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Is a New Broom Sweeping Clean? The Emergence of the China Banking Regulatory Commission

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In recent years, the Chinese legal system has come closer to meeting international concepts in the area of banking regulation and supervision. This may be seen as China's self-imposed commitment to the rules of the "international community" in order to become a reliable global partner. There are important aspects that still deviate from international standards and opinions about the changes are divided even within Chinese society. We show that the new laws and regulations mark a fundamental change in the promotion of operational independence for supervising agencies, whereas political influence of the central government still remains strong. This can be explained by the central government's aim to weaken local and provincial governments' interference in the business of commercial banks while protecting its own abilities to control macroeconomic performance via the banking system.

Keywords: banking regulation, banking supervision, Chinese law, international standards
JEL-Codes: G18, G21, G28, F02

1 Introduction

China is preparing for deeper integration into the global capital market. The financial legal framework has undergone considerable changes in order to improve the banking sector's efficiency and overall financial stability. The *Law on Commercial Banks*[1] (LoCB) and the *Law on the People's Bank of China*[2] (LoPBC) – both enacted in 1995 – redefined the boundaries between commercial banking and central banking by promoting profit-oriented business operations and independent monetary policy. Beginning 2004 the *Law on Banking Regulation and Supervision*[3] (LoBRS) strengthened the supervisory function in the People's Republic of China

1 Zhonghua renmin gongheguo shangye yinhang fa, 10 May 1995 (revised 27 December 2003, effective on 1 February 2004).

2 Zhonghua renmin gongheguo zhongguo renmin yinhang fa, 18 March 1995 (revised 27 December 2003, effective on 1 February 2004).

3 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).

(PRC) and transferred competencies from the PBC to a newly established supervisory agency: the China Banking Regulatory Commission (CBRC). Supervisory responsibilities are now shared between both agencies. The PBC is responsible for maintaining macroeconomic financial stability. It therefore monitors and assesses the situation of the financial market, supervises banking institutions,[4] other groups and individuals, and may conduct investigations.[5] The CBRC is in charge of regulating banking services and focuses on an institutional approach. Following this structural change the legal base for banking supervision in the PRC was extended by the *Law on Banking Regulation and Supervision*[6] (LoBRS) and the *Regulation Governing Capital Adequacy of Commercial Banks*[7] (New Capital Rules, NCR), which came into effect on 1 February and 1 April 2004, respectively.

The Chairman of the CBRC, LIU MINGKANG,[8] emphasised the importance of the LoBRS for China's financial system in catching up with the requirements of the *Basel Core Principles for Effective Banking Supervision* (Basel Core Principles, BCP). He also stressed that the enactment of the LoBRS marks the first time that the Chinese legislature formulated an explicit law – not just administrative rules – concerning the surveillance of financial institutions (LIU 2004). Chinese officials also claim that the New Capital Rules are based on international standards for minimum capital requirements of banks. The NCR constitute the Chinese approach to adopt the *Basel Capital Accord* (Basel I)[9] of 1988 together with the supervisory review and disclosure requirements of the *New Basel Capital Accord* (Basel II) (CHINA BANKING REGULATORY COMMISSION 2004a).

China's integration into the global capital market creates strong incentives to improve banking supervision. Especially China's WTO commitment to lift restrictions on market entry and business operations for foreign financial institutions puts considerable pressure on the central gov-

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

5 The PBC has the authority to monitor the activities of financial institutions, other groups and individuals concerning the implementation of administrative rules on reserve funds, Renminbi, interbank call and securities markets, foreign exchange, gold, clearing, fighting money laundering, as well as activities concerning the management of State treasury.

6 Zhonghua renmin gongheguo yinhangye jiandu guanli fa, 27 December 2003.

7 Shangye yinhang ziben chongzulü guanli banfa, 23 February 2004.

8 LIU MINGKANG was formerly governor of the Bank of China and vice-governor of the PBC. For a closer look at LIU MINGKANG, see NAUGHTON (2003).

9 CHINA BANKING REGULATORY COMMISSION (2003, p.2). See also PEOPLE'S BANK OF CHINA (2001, p.1): "Our present capital regulation is largely based on the 1988 Capital Accord".

ernment since the poor performance of the state-owned commercial banks (SOCBs) in connection with their implicit bail-out guarantees increases the danger of a gambling for resurrection. By the end of 2002, the Chinese banking sector captured 85% of the entire financial sector's assets (LUO 2003). The banking sector comprises state-owned banks, joint-stock banks, city commercial banks, and credit cooperatives. Accounting for 71.7% of all loans, the four big state-owned commercial banks[10] are the dominating financial institutions (OECD 2002). Loaded with heavy burdens from non-performing loans (NPL), which are estimated to reach a ratio of 21–45% of the total loan portfolio, the SOCBs are at the core of financial system reform in China. Possible clean-up costs may have ranged between 30% and 58% of GDP in 2002 (OECD 2002, p.466). The Chinese government took a phased approach in order to comply with international requirements. It actually started by replenishing the capital base of the four state-owned commercial banks in 1998. Additionally, the regulatory capital requirements were effectively reduced with a swap of NPLs for government guaranteed bonds of the newly established Asset Management Corporations (FUNG and MA 2002). Yet, the capital adequacy ratio (CAR) has declined again since then *(Table 1)*.

Table 1 Capital adequacy ratio (CAR) of the four big state-owned commercial banks

Year	1991	1992	1993	1994	1995	1996	1997	**1998**	1999	2000	2001	2002
CAR (%)	5.69	4.86	4.01	4.38	3.75	3.85	3.71	**7.01**	6.89	5.51	4.35	4.27

Source: ACBF (2003), WANG (2003).

In 2002, the CAR was only 0.56 percentage points above the all-time low in 1997 and well below the Basel minimum requirement of 8%. The joint-stock commercial banks and city commercial banks also reported low ratios of only 6.83% and 6.01% in 2002, respectively. These numbers might even be lower if calculated on the assumption of sufficient provisioning for loan losses (LUO 2003). A gradual restructuring restricts financial institutions' ability to conduct internal reforms to improve performance and hence bears the risk of regulatory forbearance in order to allow banks to continue to operate (OECD 2002, p. 463). China therefore substantially altered its supervisory and regulatory framework. By doing this, China claimed to incorporate international standards.

10 The Agricultural Bank of China, the Bank of China, the China Construction Bank, and the Industrial and Commercial Bank of China.

