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W16008

HEFEI XINGTAI FINANCIAL HOLDING GROUP: RISK MANAGEMENT

On May 8, 2012, the Hefei Xingtai Financial Holding Group Co., Ltd. (Xingtai), which was inaugurated on the same day in 2002, was celebrating its 10th anniversary. This period has been a decade of Xingtai's creation and glory. Liqiang Sun, the president of the Xingtai group, attributed the success of Xingtai's operation to effective risk management. However, one event could now change his opinion about Xingtai's risk management expertise. When he arrived at his office that morning, he received a message from a senior officer of the Hefei Municipal Government, the authorizing body of the Xingtai group. The senior officer informed Sun that Xingtai should assist the PanTeng Company with financial support. PanTeng was a solar manufacturing company, which made it a key part of the complete supply chain, so the local government intended to sustain it to help the solar industry recover from the economic recession.

Sun was already familiar with PanTeng. In August 2011, China's solar industry had ended its rapid development because of European and U.S. Anti-Dumping laws affecting solar products, as well as extreme market competition.[1] PanTeng was affected significantly by a drop of more than 45 per cent in product export volume in 2011. In order to survive, PanTeng now needed Xingtai to provide a guarantee for a CN¥100 million[2] business loan from a commercial bank. PanTeng had already been turned down by Xingtai Financing Guaranty, one of Xingtai's subsidiaries, because of the potentially high level of guarantee risk.

The message from the municipal government pressured Sun to reconsider the loan guarantee to PanTeng. As Xingtai's president, he had the power to approve PanTeng's application even after Xingtai Financing Guaranty had denied the application. If Sun approved it, Xingtai could be liable to reimburse the loan due to PanTeng's high-risk operation. Xingtai could afford such a loss, so that was not Sun's worst fear. What Sun worried most about was the fact that Xingtai might lose its risk management expertise and face further violations. However, denying the senior officer's request would hamper Xingtai's relationship with the local government, whose support had been instrumental in Xingtai's rapid development.

[1] Official Journal of the European Union. Council Regulation (EC) 1225/2009, accessed December 10, 2015, http://trade.ec.europa.eu/doclib/docs/2010/april/tradoc_146035.pdf; U.S. Government Publishing Office, Antidumping Proceedings: Calculation of the Weighted-Average Dumping Margin and Assessment Rate in Certain Antidumping Duty Proceedings, accessed December 10, 2015, www.gpo.gov/fdsys/pkg/FR-2012-02-14/html/2012-3290.htm.
[2] ¥ = CNY = Chinese Yuan. All currencies are in CNY unless otherwise stated; CN¥1 = US$0.157 on August 20, 2012.

Sun hesitated to make this important decision, which would have repercussions for the future of Xingtai's effective risk management framework and overall business operations. He decided to take a step back and review the corporate risk management that was in place at the time.

THE COMPANY

In May 2002, the Hefei Municipal Committee of the Communist Party of China and the Hefei Municipal Government issued an authorized document named *The Overall Procedure of Hefei State Capital Operating System.*[3] This procedural document served to maximize the force of Hefei financial assets and to adapt to China's financial industry trend of transforming separate operations into an integrated business. This led the Hefei Municipal Government to create the Hefei Xingtai Holding Group Co. Ltd., which was China's first local financial holding platform characterized by financial capital operations. Xingtai had been authorized to operate several municipal state-owned financial assets, including Guoyuan Securities and the Hefei branch of the Bank of Communications (see Exhibit 1).

Xintai had five departments: the President's Office, Investment and Development, Human Resources, Finance Supervision Department, and the Institute of Finance. In addition, union branch agencies and institutions were also established as parts of the organization (see Exhibit 1).

Xingtai formed a corporate governance structure that included shareholders, a board of directors, and managers. Since Xingtai was a state-owned company, the State-owned Assets Supervision and Administration Commission (SASAC) of the Hefei municipal government established the primary duties of the shareholders. Under the SASAC's authority, the board of directors exercised several shareholder functions. The board was made up of four directors, including one independent director. The president of the board was the legal representative. Xingtai's supervisory board had not yet been established.

Sun was Xingtai's president. In 2002, after having served as director of State-owned Assets Administration Bureau, office director of SASAC, president of the Supervisory Board of Hefei City Commercial Bank, and chair of Hefei Xingtai Trust Co., Ltd., Sun became the president of Xingtai.

