China's Own Version of Basel III and Its Likely Impact on China's Banking Sector

Eiichi Sekine
Senior Analyst,
Nomura Institute of Capital Markets Research

I. China's announcement of its own version of Basel III

On 3 May 2011 the China Banking Regulatory Commission (CBRC) published its *Guidelines for Implementing New Regulatory Standards in the PRC Banking Industry* ("the New Standards"), which had been enacted on 27 April[1]. The New Standards are China's equivalent of the Basel III Accord announced by the Basel Committee on Banking Supervision (BCBS) on 16 December 2010 and are sometimes referred to as "China's Basel III."

The Guidelines comprise five sections, covering their overall aims and principles, the need to improve the banking industry's prudential regulatory standards, the need to improve the regulation of systemically important banks, the need to do more to implement Basel II, and future policy (Figure 1).

The New Standards, which will come into force on 1 January 2012, show how keen the CBRC is to incorporate Basel III in its own regulatory standards, be it, for example, by adopting new rules for systemically important Chinese financial institutions or by adopting capital adequacy rules and leverage ratios that are even more stringent than those of Basel III.

We can think of a number of possible reasons for this. First, the Chinese authorities may see Basel III as a way of using "external pressure," in addition to lending restrictions, to stem the surge in bank lending that has occurred as a result of the policy of stimulating domestic demand following the global financial crisis of 2008. Second, they may see setting a good example to other G20 members at a time when China and other emerging economies are having an increasing say in international finance following the global financial crisis as a way of having an even bigger say. Third, they may see adopting a positive stance towards Basel III as a way of obtaining the consent of foreign governments to the establishment by Chinese banks of overseas branches (including the acquisition of local banks) more easily.

---

[1] See http://www.cbrc.gov.cn/chinese/home/jsp/docView.jsp?docID=20110503615014F8D9DBF4F4FFE45843249ABE00.

Figure 1: Analysis of *Guidelines for Implementing New Regulatory Standards in the PRC Banking Industry*

Main items	Secondary items	Outline
Overall aims and principles	Overall aims	(Omitted)
	Principles	Improve the prudential regulatory standards in the light of domestic current situation and international financial regulatory reform
		Combine macro- and microprudential supervision
		Combine consistency and flexible implementation of supervisory standards
		Give due consideration to both supporting sustainable economic growth and maintaining a sound banking system
Enhancement of prudential regulatory standards	Improving supervision of capital adequacy	Revise methods of calculating capital adequacy ratios
		Strengthen supervision of capital adequacy ratios
		Adopt regulatory standards for leverage ratios
		Allow a reasonable grace period
	Improving supervision of liquidity risks	Adopt standards for supervising and monitoring various liquidity risks
		Guide banks to improve liquidity risk management
		Set a reasonable grace period
	Improving supervision of loan-loss provisioning	Adopt supervisory standards on loan provision ratios and loan coverage ratios
		Build a system of dynamic provisioning
		Allow a reasonable grace period
Effective supervision of systemically important banks	-	Define SIBs
		Retain firewalls and improve ex ante entry regulations
		Strengthen macroprudential supervision
		Strengthen supervision on an ongoing basis
		Strengthen regulatory cooperation
Implementation of Basel Accords	-	Implement Basel II and Basel III in parallel
Future policy	-	Enact related legislation
		Supervise banks more closely
		Banks formulate feasible implementation plans
		Make strategic and serious efforts to modify focus of business
		Continue to improve risk management
		Improve inspection and regular assessment of how New Standards are being implemented

Note: Based on *Guidelines for Implementing New Regulatory Standards in the PRC Banking Industry* (27 April 2011).
Source: Nomura Institute of Capital Markets Research, from CBRC data

We think the adoption of the New Standards is likely to put pressure on Chinese banks, which have been protected by regulated interest and exchange rates as well as restrictions on the entry of foreign companies, to increase their regulatory capital and change their business models. Reports in the Chinese media on the adoption of the New Standards have been largely in line with the CBRC's announcement and deny any need for large amounts of additional capital. While, on the other hand, US and European media have had very little to say about the adoption of the New Standards, there have been some quotes from Chinese academics that the measures will require some RMB4 trillion of additional capital over the next four years[2].

[2] See "China Bank Regulator Wants Leverage Ratio At 4%; Medium-Term Issues May Arise", *Dow Jones Newswires*, May 23, 2011.

