# Banking Supervision in China: Basel I, Basel II and the Basel Core Principles

*Stefan Brehm/Christian Macht**

## I. Introduction

In September 1997 the Basel Committee on Banking Supervision[1] issued standards dealing with banking supervision institutions. The Core Principles for Effective Banking Supervision (Basel Core Principles, BCP)[2] are regarded as "the global standards for the quality of countries banking supervisory systems",[3] and are one of the twelve key standards for sound financial systems, issued by the Financial Stability Forum. The target of the Basel Committee was to provide minimum criteria for national supervisory and regulatory bodies in order to ensure financial stability and a level playing field for international banking.

In 1988 the Basel Committee published the Basel Capital Accord,[4] the so-called Basel I. It serves as a foundation of banking laws in more than 100 countries,[5] and nearly 150 countries apply essential parts of Basel I in their jurisdiction.[6] The Basel Committee had been formulating the successor to Basel I since the end of 1990's. The consultation process for Basel II was completed on June 26th 2004 with the publication of the New Basel Capital Accord.[7] The proposals of the Basel Committee do not have any legal force and measures connected to banking supervision have so far been explicitly excluded from international trade agreements.[8] Nevertheless it is expected that Basel II will be implemented in most of the countries, especially within the EU, being effective from 2007 onwards.

On April 28th 2003 the Chinese leadership transferred responsibilities for banking supervision to the newly created China Banking Regulatory Commission (CBRC).[9] Following this structural change the legal basis for banking[10] in the PRC was extended through the Law on Banking Regulation and Supervision[11] (LoBRS) and the Regulation Governing Capital Adequacy of Commercial Banks[12] (New Capital Rules, NCR), which came into effect on February 1st and April 1st 2004 respectively. Senior officials state that the LoBRS constitutes the Chinese approach to adopt the BCP, whereas the NCR corresponds to Basel I[13] together with supervisory review

* Stefan Brehm is a PhD-candidate at the Department of Economics at Tübingen University and is associated with the Seminar of Sinology and Korean Studies (stefan.brehm@uni-tuebingen.de). Christian Macht is a PhD-candidate at the Faculty of Law at Tübingen University (christian.macht@uni-tuebingen.de). Both received a master degree in economics (Diplom-Volkswirt) from Tübingen University.

[1] The Basel Committee on Banking Supervision is a group of banking supervisory authorities and regarded as the international standard setting body in the area of banking regulation and supervision. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States.

[2] Basel Committee on Banking Supervision (1997). In 1999 the Basel Committee issued a methodology on how to assess national compliance of the Basel Core Principles (Basel Committee on Banking Supervision (1999)).

[3] IMF and Worldbank Implementation of the Basel Core Principles for Effective Banking Supervision, Experiences, Influences, and Perspectives, Prepared by the Staffs of the World bank and the International Monetary Fund 2002 - Approved by Cesare Calari and Stefan Ingves, International Monetary Fund, The World Bank, p. 7 (http://www.imf.org/external/np/mae/bcore/2002/092302.pdf).

[4] Basel Committee on Banking Supervision (1998). Its major amendment was the incorporation of market risk in 1996 (Basel Committee on Banking Supervision (1996)).

[5] Basel Committee on Banking Supervision (1999) Capital Requirements and Bank Behaviour: The Impact of the Basel Accord, Working Papers No.1, by a working group led by Patricia Jackson, Basel, BIS, p. 1 (http://www.bis.org/publ/bcbs_wpl.pdf).

[6] Worldbank (2004), Bank Regulation and Supervision , Database (2003 version, released 3-9-2004); Washington D.C., Worldbank (http://www.worldbank.org/research/interest/2003_bank_survey/Bank_regulation_survey_3-5-04.xls).

[7] Basel Committee on Banking Supervision (2004), International Convergence of Capital Measurement and Capital Standards – A revised Framework. Basel, BIS (http://www.bis.org/publ/bcbs107.pdf).

[8] General Agreement on Trade in Services (GATS), April 15th 1994, Annex on Financial Services, 2 lit. a.

[9] Decision on Institutional Restructuring of the Government Agencies under the State Council (Guowuyuan jigou gaige fangan de jueding), in: Bulletin of the State Council (Guowuyuan gongbao) 2003, No.11, p.9, and Decision of the Standing Committee of the National People's Congress on Exerting Supervisory Responsibilities by the China Banking Regulatory Commission, Formerly Exerted by the People's Bank of China (Quanguo renmin daibiaohui changwu weiyuanhui guanyu Zhongguo yinhangye jiandu guanli weiyuanhui lüxing yuanyou Zhongguo renmin yinhang lüxing de jiandu guanli zhize de jueding), April 26th 2003, in: Bulletin of the State Council (Guowuyuan gongbao) 2003, No. 16, p. 5.

[10] At the end of 2003, China's banking sector comprised four wholly State-owned commercial banks, three policy banks, eleven joint-stock commercial banks, four asset management companies, 112 city commercial banks, 192 foreign bank branches and subsidiaries, 209 foreign bank representative offices, 723 urban credit cooperatives, 34,577 rural credit cooperatives, three rural commercial banks, one rural cooperative bank, 74 trust and investment companies, 74 finance companies, 12 financial leasing companies and numerous postal saving institutions (*TANG Shuangning,* Reforms of State-owned Commercial Banks in China, Speech by Tang Shuangning, Vice Chairman of China Banking Regulatory Commission, April 26, 2004; http://www.cbrc.gov.cn/english/).

[11] Law of the People's Republic of China on Banking Regulation and Supervision (Zhonghua renmin gongheguo yinhangye jiandu guanli fa), December 27th 2003 (http://www.pbc.gov.cn), in: Bulletin of the State Council (Guowuyuan gongbao) 2004, No. 7, p. 4.

[12] Methods on adequate capital rates of commercial banks (Shangye yinhang ziben chongzulü guanli banfa), February 23rd 2004.

[13] China Banking Regulatory Commission (2003), The letter from LIU Mingkang, the Chairman of CBRC, to Mr. Jaime Caruana, Chairman of the Basel Committee on Banking Supervision, Comments on the third

and disclosure requirements of Basel II.[14] These statements led us to analyse the degree of compliance of the new laws and regulations in the PRC with the global standards set by the Basel Committee. Is China really integrating international standards in its legal and regulatory system? The following article will lay out the legal framework of banking regulation and supervision in China and will show that China is preparing for deeper integration in the international capital markets.

## II. The Law on Banking Regulation and Supervision and the Basel Core Principles

### 1) Supervisory Institutions and Legal Framework in the PRC

In China, supervisory responsibilities are shared between the People's Republic of China (PBC) and the CBRC. The PBC is responsible for maintaining financial stability. It therefore monitors and assesses the situation of the financial market (Art. 30 LoPBC), supervises banking institutions,[15] other groups and individuals, and may conduct investigations.[16] Its focus is on the macroeconomic situation. The CBRC is in charge of regulating banking services. It has absorbed functions from the PBC and the Central Financial Work Commission, which served as a powerful authoritative instrument of government oversight of the banking system.[17] Art. 2 LoBRS specifies the Banking Regulatory Authority under the State Council[18] as the agency responsible for conducting the supervision of national banking institutions and their business activities. This is somewhat confusing, as there are two different terms – Banking Regulatory Authority and China Banking Regulatory Commission – which address the same entity. In this paper we shall take the two terms as synonymous, first because this is indicated by the Decision of the Standing Committee, which refers to the CBRC in the context of reforming the "agencies under the State Council" and second because the functions and subject of responsibility described with reference to the CBRC and the Banking Regulatory Authority under the State Council seem to be identical.