The business scope of Xingtai extended to 13 financial and pan-financial areas, as well as 17 share-controlled and participating financial and pan-financial institutions (see Exhibit 1). The company's scope fostered several central, provincial, and large regional financial companies, such as CCB Trust, Huishang Bank, and Hefei Science and Technology Rural Commercial Bank. In the 2000s, Xingtai provided funding for more than ¥60 billion for local economic and social development. As of March 2012, the company's total assets were worth ¥33.5 billion, whereas net assets were ¥6 billion. In addition, 87 per cent of its total assets were financial assets that attained an average annual increase of 25 per cent. Xingtai's main role was undertaking the reform duty of state-owned firms in Hefei. In that capacity, it dispatched more than 3,000 employees of the merged firms and successfully completed the handover work of property management for 2,057 households with estates that were approximately 130,000 square metres. These business areas introduced new challenges for the company's governance.

RISK MANAGEMENT CONTEXTS

Sun recalled the development of the company's risk management system, "In accordance with modern enterprise standards, the group has formed a relatively standardized corporate governance structure, as well as an efficient and balanced supervision and restraint mechanism. However, something is always forgotten,

[3] Hefei Xingtai Financial Holding Group Co., Ltd., About the Company, accessed December 27, 2015, www.xtkg.com/about/6/2/?2015-1-4-9064.html.

and certain problems remain." It was these problem areas that convinced Xingtai that an established risk management system was required.

POSITIONING

In 2010, Xingtai set its development goals and strategies with the objective of becoming a leader in comprehensive financial holdings. Xingtai possessed strong local financial industry consolidation abilities, as well as financial services and financial asset operations. Guided by the development goal, it attempted to develop a core platform to drive the agglomeration of the local financial industry. This consisted of a financial platform to support local economic development, an antecedent platform to test local financial innovation, and an operation platform to implement the securitization of local financial assets. To achieve this target, Xingtai implemented four strategic choices: financial agglomeration, financial services, capital operation, and integrated businesses.

After Chaohu City and Lujiang County merged into Hefei City in August 2011, Hefei City further strengthened its core status in the industrial transfer demonstration zone among the cities in the Anhui Area, along the Yangtze River. Based on Hefei City's considerable development, Xingtai gained a wider regional development footprint. In 2012, the construction of the "12th Five-Year Plan" fully unfolded. As Sun stated in the SASAC of the Hefei Municipal Government,

> Xingtai Group must enclose its financial business, serve the city's development, emancipate the mind, pioneer innovation, and continue to grow its own comprehensive strength to accelerate the platform construction for a comprehensive financial holding, to improve the local financial service system, and to make new contributions to the city's economic construction and social development.

The municipal party committee, the municipal government, and the municipal state-owned assets supervision and administration bodies had reformed state-owned enterprises (SOEs) in October 2010. This meant that the auxiliary business exit reform of the group focused on two companies: Hefei Xingtai Real Estate Development Co., Ltd. (Xingtai Real Estate) and Hefei Xingzheng Real Estate Development Co., Ltd. (Xingzheng Real Estate). Given this new situation, the group developed solutions to clear and close Xingtai Real Estate and list the transfer of Xingzheng Real Estate. On April 7, 2011, the Xingzheng Real Estate equity transfer project, which was fully state-owned, was listed in the Hefei Publicly Listed Property Right Transaction Centre. In July 2011, Anhui Oulian Investment Development Co., Ltd. won the project with a bid of ¥265.3 million, after 83 rounds of bidding among 12 transferees. This price was higher than the listing price of ¥153.8 million, by 72.43 per cent. Xingtai Real Estate's liquidation process was thus finalized, and the company seceded from the real estate industry.

RISK FACTORS

General Risks

Among the 13 fields in the financial and quasi-financial industry, Xingtai's risks encompassed general risk, including those in commercial banking, investment banking, insurance, trusts, funds, lease financing, guarantees, and investments, in addition to various other types of financial business risks that the company would be exposed to. In terms of banking, securities, and insurance, the risk of the commercial banking business generally referred to the commercial bank balance sheets and the off-balance sheet uncertainty of gains and losses. The concrete risk could be subdivided into credit, operational, interest rate, and liquidity risks. Investment banking risk corresponded to the business scope, which was primarily reflected in agency business, underwriting, and proprietary trading risks. Insurance risks included assets, pricing, asset liability mismatch, and upheaval risks. Sun realized that "a small leak will sink a great ship. If you do not focus sufficiently on these business risks, they will set a dangerous precedent for the long-term development of the group."

