

Case Study on Risk Management of Bankruptcy Event of Baoshang Bank

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Abstract: It took more than a year from the takeover of Baoshang Bank by the People's Bank of China and the China and Insurance Regulatory Commission in 2019 to the bankruptcy of Baoshang Bank Co., Ltd. by the Beijing No. 1 Intermediate People's on February 7, 2021. The bankruptcy of Baoshang Bank reflects various risks within the bank, and indirectly reflects some common problems among small and medium-sized banks. There are numerous small and medium-sized banks in China, mainly serving small and micro-sized enterprises. In the past, due to supervision by relevant departments, small and medium-sized banks expanded their business scale in order to achieve rapid development. However, in recent years, with the downturn in the economy and the deleveraging of finance, some small and medium-sized banks have limited management capabilities, leading to significant problems in credit risk, corporate governance, asset quality, and capital adequacy ratio. This paper takes the bankruptcy of Baoshang Bank as an opportunity to conduct a more detailed and cautious analysis of entire event, thereby revealing the current development predicament of small and medium-sized banks as a whole, and proposing some feasible solutions.

Keywords: Small and medium-sized banks, credit risk, corporate governance, capital adequacy ratio.

1. Introduction

The China Banking and Insurance Regulatory Commission announced on May 4, 2019, that Baosh Bank was facing extremely serious credit risks. In order to protect the legitimate interests of depositors and creditors, it officially took over Baoshang Bank. One year, on April 30, 2020, the Baoshang Bank takeover team announced that it would transfer Baoshang Bank's related businesses assets and liabilities to two banks, Mengshang Bank and Huishang Bank, respectively. This was done to ensure social stability and protect the legitimate rights and of depositors and other bank customers to the greatest extent while breaking the rigid payment of the bank according to relevant laws and regulations. On May 23, takeover team announced that the progress of subsequent disposal of Baoshang Bank needed to be appropriately extended, and the takeover period was extended to November 23, 2020. Finally, on February 7, 2021, the Beijing First Intermediate People's Court ruled that Baoshang Bank Co Ltd. would go bankrupt. This event attracted widespread attention from all sectors of society and to some extent broke the traditional concept that "banks will not be liquidated and "banks will not go bankrupt."

Domestic scholars such as Ren Zeping and Zhang Jiguang have conducted pioneering research on the difficulties of small and medium bank development and proposed corresponding solutions. However, existing research results rarely focus on a single event of a small and medium-sized bank to explore the problems currently faced by and medium-sized banks as a whole. Additionally, some research has studied the Baoshang Bank event, but it did not conduct an in-depth analysis, insteadizing the development difficulties of small and medium-sized banks with limited discussion. This paper starts from the bankruptcy event of Baoshang Bank and uses various scientific research methods as historical research and comparative research. Based on the combination of theory and practice, it uses the Baoshang Bank event as an entry point to deeply analyze the difficulties of small and

medium-sized banks and proposes solutions.

This paper is divided into eight parts, the second part is a review of related literature, the third part is an overview of the Baosh Bank bankruptcy event, the fourth part is an analysis of the causes and effects of the Baoshang Bank bankruptcy event, the fifth part is the current development status small and medium-sized banks in China, the sixth part is the difficulties encountered in the development of small and medium-sized banks, the seventh part is suggestions for the development of small and medium-sized banks.

2. Literature Review

In recent years, with the rapid development of the internet, big data, and financial technology, small and medium-sized have faced enormous pressure. What predicament are small and medium-sized banks facing now? How can they break through their development bottleneck? What reforms should they make to break of their predicament? These questions have attracted widespread attention from researchers both domestically and internationally. Currently, the research by scholars both domestically and internationally mainly focuses on liquidity risk credit risk, and governance risk. Aprio.G et al. (2007) found that banks with good corporate governance can better identify credit risks, Andres and Vallelado (2008) argue that corporate governance in the banking industry should be combined with the actual situation of the bank. Zhang Wei Jiang Min (2016) pointed out that the reform of interest rate liberalization has led to a narrowing of the interest rate spread between deposits and loans weakening the profitability of small and medium-sized banks, while also triggering credit risks. Accordingly, they proposed suggestions for how small and medium-sized banks can better cope with rate liberalization. Xu Xueming and Lu Minfeng (2020) mainly focused on the problems of small and medium-sized banks, providing specific by establishing complete systems and plans, reflecting on and summarizing the problems faced by banks, in order to better cope with various potential risks. In 209, the People's Bank of China and the

China Banking and Insurance Regulatory Commission took over Baoshang Bank, and on February 7, 201, the Beijing No. 1 Intermediate People's Court ruled that Baoshang Bank Co., Ltd. would go bankrupt. As a financial hot topic, domestic scholars have conducted detailed research and analysis on the underlying reasons for the event and the lessons learned from it (Guo Yongbin. A brief analysis of the-down of Baoshang Bank's secondary capital bonds [J]. Small and Medium-sized Enterprise Management and Technology, 2020(36). Zhu Hongun. Reviewing the risk prevention and control of small and medium-sized banks from the event of Baoshang Bank's takeover [J]. Tsinghua Financial, 2019(11).