The financial legal framework consists of the Law on Commercial Banks[19] (LoCB), the Law on the People's Bank of China[20] (LoPBC) and the Law on Banking Regulation and Supervision[21] (LoBRS) enacted by the National People's Congress as well as regulations decided by the State Council and rules issued by the PBC, the Ministry of Finance, the State Administration on Foreign Exchange Control and the CBRC. Laws are superior to regulations of the State Council, while the rules of ministries and agencies are junior to laws as well as to State Council regulations. In this section of the paper we shall assess the compliance of Chinese laws and regulations by means of addressing each of the seven sections of the Basel Core Principles.[22]

### 2) Adaptation of the BCP into Chinese Law

#### a) Section 'Objectives, Autonomy, Powers and Resources' (BCP 1)

The section 'Objectives, Autonomy, Powers and Resources' (BCP 1) deals with the definition of responsibilities and objectives, of the supervisory agency in terms of its skills, resources and independence, and its legal framework and enforcement powers. BCP 1 also requires adequate legal protection for supervisors and information sharing.

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consultative paper on the New Capital Accord, CBRC, p. 2 (http://www.cbrc.gov.cn/english/yaowen/detail.asp?id=3&keyword=Comments); see also People's Bank of China (2001), Letter of LIU Tinghuan, Deputy Governor of the People's Bank of China, to William J. McDonough, Chairman of the Basel Committee on Banking Supervision, Comments on the Second Consultative Package of the New capital Accord; Beijing, p. 1: "Our present capital regulation is largely based on the 1988 Capital Accord".

[14] China Banking Regulatory Commission (2004), Senior Official of the China Banking Regulatory Commission (CBRC) speaking to the press on the newly issued Regulation Governing Capital Adequacy of Commercial Banks, CBRC (http://www.cbrc.gov.cn/english/yaowen/detail.asp?id=42).

[15] The term "banking institutions" is not defined within the LoPBC, but within the newly created LoBRS (Art. 2).

[16] According to Art. 32 LoPBC, the PBC has the authority to monitor financial institutions', other groups' and individuals' activities concerning the implementation of administrative rules on reserve funds, Renminbi, interbank call and securities markets, foreign exchange, gold, clearing, combating money laundering as well as activities concerning the management of the State treasury.

[17] *Barry Naughton*, Government Reorganisation: Liu Mingkang and Financial Restructuring, in: China Leadership Monitor, vol. 2004, p. 7.

[18] Institution of the State Council on Banking Regulation and Supervision (Guowuyuan yinhangye jiandu guanli jigou), in: Bulletin of the State Council (Guowuyuan gongbao) 2004, No. 7, p. 21.

[19] Law of the People's Republic of China on Commercial Banks (Zhonghua renmin gongheguo shangye yinhang fa), May 10th 1995, revised December 27th 2003, effective on February 1st 2004 (http://www.pbc.gov.cn).

[20] Law of the People's Republic of China on the People's Bank of China (Zhonghua renmin gongheguo zhongguo renmin yinhang fa), March 18th 1995 (revised December 27th 2003, effective on February 1st 2004).

[21] The provisions of the LoBRS are applicable to the supervision of banking institutions, asset management companies, trust and investment companies, finance companies, financial leasing companies and other financial institutions established in the PRC. Furthermore, the CBRC supervises financial institutions, which, being subject to its approval, are established outside the PRC as well as overseas business of national institutions (Art. 2 LoBRS).

[22] (1) Objectives, autonomy, powers and resources, (2) licensing and structure, (3) prudential regulations and requirements, (4) methods of ongoing banking supervision, (5) information requirements, (6) formal powers of supervisors and (7) cross-border banking. We follow the summary of IMF/ Worldbank (supra note 3), p. 8.

The LoBRS addresses many of the BCP 1 stipulations: The CBRC is in charge of banking surveillance with the exception of issues concerning foreign exchange or national monetary policy. It therefore constitutes the main supervisory body for banking institutions in the PRC. The term 'banking institutions' is defined in Art. 2 LoBRS.[23] Art. 3 LoBRS claims that banking regulation should be exerted with the objective of promoting the safety and soundness of the banking industry and maintain public confidence in the banking industry. Art. 4 LoBRS demands that the CBRC exercises regulation and supervision in accordance with laws and regulations and Art. 5 LoBRS protects its regulators, while they perform supervisory responsibilities. Regarding information Art. 6, 7 LoBRS allows the CBRC to share information with other national and international regulatory authorities and Art. 11 LoBRS assures the confidentiality of information. Political interference at the local and regional level as well as bureaucratic resistance are limited by the centralized organizational structure of the CBRC (Art. 8 LoBRS) and its authority to claim assistance from local governments and governments departments (Art.13 LoBRS). Additionally, Art. 5 LoBRS requires that there shall be no interference by local governments, government departments on various levels, public organizations or individuals. However, operational independence stipulation in BCP 1 is not fully reflected by the LoBRS since some rules are ambiguous with respect to the role of the State Council and the CCP. E.g. Art. 15 LoBRS demands that the CBRC formulates and promulgates supervisory rules in accordance with applicable laws and administrative regulations. The same is said in Art. 21 LoBRS about prudential regulations. On the one hand this is consistent with the BCP, since it allows supervisors sufficient flexibility to set prudential rules administratively. On the other hand this can endanger effective supervision. The above mentioned hierarchy of laws, where the State Council is eligible to issue regulations senior to provisions of the CBRC creates problems in terms of possible political interference. Decisions of the State Council create a powerful instrument to shape the operational scope of the CBRC and might be used to control the supervisory process. Furthermore the CBRC is subject to the oversight by government agencies under the State Council such as the Audit Institution and the Supervisory Institution[24] (Art. 14 LoBRS). The CBRC might consider itself forced to act in obedience to 'political recommendations' because the State Council has a say in its surveillance. This certainly contradicts the BCP 1 requirement that supervisory bodies need to pursue their duties free from political pressure. Furthermore the CCP exerts a strong influence, because it controls the appointment and dismissal of all elites by means of the nomenclature system as well as by the party core groups (ministerial level) and party committees (all other levels), which represent the Party's interests within government entities.[25] Party control was even strengthened in 1998, when the CCP took on the nomenclature authority at the bureau level from the Ministry of Personnel and therefore came to preside over several thousand key-positions in Chinese society.[26] Hence, even though Art. 9 and 10 LoBRS claim that supervisory staff must have professional skills, work experience, and the integrity required for performing their duties, scepticism remains as to whether this will restrict the consideration of political merits as a criterion for appointment.

A further specification of BCP 1 – adequate resources to guarantee an effective supervision – is also in doubt. The CBRC may only collect fees amounting to five billion RMB (about $620m) from commercial banks, which are differentiated by risk level and bank type. The budget must meet all expenditures of the Commission including personnel, equipment and a branch network of 31 provincial, 400 city and 650 – 680 county offices.[27] Due to the Central State's interests and means of intervention, meeting these requirements proves a difficult task for the CBRC. On the one hand the agency needs to put pressure especially on the SOCBs to improve their business operation's efficiency and the quality of their risk management, on the other hand the CBRC must allow them to continue to operate irrespective their financial situation, which weakens the supervisory body's authority to enforce prudential regulations and gives leeway for supervisory forbearance.