Specific Risks

As a local large financial holding group, Xingtai faced risks with new characteristics because of its large-scale and complicated structure. These risks included system risk, caused by excessive dependence on financial resources, unfair inside trading risk, and conflict of interest risk. The company's opaque structure was also a risk factor.

Xingtai's 13 financial and quasi-financial businesses increased the instability of the entire system to a certain extent. Furthermore, risk transfer, repeated capital calculation, several related-party transactions, and the complexity of these transactions challenged the stability of the company's overall system.

Xingtai's objective was to develop a comprehensive financial holding group with regional leadership. However, its large scale, numerous participating enterprises, and complex relationships led to difficulties in correctly determining the risks involved. According to Sun, "This opaque and complex organization structure will make internal coordination and communication difficult for the group; timely and accurate delivery of important information is impossible, and advanced warning at the beginning of the risk is lost, which results in disastrous consequences."

Some of Xingtai's subsidiaries were involved in conflicting interests. For a financial project, subsidiaries in securities, venture capital, and equity fund companies could intervene. However, the dominant component often became the conflict's focus in internal interests.

Unexpected Accidents

Given its involvement in a wide range of businesses, Xingtai inevitably encountered different types of emergencies or accidents. For example, on July 14, 2011, a gas leak, and subsequent explosion, occurred in XiangzhangYayuan Village, which was developed by Xinzheng Real Estate and managed by Tianda Property Management Company, a subsidiary of Xingtai. This accident injured two people. Earlier that same year, in the afternoon of April 12, the roof of a Xingtai Asset Company's investment building caught fire. Chinese regulations demand that the estate developer or managers accept at least partial responsibility for these types of accidents.

RISK MANAGEMENT FRAMEWORK

The risk management framework that Xingtai developed and operated within was comprised of four major risk management components: organization, integration, compliance, and communication and reporting.

Organization

Xingtai initially established a risk management organization system in Xingtai Finance Leasing, Asset Xingtai, Xingtai Pawn, Xingtai Guarantee, Xingtai Equity, Lujiang Guarantees, Chaohu Guarantee, and its subsidiaries. The risk management framework in Xingtai Finance Leasing was based on three key phases: trial, review, and final decision. This ensured orderly compliance of its risk management program throughout the company. The business sector, risk management sector, and project review committee were in charge of the finance leasing business risks. The primary investigator held the first level of responsibility. This person was in charge of the comprehensive investigation and analysis of client and project situations. The business sectors reviewed and confirmed the adequacy of the major risks that the leasing project analysis and investigation revealed. The risk management sectors were responsible for reviewing the leasing project analysis that the business unit submitted, and proposed appropriate risk control measures. Based on an audit opinion, the project review committee collectively considered the project and views proposed by the legal representative after final approval.

Integration

Sun decided that risk management needed to be integrated into the everyday governance and development strategy of the enterprise. To be fully implemented, it needed to circumnavigate corporate governance and strategic objectives.

In the company's development process, 2008 was an important watershed year. Before 2008, Xingtai had implemented a "commercial banking system plus investment banking system" as its core strategy, with two leading enterprises emerging from this strategy: Hefei City Commercial Bank and Hefei Xingtai Trust Co., Ltd. However, both of these Xingtai companies broke away in 2005 and 2007, respectively, after the local government changed its strategic plan. This development severely affected Xingtai's commercial banking system plus investment banking system strategy, leading to the imminent implementation of a strategic transformation for the holding company.

Changes in the external environment and the government's management of SOEs led Xingtai to yet another business restructuring in 2010. "Actually, in 2008 and 2009, we had tough days, not just in business but also in economic efficiency because of the changes in development ideas on SOEs that resulted in a 'blind area' of business operation," as Sun stated.

In the second half of 2010, Xingtai collected significant amounts of research on enterprise development, was conducted by a team of scholars with graduate degrees. The company's headquarters and its subsidiaries were key participants and specifically requested that both internal and external risk management were integrated into the company's development plan. The company eventually established four development strategies: financial agglomeration, financial services, capital operation, and integrated management.