While it remains to be seen how individual banks will react to the New Standards, we need, first of all, to understand what the CBRC hopes to achieve. In the following chapters we will therefore outline the New Standards, the current capital adequacy requirements and the extent to which they have been met, and the direction in which the CBRC is likely to go.

II. Outline of the New Standards

As well as its *Guidelines* the CBRC has published a press release[3] and a Q&A document[4] on the New Standards. We conclude from these that the CBRC's response to Basel III is to try to impose the following regulatory standards on Chinese banks and then improve those standards.

1. Distinction between SIBs and other banks

The New Standards distinguish between systemically important banks (SIBs) and other banks. SIBs can be identified largely in terms of four criteria: (1) size, (2) interconnectedness, (3) complexity, and (4) substitutability.

2. Improving methods of calculating capital adequacy ratios

Under the New Standards banks' regulatory capital will consist of three tiers (core Tier 1, Tier 1 and Tier 2) rather than two (Tier 1 and Tier 2) as at present. In addition, the exceptions to core Tier 1 will be applied strictly, and a wider range of methods of calculating risk assets will be adopted.

Furthermore, the CBRC intends to optimize the methods the banks use to calculate risk assets and widen the range of risks covered by regulatory capital. As a result, the weight of risks such as operational risk and those presented by dealing, securitization and complicated OTC derivatives will be added.

3. Tightening capital adequacy rules

Once they are introduced, the three tiers will have capital adequacy requirements of 5% (core Tier 1), 6% (Tier 1), and 8% (Tier 2, including Tier 1) (Figure 2). Added to this will be a reserve excess capital conservation buffer of 2.5% and a countercyclical capital buffer of 0–2.5%. In addition, SIBs will be subject to a 1% additional capital surcharge for the time being. As a result, they will have an overall

3 See http://www.cbrc.gov.cn/chinese/home/jsp/docView.jsp?docID=2011050361A1A6D30A626FD7FFC4A1780E59B300.

4 See http://www.cbrc.gov.cn/chinese/home/jsp/docView.jsp?docID=2011050313449537ECBC567BFF46D54C7B5D1600.

Figure 2: New regulatory standards on capital adequacy rules and leverage ratios

	SIBs	All banks excl. those in the preceding column	Basel III
Core Tier 1	5%	5%	4.5%
Tier 1	6%	6%	6%
Tier 2	8%	8%	8%
Capital buffers	2.5%	2.5%	2.5%
Countercyclical capital buffers	0 ~ 2.5%	0 ~ 2.5%	0 ~ 2.5%
Capital surcharge (for the time being)	1%	–	
Capital adequacy ratios	11.5%	10.5%	10.5%
Deadline	End-2013	End-2016	End-2018
Leverage ratios	4%	4%	3%

Note: 1. Based on *Guidelines for Implementing New Regulatory Standards in the PRC Banking Industry* (27 April 2011).
2. Tier 2 requirements include Tier 1.

Source: Nomura Institute of Capital Markets Research, from CBRC data

capital adequacy requirement of 11.5%[5], while other types of bank will have a requirement of 10.5%.

According to the above-mentioned Q&A document, the 11.5% requirement for SIBs is the same as the current requirement for major banks (namely, according to the CBRC's statistical classification, Industrial and Commercial Bank of China (ICBC), Agricultural Bank of China (ABC), Bank of China (BOC), China Construction Bank (CCB), and Bank of Communications (BoCom)), while the 10.5% requirement for other banks is basically the same as the current requirement for small and medium-sized banks. In this connection it is perhaps worth mentioning that in February 2007 the CBRC issued *Guidelines on the Implementation of the Basel II Capital Adequacy Framework by China's Banking Sector*, which formed the basis of a number of related pieces of legislation. According to these, the CBRC will regard a number of major banks as subject to Basel II after a four-year adjustment period (i.e., from 2011).

Banks will have a period of grace before they are expected to comply with the new capital adequacy requirements. In the case of the SIBs, this will be until the end of 2013; in the case of other banks, it will be until the end of 2016. In both cases, however, it will be sooner than Basel III's own deadline for full compliance (the end of 2018).

The New Standards adopt a new leverage ratio of at least 4% of Tier 1 capital to total (including off-balance sheet) assets (Figure 2), 1 percentage point more than the Basel III requirement of at least 3%.