In summary most of the BCP 1 requirements are met in the LoBRS. Yet, operational independence is restricted, since the State Council and the CCP have

[23] 'Banking institutions' are financial institutions established in the PRC which take deposits from the general public, including, among others, commercial banks, urban credit cooperatives and rural credit cooperatives as well as policy banks.

[24] *Shenji jiguan* and *Jiancha jiguan*, respectively.

[25] *Kenneth Lieberthal*, Governing China – From Regulation Through Reform, New York/London 1995.

[26] *Kjeld Erik Broedsgard,* Institutional Reform and the Bianzhi System in China, in: The China Quarterly, Vol. 170, June 2002, pp. 361-386.

[27] *JIAN Xi*, The Banking Regulatory Commission is planning to collect 5 billion annual fees from supervised banks - is this the parting from dearth? (Yinjianhui ni xiang jianguan duxiang zheng 50 yi nianfei gaobie jieqian duri?), 2004 (httw://www.sina.com.cn).

various channels to exert control over the CBRC.[28] The State Council can issue regulations overruling those of the supervisory body or use the Audit and Supervisory Institution to put pressure on the CBRC. The CCP may interfere via its authority to recruit and dismiss personnel. Apart from the issue of independence, adequate resources are also in doubt. The important role of the SOCBs in providing financial stability and promoting political initiatives will therefore make interference from the Central State likely which further narrows the scope of means the CBRC may take to enforce prudential regulations.

**b) Section 'Licensing and Structure' (BCP 2-5)**

The section 'licensing and structure' (BCP 2-5) focuses on permissible activities of banks, licensing criteria and the licensing process. It requires supervisors to review major acquisitions and investments by banks and to review – and have the power to reject – all significant transfers of ownership in banks. 'Licensing and structure' stresses that explicit criteria should outline the population of institutions to be supervised, reduce the potential influence of political interference and lower the number of unstable institutions.

In China, the licensing authority is the CBRC (Art. 18 LoBRS). Without permission of the CBRC, no institution or individual may establish a banking institution or engage in banking business (Art. 19 LoBRS). The CBRC may approve or reject applications for the establishment, restructuring and termination of banking institutions. But, except for reviewing the ownership structure (Art. 17 LoBRS) as well as conducting fit and proper tests for directors and senior directors (Art. 20 LoBRS), the LoBRS includes no explicit licensing criteria (Art. 17 LoBRS). The LoBRS also does not include any fiat which allows the CBRC to set criteria for the establishment of a banking institution. Hence the CBRC has to decide according to Chapter II of the LoCB, which mentions explicit rules for the establishment of a commercial bank (Art. 12-15 LoCB) and of a bank branch (Art. 20 LoCB). The essential application documents for establishing a banking institution mentioned in the LoCB address the requirements of the Basel Core Principles: (i) operating plan, systems of control and internal organization and (ii) financial projections including capital. Apart from that, the BCP demand the prior approval from the home country supervisor when the proposed owner is a foreign bank. This issue is dealt with in Art. 6-8 of the State Council's Regulations of the People's Republic of China on the Administration of Foreign-funded Financial Institutions.[29] Due to Art. 17 LoBRS, "changes in the shareholders that hold a certain percentage or more of the total capital" have to be approved by the CBRC, which is in line with the BCP. The "certain percentage" is stipulated in Art. 24 of the LoCB and has been lowered from 10% to 5% in the revised law. BCP 5 claims the approval of the supervisory body for 'major acquisitions or investments' by a bank. This is not mentioned in the LoBRS, but in Art. 25 LoCB.

All in all, the Chinese regulatory framework fully complies to the BCP on 'licensing and structure'. The competences of the licensing authority are stated in the LoBRS, while the criteria for the establishment, restructuring, and termination of banking institutions is laid out in the LoCB and further regulations.

**c) Section 'Prudential Regulations and Requirements' (BCP 6-15)**

'Prudential Regulations and Requirements' (BCP 6-15) deal with minimum capital adequacy requirements, granting and managing loans and making investments. They set forth rules for evaluating asset quality, the adequacy of loan-loss provisions and reserves, for identifying and limiting concentrations of exposures to single borrowers, or to groups of related borrowers, and for lending to connected or related parties. The section requires banks to have policies for identifying and managing country and transfer risks, have systems to measure, monitor and control market risks and all other material risks as well as have adequate internal control systems. It sets out rules for preventing fraud and money laundering. 'Prudential Regulations and Requirements' are an essential part of the BCP, accounting for a total of ten Principles out of twenty-five.

Conversely, the LoBRS responds to this important issue only in Art. 21. It states – as mentioned above – that prudential rules and regulations may be stipulated in laws or administrative regulations formulated by the CBRC in accordance with applicable laws and administrative regulations. The term 'prudential rules and regulations' as it is used in the LoBRS, covers among others risk manage-

[28] For the political influence of the CCP, especially via the installation of the senior officials, see *Naughton* (supra note 17).

[29] Rules of the People's Republic of China on Foreign-funded Financial Institutions (Zhonghua renmin gongheguo waizi jinrong jigou tiaoli), December 20th 2002, in: Proclamations of the People's Bank of China (Zhongguo renmin yinhang wengao) 2002, No. 1, pp. 3-10.

ment, internal controls, capital adequacy, asset quality, loan loss provisioning, risk concentrations, connected transactions and liquidity management (Art. 21 LoBRS). This addresses many of the Basel Core Principles, but without providing a statement of implementation or quality requirements. Yet, these issues are regulated in separate provisions. Most prominent are the New Capital Rules, which deal with minimum capital requirements mentioned in BCP 6. This topic will be discussed extensively in section 3 of this paper. Apart from a general low capital adequacy ratio, a second major concern of the Chinese financial system is the misallocation of capital due to lending policies stamped by technical deficiency, malpractice, cronyism and political influence.[30] According to the BCP it is necessary to implement a management information system which provides essential details on the condition of the loan portfolio, including internal loan grading and classifications, in order to control banks' credit risk. Although this topic is not mentioned in the LoBRS, the Chinese government has been dealing with it since 1998. Influenced of the Asian financial crisis in 1997, the PBC issued guidelines for lending policies and loan documentation.[31] Since then loans have to be classified according to five categories: (1) normal (zhengchang), (2) under observation (guanzhu), (3) second-rate (ciji), (4) doubtful (keyi), (5) lost (sunshi). The last three are named "bad loans (buliang daikuan). Aimed at lowering the risk of bank failure due to non-performing loans, the PBC formulated the Guidance for the Calculation of Loan Loss Provisions[32], which addresses adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and loan loss reserves. The Guidance for Implementing a Unified Lending System of Commercial Banks[33] should mitigate a high risk concentration.[34] In addition, the Guidance for Internal Control of Commercial Banks (GICCB)[35] deals with various Basel Core Principles in more detail.[36] In Art. 31 GICCB for example, banks are required to set up an internal control system that ensures sound unified credit management and prevents abuses arising from connected lending. However, no prudential limits are set, inducing intervention by the supervisory body. Risk management is mentioned in several regulations: The New Capital Rules deal with the calculation of various risks (credit risk, country and transfer risk, market risk, interest rate risk, liquidity risk, but not operational risk). Due to Art. 10 GICCB, banks have to establish a management system, procedures and methods helping to recognize, measure, as well as control, risks.[37] They also need to deal with off-balance-sheet risks,[38] and furthermore, banks need to make their situation regarding credit risk, liquidity risk, market risk, operational risk and other risks public.[39]

All in all China does address the problems connected to the granting of loans and the dangers of risks arising from financial operations, which are mentioned in the section 'prudential regulations and requirements' of the BCP. However, as was already stated, in terms of internal compliance of the CBRC itself, the rules concerning prudential regulations only supply a crude general guidance and leave out detailed criteria, clear quality standards and explicit time limits for their implementation. The New Capital Rules are a notable and important exemption.