Compliance

According to Sun, "the company's decision-making mechanism is running in strict accordance with the The Articles of Association and the internal system." The president of the board was responsible for the overall operation and management, as well as two departments: the Investment and Development Department and the Finance Supervision Department. He also served as the president of Anhui Xingtai Finance Lease Co., Ltd. The vice-president was in charge of the president's office and the company's Human Resources Department, as well as concurrently serving as the chair of Hefei Xingtai Asset Management Co., Ltd. and Anhui Equity Exchange Co., Ltd. The leaders of the subsidiaries were appointed from headquarters, and major decisions of the subsidiaries were reported to headquarters.

Xingtai's investment projects focused on financial and pan-financial areas such as banking, trust, financial leasing, guarantees, mortgages, insurance, funds, asset management, industry funds, venture capital funds, and microfinance. "All investment projects are in accordance with our company's internal control procedures," Sun said.

Communication and Reporting System

Sun claimed, "the success of risk management depends on close contact between daily business planning, reporting and management, and strategic vision." He believed that holding regular meetings regarding risk control among managers was important. On the one hand, these meetings could find solutions to existing risk points. On the other hand, such meetings helped to find the management point on the value chain, improve management effectiveness, and reduce management risk.

This led Xingtai to gradually establish risk management and control communication including monthly, quarterly, and annual reporting mechanisms, as well as a regular exchange system. The risk management meetings were held regularly by the risk management committee to discuss issues and highlight the significant risks at the headquarters level.

Xingtai developed a comprehensive risk management assessment report, a summary of significant risks encountered in the past year, tools, measures, and a list of deficiencies and gaps for the year. "This normalization mechanism of communication not only promoted risk management but also increased the company's cohesion. The most evident effect is that, despite the grim macroeconomic situation in recent years, all financing operated by the Xingtai group had no breach of contract, and this earned a good reputation in the industry," Sun stated.

CONTROL SYSTEMS OF PARENT SUBSIDIARY CORPORATIONS

With rapid development and regional expansion, Xingtai encountered new challenges and requirements for existing control methods. "We have different corporate cultures because of several new restructuring companies and different professional background leaders and staff in the corporations. Most have totally different management ideas and methods," Sun said. "Deciding how to innovate the control mode, the unified thought, and the development plan is particularly urgent now," Sun added.

Based on Authority Division

Xingtai introduced a new system called the Group Work Purview Division System and Process. This procedure divided the work content and permissions, and clearly defined the cross-function area between the parent company and subsidiary corporations. The responsibility boundary between the parent and the subsidiary corporation was "the full responsibility boundary, the nodes at which the activities of the subsidiary corporation need to be reported or approved by the parent company, and the scope of business monitoring and management." These nodes were clear, regarding the basic aspects of the purview division, and they listed the key point of parent company controls.

However, the rule regarding the parent company monitoring remained within the authority announcement regulation. The subsidiaries were required to work in accordance with the provisions of its mandated responsibilities, complete the job responsibilities according to company policy and procedures, and provide the corresponding outcomes. In addition, the subsidiaries were required to cooperate on work, such as review, audit, inspection, and record, with the parent company.

Focusing on Capital Controls

Xingtai established a capital settlement centre in its headquarters and disseminated the centralized management mode regarding capital to subsidiary companies in 2005. The capital settlement centre allocated monetary funds to member enterprises, obtained external financing, and addressed direct contacts and settlements among subsidiaries. These procedures strengthened the business operation's monitoring of enterprises, as well as effectively prevented the "indiscriminate investment, indiscriminate financing, and indiscriminate guarantee," which Sun considered Xingtai's main risk factor.

Conversely, the capital settlement centre highlighted the group's resource allocation function, which was determined according to the principle of output and investment profit risk matching for the approval of each unit's budget. Sun explained that, "through this model, we can unify the supervision and management of the cash flow of subsidiaries, integrate capital within the scope of the entire group, and realize the complementary advantages of resources."

Performance Management

Using minimal input including human and material resources to achieve maximum output required establishing a management method that had internal equity and was externally competitive. Sun stated that, "to improve the corporate operation efficiency, we must develop performance and compensation management systems, which have strategic orientation for the long-term development of the parent company."

