

Risk Assessment of Banks and Financial Institutions in China

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Abstract. In the aftermath of the COVID-19 pandemic, economic development has emerged as a paramount concern globally. Governments, including that of China, have implemented various policies to reignite growth. However, this pursuit of rapid expansion brings with it inherent risks. This study conducts a comprehensive analysis of the risks facing China's domestic banks and financial institutions. It systematically identifies the factors contributing to their vulnerabilities, highlighting the complexities of the economic landscape. The research reveals that external economic conditions, lingering effects of the pandemic, and internal factors such as banks' understanding gaps collectively drive these risks. By illuminating these dynamics, the study aims to enhance understanding of the challenges confronting financial entities. It seeks to provide valuable insights for the comprehensive evaluation of China's domestic financial landscape in the future. Understanding these risks is crucial for policymakers, regulators, and stakeholders in crafting effective strategies to navigate the evolving economic environment. Ultimately, this analysis contributes to a more informed approach towards bolstering the resilience of China's banking and financial sectors amidst ongoing uncertainties.

Keywords: Banks, Interest Rate, Risk Assessment, Systemic Risk.

1. Introduction

After the COVID-19 pandemic, all industries in China are facing varying degrees of impact. China's domestic financial market has been severely impacted by the epidemic. Major domestic central banks in China have announced interest rate cuts, with deposit rates even below 2% (1-year). China's stock market fell to less than 2700 points on the eve of the Chinese New Year in 2024, creating a new record low in recent years [1]. In terms of daily life, residents are increasingly conservative in their consumption attitudes and have gradually lost their enthusiasm for consumption, which has made the domestic economic situation less optimistic. In terms of international affairs, the Federal Reserve's interest rate hike has triggered instability in the global economy. It is possible to trigger short-term capital outflows from China, further weakening the confidence of domestic investors. At the same time, major European central banks have also taken interest rate hikes, and the Fed's interest rate hike policy has led to a vicious circle in the global economy. The Federal Reserve's interest rate hike has had a significant negative impact on the global economy.

China is the second largest economy in the world. Major domestic banks and financial institutions in China have played an important role in maintaining the stability of China's financial market and promoting its prosperity. Therefore, this paper focuses on analyzing the impact of some risk factors on banks and financial institutions in China's post-pandemic era. In the post-pandemic era, it is of vital importance to conduct effective research and judgment on the potential risks of China's domestic banks and financial institutions. This will help promote the healthy and beneficial development of China's domestic financial industry, and stimulate investors' enthusiasm and confidence.

2. Liquidity Risk

Banking liquidity risk refers to the potential risk that commercial banks encounter difficulties in capital turnover, fail to obtain sufficient funds in a timely manner to meet their capital needs, or need to obtain funds at a higher cost. The assets owned by banks cannot be quickly converted into cash to meet liquidity needs, and deposits and other sources of funds are insufficient to meet debt and liabilities. Liquidity risk has had a significant impact on the operation of banks. On the other hand, due to the economic downturn after the COVID-19 pandemic, the business environment for all

industries in China has become difficult. For example, many catering businesses are facing the risk of closure due to the impact of the pandemic, resulting in lenders losing the ability to repay their debts. Many investors have therefore lost their enthusiasm for investment and turned to more conservative business strategies. These factors have led to a slowdown in financial liquidity. The possibility of liquidity risks has further increased. This has not only had a profound impact on the development of China's economy, but also on the survival and progress of all walks of life.