Although the political rhetoric of the central government as well as the economic need to improve the performance of the banking sector, the implementation of the Basel standards cannot be taken for granted due to many opposing interests and disincentives that influence regulatory practice. In China, laws and administrative rules issued by the National People's Congress and the State Council respectively, outline general guidelines, which become subject to the reinterpretation of responsible government departments and agencies. Extra-legal norms and lobbying thus exert a major influence on the agents in charge of implementing and executing laws and compromise original intensions (CORNE 2000). In fact, there are strong incentives for political interference. State-owned enterprises (SOE) not only employ a major share of the urban population, but also provide welfare services for the workers' families. In order to maintain social stability the Chinese leadership is still prepared to intervene in the lending decisions of the SOCBs and provide financial funding for loss-making SOEs. The SOCB also serve as a means to promote political initiatives. A strict enforcement of prudential regulations would severely restrict this function and is therefore not consistent with the central leadership's preference for economic adjustment through direct intervention. In addition, due to the decentralisation of financing responsibilities the local government level has an incentive for excessive lending to its Township and Village Enterprises (TVEs) thereby increasing inflationary pressure. Market instruments for controlling money supply are still not effective. As a consequence, the Chinese Central Bank interferes directly in the banks' lending decisions to slow down credit growth. And finally, as in many developing countries, China lacks human resources and technical expertise to transfer sophisticated international standards and prudential regulation and supervision.

This paper focuses on the *de iure* implementation of the Basel Capital Accord, Basel I and Basel II in China and its potential implications on banking performance and monetary policy. As we will point out, China is catching up with international banking standards. However, due to political reasoning, some deviations from the Basel Core Principles and the Basel Capital Accords still represent risks to financial stability. As a result, supervision of share-type banks will be more stringent than the supervision of the SOCBs in the medium term at least. Still, the CBRC is equipped with far-reaching powers to control and supervise credit decisions, which will limit the share of the SOCBs' political lending and hence help to improve their performance as well as the effectiveness of monetary policy. In *Section 2* we assess China's compliance with the Core

Principles for Effective Banking Supervision, the Basel Capital Accord of 1988 (Basel I) and its successor, the New Basel Capital Accord (Basel II) in order to show how far the Chinese government's intentions are compatible with international requirements. In *Section 3* we then discuss the impact of the new supervisory framework on the performance of the banking industry and the macroeconomic environment. *Section 4* concludes.

2 The Basel Core Principles, Basel I and Basel II in China

Originally, the Capital Accord of 1988 (Basel I)[11] proposed by the *Basel Committee on Banking Supervision*[12] was designed to improve the soundness of internationally active banks based in the G-10 states. Over the last decade, the Basel requirements became a widely accepted global standard for banking supervision. The Basel Committee does not possess any formal supranational supervisory authority and its conclusions do not have legal force. Therefore, national authorities are neither compelled nor required by international law to subject themselves to the decisions of the Basel Committee. It just formulates broad supervisory standards and guidelines and recommends statements of best practices expecting that individual authorities from different countries will take steps to implement them through arrangements suited to their corresponding national systems. Thus, the Committee encourages convergence towards common standards without detailed uniformity or harmonisation of countries' techniques of supervision. The Basel Committee is often described as an 'international financial regulatory organisation' (e.g. ZARING 1998) and its proposals are mostly subsumed under the broad definition of *soft law* (e.g. LEE 1998; CROCKETT 2003).

11 See BASEL COMMITTEE ON BANKING SUPERVISION (1988). Basel I was amended several times, with the incorporation of market risk in 1996 being the most notable change (BASEL COMMITTEE ON BANKING SUPERVISION 1998).

12 The Basel Committee is a group of banking supervisory authorities and regarded as the international standard-setting body in the area of banking regulation and supervision. It was established by the central bank governors of the Group of Ten Countries in 1975. The Basel Committee 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. It usually meets at the Bank for International Settlements (BIS) in Basel, where its permanent secretariat is located.

Implementation of the Basel Core Principles

The target of the Basel Core Principles (BCP)[13] is to provide minimum criteria for national supervisory and regulatory institutions in order to ensure financial stability and a *level playing field* for international banking. Notably, the BCP do not have a wide implementation outside the G-10. In addition, a survey conducted by the International Monetary Fund and The World Bank gives evidence that the implementation of the BCP depends on the level of development. Two thirds of the industrialised nations are compliant with more than 21 principles out of 30 while 50% of transitional and less-developed nations implemented less than 10 of the principles (IMF and WORLD BANK 2002). The empirical record raises suspicion as to whether norms devised for developed countries are transferable to developing or transitional nations. Despite these concerns, China is accelerating reforms of the supervisory landscape in order to comply with the BCPs.

The LoBRS is claimed to implement the BCP issued by the Basel Committee in September 1997. Even though the LoBRS is the main legal source for the implementation of the BCP, any analysis cannot be limited to it. This is because several requirements are regulated in the LoCB, the LoPBC, 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. Our analysis is structured along the methodology of the Financial Stability Assessment Program, which differentiates seven sections of the Basel Core Principles (IMF and WORLD BANK 2002, p. 8). *Annex A* provides a short contents list of the seven sections of the BCP and its counterparts in the LoBRS and additional regulations. In sum, the legal base of the Chinese institutional framework on banking supervision is now close to international standards, but shortfalls still remain.[14]

1. Most of the BCP's "objectives, autonomy, powers and resources" are met in the LoBRS. Supervision is meant to ensure the soundness of commercial banks, maintain public confidence, and protect regulators while performing supervisory responsibilities. Interference by local governments, government departments on various levels, public organ-

13 See BASLE 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).

14 For a detailed *de iure* analysis, see BREHM and MACHT (2004).

isations or individuals is prohibited. Yet, independence is restricted since the State Council and the CCP have various channels through which to exert control over the CBRC. 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. Furthermore, adequate resources are rarely available.

2. The Chinese regulatory framework complies fully with the BCP on "licensing and structure". The competencies of the licensing authority are stated in the LoBRS, while the criteria for the establishment, changing, and termination of banking institutions is laid out in the LoCB and further regulations. The CBRC may approve or reject applications for the establishment, changing, and termination of banking institutions. Chapter II of the LoCB mentions the criteria for the establishment of a commercial bank, of a bank branch, and deals with essential application documents and the issue of changes in the shareholders. With respect to foreign banks, further requirements apply according to the State Council's Administration of Foreign-funded Financial Institutions.[15]

3. China addresses 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". They are not regulated explicitly in the BCPs, but are subjected to rules formulated by the CBRC in accordance with applicable laws and administrative regulations (Art. 21 LoBRS). The NCR are the most extensive and important source to substantiate prudential rules and regulations.