3. Overview of the Baoshang Bankruptcy Event

Baoshang Bank Co., Ltd. was officially established in Baotou City, Inner Mongolia Autonomous Region on December 28, 1998, with the approval of the People's Bank of China. Its predecessor was Baotou City Commercial Bank, a regional-stock commercial bank.

On May 4, 2019, the China Banking and Insurance Regulatory Commission (CBIRC) announced that due to the extremely credit risk of Baoshang Bank, in order to protect the legitimate interests of depositors and creditors, it would take over Baoshang Bank. This was first time the CBIRC had taken over a bank since its establishment in 2003. In fact, the reason Baoshang Bank met the conditions takeover was due to problems with the equity of Tomorrow Group. According to information disclosed by relevant regulatory authorities, Tomorrow Group held a total of 89% of Baoshang Bank's shares, but the major shareholder misused a large amount of Baoshang Bank's funds and was unable to repay it, leading to an payment and causing Baoshang Bank to face serious credit risks. To date, Baoshang Bank has not disclosed its annual reports for 2017-2018. From the information I could find, it appears that Baoshang Bank had problems as early as 2017, with its adequacy ratio falling below the minimum level required by regulators.

Just one year after the announcement of the takeover, on April 30, 202, the Baoshang Bank Takeover Group announced that it would transfer Baoshang Bank's related businesses and assets and liabilities to two banks, Mengshang

and Huishang Bank, to ensure social stability and minimize the harm to the legitimate rights and interests of depositors and other bank customers, while breaking the bank rigid payment according to relevant laws and regulations. On May 23, the Takeover Group announced that the progress of Baoshang Bank's subsequent disposal would appropriately extended, with the takeover period extended to November 23, 2020. On February 7, 2021, the No. 1 Intermediate People's Court ruled that Baoshang Bank Co., Ltd. would go bankrupt.

4. Analysis of the Risk Management in The Bankruptcy Event of Bao Shang Bank

In recent years, China's macro-economy has been in a phase of gear-changing for growth. The country has encouraged the implementation of supply structural reforms. Meanwhile, there has been increasing downward pressure on the economy, with continuous efforts to deleverage the financial sector and strengthen supervision. As a result, small and medium-sized banks are facing increasing credit risks. As a small and medium-sized bank located in Baotou City, Inner Mongolia, Baoshang Bank seen a continuous increase in non-performing loan ratio in recent years due to the slowdown in Baotou's economic growth and the impact of capacity clearance, reaching high level domestically.

4.1. Credit risk

The equity issue of the Tomorrow Group, the largest shareholder in Baoshang Bank, was the main reason for the bank's takeover. the equity structure diagram of Baoshang Bank, we found that the Tomorrow Group held as much as 89% of the shares. From the disclosed reports we can see that a large amount of funds from Baoshang Bank were improperly used by the Tomorrow Group, gradually turning the bank into an ATM for outsiders. funds were illegally occupied by the major shareholder, and the major shareholder was unable to fully repay all debts upon maturity, which further led to overdue payments. In the, Baoshang Bank suffered a credit risk. In order to protect the interests of depositors and creditors, our country decided to take over Baoshang Bank, the takeover period being one year.

Table 1. Selected annual report data of Baoshang Bank from 2013 to 2017

Year	Net Profit(hundred million)	Capital adequacy ratio	Tier 1 capital adequacy ratio	Tier 1 capital adequacy ratio
2013	23.65	12.05%	11.42%	11.42%
2014	28.90	11.19%	10.59%	10.58%
2015	34.17	12.22%	9.34%	9.33%
2016	41.12	11.69%	9.07%	9.04%
2017	32.31	9.30%	7.28%	7.28%

Data source: Baoshang Bank's annual reports from 2013 to 2017

From Table 1, we can clearly see that Baoshang Bank's net profit increased from 2013 to 2016, but in 2017, the net profit dropped significantly. Moreover, the capital adequacy ratio, Tier 1 capital adequacy ratio, core Tier 1 capital adequacy ratio for 2017 were all lower than those for 2016, and even fell below the requirements 10.5%, 8.5%, and 7.5% for non-systemically important banks in China. Baoshang Bank's capital adequacy ratio did not meet the national regulatory standards, making it difficult for the bank to cope with emergencies that require these funds, and thus unable to

protect the interests depositors and creditors.