Xingtai had a performance index system to assess personnel at all levels and a Key Performance Indicator index system for all departments and subsidiaries. This was created by combining the company's strategic planning, specific business, and industry management modes to determine the effective controls regarding risk, business, personnel, and the capital of different business modules. At the subsidiary level, the performance management system operated separately. For example, Xingtai Financing Lease Company established a risk-oriented business performance evaluation mechanism that had company staff performance appraisals pegged to the investment scale and also linked to the rate of rent received. The scale of putting money in the market was proportional to the employee's performance salary scale. Therefore, the larger the scale, the higher the corresponding performance pay; whereas the lower the rate of recovery, the lower the performance salary of employees. This type of performance evaluation mechanism greatly improved enthusiasm among staff and mobilized their awareness of risk prevention and control. Consequently, these measures rapidly increased the money supply and improved the project funding's safety measures.

NEW CHALLENGES

Sun was very proud that Xingtai was the handhold and platform that established and improved the system for local government financial services. However, he began to feel more pressure after he attended the 2012 Hefei People's Congress in January 2012. At this meeting, Xingtai was expected to be a comprehensive financial holding platform to serve the rapid development of Hefei's economy over the next five years, as announced by the mayor in his annual Work Report. The main task was to develop Xingtai as a state-controlled, public-float comprehensive financial holding platform, as explained in that report.[4]

[4] 合肥政务信息公开网(Office Website of Hefei Government Information Disclosure), 2012 年政府工作报告(2012 Hefei Government Work Report), accessed June 17, 2015, http://zwgk.hefei.gov.cn/zwgk/public/spage.xp?doAction=view&indexno=002991856/201201-00013.

The major source of pressure was the change in Xingtai's business environment. This included a moderate change in government policies, the ongoing straightening of equity exchanges, the exit from the real estate business, and the removal of Huishang Bank, CCB Trust, and other major financial companies. Sun felt that there was a considerable direct effect of government policies on the company's development. The company's internal problems and pressures continued to rise. In the beginning of 2012, most subsidiaries encountered tight cash flow. More business conflicts emerged from the overlapping of subsidiaries. These conflicts led Sun to focus on the security of the operation chain. The company's expansion increased pressure on Sun to operate new business units. These challenges made Sun feel more uncertainty in the comprehensive financial holding platform development process.

In March 2012, Xingtai held a meeting with senior management, including headquarters leaders, department managers, and subsidiary directors to discuss how to manage risk during the comprehensive financial holding platform development process. In this meeting, most managers concluded that Xingtai had encountered a complex, evolving business environment with the following three major issues:

- The external environment remained severe. In early 2012, the international economic environment was in serious trouble. The European debt crisis continued to spread and worsen. Domestic macroeconomic regulations and controls remained tight. With the rumour of a monetary loosening policy, which was keeping the market overinflated, the stock market, housing market, bond market, and external economic environment were not optimistic.
- Although reforms were implemented in China's financial industry, the government continued to strengthen its supervision. Therefore, the financing environment was not optimistic. The reform and development of SOEs had entered a new stage where investors in resource integration, enterprise restructuring, and direct stakes were explored. Therefore, the company's development encountered many challenges.
- Most subsidiary companies encountered tight cash flows and a scarcity of innovation. The constant expansion of business scale and the financial chain created greater operation risk.