4. Compliance of the LoBRS with "methods of ongoing supervision" is good. The law allows the CBRC to conduct on-site and off-site examination and defines the measures it may take. The supervisory agency has to establish an information system for analysing and assessing the risk profile of banking institutions, a rating system to decide on the scope and frequency of on-site examination, and an early warning system to identify and report emergency situations in the banking sector.

15 Regulations of the People's Republic of China on the Administration of Foreign-funded Financial Institutions (Zhonghua renmin gongheguo waizi jinrong jigou tiaoli), 20 December 2002.

5. With respect to "information requirements", 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. The issue of quality is not addressed in the LoBRS, but in the NCR. Banks need to make honest, precise, and complete information public in accordance with law and regulations, the national unified accounting system, and the provisions stipulated by the CBRC. Therefore "information requirements" have improved with the LoBRS and came closer to meeting international standards. The quality and trustworthiness – and therefore compliance with the BCP – remain doubtful due to insufficient auditing and accounting standards, as well as weak enforcement mechanisms (OPPER 2003).

6. Chapter IV LoBRS deals with "remedial measures and exit" and is fully consistent with the BCPs' claims on formal powers of supervisors. Whenever a bank fails to meet prudential rules and regulations, the CBRC may decide on remedial measures ranging from suspending part of the business to closing down the institution. The power to intervene can also be illustrated by the New Capital Rules, where 'corrective actions' for banks failing to meet capital regulations are stated.

7. The LoBRS is consistent with the BCPs requirements on "cross-border banking". According to Art. 32 of LoBRS, the CBRC may engage in international activities related to banking regulation and supervision. The requirement of global consolidated supervision is regulated in the *Guidance on Supervision of Foreign Institutions of Commercial Banks.*[16] A problem may arise from the non-obligatory character of Art. 32, which could lead to low international cooperation for political reasons.

All in all, the LoBRS meets the requirements of the Basel Core Principles well, yet with the notable exception of the agency's independence. The International Monetary Fund and the World Bank stress the importance of this issue in their BCP compliance assessment report. According to their survey, 40% of the assessed countries do not have an independent agency. This seriously threatens effective banking supervision (IMF and WORLD BANK 2002). As indicated in the summary, the Chinese leadership

16 Shangye yinhang jingwai jigou jianguan zhiyin, 20 August 2001.

may use different channels to exert influence on the CBRC. The State Council can overrule prudential regulations due to the hierarchical structuring of the Chinese legal system. Furthermore, the CBRC is subject to oversight by government agencies under the State Council such as the *Audit Institution* and the *Supervisory Institution.*[17] Also, the CCP has strong means of influence because it controls the appointment and dismissal of all elites via the nomenclature system, the party core groups (ministerial level), as well as party committees (all other levels) within government entities (LIEBERTHAL 1995). Party control was even strengthened in 1998, when the CCP took on the nomenclatura authority of the bureau level from the Ministry of Personnel (BRØDSGAARD 2002). Besides the claim for operational independence, the requirement of adequate resources to guarantee an effective supervision – mentioned in BCP 1 – is in doubt as well. The CBRC may only collect fees of five billion RMB (about $620m) from commercial banks 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 (JIAN 2004).

Implementation of Basel I

More than 100 nations implemented the minimum capital adequacy ratio (CAR) of 8% and further requirements stipulated in Basel I (WORLDBANK 2004). Basel I was generally considered to be an important step to promote international financial stability. Its successor – Basel II[18] – is a more risk-sensitive approach that shifts the focus from capital adequacy requirements (pillar I) toward more sophisticated supervision (pillar II), and market discipline (pillar III). The EU and the U.S. will implement most of the new framework, albeit with different scopes of application. Lacking technological expertise and human capital, most transition and developing countries on the other hand will not implement Basel II in the medium term. Still, China decided to implement Basel I and parts of Basel II in 2004.

The assessment of the minimum capital requirements in the PRC is based on the *Basel Capital Accord* (Basel I). The regulatory framework up to 2003 left various loopholes and did not provide guidance on supervisory

17 Shenji jiguan and Jiancha jiguan, respectively.
18 After several postponements, Basel II was published in late June 2004, see BASEL COMMITTEE ON BANKING SUPERVISION (2004).

actions to address the many under-capitalised banks (China Banking Regulatory Commission 2004b, p. 10). The lack of clearly stated possibilities for corrective action weakens an effective supervision and damages its authority. The *Regulation Governing Capital Adequacy of Commercial Banks,* called the *New Capital Rules* (NCR), fills this gap.[19] The NCR has many similarities to Basel I. Notably, the new regulations require coverage of market risk,[20] which has only been implemented in a few countries up to now (World Bank 2004). Consistency can also be found in the fundamentals: the target capital adequacy ratio of 8% is met, together with the requirement of at least 4% core capital.[21] The formula with which to calculate the adequacy ratio is the same, with only the definitions of the capital elements being marginally softer than the Basel requirements. *Annex B* provides an overview of the implementation of Basel I and II in China with some deviations being elaborated in further detail in the following section.

As regards the risk weighting, 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, the NCRs distinguish between the various risk weights on the basis of ratings of external credit agencies.[22] Other deviations give further insight into biased implementation of the Basel requirements: 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. Art. 19 NCR also defines the risk weight on claims on domestic public-sector entities,[23] invested by the Chinese central government as being 50%, but it prohibits this 50% risk weight for public-sector entities invested in 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

19 The new regulations took effect on 1 April 2004, but the CBRC has set the deadline for meeting the new requirements at 1 January 2007.

20 Only commercial banks whose trading position is above a given threshold are subject to market risk capital charge.

21 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 required to be deducted. Since October 1998, innovative capital instruments – limited to a maximum of 15% of tier 1 capital – are also eligible for inclusion.

22 The risk weights on various foreign claims are to be based on the ratings of external credit assessment agencies for the sovereigns or the regions. Below an AA- rating, the risk weight is 100%, otherwise 20%. This increases in Basel II, which is discussed below.