4.2. Liquidity risk

Liquidity risk analysis of Baoshang Bank is indispensable. From the above Table 1, it can be seen that Baoshang's capital adequacy ratio in 2017 was 9.30%, significantly lower than the industry's minimum standard of 10.1 This result indicates that Baoshang Bank's capital structure is extremely unreasonable, with a large amount of illiquid secondary bonds held internally, which greatly reduces the liquidity Baoshang

Bank's assets. Recently, banks in Europe and the United States have been experiencing crises one after another. Taking Silicon Valley Bank as an example, cause of its bankruptcy boils down to the liquidity shortage triggered by the Federal Reserve's interest rate hike. The most serious consequence could lead to a run on many banks causing systemic financial risk.

4.3. Operational risk analysis

The Basel III Protocol redefines operational risk. Bao Shang Bank's internal business department violates industry regulations to obtain as much funds as possible, such as issuing false invoices. Secondly, the regulatory aspects of the bank's various branches are unreasonable, so the original Banking Regulatory Commission imposes multiple on it. In addition, its irregularity operations by internal staff deteriorate the bank's reputation and generate adverse effects, posing a certain reputational risk. The credit, liquidity risks, and operational risks exposed by Bao Shang Bank pose some threat to individual customers; however, due to China's deposit insurance system effectively safeguard depositors' interests, their actual impact is relatively minor. Individuals tend to withdraw their deposits quickly and choose other banks with lower credit risks for savings. For individually financial products, their repayment priority is generally after deposits, carrying greater risk. If the incident escalates further, it could lead to runs on the bank. With banks having significantly less competitive power than large commercial banks, people prefer transactions with larger banks when credit risks, operational risks, and liquidity management are poor. As a result, investment interest in small and medium-sized banks decreases considerably.

5. Current Development Status of Medium and Small Banks

At present, the development status of small and medium-sized banks in our country is also pessimistic. In terms of scale, and medium-sized banks cannot be compared with the five major state-owned commercial banks. There are significant gaps in the density of outlets and technological innovation compared to other large banks. In terms of profitability, small and medium-sized banks cannot compete with large commercial banks. In terms of capital

replenishment capability, small and medium-sized have a single capital replenishment channel, and it is difficult to obtain sufficient funds to reduce risks when risks occur. In terms of corporate equity structure, some small medium-sized banks have unreasonable equity structures, and some even have local government agencies holding shares. In addition, some small and medium-sized banks have aggressive business styles, a clear understanding of their own positioning, and have deficiencies in management concepts, strategic planning, and technological capabilities. Some even engage in reckless expansion. Previously, the of small and medium-sized banks in our country might have been relatively loose, leading to their accelerated expansion during this period. However, in recent years, with the pressure of economic downturn, the continuous advancement of financial deleveraging, and strict supervision, some small and medium-sized banks with limited capabilities have increased credit risks. the same time, their problems in corporate governance, profitability, and capital adequacy ratio have gradually emerged, posing significant challenges to the development of small and medium-sized.

6. Problems Encountered in The Development of Small and Medium-sized Banks

6.1. Deterioration of profitability

In pursuit of higher returns, small and medium-sized banks had proactively absorbed deposits and used them to invest in bonds, stocks, and products that could generate high returns before 2016. In recent years, however, one of China's goals has been to guide the economy away from and toward real economic activities, reducing the amount of money lent by banks that flows into the real estate market and stock and bond markets. To implement this policy, People's Bank of China has tightened the money supply and extended the duration of funds to raise interest rates in the money market. This has not only increased the cost liabilities for financial institutions but also naturally reduced the profitability of small and medium-sized banks to varying degrees. In addition, the reform of interest rate liberalization has been pursued in China, and the profitability of small and medium-sized banks has gradually been eroded by the reform of interest rate liberalization.

