

# Operational Risk Management in Local Chinese Securities Companies

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## **Abstract**

The operation and management of local Chinese securities companies is not yet mature with a history of less than 20 years. The fact remains that most of the risk lies on the companies' embezzlement of customers' funds or failure of supervising the behavior of their branches. Thus we developed an operational risk management framework for local Chinese securities companies and a set of tools to manage their branches. This framework sets up procedures and instructions for establishing the control environment of the companies. The tools develop systems for collecting and monitoring information and evaluating and appraising branches accordingly. This framework and these tools have been implemented in the first IPO securities company of China and good results have been achieved.

## 1. Introduction

China's securities markets embarked on a rapid track for development with the Shanghai Stock Exchange and Shenzhen Stock Exchange both established in late 1990. At present, China's securities market offers several types of financial instruments, including: A shares, B shares, T-bonds, corporate bonds, convertible bonds, investment funds, warrants and so on. By the end of 2006, some market data are presented as following<sup>2</sup>:

1. There were 1,507 listed companies in China, out of which 1,398 companies issued A shares, the other 109 companies issued B shares;
2. There was an aggregate market capitalization of RMB 8, 940.4 billion,<sup>3</sup> among which the capitalization for tradable stocks amounted to RMB 2, 500.3 billion;
3. In the year 2006, the turnover of stocks and funds reached RMB 9, 247.2 billion;
4. About 77 million securities investment accounts were opened; most of them are retail investors. The institutional players include securities companies, insurance companies, investment fund management companies, Qualified Foreign Institutional Investors (QFII), corporate annuities and China National Social Security Fund, etc.

As the important intermediaries in China's capital market, there are over 100 securities companies in China, most of which are local (in the rest of the article, we use *securities company* to refer to the *local Chinese securities company*). Based on the mechanism of category regulation of the China Securities Regulatory Commission (CSRC), 19 securities companies are classified as the innovation category ones; 30 securities companies are classified as the normative ones according to their net capital, business management and so on. In the meantime, about 40 securities companies were closed by the CSRC. One or more of the following reasons explain their closures:

1. embezzlement of customers' funds;
2. embezzlement of customers' bonds by repurchasing;
3. illegal operation—for example overdraft and issuing bonds without authorization.

All of the above reasons have a relationship with out-of-control operational

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<sup>2</sup> Source: <http://www.wind.com.cn>.

<sup>3</sup> The ratio to GDP reached about 50 percent.

risk management in the securities companies. In the securities market, the overall level of quality of the securities companies is important and determinant to the health and stable operation of the securities market and the country's financial system. Therefore, operational risk management becomes important and necessary to every securities company. It is important for us to develop a suitable framework to manage the risk of loss resulting from inadequate or failed systems, people and internal processes, especially to prevent the companies and their branches from embezzling the customers' funds. We have developed a framework for local Chinese securities companies to manage their operational risk, which covers the organization, operation, monitoring and reporting in the securities companies. Some parts of the framework seem to be platitudes; however, they are extremely important for the local Chinese securities companies because the development of the Chinese securities companies does not have a long history, and the risk management in these companies has also just started. Some principles, which are supposed to be general knowledge or guidelines in risk management, have not been properly implemented and enforced in China's securities companies. Taking that into account, some of these contents are considered in our framework. It is possible for the securities companies to design and arrange their operational risk management, and to evaluate their operational risk management accordingly. This framework surely provides a reference for the regulators and any others who are interested in evaluating the risk management of China's securities companies.

## **2. Operational Risk Management Framework—Organization**

### **1. Separation of decision-making, implementation and supervision**

There should be an appropriate division of work and organization in the securities companies to guarantee that the decision-making, implementation and supervision are separated.

### **2. Chinese wall system**

The decision-making, information, staffs and offices of the departments of brokerage, asset management, proprietary trading and underwriting and sponsorship in each securities company should be separated to prevent insider trading and market manipulation.

### **3. Segregation of duties between the front offices and back offices**

The front offices should not take the duties of the back offices, such as

settlement and accounting. On the other hand, the back offices, such as the department of settlement, should not do trading with customers.

#### 4. The vertical management of branches

In China, securities companies generally own 10 or more branches distributed in a broad range of the country. Every branch has its own staffs and departments for business, finance and information & technology to support its running. To prevent the failure of internal control, those three kinds of staffs must be directly under the control of headquarters. The employment, assessment, salary and routine management of those staffs must be determined independently by the three corresponding departments in the headquarters. Regular rotation, mandatory vacation and audit should be enforced. This organization arrangement is the base of the following reporting tool.