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30 *Joel Baglole*, Chinese Credit Ratings - A Huge Leap of Faith, in: Far Eastern Economic Review, 8th January 2004.

31 Leading Principles on Credit Risk Classification (Daikuan fengxian fenlei zhidao yuanze), April 20th 1998, in: Proclamations of the People's Bank of China (Zhongguo renmin yinhang wengao) 1998, No. 6, and the Circular on the Work of the People's Bank of China Regarding the Complete Enforcement of the Five Loan Categories (Zhongguo renmin yinhang guanyu quanmian tuixing daikuan wu ji fenlei gongzuo de tongzhi), July 27th 1999, in: Proclamations of the People's Bank of China (Zhongguo renmin yinhang wengao) 1999, No. 12, pp. 13-19.

32 China Foreign Firms Assignment (of the People's Bank of China) " Guidance for the Calculation of Loan Loss Provisions" (Zhongguo yanghang zhiding (Zhongguo renmin yinhang) yinhang daikuan sunshi zhunbei jiti zhiyin), in: Proclamations of the People's Bank of China (Zhongguo renmin yinhang wengao), 2002, No. 10, pp. 3-5.

33 Guidance for Implementing a Unified Lending System of Commercial Banks (Shangye yinhang shishi tongyi shouxin zhidu zhiyin), in: Proclamations of the People's Bank of China (Zhongguo renmin yinhang wengao) 1999, No. 4, pp. 3-6.

34 Thus, a lending policy has to be grounded on a consolidated basis regarding four aspects: (1) the subject of lending (shouxin zhuti de tongyi), meaning different departments of a bank approving a loan, (2) the kind of loans (shouxin xingshi de tongyi), (3) different currencies (butong bizhong shouxin de tongyi), and (4) the object of lending (shouxin duixiang de tongyi), meaning the legal person (faren) receiving a loan.

35 Guidance for Internal Control of Commercial Banks (Shangye yinhang neibu kongzhi zhiyin), in: Bulletin of the State Council (Guowuyuan gongbao) 2003, No. 14, pp. 31.

36 The GICCB is divided into seven chapters: (1) general provisions, (2) basic requirements for internal control, (3) internal control of lending, (4) internal control of financial services, (5) internal control of savings and retail services, (6) internal control of broker services, (7) internal control of accounting, (8) internal control of the electronic information system, (9) supervision and adjustment of internal control.

37 Such risks are credit risks (xinyong fengxian), market risks (shichang fengxian), liquidity risks (liudongxing fengxian), operational risks (caozuo fengxian) and other risks (qita fengxian) (Art. 11 GICCB) as well as country risks (guojia fengxian) (Art. 27 (3) GICCB).

38 Guidance on the Risk Management of Commercial Banks' Off-Balance-Sheet Services (Shangye yinhang biaowa yewu fengxian guanli zhiyin), November 9th 2000, in: Proclamations of the People's Bank of China (Zhongguo renmin yinhang wengao) 2000, No.18, pp.28-30. Risks are devided in guarantees (danbao), promises to undertake (chengnuo) and clean financial transactions (jinrong weisheng jiaoyi). Off-balance issues are also included in the calculation of the adequade capital base in the NCR (Art. 27 and Annex 3 NCR).

39 Claimed in Art. 22 of the Interim Methods on Commercial Bank Disclosure (Shangye yinhang xinxi bolu zanxing banfa), January 2003, in: Bulletin of the State Council (Guowuyuan gongbao) 2003, No. 6, pp. 26.

**d) Section 'Methods of Ongoing Supervision' (BCP 16-20)**

'Methods of Ongoing Supervision' (BCP 16-20) define the overall framework for on-site, off-site and consolidated supervision. They require supervisors to have regular contacts with bank management and staff, and to fully understand banks' operations as well as to conduct on-site examinations or to use external auditors for validation of supervisory information.

Art. 23 LoBRS claims that the CBRC should conduct off-site surveillance. For this purpose, the CBRC will have to establish a supervisory information system for analysing and assessing the risk profile of banking institutions (Art. 23 LoBRS). Furthermore, the Commission needs to set up a rating system and an early warning system which helps to decide the frequency and the scope of on-site examinations (Art. 27 LoBRS). Additionally, according to Art. 28 LoBRS the CBRC shall establish a system to identify and report emergency situations in the banking sector. BCP 19 suggests creating means of independent validation for banking supervisors either through on-site examinations or use of external auditors. The Chinese law favours the former (Art. 24 LoBRS), since external auditing in China is susceptible to misreporting and fraud.[40] Additionally on-site surveillance – if exercised by a supervisory body dominated by the state – may serve as an instrument of the Central Government to control and influence commercial banks activities and thereby mitigating the principal-agent problem of hidden action. Art. 34 LoBRS, describes in detail the measures of on-site examination, which the CBRC may take.[41] The means of on-site and off-site examinations, as described in the LoBRS, are in line with the demands of BCP 18, which calls for means of collecting, reviewing and analysing prudential reports and statistical returns from banks. Yet, the BCP stipulate a review on a solo and consolidated basis, while the CBRC is required to regulate and supervise banking institutions on a consolidated basis only (Art. 25 LoBRS). According to Art. 35 LoBRS, the CBRC may hold supervisory consultations with the directors and senior managers of a banking institution in order to inquire about the major activities concerning its business operations and risk management. This is in accordance with BCP 17, which suggests regular contact of bank supervisors with bank management and thorough understanding of the institution's operations.

Compliance of the LoBRS with the BCP regarding ongoing supervision is strong. The law allows the CBRC for on-site and off-site examination and defines the measures it may take.

**e) Section 'Information Requirements' (BCP 21)**

BCP 21 ('Information Requirements') demands banks to maintain adequate records reflecting the true condition of the bank, and to publish audited financial statements.

Art. 33 and 36 LoBRS deal with the information issue: The CBRC has the authority to require banking institutions to submit balance sheets, income statements and other financial or statistical reports, information concerning business operations and management as well as audit reports prepared by certified public accountants (Art. 33 LoBRS). This is not fully consistent with BCP 21, as the stipulation of the LoBRS focuses on the authority to require information, while the BCP stress the quality of such information described as "adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business".[42] According to Art. 36 LoBRS, the CBRC has to ensure that banks disclose reliable information to the public.[43] The concern about quality is not addressed in the LoBRS, but rather in the above mentioned NCR and the Interim Methods on Commercial Bank Disclosure, which deals with the content and frequency of financial reports. There, Art. 5 states that banks need to make information public in a truthful, precise and complete way according to laws and regulations, the national unified accounting system and the provision stipulated by the CBRC. One might not be very confident that this will be enough to get Chinese information requirements in line with the Basel

[40] *Sonja Opper*, Enforcement of China's Accounting Standards: Reflections on Systemic Problems, in: Business and Politics 2003, vol. 5,2 pp. 151-173.

[41] The measures that the CBRC may take in conducting on-site examinations are: (1) to enter a banking institution for on-site examination, (2) to interview the staff of the banking institution and require them to provide explanations on examined matters, (3) to have full access to, and make copies of, the banking institution's documents and materials related to the on-site examination, and to seal up documents and materials that are likely to be removed, concealed or destroyed, and (4) to examine the banking institution's information technology infrastructure for business operations and management.