23 Public-sector entities provide public services (water, gas, communication, telecommunication, etc.) and investments are significant.

controlled by the national government. Art. 21 states that the risk weight on domestically incorporated commercial banks shall be 20%.[24] This preferential treatment is not related to the soundness of banks. 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. Therefore, transferring NPLs from banks to the 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.

Implementation of Basel II

Despite having a basically positive effect, Basel I was repeatedly criticised for its low risk sensitivity. In June 2004, the Basel Committee finally published a revised framework – *Basel II* – to overcome the existing deficits. Most prominent is the reliance of pillar I on internal ratings-based approaches to assess risk more accurately. Some banks in China already work with an internal ratings-based approach for their own use (ZHOU 2004, p. 1). However, the full implementation of the advanced approaches – for credit and operational risk – is clearly an enormous task, and Chinese banks are not prepared. China faces the same problems with the adoption of Basel II as many less developed economies[25] and will not introduce advanced approaches of pillar I within the next few years (CHINA BANKING REGULATORY COMMISSION 2003). The New Capital Rules have already incorporated parts of it though, as can again be seen in *Annex B.*

A major setback in the adoption of the New Accord is the omission of *operational risk*[26] 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. China did not force its banks to include operational risk at this time, but it is at least included in the new supervisory framework via the demand for internal risk management systems and disclosure.

24 If the maturity is four months or shorter, it will still amount to 0%.
25 For an overview of the criticism on Basel II regarding less developed economies, see WARD (2002), GRIFFITH-JONES, SEGOVIANO and SPRATT (2003).
26 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. See BASEL COMMITTEE ON BANKING SUPERVISION (2004, par. 644).

The *supervisory review process* in the second pillar demands a closer working relationship and understanding between banks and their supervisors. It represents a major 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. It is not as rigorous as Basel II and one principle is only partially implemented,[27] but especially the remaining principles can be found in the New Capital Rules, which deal with the duties of the supervisors. The NCR also state that the CBRC may require a higher capital adequacy ratio considering the banks' risk profile and its capability of risk management. Banks are divided into three categories (adequately capitalised banks, undercapitalised banks, and significantly undercapitalised banks), and the NCR call for an early intervention with far-reaching corrective actions.

In its third pillar on *disclosure,* Basel II relies on market discipline and requires that banks and regulators publish detailed information on banks' risky businesses. The Chinese regulations on disclosure are generally in line with Basel II, especially when taking into account further disclosure requirements of the Chinese framework.[28]

3 The economic impact of the new supervisory framework

Regulation in general, but especially of the banking system is dependent on what OLSON (2000) called "market-augmenting government". For market-augmenting government to be truly incorporated in the country's institutions, it needs the backing of the institutions, which themselves need the support and legitimacy of the political leadership. With effective prudential supervision also relying on operational independence of the supervisory agency, it is easy to be pessimistic about the effectiveness of CBRC, since it can be jeopardised by the central government's preference for direct political intervention. The CBRC will not tackle the decisions of the central government as it is an agency directly subordinated to

27 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 in 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.

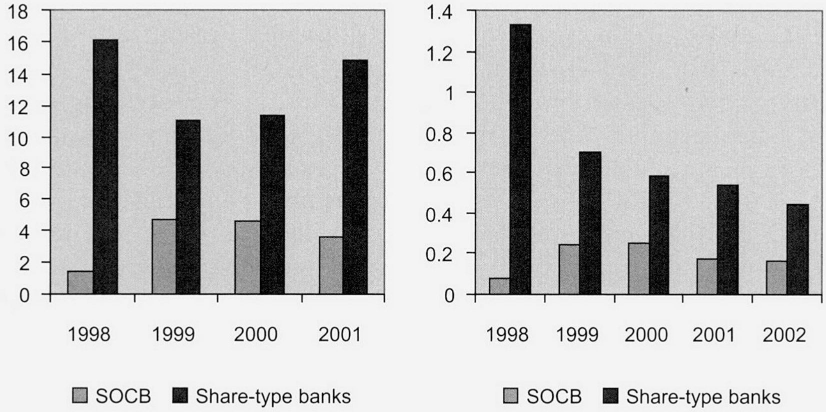
28 For example, the LoBRS and the *Interim Methods on Commercial Bank Disclosure.*

the state council. But even leaving this problem unsolved, the many stakeholders benefiting from the present financial system will build a strong coalition to oppose prudential regulation and supervision. The SOCBs allow for direct access to low-cost financial resources for SOEs and TVEs. Additionally, the SOCBs employ a staff of about 1.67 million in more than 108 000 branches (Shirai 2002). A restructuring of the banks' operations in order to meet higher supervisory standards and improve efficiency will most likely be accompanied by a reduction in personnel and a loss of network influence, thus provoking resistance within the SOCBs. Insolvent enterprises, most of them state-owned and dependent on cheap and unquestioned methods of financing, will consider their future to be at stake. In addition, venal local and provincial cadres also benefit from the current system and therefore back the so-called *guanxi-system*. To prevent the misallocation of capital in an environment prone to cronyism, regulators will have to mobilise substantial political authority behind their decisions, and the ways in which their regulatory agencies are established will affect the degrees of success they ultimately achieve (Naughton 2003). Facing resistance from the start, the central leadership went to National People's Congress for support. The enactment of a law – the LoBRS – strengthened the legitimacy of institutional change in contrast to an administrative regulation, as was the case for the China Securities Regulatory Commission and the China Insurance Regulatory Commission. However, local governments, the banks' management, and even the central government itself all have incentives to resist the application of high standards for prudential regulation and supervision. In the following section we therefore discuss the potential impact of the regulatory law on banking performance and monetary policy in more detail.

Banking Performance

China's integration into the global capital market creates strong incentives to improve banking supervision. The WTO commitment to lift restrictions on market entry and business operations for foreign financial institutions puts considerable pressure on the central government since the poor performance of the SOCB (see *Figure 1*) increases the danger of entering into risks for a second chance in connection with their implicit bail-out guarantees.

Figure 1 ROC (left) and ROA (right) of SOCBs and share-type commercial banks (%)



Source: SHIH, ZHANG and LIU (2004), and BLOOMBERG.