One of the main reasons for bank liquidity risk is the liquidity mismatch of funds [2]. Liquidity mismatch refers to the unreasonable liquidity matching between assets and liabilities of banks, which means that the assets held by banks cannot be quickly converted into cash to meet payment needs. Or banks may not be able to fully rely on deposits and other sources of funds to effectively support their debt and other liability payments. This mismatch may lead to liquidity challenges for banks, which may prevent them from fulfilling payment obligations in a timely manner and even trigger liquidity risks. After the COVID-19 pandemic, all industries have suffered a huge impact. In order to promote the recovery of the real economy, major banks have reduced interest rates by a total of 1.5 trillion yuan. This is mainly due to liquidity mismatch. Although this measure helps the recovery of the real economy to some extent, it also further increases the liquidity risk of banks. In order to effectively manage liquidity mismatch risks, banks need to establish a scientific and reasonable asset and liability management mechanism, and ensure adequate liquidity buffer reserves. Through effective liquidity management measures, banks can more efficiently address various liquidity challenges, ensure smooth operations, and reduce potential liquidity risks.

In addition, the instability of economic policies can also lead to a mismatch in bank liquidity [3]. Due to factors such as the US-China trade war and a domestic economic slowdown, China's financial market is facing unprecedented challenges. To this end, China has introduced a series of economic policies to stabilize the economy and promote development. This situation leads to frequent changes in economic policies, while banks still need to bear the related risks, thus triggering risks in terms of capital liquidity.

In order to alleviate local financial pressure when the economy is growing slowly, the government actively promotes economic growth through administrative intervention. However, this approach also brings about an increase in financial risks and leads to the emergence of bank liquidity risks [4]. In order to achieve economic recovery, local governments often promote financial activities such as credit through implicit guarantees. However, this practice may lead to problems such as excessive credit growth. Due to the implicit government guarantee, banks may be more inclined to expand loan scale. If these loans are not repaid in a timely manner, it will have a significant impact on the bank's liquidity. Therefore, in the post-pandemic era, paying more attention to liquidity risks is crucial for the healthy development of banks and financial markets.

3. Credit Risk

The official definition of credit risk is: due to the influence of various uncertain factors, in the process of bank operation and management, the actual return results deviate from the expected return targets, and there is the possibility of asset losses. This situation usually occurs when a borrower is unable to fulfill its contractual repayment obligations due to specific factors, resulting in losses for financial institutions such as banks. From another perspective, China, as the world's second largest economy, has made rapid progress in economic development. However, behind the rapid development, there are also some potential risks. Some banks have accumulated a large number of non-performing loans and assets, which have seriously affected the normal capital turnover operation of financial institutions and led to actual losses.

Studies have shown that the lack of repayment awareness among borrowing companies is one of the important factors leading to credit risks [5]. Due to the lack of repayment awareness, the borrower has no intention to repay since the date of borrowing. At the same time, regarding such behavior as a profit making means and obtaining improper benefits through this approach. In addition, due to the

extensive operation mode, enterprises often need to make high investment and obtain relatively low returns. Most of the time, enterprises are in the red, and the products they produce often fail to accurately grasp the core of market demand, resulting in inventory overstock. In the end, the funds provided by the loan failed to inject momentum into the development of the enterprise, but became a pointless waste. The company itself has fallen into a vicious circle of operation, and has also lost the ability to repay debts in terms of economy.

Small and micro enterprises are an important pillar of bank credit. Since small and micro enterprises are in the initial stage of establishment and scale expansion, they have a prominent demand for funds, which also makes bank credit their first choice. However, although small and micro enterprises can obtain key financial support by applying for loans from banks, there are also risks. At present, most banks have not established a sound loan system for small and micro enterprises [6]. For small and micro enterprises, the existing credit system is often too vague and general, and repayment willingness cannot be accurately evaluated only by financial ratios. In addition, compared with traditional enterprises, small and micro enterprises are more vulnerable to market competition and other factors, and have a smaller scale and weaker resistance to pressure. This makes them more vulnerable to bankruptcy or insolvency caused by specific factors, which will bring economic losses to banks. Therefore, when facing small and micro enterprises, banks should establish a more sound credit system to reduce risks.