[42] Basel Committee on Banking Supervision (1997), Core Principles of Effective Banking Supervision; Basel, BIS, pp. 6f (http://www.bis.org/publ/bcbs30a.pdf).

[43] Such information has to include, among others, financial reports and statements, risk management policies and procedures, changeover of directors and senior managers and information on other significant matters.

Core Principles, since accounting and auditing standards, together with their enforcement are weak.[44]

Information requirements have improved with the LoBRS and have come closer to international standards. But the quality and trustworthiness – and therefore compliance to the BCP – remain more than doubtful and have to be strengthened.

#### f) Section 'Remedial Measures and Exit' (BCP 22)

BCP 22 ('Remedial Measures and Exit') requires the supervisor to have, and promptly apply, adequate remedial measures for banks when they do not meet prudential requirements, or are otherwise threatened.

Chapter IV LoBRS responds to the BCP's stipulations on the formal power of supervisors. Whenever a bank fails to meet prudential rules and regulations, the CBRC may decide about remedial measures ranging from suspending part of the business (Art. 37 LoBRS) to closing down the institution (Art. 39 LoBRS). The power to intervene is also illustrated by Art. 36-41 of the New Capital Rules, where 'corrective actions' for banks failing to meet capital regulations are stated.

Formal powers of the Chinese supervisory body are far reaching and seem to be fully consistent with BCP 22.

#### g) Section 'Cross-border Banking' (BCP 23-25)

The section 'Cross-border Banking' (BCP 23-25) demands that supervisors apply global consolidated supervision over internationally active banks, establish contact and information exchange with other supervisors involved in international operations, such as host country authorities. It stipulates that local operations of foreign banks are conducted to standards similar to those required of local banks, and that the supervising authority has the power to share information with the corresponding home country supervisory authority.

According to Art. 32 LoBRS, the CBRC may engage in international activities related to banking regulation and supervision. This builds the legal basis for international cooperation as is stipulated in BCP 24. However, cooperation is not formulated as an obligation. The requirement of global consolidated supervision cannot be found in the LoBRS but is regulated in the Guidance on Supervision of Foreign Institutions of Commercial Banks.[45] Therein, Art. 36 mirrors the demand of BCP 23. It stipulates that foreign institutions of Chinese commercial banks have to accept the supervision and examination conducted by the CBRC. The Provisions on Consolidated Supervision of Foreign Banks[46] ensure equal treatment of foreign and domestic banks with respect to supervision. This is in line with BCP 25.

On the whole, cross-border banking requirements in the LoBRS are consistent with those in the BCP. A problem may arise from the non-obligatory character of Art. 32, which could lead to low international cooperation – if the CBRC is not disposed to share information about domestic banks with foreign supervisory bodies due to political reasons.

## III. The New Capital Rules, Basel I and Basel II

Currently, international banking regulation is still based on Basel I, but already influenced by its successor, Basel II. Basel I urges banks to set aside 8% of the capital spent for loans (credit risk) using a simple matrix, which distinguishes between creditors (sovereigns, banks and companies) and their geographical location (mainly OECD countries and non-OECD-countries).

### 1) Compliance of Chinese Regulations with Basel I

#### a) Capital Adequacy Ratios

Although the level of 8% is clearly defined as the minimum level of the banks' capital adequacy ratio in Art. 39 of the Law on the People's Bank of China from 1995, the laws and regulations have left various loopholes and do not provide guidance on supervisory actions to address the many under-capitalized banks.[47] The lack of clearly stated corrective action possibilities weakens effective supervision and damages its authority. The Regulation Governing Capital Adequacy of Commercial Banks, called the New Capital Rules (NCR), fills this gap.[48] *Prima facie*, the NCR show many similarities to Basel I. Notably the new regulations require coverage of

[44] *Opper* (supra note 40).

[45] Guidance on Supervision of Foreign Institutions of commercial Banks (Shangye yinhang jingwai jigou jianguan zhiyin), PBC August 20th 2001, in: Proclamations of the People's Bank of China (Zhongguo renmin yinhang wengao) 2001, No. 17, pp. 3-10.

[46] Provisions on Consolidated Supervision of Foreign Banks (Waizi yinhang bingbiao jianguan guanli banfa), March 8th 2004, effective from April 1st 2004.

[47] China Banking Regulatory Commission (2004), Turning a New Page in China's Banking Supervision and Regulation, CBRC, p. 10.

[48] The new regulations took effect on April 1st 2004, but the CBRC has set the deadline for meeting the new requirements at January 1st 2007 (Art. 53, 55 NCR).

market risk,[49] which up to now is done only in few countries.[50] Consistency can also be found in the fundamentals: The target capital adequacy ratio of 8% is manifested in Art. 7 NCR, together with the requirement of at least 4% core capital.[51] The formula to calculate the adequacy ratio is the same, with only the definitions of the capital elements being marginally softer than the Basel requirements.[52] Basel I puts the deduction of holdings of other banks' capital at national discretion.[53] The PRC does not choose this option. Rather, Art. 14 NCR demands deductions for equity investment in unconsolidated financial institutions. This is an important measure as it hampers potential systemic dangers for the banking system due to such double-leveraging after the privatisation of some Chinese banks.[54] Additionally, according to Art. 14 NCR, equity investments in commercial real estate and in business enterprises shall be deducted from the total capital base, with 50% to be deducted from core capital (Art. 15 NCR).[55] This appears to be an outflow of the threat of a commercial real estate bubble, which was one of the main sources of the Asian Crisis in 1997. Finally, the calculation and measurement of capital adequacy ratios is to be done on a stand-alone basis and on a consolidated basis, as required by Basel I.

It can be concluded, that the fundamentals of the Basel Capital Accord of 1988 are generally fulfilled in the New Capital Rules.

**b) Risk Weights**

Regarding the risk weights, the general classification of four buckets (0%, 20%, 50%, and 100%) omits one bucket of Basel I (10%), which may only be a sign of simplification. Crucial is the classification of claims regarding these buckets. Parts, like the 100% risk weight for claims on business enterprises and individuals or the 50% risk weight for residential mortgage, are the same as defined in Basel I. But one main deviation is that the Basel distinction of claims in the OECD (low risk weights) and claims outside the OECD (high risk weights) – the so-called OECD club rule – does not exist in the New Capital Rules. Instead, Art. 17 NCR distinguishes between the various risk weights on the basis of ratings of external credit agencies.[56] There are still other deviations: Art. 19 NCR defines the risk weight of claims on the Chinese central government denominated in both domestic and foreign currency as 0%. This goes beyond Basel I, where only claims denominated in national currency have a 0% risk weight. Different risk weights for claims in national and foreign currency, resulting in a spread in the interest, would undermine the reputation of the government. It would furthermore "directly set the supervisor [the CBRC] on course of collision with the Ministry of Finance, which likely enjoys a higher status in the government".[57] China therefore demanded a more flexible treatment and the possibility of national discretion with respect to claims on sovereigns. Art. 19 NCR gives two more insights: It defines the risk weight on claims on domestic public-sector entities, invested by the Chinese Central Government (not by local governments) as being 50%.[58] This is considerably high, considering that Basel I provides the possibility of a 0% risk weight. But it prohibits this 50% risk weight for public-sector entities invested by the local government, which is now 100%. Furthermore, Art. 20 NCR allows for a 0% risk weight for claims on (domestically incorporated) policy banks, which are controlled by the national government.[59] Art. 21

[49] Only commercial banks whose trading position is above a given threshold are subject to market risk capital charge (Art. 30 NCR).