Several characteristics contribute to this situation. Inefficiencies arise from the overstaffing of SOCBs and their extensive branch network with small and poorly located offices. Low productivity is also a result of the use of low and outmoded technology (OECD 2002). Yet, the most important reason is the loss of interest income due to large portfolio shares of non-performing loans. In September 2003, the non-performing loans of state-owned commercial banks reached nearly 2 trillion RMB ($244 billion). This is an NPL ratio of 21.4% and the equivalent of 20% of GDP in 2002 (LUO 2003, p.3).[29] In fact, the total amount of NPLs is probably even higher due to an inadequate accounting system. For example, Moody's analysed banks listed in Shanghai as a barometer for the system as a whole. *Shanghai Pudong,* the *Bank of Communications,* the *Shenzhen Development Bank* and the *China Merchants Bank* must prepare their accounts to Chinese GAAP, as well as to international accounting standards. A comparison showed an understatement of NPLs between the two accounting systems of roughly 25% (HORNE 2002). Independent estimates on the accumulation of NPL therefore amount up to 45% of outstanding loans in recent years.[30] NPLs impose severe restrictions on the restructuring of the

29 The NPLs of the banking sector, including state-owned banks, policy banks, and joint stock banks, amounted to more than Rmb 2.5 trillion ($305 billion), and the NPL ratio was 18.7%, but data weaknesses and judgement bias adopting the classification suggest that the scale of the problem loans may be higher. See Luo (2003, p.3).

30 For example, LARDY (1998) stated 40%. For an overview, see LOU (2000, Footnote 1).

SOCBs that carry most of the financial burdens stemming from the former monobank system, and which have traditionally served as a means to supplement political initiatives. Another reason for the low profitability in recent years is the risk aversion of the SOCBs after Premier ZHU RONGJI imposed quotas for reducing the NPL ratios on banks in 1998. Instead of decreasing the amount of bad debts many branches just increased their assets to bring their ratio down. Hence, total assets of the SOCBs rose by almost 60% between 1997 and 2002 from Rmb 7913.7 trillion to Rmb 13549.6 trillion (ACBF 1998; 2003). Furthermore, the management of the SOCBs switched more and more to investments in relatively save but low-interest state bonds in order to avoid credit failure. The SOCBs' claims on the central government rose between 1997 and 2002 from Rmb 25.2 billion to Rmb 837.9 billion (ACBF 1998; 2003). This indicates that banks still lack the means and instruments to control loan quality.[31]

The way in which banking supervision will be exerted depends on the political role of the different types of banks and their financial situation. Disparate standards for banking supervision are likely, given the lack of political independence of the CBRC and given the divergent weighting of political and economic responsibilities held by the SOCBs on the one hand and the JSBs, as well as the CCBs on the other hand. The CBRC will have to allow the SOCBs to continue operations leading to low asset quality and probable losses if they enjoy political priority and the backing of the central government. Another threat for strict prudential regulation is the gradual restructuring of the SOCBs. Due to their financial burdens, higher standards for supervision can only be applied gradually. Yet, supervisory discretion gives leeway to ongoing unsound bank management. Even the NCR are no guarantee for effective banking supervision because they still consist of loopholes that put the soundness of banking institutions at risk. For example, systemic risks can arise due to the critical issue of a zero risk weight for claims on AMCs. 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%. Since this drastic risk reduction cannot be solely justified by the abilities of the AMCs to recover bad debts it points to an implicit state guarantee and shows that there still is room for risky moral behaviour by banking institutions. The threat of increasing non-performing loans and the erosion of the capital base conse-

31 The lack of adequate risk management is a problem threatening not only the SOCBs, but also the joint stock banks (JSBs) and city commercial banks (CCBs). See SHIH, ZHANG and LIU (2004).

quently remains intact to some extent. This situation imposes major challenges to the CBRC because incentives for excessive risk taking are high and the threat of sanctions is low. Increasing competitive pressure from foreign banks and the implicit state guarantees enhance the probability of 'gambling for resurrection'. Inefficient governance and internal accountability within the SOCBs, as well as the lack of effective sanctions, weaken the authority of the CBRC and thus its power to counterbalance incentives for excessive risk taking.

The situation for share-type banks is somewhat different. The JSBs and the CCBs may neither restructure their business gradually, nor can they expect a government bail-out. The bankruptcy of the *Hainan Development Bank* demonstrated that the central government is not afraid to allow insolvent JSBs and CCBs to exit the market. Furthermore, they have stricter standards for banking regulation, the *Minsheng Bank* for example, whose CAR went down to 7.11% in part because the CBRC did not accept a Rmb 4 billion convertible bond guaranteed by the *Industrial and Commercial Bank of China* as part of its regulatory capital because of the guarantor's default risk (SLATER 2004). Apparently, the CBRC is able to supervise share-type banks more strictly. Since there is less political interference, the banks have to adjust to higher standards, incentives for the management are more market-based, and the supervisory agency has effective means to impose sanctions. However, since the SOCBs dominate the banking sector with respect to lending, deposits and assets (OECD 2002), overall banking performance will depend on the CBRC's authority to exert their regulatory power over more than just JSBs and CCBs.

Monetary Policy

The Central Bank has undergone considerable restructuring in order to adjust to the reforms within the financial sector. In 1993, the *Decision of the State Council on the Reform of the Financial System*[32] marked a new era with respect to the PBC's functions; it now was primarily responsible for maintaining price stability and hence switched from direct market intervention to open market instruments to fulfill this task. This move became most evident in 1998, when the binding credit plan was abolished and was replaced by referenced targets for bank lending. With the change from directly administrating the money supply to indirect control by

32 Guowuyuan guanyu jinrong tizhi gaige de jueding.

altering the money base, the effectiveness of monetary policy relies on both effective instruments to alter M0 as well as a stable and predictable money multiplier. These preconditions are not yet implemented fully in the Chinese institutional framework. Money is rarely controlled by altering the interest rate, but often by adjusting the reserve requirements.[33] Additionally, it is dominated by the nation's dollar peg and the ability of the PBC to sterilise its foreign exchange purchases. The volume of bond issues therefore rose from 12% of the PBC's total assets in 1993 to 48% in 2003. The monetary instruments of the PBC are not powerful enough to exert significant impact on the real sector and hence are not sufficient to control investment growth effectively (Qin et al. 2004). The root of the problem goes back to tax reform in the 1980s, when local governments were forced to achieve balanced budgets. Tax reform, however, was eluded by institutional change in the financial system with banks converting from passive to active financing institutions. This created – due to strong political influence – a new financing facility for local governments (Nanto and Radha 2002). At that time, control and financing rights via local banks were separate. The control rights over banks belonged to the local governments while the central government maintained financing rights. In addition, fiscal and monetary responsibilities were shared respectively. This functional separation led to moral hazard behaviour apparently viable through rapid credit growth and the accumulation of NPLs. Local governments have a say in the appointment of the regional directors of the PBC, who supervise the decisions of the central government. Local governments could therefore undermine the central credit plan. Apart from that, they have an indirect influence by deciding about commodities such as water supply, electricity, housing, recruitment of bank employees, and schooling for their children (Huang 1999). Money supply in China therefore is an endogenous variable and can hardly be controlled by market measures such as interest rates (Mookerjee 1996).