Table 2. Net Profit of Some Small and Medium-sized Banks from 2015 to 2019

Unit: Billion Yuan

Bank name	2015Net profit	2016Net profit	2017Net profit	2018Net profit	2019Net profit
Tianlong Bank	14.83	20.10	24.19	27.70	31.79
Foshan Rural Commercial Bank	6.53	6.90	7.60	8.90	13.67
Yuhang Rural Commercial Bank	5.81	6.45	7.71	8.14	9.36
Zhengzhou Bank	43.62	52.57	55.47	30.59	32.85
Qingdao Bank	18.13	20.89	19.04	20.43	23.36
Jinzhou Bank	49.02	81.99	90.90	-45.38	-11.10

Data source: The annual reports of the above small and medium-sized banks from 2015 to 2019

The above table is compiled based on the net profit data of some small and medium-sized banks from 2015 to 2019 searched online. From Table 2, we can see that the net profits of some small and medium-sized banks show a trend of fluctuating up and down and some small and medium-sized banks have a growth rate that is continuously lower than the

industry as a whole, indicating a deterioration in profitability. In 200, due to the impact of the COVID-19 pandemic, the profitability of some small and medium-sized banks in our country has accelerated its decline. In, influenced by economic reforms and other factors, the ability of small and medium-sized banks to attract deposits has also been

weakening year by year. If a bank does not have enough deposits, it naturally cannot generate more income, and its net profit cannot be effectively increased.

6.2. Weak links in corporate governance

The main reason for the bankruptcy of Baoshang Bank is the equity issue of Tomorrow Group, which holds 89% of Baoshang Bank's shares. The major shareholder misused funds, leading to overdue payments and causing serious credit risks for Baoshang Bank. This individual case reflects a common, indicating that Baoshang Bank is not the only one with such issues. Some other small and medium-sized banks also have similar problems of irregular corporate governance structure.

From the perspective of shareholder structure, some small and medium-sized banks have relatively dispersed shareholdings, and the shareholding ratios unreasonable. Under the company structure with relatively concentrated shares, some banks have internal shareholders who violate regulations by occupying resources and transferring benefits through related-party transactions. These banks controlled by outsiders and become cash machines for them (like Baoshang Bank). In the company structure with relatively dispersed shares, some banks have shareholders who are inactive find it difficult to act, leading to a vacuum in supervision. These banks are controlled by insiders and become cash machines for them (like Hengfeng Bank). Therefore, it can be seen that the issue of shareholder equity is a key factor affecting the healthy operation of small and medium-sized banks. From the perspective of shareholder, it can be said that the shareholding ratios of some small and medium-sized banks in our country are relatively dispersed, and the equity structure is quite complex. Of these banks, including city commercial banks, rural commercial banks, and rural credit cooperatives, have close ties with local governments, which may hold certain shares in. Moreover, these small and medium-sized banks lack supervision when introducing capital, leading to chaotic operations within the banks and affecting their healthy operations.

7. Countermeasures of Small and Medium-sized Banks

7.1. Improving the operating management model to enhance profitability

The measures that I propose for small and medium-sized banks to take in terms of management are as follows: 1. Small and medium-sized banks should rebuild their management frameworks. To achieve this, they need to break away from traditional management models and redefine the boundaries of their operations. This includes the design of business processes, risk prevention measures, service quality and efficiency, cost control, and branch management, among other aspects. This will promote a comprehensive improvement of the bank's service system. 2. Small and medium-sized banks need to enhance their management capabilities. By adopting scientific management tools and advanced technology, they can achieve the professionalization, automation, standardization, and refinement of internal operations. This will significantly reduce the time needed for business transactions and improve the overall service level, and quality of the bank. 3. Small and medium-sized banks should improve their risk management capabilities. They can optimize their systems and use advanced technology to reduce the number of customers at the counter and effectively control potential risks. On one hand,