[50] Worldbank 2004 (supra note 6).

[51] Core capital as set by the Basel Committee: The sum of tier 1 capital elements (paid-up share capital/common stock and disclosed reserves), less goodwill and other intangible assets. Since October 1998, innovative capital instruments – limited to a maximum of 15% of tier 1 capital – are also eligible for inclusion. The NCR do not allow for these innovative instruments, but accept minority interests as tier 1 capital.

[52] *Desombre, Michael* and *CHEN Weiheng*, New Capital Rules Bring China's Banking Regulation Up to Global Standards, in: China Law & Practice, vol. 18,3 (2004), p. 13 argue that the inclusion of convertible bonds and in particular long-term subordinated debt will "broaden the avenues available to PRC commercial banks to improve their capital base". This is true, but absolutely in line with Basel I (and therefore also with Basel II), where hybrid (debt/capital) instruments and subordinated debt with a minimum original term to maturity of over five years may be included within the supplementary elements of capital (Basel Committee on Banking Supervision 1998: par. 22 f, Annex 1). Also in line with Basel I is the inclusion of general provisions within supplementary capital, with specific provisions being deducted from the book value of the loan (Art. 16 NCR), but not counting as capital.

[53] Basel Committee on Banking Supervision (1998), par. 24-27, Annex 1, C. (ii).

[54] The China Securities Regulatory Commission announced to list the Bank of China and the China Construction Bank on the Shanghai stock exchange. For further details, see Guidelines on Corporate Governance Reforms And Supervision of Bank of China and Construction Bank of China (Guanyu Zhongguo yinhang Zhongguo jianshe yinhang gongsi zhili gaige he jianguan zhiyin), issued by the CBRC on March 11th 2004 and effective the same day.

[55] The NCR also eliminate any favourable risk weight for claims secured by property, real estate and residential buildings (*Desombre/CHEN* (supra note 52),p. 14, with further details).

[56] The risk weights on various foreign claims shall be based on the ratings of external credit assessment agencies for the sovereigns or the regions. Below an AA- the risk weight is 100%, otherwise 20%. This inclines to Basel II, which is discussed below.

[57] People's Bank of China 2001 (supra note 13), p. 3.

[58] Public-sector entities provide public services (water, gas, communication, telecommunication, etc.) and investments are significant (Art. 52 NCR).

[59] As banks are fully secured by the central government, this risk weight waiver is in line with international practise. E.g., Germany allows a 0%

states that the risk weight on domestically incorporated commercial banks shall be 20%[60], which deviates from Basel I, where only banks within the OECD are eligible to a 20% risk weight.[61] As this preferential treatment is not related to the soundness of banks, this is a major deviation from the Basel I requirements (and from Basel II). Art. 22 NCR defines the risk weight to be 0% for claims on specific debts issued by the domestically incorporated financial Asset Management Companies (AMCs) to purchase the state-owned banks' non-performing loans.[62] Hence, transferring non-performing loans (NPLs) from banks to AMCs can lead to risk weight reduction down to zero. This helps to lower the capital base of Chinese banks, but does not provide a step towards prudential supervision and enhanced stability.

### c) Risk Mitigates

Further differences are found in the list of financial instruments, which can serve as risk mitigates. Besides some financial instruments, which are not part of Basel I but of Basel II, the NCR for example allow for the following to serve as risk mitigates: Loans secured by bonds, papers issued and bills accepted (Art. 25 NCR) or guaranteed (Art. 26 NCR) by policy banks and Central Government invested public sector entities. All of these have the same risk weight as the instruments or the guarantor.[63] All these exemptions can be subsumed under Basel I, but show a trend towards favourable treatment of central government entities.

Overall, the New Capital Rules show a general commitment to incorporate the Basel I standards on the one hand, but at the same time a few loopholes are created to safeguard the national banking system and central government sway on the other. After the establishment of the AMCs in 1998, a radical solution of the non-performing loan problem seems to be postponed once again. China circumvented a clear cut solution and undermined the purpose of Basel I. This is consistent with the Central Government's gradual approach to restructure the banking system. Pressure on the SOCBs to improve performance therefore might not be sufficient and will give an incentive to accumulate new NPLs rather than to 'outgrow' the problem. Only if the supervisory agency can act independently and in the spirit of prudent supervision will China make a big step towards international standards in banking regulation and supervision as well as move towards a more stable and efficient banking sector.

## 2) Compliance with Basel II

Despite having a basically positive effect, Basel I was repeatedly criticized for its low risk sensitivity.[64] To correct the existing deficits, the Basel Committee finally released Basel II on June 26th 2004. The New Basel Capital Accord will have a similarly strong impact on the international regulation of banks as Basel I. The differences between the old accord and Basel II are significant.

### a) Pillar I: Risk Models

Most prominent is the reliance of the New Accord on internal-ratings-based approaches to a more accurately assessed risk in Pillar I. In a nutshell, these approaches seek to use the banks' own expertise and risk models to help determine the amount of regulatory capital a bank needs to hold. Because the committee realized that risk varies greatly within categories of assets, the proposed accord bases risk weights on bond ratings, credit ratings, and other measurements of market assessments whenever possible.[65] In addition, the proposal recognizes that computer failure, fraud, and other kinds of risks (like terrorist attacks) exist within banks, and that a quantification of such operational risks is required as well. Another planned new addition is the supervisory review process as the second pillar of Basel II. The third pillar of Basel II is, for the first time, aimed explicitly at strengthening the market discipline.

Some banks in China already work with an internal-ratings-based approach for their own use.[66] But the full implementation of the advanced approaches – for

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risk weight for the KfW banking group (Deutsche Bundesbank 2001, Grundsatz I über die Eigenmittel der Institute, §13 (1) 1 a)). But this preferential treatment is also commercially needed, as the policy banks are the ones who will suffer most from the impact of the Chinese WTO accession (*CHEN Chien-Hsun/SHIH Hui-Tzu*, Banking and Insurance in the New China - Competition and the Challenge of Accession to the WTO, Cheltenham, UK/Northampton, MA, USA,2004, p. 89).

[60] In case maturity is at of four months or shorter, it will amount to 0%.

[61] The OECD club rule is justifiably criticized, as for example claims (with a residual maturity of over one year) on Singaporean banks have a 100% risk weight, whereas claims on banks from the OECD-member Mexico, which are individually rated several classes lower, have a 20% risk weight.

[62] China established four AMCs in 1998/1999 to take over about 1.4 trillion RMB (US$ 168 billion) of NPLs from the four big State-owned commercial banks.

[63] The same possibilities are given to commercial banks, which is not *prima facie* justified by state guarantees. It can either be explained by implicit state guarantees or again by the favourable treatment of Chinese banks.

[64] On the deficits of the Basel Capital Accord of 1998 cp. Basel Committee on Banking Supervision (1999).

[65] But with its Standardised Approach, Basel II still allows the calculation of capital requirements for credit risk by using external credit assessments.