5 Assuming no countercyclical capital buffer.

4. Better liquidity rules

In addition to the liquidity coverage ratio (LCR) and net stable finance ratio (NSFR) prescribed by Basel III, the New Standards contain rules intended to monitor liquidity risks. These include a liquidity ratio, a loan/deposit ratio, a core debt ratio, a liquidity gap ratio, deposit concentration, and an interbank funding ratio. As in the case of the new capital adequacy rules, the banks will have a period of grace before they are expected to comply with the new liquidity rules. In the case of the SIBs, this will be until the end of 2013; in the case of other banks, it will be until the end of 2016.

5. Stricter loan provision rules

Under the New Standards banks will be expected to have a loan provision ratio (i.e., a general loan provision ratio) of at least 2.5% and a provision coverage ratio (i.e., a ratio of provisions for specific nonperforming loans) of at least 150%.

Furthermore, the CBRC will adjust its provision requirements by means of dynamic provisioning and differentiation. In other words, it will require banks to make correspondingly greater provision during cyclical uptrends but moderate this in line with the extent to which they drawn down those provisions during cyclical downtrends. China has therefore taken a lead in adopting dynamic provisioning, which has been seen as a means of dealing with procyclicality, one of the issues that reform of the international financial system needs to address. The CBRC will also adjust its classification of the different grades of provision in line with the quality and profitability of banks' receivables.

As in the case of the two sets of rules mentioned above, the banks will have a period of grace before they are expected to comply with the new provisioning rules. In the case of the SIBs, this will be until the end of 2013. In the case of the other banks, those that are profitable and whose underprovisioning is moderate will have until the end of 2016, while those that are unprofitable and need to make considerably more provisioning will have until the end of 2018.

In this connection it is perhaps worth mentioning that, according to the CBRC, China's banks have an average loan provision ratio of nearly 2.5% and an average provision coverage ratio of 230%, with more than 50% of its banks already in compliance with the new loan provision requirement and more than 80% in compliance with the new provision coverage requirement.

6. Regulation of SIBs

The New Standards set out regulatory policies for SIBs from four different perspectives (Figure 1). These are in line with the policy of the Financial Stability Board (FSB) and the BCBS to tighten the rules for systemically important financial institutions (SIFIs).

1) Retaining firewalls and improving ex ante entry regulations

First, the firewalls that currently exist between the banking system and capital markets, between the banks and their controlling shareholders, and between the banks and their subsidiaries will be retained to stop crises from spreading.

Second, banks' freedom to engage in highly-leveraged activities with complicated structures will be strictly limited to prevent them from taking excessive risks.

Third, banks will be required to exercise caution when they conduct pilot programs in universal banking. If a bank's profits from universal banking are below the sector average, it will be required to discontinue its universal banking operations.

2) Improving macroprudential supervision

First, SIBs will be required to issue bail-in bonds to increase their ability to absorb losses.

Second, the CBRC will supervise the banks' liquidity more strictly.

Third, the banks will be subject to stricter rules on commercial lending and required to reduce their lending to particular borrowers or groups to a reasonable percentage of their net capital.

Fourth, the CBRC will tighten its supervision of risks at group (consolidated) level.

3) Improving supervision on an ongoing basis

First, the CBRC will focus its resources on SIBs, give its inspectors wide-ranging powers, and strengthen its supervision of banks' decision-making and implementation processes in order to identify risks as early as possible and take the necessary action.

Second, it will improve and extend its off-site supervisory system, create a system for evaluating its monitoring of the risks posed by SIBs, give advance warning of risks, identify risks accurately, and deal with them as rapidly as possible.

Third, it will improve its capacity to inspect SIBs on site, persuade them to improve their governance and risk management, and try to prevent and reverse risky and unsound management decisions.

Fourth, it will ensure that it has the supervisory tools (in the form, for example, of product analyses, model tests and stress tests) to deal with the SIBs' increasingly complex operations and structures.

Fifth, the CBRC will supervise the SIBs in drawing up recovery, resolution and contingency plans in order to help them increase their powers of self-preservation.

4) Increasing regulatory cooperation

The CBRC will seek to increase cooperation with other regulators, both at home and abroad. As part of its cooperation with overseas regulators, it will develop mechanisms for evaluating their regulatory competence and seek to improve the mechanisms for discussing with them how to supervise SIBs with cross-border operations.