In addition to the external reasons mentioned above, the factors of the banks themselves cannot be ignored. Commercial banks still need to improve their credit management mechanisms [7]. There is a gap between the upper-level decision-making and the implementation of the lower levels in some banks, which leads to the apparent strengthening of the banks' credit management, but the actual implementation is difficult. In addition, the lack of sufficient credit risk awareness within the banks is also an important reason [7]. In the early stage of economic development, many banks tend to focus on expanding the market size and ignore the factor of credit risk. At the same time, bank employees do not pay enough attention to credit risks, and there are irregular operations in their daily work. This has laid a potential crisis for future credit risks.

4. Market Risk

Compared with other risks, market risk is the most important risk faced by banks. However, in order to control inflation and stabilize economic growth, the Federal Reserve has adopted the economic policy of raising interest rates. At the same time, other countries have also chosen to raise interest rates to mitigate the adverse impact on their own economies and financial markets. Therefore, in the context of the Federal Reserve's interest rate hike, interest rate risk has become one of the main market risks. Market interest rate fluctuations will pose risks to banks' profitability and balance sheet structure. In the process of operation, banks will face two types of interest rate risks: asset-side and liability-side. Although banks manage interest rate risk through various model tests such as interest rate sensitivity tests and interest rate hedging, they still encounter some problems and challenges in the management process. Preventing interest rate risk is a long way to go.

Since the reform and opening up, China has gradually achieved the goal of interest rate liberalization and transformed the past controlled interest rate management methods. Interest rate liberalization has promoted the development of national financial institutions and optimized capital allocation. However, there is also an important issue - repricing risk [8]. This is caused by the difference between the repricing time point and the maturity date of the original assets and liabilities. The fluctuation of interest rates and market interest rates or related price changes of banks and other financial institutions may cause asset value fluctuations, thus bringing repricing risks. Repricing risks have caused damage to banks and other financial institutions in many ways: (1) decline in profitability; (2) mismatch of assets and liabilities; (3) pressure on capital supply. Therefore, financial institutions need to manage repricing risks through effective asset and liability management and risk control

measures as well as timely monitoring and response mechanisms to ensure their stable operation and sustainable development.

For local banks, interest rate liberalization can bring greater benefits, but it also poses significant challenges. Some local banks have problems such as backward interest rate risk management methods and weak management awareness, which are one of the main causes of interest rate risks [9]. Take Wenzhou Bank as an example. Although interest rate liberalization has brought greater benefits to the bank, the bank's own interest rate management methods lag behind, and bank personnel lack sufficient attention to preventing interest rate risks. At present, most commercial banks in China use tools such as interest rate sensitivity gaps for interest rate risk management. However, with the further promotion of interest rate liberalization, the financial market is volatile, and traditional management methods can no longer adapt to the current financial environment. In addition, Wenzhou Bank only relies on a single investment channel, which leads to the lack of effective interest rate hedging tools. Wenzhou Bank mainly focuses on loans and advances, and mainly serves the financial service industry. However, in the current context, the competition among major financial institutions is becoming increasingly fierce. Therefore, it has become extremely difficult to obtain profits only by relying on a single investment channel.

In the early 21st century, the rapid development of the Internet has not only changed people's lifestyles, but also penetrated the financial industry. Convenient payment methods such as online payment have brought convenience to people, promoted consumption growth, and promoted economic development. However, the development of Internet finance is a double-edged sword: although it can promote economic growth, it also increases interest rate risk [10]. The impact of Internet finance on interest rate risk is mainly reflected in the following aspects: (1) The speed of market interest rate transmission is accelerated: The emergence and development of Internet financial platforms make the information transmission in the financial market more rapid and efficient. Once market interest rates change, Internet financial platforms can reflect such changes more quickly, and then affect a wider range of financial market participants, thus accelerating the speed of market interest rate transmission. (2) New interest rate risks are brought by product innovation: The rapid development of Internet finance has promoted the innovation of various financial products and services, including various financial products that are sensitive to interest rate fluctuations. These new products may have a new impact on interest rate risks. For example, financial products that adjust their returns according to market interest rate fluctuations will expose investors to potential losses caused by frequent conversions between rising and falling interest rates. (3) Regulatory policies play an important role in managing interest rate risks: Regulatory authorities' regulations, access thresholds, and emphasis on risk control requirements for Internet financial products directly affect the management and response of enterprises to their responsibilities. (4) User behavior and market sentiment amplify interest rate risks: The behavior patterns and market sentiments of users when using Internet financial platforms may also amplify the relevant volatility problems caused by existing substantive or non-substantive factors.