[66] *ZHOU Xiaochuan*, Basaier Xinzibenxieyi he diqu fengxian chayi (The New Basel Capital Accord and Regional Disparities in Financial Risks), Speech by Mr. ZHOU Xiaochuan, Governor of the People's Bank of China, at the Seminar on Risk Management and Internal Control of Commercial Banks, Beijing 8th January 2004, p. 1 (http://www.pbc.gov.cn/hanglingdaojianghua/detail.asp?col=xinwen&ID=54).

credit and operational risk – is clearly an enormous task, for which Chinese banks are not prepared. China faces the same problems with the adoption of Basel II as many less developed economies[67] and will not be able to introduce advanced approaches of Pillar I within the next years.[68] It will be difficult to implement even the standardized approach for credit risk, where a market for external credit assessment institutions (ECAIs) is needed.[69] Even the biggest international agencies rated less than 100 enterprises out of about eight million Chinese corporations and 130 banks and the 20 domestic rating agencies do not seem to be credible.[70] However, Basel II allows for the broad discretion of national authorities in recognizing and setting requirements for rating agencies. As Basel II permits purely national rating agencies, it can be expected, that in the near future, Chinese rating agencies will mushroom and dominate the scene. Increased competition among these national ECAIs might lead to favourable ratings. For these reasons the CBRC urges the internationally operating banks to build up a robust internal credit rating system benchmarked to Basel II and to start collecting the necessary data. But it will only "consider the use of an internal-ratings based approach (…) when banks are ready".[71] Right now, the full implementation of Basel II would require Chinese banks to increase their capital base. Using the standardized approach, the total risk-weighted assets would increase by 9.02%. The CRBC has also concluded that Basel II would only marginally improve risk sensitivity – they particularly criticized the crude operational risk measurement – but would increase the overall capital for the Chinese banking sector.[72]

[67] For an overview of the criticism on Basel II regarding less developed economies, see *Jonathan Ward,* The New Basel Accord and Developing Countries: Problems and Alternatives, Working Paper No. 4, ESRC Centre for Business Research, Cambridge, UK 2002; *Stephanie Griffith-Jones, Miguel A. Segoviano & Stephan Spratt,* Submission to the Basel Committee on Banking Supervision: CP3 and the Developing World, Institute of Development Studies, Brighton 2003.

[68] China Banking Regulatory Commission 2003 (supra note 13).

[69] ECAIs play a crucial role in the new Basel II framework in case a bank is not using internal methods – this will be the likely for most of the Chinese banks.

[70] *Baglole* (supra note 30); for example, until July 2003 Standard & Poor`s only rated seven banks and twelve companies in the PRC (China banking Regulatory Commission 2004) and only eleven non-financial companies in April 2004 (standardandpoors.com). China had already criticized the non-existent, poor or not reliable ratings in developing countries to the Basel Committee in 2001. (People's Bank of China 2001 (supra note 13), p. 2).

[71] *TANG Shuangning*, Reforms of State-Owned Commercial Banks in China, Speech by TANG Shuangning , Vice Chairman of China Banking Regulatory Commission, April 26, 2004, Washington D.C., http://wwwcbcr.gov.cn/english/.

[72] China Banking Regulatory Commission (2003): Attachment, p. 1; the results come from five banks, which represent nearly 50% of the total assets of all financial institutions.

### aa) Credit Risk

Yet, the New Capital Rules already incorporate the two important expected changes.

First, basing the risk weights for credit risk on external assessments corresponds with the Standardised Approach of Basel II. Nevertheless, the New Capital Rules are much cruder than those of Basel II. Basically, all claims on central governments and central banks with a rating of AA- or better receive a 0% risk weight.[73] Risk weights for claims on foreign banks depend on the rating of the sovereigns or regions, with a 20% risk-weight for an AA- or better. All other claims, including claims on corporations have a 100% risk weight.[74] Risk weights for domestic corporations are effectively 100% and a more risk sensitive approach useless, due to the near absence or non-sufficient ratings of international rating agencies for Chinese corporations and banks[75]. In addition, Chinese rating agencies are not yet sophisticated enough to fill this gap.[76] It is worth noting that off-balance sheet items receive nearly the same treatment (Art. 27 NCR and Annex 3 NCR for the conversion factors) as in Basel II (and Basel I). Other points, however, are omitted in the New Capital Rules. E.g., past-due loans are not mentioned. In the Basel II standardized approach, past due loans should have a 150% (100%) risk weight, if specific provisions are less (more) then 20% of the outstanding amount of the loan.[77] This is significant, as the PRC is facing a still severe NPL problem. China also does not apply the Higher-risk Categories, where certain claims[78] should receive risk weight of 150% or higher. This issue is only dealt with in Art. 16 NCR, where it is stated, that specific provisions shall be deducted from the book value of loans when commercial banks calculate risk-weighted assets.[79] This results in lower capital requirements for Chinese banks.

[73] *Desombre/CHEN* (supra note 52), p. 13, highlight the fact, that the NCR treat the Chinese Central Government as if its rating were AA-, even if its long- and short-term foreign currency sovereign credit rating from Standard & Poor's is BBB+/A-2. As mentioned above, this is in line with Basel II, which allows for a 0% risk weight to banks' exposures to their sovereign (or central bank) of incorporation if denominated in domestic currency and funded in that currency. The deviation lies in the inclusion of exposures denominated in foreign currencies.

[74] This alone is a major advantage, as SOEs and business enterprises are treated equally (*Desombre/CHEN* (supra note 52) p. 14).

[75] Out of the 13 rated banks in the PRC by Moody's in April 2004, no Chinese bank has a rating of AA- or better, with only one bank having a positive outlook (Moody's Investors Service, bank Credit Research, Monthly Rating List - April 2004, p. 41).

[76] China Banking Regulatory Commission (2004) (supra note 14).

[77] Basel Committee on Banking Supervision (2003), (supra note 71), p. 48. If specific provisions are more then 50% the risk weight could be lowered to 50% at national discretion.

[78] Claims on sovereigns, public-sector entities, banks, and securities firms rated below B-, as well as claims on corporates rated below BB-.

[79] Other provisions for impairment losses shall also be deducted from the book value of relevant assets items (Art. 16 NCR).

**bb) Market Risk**

Second, market risk[80] is incorporated in the NCR. The implementation of market risk is comparable to the amendment to Basel I to incorporate market risk in 1996, which is also part of the Basel II framework. Market risk is stated in the NCR, among others, in Art. 5, 28, and 32 NCR. Art. 32 NCR requires the use of the standardized approach of Annex 4 NCR,[81] but Art. 32 NCR also allows for the usage of internal models to measure market risk, subject to the review and approval of the CBRC.[82] This proves the extent of CBRC discretion, as it is the sole institution to decide on the use of internal methods. Basically, the NCR only incorporate the standardized measurement method of the Basel II framework, but with some limitations. Annex 4 NCR and the maturity method of the Basel II requirements for market risk are virtually the same - just a bit cruder and stricter. The possibility for national discretion is not allowed in the NCR.[83]

**cc) Operational Risk**

A major setback in the adoption of the New Accord is the omission of operational risk[84] in the NCR. Operational risk marks a fundamentally new category for minimum capital requirements in Basel II, where it is introduced for the first time, and will play a crucial role after the incorporation of Basel II. As other countries will apply Basel II in 2007 at the earliest, it is understandable that China did not force its banks to include operational risk now, but it also seems unlikely that it will be part of the capital requirement framework in the near future, as examples of other banks show a significant increase in the overall capital base.[85] However, operational risk is at least included in the new supervisory framework via the demand for internal risk management systems and disclosure.

In a nutshell, the Chinese rules on minimum capital requirements are a simplified version of Pillar I of the Basel framework, without operational risk measures. Despite this encouraging step, it has to be noted, that some rules are simply too broad, and detailed specifications are needed. This holds true especially for the treatment of derivatives.