small and medium-sized banks can gradually move the risk-prone tasks from the counter to the back office, thereby improving the level of risk management. On the other hand, with the advent of more high-tech products, many tasks are now performed by machines. Introducing machines into banks can reduce the pressure on staff and minimize errors caused by human oversight. Fourth, small and medium-sized banks need to innovate in their customer relationship management, formulate different plans for different types of customers, and adopt differentiated service methods. They should strive to ensure that customers receive the most satisfactory and fastest service experience within the bank, thereby enhancing customer loyalty and brand. This will lay a solid foundation for the bank's future development. Fifth, small and medium-sized banks should actively promote business transformation, actively expand their services, and vigorously develop these services to increase the proportion of intermediary services in their total business. Sixth, small and medium-sized banks can rely on technology to promote their own business transformation. In the context of the Fourth Industrial Revolution, financial technology is gradually changing the operating status of the entire banking industry. By using financial technology, small and medium-sized banks can actively improve their operating models and achieve leapfrog development. This will enable them to compete with large banks in terms of scale and human resources. Seventh, due to their geographical advantages, small and medium-sized banks have made significant contributions to serving small and micro-sized enterprises. In the future, small and medium-sized banks should continue to deeply serve small and micro-sized enterprises and support the development of new economic fields. Premier Li Keqiang presided over and held an economic situation expert and entrepreneur symposium on July 15, 2019. At this symposium, Premier Li Keqiang proposed that we should develop more "unicorn enterprises" and "gazelle enterprises" as well as new leading enterprises. Small and medium-sized banks should follow the trend of China's new economic development, truly realize the service of small and medium-sized banks to private small and micro-sized enterprises, and strongly support unicorn enterprises and "gazelle enterprises" among private small and micro-sized enterprises. In summary, small and medium-sized banks can prevent their profit situation from further deteriorating by adopting the above seven management methods.

7.2. Optimizing the internal equity structure by improving the corporate governance mechanism

The effectiveness and standardization of corporate governance are the important foundation for the long-term stable and healthy development of the entire financial system. In commercial banks, especially small and medium-sized banks, their corporate governance capabilities are the key to the daily stable operation of the bank. It is necessary to establish and improve the governance mechanism of small and medium-sized banks according to the existing enterprise management standards, and optimize the internal equity structure of the bank. Firstly, small and medium-sized banks should increase the punishment for shareholders who use their equity to engage in illegal activities, and carry out the cleanup and rectification of the irregularities of some high-risk small and medium-sized bank shareholders in an orderly and stable manner. Secondly, small and medium-sized banks should standardize their own equity custody, understand the current status of the bank's equity,

improve the transparency of the internal equity information of the bank and the corresponding equity management level, and effectively curb the improper control the bank by shareholders and the pursuit of improper private interests, which may lead to the bank being taken over or even going bankrupt. Thirdly, the relevant supervision management departments should strengthen the due diligence and evaluation of the corporate governance status of small and medium-sized banks, and establish a set of standards for corporate governance methods to and supervise small and medium-sized banks to implement these standards in their business operations. It is necessary to take practical actions to solve problems, rather than just talking about. Fourthly, it is necessary to strengthen the management of the entry conditions for the shareholders of small and medium-sized banks. Since small and medium-sized banks have characteristics of concentrated risk, both major shareholders and minor shareholders must undergo strict review during the entry stage, and improving the entry standards and regulations should be put on the schedule.

7.3. Effectively replenish capital through the implementation of capital supplement tools

First, small and medium-sized banks can increase the speed of disposal of internal non-performing assets, do a good job in asset, and at the same time, increase the provision for bad debts and profit retention, thereby enhancing the ability of small and medium-sized banks to supplement their internal capital. Second, small and medium-sized banks should continue to use the central bank bill swap tool to improve the liquidity of their own perpetual bonds. In 202, due to the impact of the COVID-19 pandemic, China's economic downturn pressure was high. The central bank took relevant measures to stabilize the market, of which was the issuance of special anti-epidemic government bonds. Special government bonds refer to a type of bond issued due to the needs of national strategic during special periods. They are a kind of national bond that is not counted into the public fiscal deficit, and their issuance has the role of avoiding the rise of debt and regulating counter-cyclical effects. Therefore, it is necessary to make good use of special anti-epidemic government bonds to inject capital into financial, thereby encouraging small and medium-sized banks to increase their credit support for small and micro enterprises severely affected by the epidemic, and maintain the early recovery and

stability of entire financial economy. Thirdly, small and medium-sized banks can diversify their capital replenishment channels by issuing common stocks, preferred stocks, and perpetual. Fourthly, small and medium-sized banks can replenish their capital through IPOs. Firstly, IPOs help small and medium-sized banks to quickly replenish core Tier 1 capital, meet the regulatory requirements of financial authorities, and alleviate the external regulatory pressure on small and medium-sized banks. Secondly, it helps to the capital adequacy ratio, enhance the ability of small and medium-sized banks to resist risks with their own capital, not only reflecting the safety of the bank's operations, but also reflecting the changes in the bank's operating conditions in recent years. That is, the bank has entered the risk management era from the asset and management era, which fully demonstrates how much the bank values the principle of three-property balance. Finally, it is also conducive to the improvement of the bank's own and popularity, so as to attract more depositors to store funds in the bank, and at the same time increase the resources of credit customers, thus expanding the's business scale.

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