There are also positive signs. In order to overcome the influence of local governments the PBC reduced its 32 branches to 9 in 1998. Additionally, as was shown in *Section 2*, the central bank issued various regulations aimed at strengthening banking supervision and limiting the influence of government agencies at the local and provincial level. In 2000, the PBC started an assessment of state-owned banks in order to get a better impression about the risk situation and to investigate the causes of non-per-

33 On 28 October 2004, the PBC raised interest rates for the first time since July 1995 lifting its benchmark lending rate from 5.31% to 5.58%.

forming loans (ACBF 2000, p. 125).[34] Furthermore, the Central Committee of the Communist Party and the State Council established the *Supervisory Committee for Key State-Owned Financial Institutions* (Supervisory Committee) and dispatched missions to financial institutions with a view to further strengthening supervision (ACBF 2000, p. 25).

According to an official statement, the Supervisory Committee provides a necessary instrument for imposing stricter management and supervision on the cadres of state-owned financial institutions and an effective measure for enhancing the institutions' management and profitability (GUOWUYUAN 2000). Structural and institutional changes have not been sufficient to repel local government intervention significantly, however. YU YONGDING – member of the monetary policy commission of the PBC – regards local governments' interference as the main reason for the low effectiveness of the current monetary policy to slow down money growth (YU 2004).

In this context, the new supervisory framework appears to be a further step of the central leadership to regain control rights. The LoBRS is aimed at solving the principal-agent problem between the Central Leadership and the local governments and promotes a centralised organisational structure of the CBRC. The CBRC may set up local offices if deemed necessary and exercises centralised oversight. These local offices are to perform authorised supervisory functions. The CBRC may close such offices as well as assign and withdraw supervisory functions. Therefore, the LoBRS provides an effective instrument to ensure compliance with the central authority. Moreover, the central government may impose sanctions against local governments opposing the *de facto* deprivation of political influence, as the LoBRS demands their cooperation and assistance for the CBRC to exercise its supervisory activities. The far-reaching supervisory competencies stipulated in the LoBRS represent an important feature for the supervisory body to enforce rules and regulations in an environment shaped by blurred boundaries between political and economic entities at the local level. Additionally, the NCR reflect the aim of restricting political lending in general but especially on the local level. Before the introduction of the NCR, SOCBs lent to SOEs and TVEs not just because of the political influence of the local governments, but also because this kind of loan had a favourable risk-weight for the calculation of the regulatory

34 The PBC therefore examined the quality of loans, profits and losses, the implementation of the internal control system, and the qualifications of senior executives.

capital. While loans to private enterprises counted at 100% of face value, local TVEs were counted at just 70%, provincial SOEs at 50%, and central government SOEs at 20%. This situation has now changed. The NCR demand a 100% risk weight for public-sector entities invested by the local and provincial governments. Also the risk weight for central government enterprises went up to 50%.

The higher standards will strengthen asset quality and increase the interest rate sensitivity of investments, and hence will have an important impact on the PRC's market-based instruments to control money growth. The SOCBs were set a time limit of 2006 to come into line with the regulatory capital requirement of 8%. Since the risk-weights for SOEs on all levels beneath the central level and non-state enterprises (including TVEs) account for 100% SOCBs will base their lending decisions more on economic principles than on the borrowers' ownership structure. Most likely, more resources will be allocated to the private sector. Already in recent years, this share has grown rapidly, with non-state enterprises receiving 38.9% in 1996 and 47.7% in 2000 of all loans from non-financial institutions through indirect and direct channels (OECD 2002). In 2002, loans to private and collective enterprises accounted for more than 25% of total fixed asset investments and about 50% of non-state enterprises' fixed asset investments (ACBF 2002, 2003). Even though the NCR standards and the centralised oversight of the CBRC will increase the price elasticity of money demand, asset quality of the SOCBs will stay poor in absolute terms in the near and medium future. Private enterprises as well as TVEs operate on hard budget constraints (WHITING 2000). This is why most of the bad debt is accumulated by SOEs. The major part of these enterprises, though insolvent, will continue to receive financial funding because there is no social safety net and no clear procedures for bankruptcy, which is a necessary precondition to make market exit a feasible option.

4 Conclusion

The recent changes in the Chinese supervisory system, namely the enactment of the LoBRS and the NCR with the subsequent institutional changes, altered the Chinese supervisory landscape fundamentally. They will foster financial stability in the Chinese banking sector and demonstrate the aim of the Chinese leadership to play an integrated role in the global financial market. Full compliance with global standards has not yet been reached for two main reasons. First, China – like most of the less developed countries – still lacks the technical expertise and human resources necessary for the implementation of Basel II. Second, the option of inter-temporal burden sharing of the costs arising from bank reforms still allows for the postponement of the resolution of the existing NPL problem. Third, the SOCB will still play a crucial role in financing government decisions in the near future. However, these reforms will contribute to the improvement of financial institutions and will lead to better performance.

Tightened control and prudential regulations are aimed at overcoming the principal-agent problem between the central and local governments. Several years of banking reform have already weakened the influence of local government officials over lending decisions of state-owned commercial banks. Now, the PBC – which was deeply embedded in local and provincial networks – again lost significant influence on the SOCBs. Recentralisation strengthened Beijing's control, which can now more effectively dictate terms to the Big Four. Hence, there is a danger that the Chinese leadership will consider its effective control over agents as a substitute for prudential regulations and stick to political interference at the central level. This fear becomes likely on the grounds of increasing government deficits due to an inefficient tax system and the predominance of domestic financing.