**2) Pillar II: Supervisory Review Process**

The supervisory review process in the second pillar demands a closer working relationship and understanding between banks and their supervisors. It represents a significant change from the currently effective regulations of Basel I and is determined by four key principles of supervisory review as well as by recommendations regarding supervisory transparency and accountability. Chapter III of the New Capital Rules shows significant similarities to Pillar II of the New Accord, however it is not as rigorous as Basel II and one principle is implemented partially.[86] It is especially the remaining Principles, which deal with the duties of the supervisors which can be found in the New Capital Rules (Art. 36-41 NCR). Art. 37 NCR for example states that the CBRC may require a higher capital adequacy ratio considering the banks' risk profile and its capability of risk management. Art. 38 NCR divides the banks into three categories (adequately capitalized banks, undercapitalised banks, and significantly undercapitalised banks). Art. 39 NCR calls for an early intervention, while Art. 40, 41 NCR state the possible corrective actions, which are far-reaching.[87] This is an important step, as the CBRC can act on undercapitalised banks and corrective actions are

[80] Market risk is defined as the risk of losses in on- and off-balance sheet positions arising from movements in market variables (e.g., interest and foreign-exchange rates or equity and commodity prices). Only commercial banks whose trading book positions are more than 10% of the total on- and off-balance sheet assets or more than 8.5 billion RMB are subject to market risk capital charge (Art. 30 NCR).

[81] The NCR divide market risk into the following subgroups: Interest rate risk, equity risk, foreign exchange risk, commodities risk, and options risk. The same classification is used in the Basel I framework. There are some deviations from the Basel standardized approach. For example, within options risk only the simplified approach and the delta plus method is allowed, whereas the more advanced scenario analysis is not incorporated in the NCR.

[82] The amendment for market risk did for the first time in the Basel framework allow for internal methods.

[83] The Basel Committee allows for short-term subordinated debt (as a third tier capital) to be eligible to cover for market risks (Basel Committee on Banking Supervision (1996), Amendment to the capital accord to incorporate market risk, Basel, BIS, p. 7).

[84] Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. It includes legal, but not strategic and reputational risk (Basel Committee on banking Supervision (2004), (supra note 7) par. 644). The explicit treatment of operational risk is not yet finalized in the current consultation process.

[85] For example, in the Quantitative Impact Study 3 for minimum capital requirements under Basel II in October 2002, the overall increase in capital for banks outside the G10 and the EU and using the standardized approach – which is the likely for most of Chinese banks – was 12%, with operational risk accounting for 11% (Basel Committee on Banking Supervision (2003), Quantitative Impact Study 3 - Overview of Global Results; Basle, BIS, Table 2). Notably, the Chinese results – also using the standardised approach – differ in regard of the contribution of credit and operational risk. Of the total 9.02% increase, 5.19% is attributable to credit risk and only 3.83% is attributable to operational risk (China Banking Regulatory Commission 2003 (supra note 13), Attachment, p. 1).

[86] Principle 1 demands that banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital level and is divided into five main features+. Including various regulations issued by the PBC (especially the Guidance for Internal Control of Commercial Banks from September 2002) most features can be found in the Chinese regulatory framework, but much leeway is given due to broad definitions and the lack of clear requirements and structure.

[87] For example the CBRC may require banks to restrict dividend payouts or other forms of payments to shareholders (Art. 40 NCR) or even require the removal of senior management (Art. 41 NCR).

taken at different levels of capitalization. If the CBRC can turn itself into an active and independent player, these provisions will play a key role in the future of the Chinese banking regulation.

### 3) Pillar III: Disclosure

In its third Pillar on disclosure, the New Basel Capital Accord relies on market discipline and requires that banks and regulators publish detailed information on banks' risky businesses. The rules of the NCR show broad similarities to the New Basel Capital Accord. Art. 43 NCR states that commercial banks should disclose information on the areas of (1) objectives and policies of risk management, (2) scope of application (3) capital, (4) capital adequacy ratios, and (5) credit and market risk. Annex 5 NCR (Disclosure) lists the required information, but the way the requirements have to be fulfilled is not specified. However, the regulations on disclosure are broadly in line with Basel II, especially, when taking into account further disclosure requirements of the Chinese framework.[88] Problems can arise with enforcement and with the reliability of information. These rules can only be seen as a first step in the right direction, however this notable issue is yet not clearly defined for the Basel rules either.

## VI. Conclusions

The new Chinese regulatory framework shows a high degree of compliance with the Basel Core Principles. Hence, on a de iure basis China is getting closer to international prudential requirements. On the one hand this shows Chinese self-commitment to the rules of the "international community" in order to become a reliable global partner. On the other hand, Chinese politics traditionally build upon political control – which contradicts the concept of independent supervision as intended by BCP intend. In fact the new LoBRS allows for discretion and political interference of the central government raising suspicion that the Core Principles serve as an external stick for structural changes in order to tighten control over local agents. In this case de facto compliance presumably will be restricted to the central leadership's power politics.

As is also stated in the comments of the CBRC to the Basel Committee, China will remain at the level of Basel I – at least for a few more years after 2007 – but will incorporate Pillar II and III of Basel II. China has thus created its own "Basel 1.5" and will most likely neither change to internal methods for the calculation of credit risk nor incorporate operational risk. As most of the Chinese banks currently do not meet the 8% target ratio,[89] the implementation of the NCR could improve national requirements by specifying domestic regulation in line with a patchwork of Basel I and II specifications. In addition, the incorporation of the supervisory review process as well as disclosure requirements help the central government to restrict local and provincial cronyism, and increase financial stability. Yet, the NCR are no guarantee for effective banking supervision because loopholes which put the soundness of banking institutions at stake persist.

Both – the LoBRS and the NCR – mark an important step towards increased financial stability in the Chinese banking sector and demonstrate the aim of the Chinese leadership to play a major role in the global financial market. Full compliance with global standards has not yet been reached due to two main reasons. First, China – like most of the less developed countries – still lacks technical expertise and human resources necessary for the implementation of Basel II. Second, the option for inter-temporal burden sharing of the costs arising from bank reform still allows for the postponement of the resolution of the existing NPL problem. For example, AMCs may issue bonds to finance the purchase of NPLs thereby reshuffling bad loans to a specially created vehicle, with specialist skills and purposes. The simple shifting of bad loans allows for a risk weight of 0% and prevents banks and the government from immediate action. Both restrictions – technical and inter-temporal – will diminish over time and consequently enable better compliance. The Basel standards are in line with the policy of the Central government to decentralize political and economical powers. This was fundamental for a high degree of compliance. However the subordination of the Basel standards to the Chinese central leadership's interests will impose the binding restriction for extended compliance. In the future we therefore expect a trend toward stronger conformity with the Basel standards but no full compliance, since this is not likely without a change of the system, which is dominated by political control.

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[88] For example Art. 32 LoBRS and the Interim Methods on Commercial Bank Disclosure, therein especially Art. 22.

[89] *Fergus Duncan*, China's banking Sector: An Uneven Playing Field, from: FinanceAsia.com, 14th February 2001; *WANG Xiaofeng*, Research on the Capital Adequacy Ratio of Chinese Banks (Woguo Shangye Yinhang Ziben Chonzulü de Yanjiu), in: Research on Financial and Economic Issues (Caijing Wenti Yanjiu), Vol.10 2003, pp. 29-34; AMC's to play bigger role in reducing NPL's, in: China Daily (Online Edition), 6th January 2004.