III. Current capital adequacy rules and their degree of attainment

1. Legal basis of China's capital adequacy rules

We now take a closer look at the capital adequacy rules governing China's commercial banks. First, according to Article 39 of the *Commercial Bank Law of the People's Republic of China* (amended and promulgated on 27 December 2003, and effective since 1 February 2004), which contains four requirements on the ratios of assets and liabilities that commercial banks must comply with, "the capital adequacy rate shall not fall short of 8%."[6] Similarly, the *Guidance to Corporate Governance of State-owned Commercial Banks and the Relevant Supervision thereof* (enacted on 18 April 2006 and effective since 24 April 2006) stipulates that "the capital adequacy ratio after financial reorganization shall be kept more than 8%."

Second, the CBRC's *Provisional Risk Assessment System for Joint-Stock Commercial Banks* (promulgated on 22 February 2004), which sets out rating standards for capital adequacy, asset safety, and the performance of commercial banks, adopts an approach to supervision whereby inspectors are allowed to apply less stringent criteria to banks with a high rating but are required to apply more stringent criteria to those with a low rating. In the case of capital adequacy, banks with a capital adequacy ratio of 10% or more are awarded full marks, while those with a ratio of 2% or less are awarded zero marks. Similarly, those with a core capital adequacy ratio of 6% or more are awarded full marks, while those with a ratio of 1% or less are awarded zero marks.

2. Capital adequacy rules in detail

On this legal basis the CBRC issued (initially with effect from 1 March 2004 and subsequently, as amended, with effect from 3 July 2007) its *Regulation Governing Capital Adequacy of Commercial Banks*. Its definitions of and methods of calculating regulatory capital can be found in Figure 3.

6 In this connection it is perhaps worth mentioning that the article also sets requirements for the ratio of loans to deposits (maximum of 75%), the liquidity ratio (minimum of 25%), and the ratio of outstanding loans to one borrower to that of a bank's capital (maximum of 10%).

Figure 3: Definition of and method of calculating capital adequacy ratios of Chinese commercial banks

	Capital adequacy ratio	Core capital adequacy ratio
Definition	Ratio of capital to risk-weighted assets	Ratio of core capital to risk-weighted assets
Minimum requirement	At least 8%	At least 4%
Method of calculation	(Capital – deductions)/risk-weighted assets + 12.5 × market risk capital charge	(Core capital – deductions from core capital)/risk-weighted assets + 12.5 × market risk capital charge
Definition of capital	Capital = core capital + additional capital Core capital: includes paid-up capital, common stock, capital surplus reserve, retained surplus reserves, undistributed profits, and minority interests. Additional capital: includes revaluation reserves, general reserves, preferred stock, convertible bonds, mixed capital bonds, and long-term subordinated debt.	
Deductions from capital	(1) Goodwill, (2) equity stakes and investments in unconsolidated financial institutions, and (3) real estate investments by commercial banks (not for own use) and equity stakes in nonfinancial companies	
Deductions from core capital	(1) Goodwill, (2) 50% of equity stakes and investments in unconsolidated financial institutions, and (3) 50% of real estate investments by commercial banks (not for own use) and equity stakes in nonfinancial companies	
Additional capital ratio	Additional capital may not exceed 100% of core capital.	
Subordinated debt ratio	Long-term subordinated debt included in additional capital may not exceed 50% of core capital.	

Note: Based on *Regulation Governing Capital Adequacy of Commercial Banks* (effective from 3 July 2007).
Source: Nomura Institute of Capital Markets Research, from CBRC data

3. Degree of attainment of capital adequacy requirements

As of the end of 2010, the capital adequacy ratio of Chinese commercial banks as a whole was 12.2%, while the core ratio was 10.1% (Figure 4). As of the end of March 2011, the capital adequacy ratio of Chinese commercial banks as a whole was 11.8%, while the core ratio was 9.8%. Under the New Standards, the core Tier 1 capital adequacy requirement is set at 5% (0.5 percentage point higher than Basel III's 4.5% requirement). This is because Chinese banks have already attained this level of capital adequacy and an additional 0.5 percentage point was considered unlikely to have a negative impact on their operations. This is also why the deadline for implementing the new capital adequacy rules is sooner than the Basel III deadline of the end of 2018.