### **3. Operational Risk Management Framework—Operation**

#### 1. Accounts

- (a) To ensure the reality and integrity of the information of customers' accounts;
- (b) To establish the one-to-one relationship between security account, capital account and bank account to prevent the embezzlement of the customers' funds;
- (c) To set up the backup documents of the important customers in the headquarters instead of only leaving them in the branches.

#### 2. Clearing, Settlement & Custody

- (a) To ensure clearing & settlement department is independent to trade units; to check the clearing & settlement results with trading recordings;
- (b) To deposit more than 70 percent of customers' funds in the headquarters instead of branches to prevent the embezzlement by the branches;
- (c) To set up a detailed record of bonds' ownership to prevent the repurchasing without customers' authorization.

#### 3. Accounting

- (a) To make sure that the accounting is standardized and timely;
- (b) To check the customers' asset records with different sources every day;
- (c) To check the accounts with banks against unilateralism record.

#### 4. Trading

- (a) To make sure there's a completed procedure of the key business such as the opening of securities investment accounts and depositing;
- (b) To separate the conflicting authorization in the trading system; to make sure an approval process for special authorities exists;
- (c) To make sure that the change or upgrade of the trading system, or set system parameters, should be set up by headquarters.

### 4. Operational Risk Management Framework—Monitoring

The internal supervision organizations of a securities company should include the board of supervisors, the risk management committee under the board, the risk management department, the audit regulation department, the legal department and so on. We have also set up a *Real-time Monitoring and Early-warning System* (RMES) to monitor the large amounts or suspicious transactions of money or securities, and give proper warning. It is an important means to check the operation and misappropriation of customers' assets.

#### 1. Data Sources Needed in the RMES

- (a) Trading system;
- (b) Accounting system;
- (c) Banking system;
- (d) Clearing & settlement system.

The purpose to acquire the data from difference sources is to achieve a balance check or double check. In addition, a series of monitoring indicators from these sources can detect the abnormal behaviors to determine suspicious operations.

#### 2. Tools in RMES:

##### (a) Real-time Monitoring and Early Warning

To monitor each securities transaction and the deposit of funds; to compare them with a pre-determined threshold value; to give early warning information;

##### (b) Account management

To check the legitimacy and completeness of customers' accounts; to check one-to-one relationship between the customer security account,

capital account, and bank account; to check whether the trading fee is abnormal;

(c) Special operations watching

To check whether there are special business operations and abnormal behaviors, such as overdraft, record correcting, manual deposit of securities and abnormal bank stock transferring;

(d) Bond repurchase check

To check whether there is any bond repurchase without customers' authorization;

(e) Fund balance check

To check in the trading system, the financial system, the settlement system and the banking system whether the funds' records meet the balance equation;

(f) Inquiries function

To meet the demand of inquiries of customer information, transaction history and other information on bank accounts

## **5. Operational Risk Management Framework—Reporting**

Each business line in a securities company has its own reporting systems. To further guard against risk in particular for cases where the branches are out of rule, we have designed a reporting tool to strengthen internal control in the branches. We try to prevent the misappropriation of customer assets with this tool. This reporting tool includes what to report, who to report and the reporting process.

### **1. What to Report**

The contents of the report are set by the department of risk management in the headquarters of the securities company. The contents are mainly on the abnormal operations, such as large amount of funds withdrawn or other adjustments;

### **2. Who to Report**

There should be the signatures of the manager and staffs from the departments of business, finance, information & technology in the branches on the report to ensure the accuracy and integrity of the contents of the report;

### 3. Reporting Process

Everyday branches should report business status of last day. Staff in the department of risk management should check the accuracy and completeness using the RMES. For abnormal conditions, they should make a tracking and follow-up process.

Due to the vertical management of these organizations mentioned above, staffs can be mutually supervised. The reporting tool will help to reinforce the internal control, and to improve the operation of the staffs (any operational or procedural error must be reflected in the report and seen by the related manager). In this way, the operational risk of the branches can be reduced.

## 6. Conclusion

We present a framework for China's local securities companies to improve their operational risk management, which includes organization, operation, monitoring and reporting. We have also developed a series of tools in monitoring and reporting for support. It may be a source of reference to formulate system and process standards and adjust them according to actual situations for all securities companies to establish their own operational risk management systems, based on this framework and tools. Some parts of our framework and tools are adopted by the supervisory institution used to judge whether a securities company can be classified as an innovation category or another one. It is also implemented and proved to be effective in CITIC Securities Co. Ltd., the only securities company listed in China up to now.