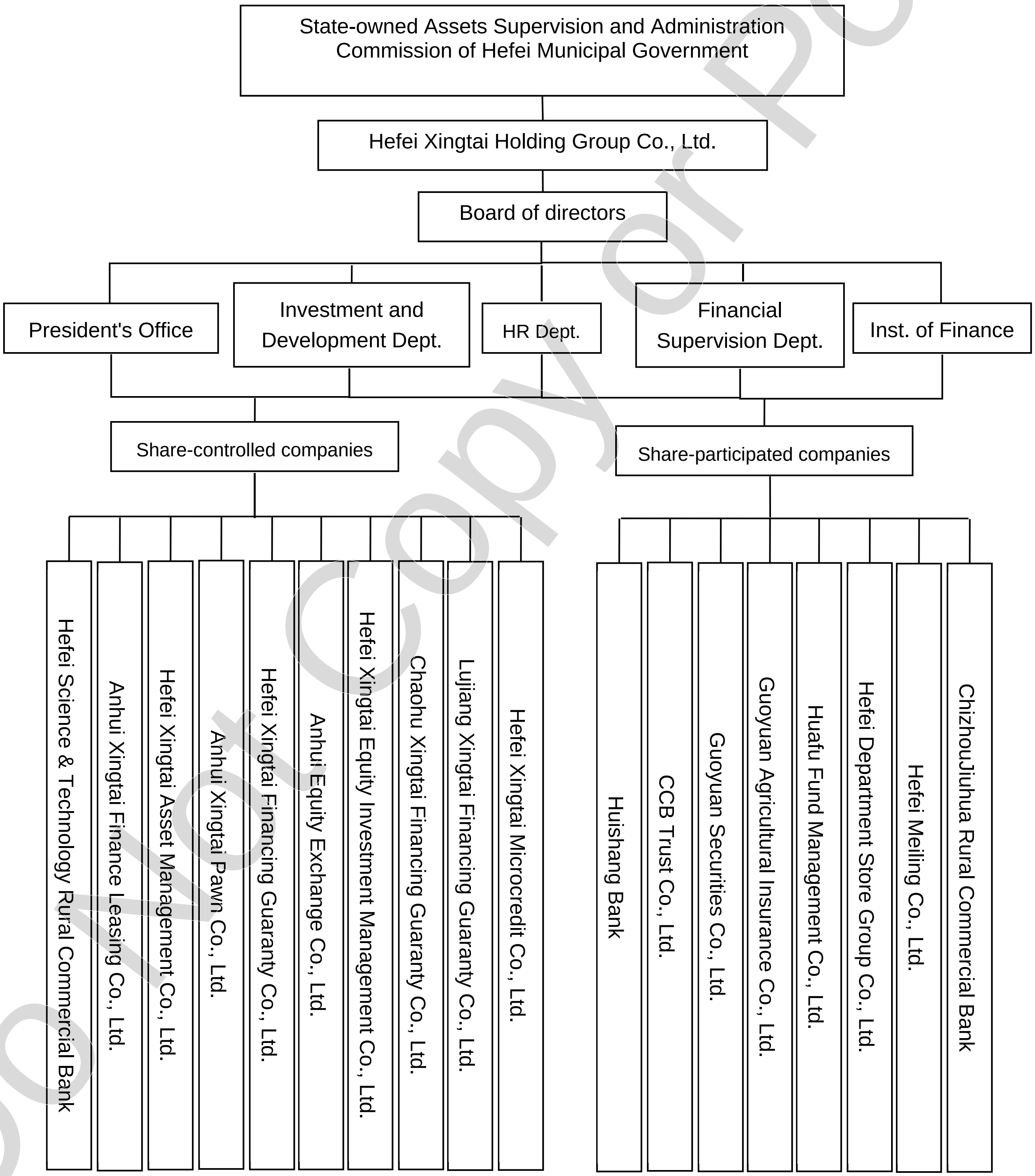
In that same March 2012 meeting, senior managers proposed a number of strategies as their response to manage risk during the comprehensive financial holding platform development process. The three main points were:

- Comprehensive management must be continued, the company's overall development concept must be unified, and the subsidiary's execution by instruction should be enhanced. Currently, the integrated collaborative business volume of the company is small, the cooperation degree is shallow, and a long-term mechanism is absent.
- Xingtai must continue expanding its influence, and improve its influence to tamp Xingtai's core status in the financial industry in Hefei City. In addition, the relationship with the local government should be strengthened, which may create more business opportunities.
- The investment structure should be advanced and transferred. Currently, Xingtai can end the equity of certain enterprises to support the short-term development of one or two companies, extend the scope of the financial industry, and confirm their entry in the traditional financial industry.

After the meeting, Sun remained dissatisfied with the risk management suggestions raised by the company's managers because he believed more measures remained that should be addressed.

A telephone call from Sun's secretary informed him that the Development and Reform Commission of Hefei Municipal Government had scheduled a meeting about the local industries' development that afternoon, and Sun was invited to attend the meeting. After the call, Sun knew he had very little time to make a decision.

EXHIBIT 1: THE ORGANIZATIONAL STRUCTURE OF HEFEI XINGTAI FINANCIAL HOLDING GROUP



Source: Company files.