely was not in competing with the other larger banks for customers. As a result, our bank's leaders changed the strategic positioning to focus on serving the public, small- and medium-sized enterprises as our core customers. Therefore, I think one of the most important bases for success is a clear strategy from the bank's leadership.

The second most important factor for BSB's success is the entire bank's full support and cooperation. Once the bank's leadership had such a strategy, it was important that all departments and branches support one another. This is particularly important for departments that are related to the microfinance department (e.g. human resources, operations and business departments). Seven years ago, microfinance was a new business that we had never been done before, so at that time we needed good cooperation between all departments. Currently, we have a large number of branches and the mutual understanding and mutual accommodation between different departments and between the departments and the headquarters are critically important.

The third factor contributing to our success is at the operational level. Some people say that models and methodology are very important, but we consider the staff to be an even more important factor. When we have a relatively good model and methodology to operate MSE lending and control credit risk, we must also have a strong team. We started MSE lending¹ from zero and we have already achieved a loan portfolio of RMB 7 billion (approximately USD 1.1 billion) at the end of last year. Only by relying on the 1,100 "foot soldiers" of the small loans division, did we reach the point where we are today.

2. What do you think are the biggest risks Baoshang Bank currently faces in terms of MSE lending?

Our non-performing loan ratio for MSE lending increased from 0.44% last year to 0.77% this year, which is a relatively large increase. We manage our bad loan rate to stay below 1% because we feel that as soon as it starts exceeding 1%, it escalates the risk factors. The main source of risk is external risk. In particular, our offices in Ningbo, Shenzhen, and the Ordos region have registered relatively high default rates because these places were subject to large macroeconomic fluctuations.

Small businesses are the first to be affected when there is an economic downturn because they are at the bottom of the economic strata, and are least stable. For example, you can call a client today and his business is going on as usual, then the next day you hear that his business has collapsed, and within one night the entire factory has moved and you cannot find the client

¹ MSE loans are loans of RMB1 million (about USD 157,250) and below

anymore. Clients who are unable to continue their business operations are very common in the coastal areas. Whereas a place like Ordos (in Inner Mongolia) mainly relies on natural resources for its economy, and its real economy is quite small, and a lot of business gets lost when there is an economic downturn.

For our internal operations, we are still very confident that we can control risk using our credit methodology. For external economic fluctuations, because we have never experienced a full economic cycle, our default rates have always been very low. Therefore, economic volatility has prompted us to think of different ways to deal with such situations in the future. This is a relatively new environment, and within this environment we are focusing on how to solve these problems. Even though we do have some concerns, we are still confident.

3. How has your credit risk methodology evolved since you first implemented cash flow-based lending methodology under the China Development Bank downscaling in 2005? For example, do you have plans to develop statistically derived credit scores, and shift away from your focus on onsite loan officer analysis?

We have basically not changed our credit methodology at all, and still mainly rely on our loan officers to collect and analyze information about the client -- because it is a relatively successful model, at least for the time being. We have also considered whether the scorecard model is applicable, but we haven't made plans to develop the scorecard because so far we feel that the scorecard is not a substitute for the loan officer's analysis in China, and can most likely only be a supplementary tool.

We haven't drawn up specific plan for implementing a scorecard system in the future. However, scorecards will definitely be a trend for the future. I think the applicability of the scorecard relies on there being an adequate customer sampling size. We currently have more than 100,000 clients, but it is unclear whether this is sufficient to develop a good credit rating system.

In addition, the scorecard is subject to many restrictions, such as the effectiveness of credit bureau system. I'm not too familiar with the United States, but I've heard that it has a complete credit system. For example, individuals have records of their credit, including payments that can reflect their usual day-to-day use of credit and their way of life. However, currently the People's Bank of China's credit system only displays information regarding credit card usage, overdraft level, as well as borrowing from certain financial institutions. There are no records regarding loans from microcredit companies, let alone records of payments such as electricity or phone bills. There isn't a lot of information in our current credit bureau system and this causes information asymmetry and blind spots for our customer credit rating system.

4. Do you see a difference between the risk s for MSE and for SME lending?

From the risk control perspective, it is difficult to say they are very different, but I personally feel that the risk level may be higher for micro-enterprises. This is because the risk characteristics of these types of clients are more prominent. For example, they don't have any formal financial records and collaterals, their customer base is very small, and they have a relatively weak ability to mitigate risks. On the other hand, small businesses generally are of a certain size, they have experience in their industry, their fixed assets and financial system are more robust and their capacity to insure against risks is stronger than for micro enterprises. They can also generally offer some form of collateral as a secondary source of repayment, which can act as a repayment protection. As a result, I think micro businesses have a relatively higher risk.

Despite this, I still feel that analytical techniques based on cash flow are able to control this risk.

From the beginning, our credit methodology did not rely on collateral as a form of loan guarantee, therefore even though these clients might have a higher risk profile compared to small enterprises, we believe that as long as we analyze our clients thoroughly, and use our methodology appropriately, then we can definitely control the risk. In terms of small enterprises, their business is more complex, so it is more challenging for loan officers to analyze small-enterprise data in a short time, compared to micro-enterprises.

I feel that small-and micro-enterprises both present risks, but these risks are different: I feel that the risk with microloans is more concentrated on the clients because their risk characteristics are more apparent, while the risk for small enterprise loans lies in the information asymmetry between the enterprise and the loan officer.

5. Based on your long-time experience in China's microfinance market, what do you think are the key challenges to the overall microfinance industry in the next three years?

On the risk side, I think that we really don't have a lot of experience in dealing with overdue loans, particularly in dealing with clients who intentionally try to avoid repayment: we are limited in what we can do. If a client cannot be found, we have heard that private lending sector may resort to the use of violence to collect debt. But as a bank that is a formal financial institution, we do not sanction such methods, and they also run counter to client-protection principles. Yet when we use legal means against such clients, these means are found to have their limits: even if the court makes a decision in our favor and we still cannot find the client, there is no way to enforce the legal decision. This is a difficult problem to resolve these days.

Another of our present difficulties is the write-off system, in particular pre-tax write offs. In the past few years, the government has been exploring how to implement a pre-tax write-off system. Micro-credit companies can directly write off bad debts, but the process is more complex and less flexible for banks. Pre-tax write off is a problem we need to solve because we will definitely incur loss when loans are not repaid, however, we can't write them off and when we can't resolve this through any other means, it will start accumulating as our bad debt. As a result, the ability to write off bad debts is a relatively major problem we are facing.