Nevertheless, the LoBRS provides the CBRC with effective means to set prudential rules and conduct banking supervision. This is accompanied by the New Capital Rules, which incorporate most of Basel I and parts of Basel II. With its entry into the WTO, China agreed to remove all geographical restrictions and limits in scope of business for foreign banking institutions until 2006. In this context, the new supervisory framework is not only part of China's further integration into the global financial market, but also a necessary step in improving the performance of China's domestic banks, which is well below international average. Prudential regulation will put pressure on loss-making deals driven by local cronyism by increasing the costs of loans and by making them transparent. Therefore, the new framework has the potential to improve systemic stability as well as the single bank's performance. The systemic stability effect is necessary for the long-term prospect of the economy in China and other nations, whereas the performance effect will have a short-term impact. Several stakeholders will face adjustment costs or downright losses and will oppose the new framework. Herein lies the nucleus of the problem in China and the outcome of this power game is impossible to predict for the near future.

In any case, the next stage of reform needs to be an increase in the autonomy of the commercial banks from the central government. The experiences in transition economies have shown that without changing ownership, management, and control mechanisms, simply recapitalising the banking system will cause continued accumulation of NPLs (LIU 2002). Therefore, the Chinese government needs to reduce its shares in bank ownership and allow for a diversified structure. Privatisation will help to come in line with international capital standards since private shareholders would enhance corporate governance and controls. Politically, this is a difficult task since private ownership in the banking sector will induce a shift of capital allocation from the state to the market, which in turn challenges the political power of the CCP. However, failure to move further in this direction could result in a regime of politicised lending at the behest of local officials being replaced by a regime of politicised lending at the will of central government officials.

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4.1.1 Annex A

The Basel Core Principles for effective banking supervision in Chinese laws, administrative rules and regulations

Issue	No.	BCP	No.	LoBRS	Additional Regulations	Compliance
Objectives, autonomy, powers and resources	BCP 1	Responsibilities and objectives	Art. 3	Promote safety and soundness, and maintain confidence		Yes
		Legal framework	Art. 4	According to laws and regulations		Yes
		Independence	Art. 5	No interference of local governments, government departments, public organisations or individuals – no central government independence		Partial
		Legal protection	Art. 5	Legal protection of regulators		Yes
		Information sharing	Art. 6–7	Information sharing		Yes
		Skills and resources	Art. 9–10	Professional skills, work experiences and integrity but appointment and dis-missal of stuff is decided by the CCP and resources are severely limited		Partial
		Confidentiality	Art. 11	Confidentiality of information		Yes

Issue	No.	BCP	No.	LoBRS	Additional Regulations	Compliance
Licensing and structure	BCP 2	Permissible activities and definition of 'banks'	Art. 2	Definition of 'banking institutions'		Yes
	BCP 3	Right to set criteria and reject applications for establishment	Art. 19	CBRC is the licensing authority		Yes
	BCP 4	Minimum licensing criteria	Art. 17 Art. 20	Ownership structure, fit and proper tests for directors	LoCB: Criteria for the establishment of a commercial bank (Art. 12–15) and of a bank branch (Art. 20); Regulation for the administration of foreign financial institutions: prior approval from home country supervisors (Art. 6–8)	Yes
		Right to reject transfer of significant ownership	Art. 17 –	Approval by the CBRC	LoCB: For shareholders holding more than 5% (Art. 15)	Yes
	BCP 5	Right to review major acquisitions and investments	–	Not mentioned	LoCB: need the approval of the CBRC (Art. 25)	Yes
	BCP 6	Minimum capital requirements	Art. 21	May be stipulated in rules and regulations formulated by the CBRC in accordance with laws and administrative regulations	Topic is dealt with in the NCR (see *Annex B*)	Partial

Issue	No.	BCP	No.	LoBRS	Additional Regulations	Compliance
Prudential regulations and re-quirements	BCP 7	Evaluation of loan policy		Leading Principles on Credit Risk (loan classification along five categories)		Yes
	BCP 8	Evaluation of asset quality			Guidance for the Calculation of Loan Loss Provisions (evaluation of the quality of assets, adequacy of loan loss provisions and loan loss reserves)	Yes
	BCP 9	Limiting risk concen-tration to single lenders			Guidance for Implementing a Unified Lending System of Com-mercial Banks (mitigate high risk concentrations)	Yes
	BCP 10	Abuses arising from connected lending			Guidance for Internal Control of Commercial Banks (Art. 31)	Yes
	BCP 11 BCP 12 BCP 13	Procedures controlling country risk, market risk, all other material risks			Guidance for Internal Control of Commercial Banks (Art. 27 [3], 10 and 11)	Yes
	BCP 14	Internal controls ade-quate for the bank's business			Guidance for Internal Control of Commercial Banks	Yes
	BCP 15	'Know-your-customer' rules				Yes

Issue	No.	BCP	No.	LoBRS	Additional Regulations	Compliance
Methods of ongoing supervision	BCP 16	supervisory body shall conduct off-site and on-site examination	Art. 23 Art. 24	CBRC shall conduct off-site examination and on-site examination		yes
	BCP 17	regular contact with bank management	Art. 35	CBRC may hold consultations with directors and senior managers of banks but no obligation		yes
	BCP 18	means of collecting, reviewing and analysing prudential reports on a solo and consolidated basis	Art. 27 Art. 28	CBRC shall set up rating system and early warning system to decide about on-site examination; CBRC shall establish system to identify emergency situations in the banking sector		yes
	BCP 19	independent validation of supervisory information through on-site examination or external auditors	Art. 34	Measures of on-site examination		yes
	BCP 20	ability to supervise on consolidated basis	Art. 25	examination on a consolidated basis		yes

Issue	No.	BCP	No.	LoBRS	Additional Regulations	Compliance
Information requirements	BCP 21	Records enable supervisors to get a true and fair view on the financial conditions of the bank	Art. 33	CBRC has the authority to require bank's balance sheets, income statements other financial reports, information concerning business operations and management and audit reports		Partial
		Publishing financial statements on a regular basis	Art. 36	CBRC has to ensure that banks disclose reliable information to the public – no quality criteria are mentioned	Interim Methods on Commercial Bank Disclosure: making information public in a truthful, precise and complete way according to laws and regulations, the national unified accounting system and provisions stipulated by the CBRC (Art. 5) – quality criteria are different from international accounting standards	Partial
Remedial measures and exit	BCP 22	Supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements	Art. 37 Art. 39	CBRC may decide about measures ranging form suspending part of the business to closing down institutions	NCR: states 'corrective actions' for banks failing to meet capital requirements (Art. 36-41)	Yes