In the face of a volatile economic environment, financial institutions such as banks should develop corresponding risk management strategies to meet the challenges brought by interest rate fluctuations in different situations.

5. Systemic Risk

Systemic risk in banking is a collective risk that refers to the risks faced by the entire banking or financial system when facing internal or external shocks, with a wide range of impacts that have a significant impact on the entire financial system or economic system. Systemic risk in banking is usually not limited to a single bank, but involves the health and stability of the entire financial system. In other words, an economic crisis caused by a single bank may spread to the entire financial system, forming a systemic crisis. At the same time, systemic risk has a wide range, including all the risks mentioned above.

Among many factors, the innovation level of commercial banks has the greatest impact on bank systemic risk [11]. Research has shown that when the innovation level of commercial banks is lower than the critical value, it will lead to a surge in bank systemic risk. The greater the gap between the innovation level and the critical value, the higher the systemic risk that banks face, which is not conducive to the development and growth of banks. At the same time, innovation also brings opportunities and challenges. New business opportunities and profit models may emerge in the process of promoting innovation. However, due to the complexity and uncertainty of new financial products and services, systemic risks are more likely to occur when regulatory authorities and bank staff have insufficient understanding and prevention of risks.

Secondly, investor sentiment and economic policy changes are also important factors that trigger systemic risks in banking [12]. Firstly, investor sentiment is negatively correlated with systemic risks in banking. This is because when investors are optimistic, they are more inclined to make high-risk investments, which leads to a large amount of capital flowing into the market and alleviates the pressure on the capital chain. Conversely, under pessimistic sentiment, the market may face selling pressure and increase systemic risks. However, unstable economic policies are positively correlated with systemic risks in banking. Large-scale fiscal expenditures may stimulate economic growth, but they may also lead to inflation and asset price bubbles, and increase systemic risks in the financial system. At the same time, it may also lead to loose regulatory policies, a decline in the risk management level of banks and other financial institutions, and further increase systemic risks in the financial system.

Systemic risks in banking have a catastrophic impact on the entire economic system and the macro environment, seriously impeding economic development and exacerbating the social wealth gap. Therefore, effective management and monitoring of systemic risks in banking is of great significance in maintaining financial stability, promoting healthy economic development, and maintaining social stability.

6. Conclusion

After analysis, it was found that China has achieved rapid economic growth since the beginning of the 21st century and has rapidly risen to become the world's second largest economy. However, in this rapid development process, the risks faced by financial institutions have gradually emerged. Through in-depth research, we found that bank risks mainly come from three aspects: the international financial environment, the epidemic environment, and the internal bank. On the international level, the Federal Reserve's interest rate hike policy has led to instability in major economies around the world; a series of measures to promote economic development in the post-epidemic era have exposed the risk factors of banks and other financial institutions; in addition, the lack of risk awareness among bank staff is also an important issue. Therefore, a detailed analysis of the risks of banks and other financial institutions in the post-epidemic era can provide reference for optimizing the existing risk management system, and help investors more accurately recognize various bank risk factors and improve the accuracy of investment decisions. Finally, it is worth noting that there are two problems in this paper: insufficient interdisciplinary integration and insufficient empirical cases, and there are still differences between theoretical analysis and practical cases. In the future, in-depth research can be conducted based on the above theoretical framework combined with more empirical cases to promote the better development of this issue.

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