Issue	No.	BCP	No.	LoBRS	Additional Regulations	Compliance
Cross-border banking	BCP 23	Global consolidated supervision over inter-nationally active banks			Guidance on supervision of foreign institutions of commercial banks: have to accept supervision and examination conducted according to the law by the CBRC	Yes
	BCP 24	Establishing contact and information exchange	Art. 32	CBRC may engage in international activities related to banking regulation and supervision		Yes
	BCP 25	Local operations of foreign banks must be conducted to the same standards as required for domestic institutions			Provisions on consolidated supervision of foreign banks: foreign banks will be supervised to the same standards as national banks are	Yes

4.1.2 Annex B

The Basel capital accords in Chinese laws, administrative rules and regulations

Issue	Subject	NCR	Major contents	Comments	Compliance
Definition of regulatory capital Basel I and II	Core Capital	Art. 12	Paid-up capital/common stocks, reserves, capital surplus, retained earnings and minority interests	No allowance for innovative instruments, which could be included since October 1998, but acceptance of minority interests as tier 1 capital	Yes
	Supplementary Capital	Art. 12	Revaluation reserves, general loan-loss reserves, preference shares, convertible *bonds and long-term subordinated debt* (which shall not exceed 50% of core capital (Art. 13 NCR))		Yes
	Deductions (Core Capital)	Art. 15	Goodwill; equity investments in the unconsolidated financial institutions, on commercial real estate and in business enterprises		Yes
	Deductions (Total Capital)	Art. 14	Goodwill; 50% of the equity investments in the unconsolidated financial institutions,on commercial real estate and in business enterprises		Yes
	Capital coefficient	Art. 7 and Art. 39 LoPBC	8%; calculation and measurement of capital adequacy ratios are to be done on a stand-alone basis and on a consolidated basis (Art. 6)		Yes
	Core Capital coefficient	Art. 7	4%		Yes

Issue	Subject	NCR	Major contents	Comments	Compliance
Market Risk (1996 amendment) Basel I and II		Art. 5, 28, and 32 NCR (among others)	Art. 32 NCR requires the use of the standardised approach of Annex 4 NCR (divided into the following subgroups: interest rate risk, equity risk, foreign exchange risk, commodities risk, and options risk) 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. Basically the NCR only incorporate the standardised 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	There are some deviations from the Basel standardised approach. E.g. 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. The possibility for national discretion within Basel II is not opted for in the NCR	Yes

Issue	Subject	NCR	Major contents	Comments	Compliance
Risk weights Basel I and standardised approach of Basel II	Sovereigns, banks, and corporations		See *Table* below	Art. 21 states that the risk weight on domestically incorporated commercial banks shall be 20% (0%, if maturity is 4 months or shorter)	Partial
	Central government	Art. 19	0% for claims on the Chinese central government denominated in both domestic and foreign currency	Only claims denominated on domestic currency are eligible for a 0% risk weight	No
	Asset management companies (AMC)	Art. 22	0% for claims on specific debts issued by the domestically incorporated financial AMCs to purchase the state-owned banks' non-performing loans 100% for other claims on these AMCs		Partial
	Residential mortgage	Art. 24	50%		Yes
	Individuals, all other assets	Art. 23	100%		Yes
	Public-sector entities (PSE)	Art. 19	50% (for PSEs invested by the Chinese Central government)	The risk weight reduction does not apply to PSEs invested by local governments	Yes

Issue	Subject	NCR	Major contents	Comments	Compliance
Credit risk Pillar 1 – Basel II	Standard approach		See *Table* below		
	Off-balance sheet	Art. 27, Annex 3	Commercial banks shall set aside capital for credit risk for off-balance sheet items	Off-balance sheet items receive nearly the same treatment	Yes
	Risk mitigants and guarantors	Art. 25 Art. 26	Loans secured by certain financial instruments shall have the same risk weights as the instruments; certain guarantors are eligible for risk mitigation	The NCR apply a mixture of the simple and the comprehensive approach for risk mitigation and collateral	
	Past due loans and higher-risk categories		–	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. Other provisions for impairment losses shall also be deducted from the book value of relevant assets items (Art. 16 NCR)	No
	IRB-approach		–		No
Operational risk Pillar 1 – Basel II			–	Operational risk is at least included in the new supervisory framework via the demand for internal risk management systems and disclosure	No

Issue	Subject	NCR	Major contents	Comments	Compliance
Supervisory Review Process (SRP) **Pillar 2 – Basel II**		Chapter III Art. 33–41	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 capitalised 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. E.g. the CBRC may require banks to restrict dividend payouts or other forms of payments to shareholders (Art. 40 NCR) or require the removal of senior management (Art. 41 NCR)	Not as rigorous as Basel II and Principle 1 of the SRP being only implemented partially. But especially the remaining Principles, which deal with the duties of the supervisors can be found in the New Capital Rules. Including various regulations issued by the PBC (especially the *Guidance for Internal Control of Commercial Banks* from September 2002) most features (also from Principle 1) can be found in the Chinese regulatory framework. Still, leeway is given due to broad definitions and the lack of clear requirements and structure	Yes
Market Discipline **Pillar 3 – Basel II**		Art. 42–46, Annex 5	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 lists the required information	The way the requirements have to be fulfilled is not specified. Further disclosure requirements of the Chinese framework have to be taken into account (For example example, Art. 32 LoBRS and the *Interim Methods on Commercial Bank Disclosure*)	Yes

Claims on sovereigns						
Credit assessment	**AAA to AA–**	**A+ to A–**	**BBB+ to BBB–**	**BB+ to B–**	**Below B–**	**Unrated**
Risk weight Basel II	0	20	50	100	150	100
Risk weight NCR	0	100	100	100	100	100
Risk weight Basel I	0 for OECD and 100 for non-OECD					

Claims on banks (based on the rating of the sovereign or region)						
Risk weight Basel II	20	50	100	100	150	100
Risk weight NCR	20	100	100	100	100	100
Risk weight Basel I	20 for OECD or maturity of less than 1 year and 100 for the rest					

Claims on corporates					
Credit assessment	**AAA to AA–**	**A+ to A–**	**BBB+ to BB–**	**Below BB–**	**Unrated**
Risk weight Basel II	20	50	100	150	100
Risk weight NCR	100				
Risk weight Basel I	100				