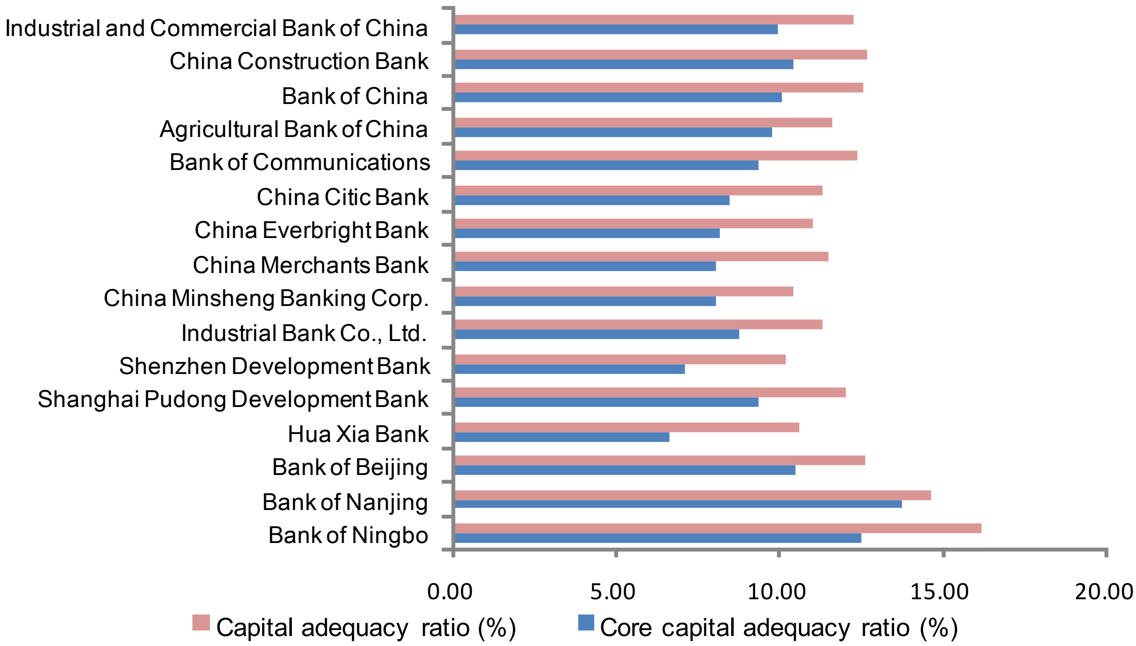
The capital adequacy ratios of Chinese commercial banks (as of the end of 2010) whose shares are listed on Chinese stock exchanges (A-shares) can be found in Figure 5. All 16 have a capital adequacy ratio of at least 8%. The bank with the highest capital adequacy ratio is Ningbo Bank (Zhejiang Province) with a ratio of 16.2%, while the bank with the highest core ratio is Nanjing Bank (Jiangsu Province) with a ratio of 13.75%. The five banks classified by the CBRC as "major banks" (ICBC, ABC, BOC, CCB and BoCom) all have a capital adequacy ratio of at least 11.5% as required of SIBs by both China's existing rules and the New Standards.

Figure 4: Capital adequacy ratios of Chinese commercial banks

	End-2010	End-March 2011
Core capital	RMB4,298.5bn	RMB4,553.4bn
Additional capital	RMB1,029.5bn	RMB1,078.1bn
Capital deductions	RMB319.6bn	RMB323.8bn
(On-balance sheet) risk-weighted assets	RMB35,537.1bn	RMB38,702.9bn
(Off-balance sheet) risk-weighted assets	RMB5,323.4bn	RMB5,799.0bn
Market risk capital charge	RMB27.3bn	RMB27.4bn
Capital adequacy ratio	12.2%	11.8%
Core capital adequacy ratio	10.1%	9.8%

Source: Nomura Institute of Capital Markets Research, from CBRC data

Figure 5: Capital adequacy ratios of Chinese commercial banks with shares listed on Chinese stock exchanges (A shares) (end-2010)



Source: Nomura Institute of Capital Markets Research, based on data from banks concerned

IV. CBRC's future stance

1. CBRC's policies on implementing the New Standards

The CBRC plans to implement the following policies in order to ensure that the New Standards are implemented (Figure 1).

1) Enactment of related legislation

First, the CBRC has been working on amendments to its *Regulation Governing Capital Adequacy of Commercial Banks* in order to ensure that the New Standards are implemented in time.

Second, it has been carrying out extensive training programs and publicity campaigns in order to familiarize both regulators and bankers at all levels with the New Standards.

2) Closer supervision of the bank

First, the CBRC takes the view that each bank should appoint someone to form a team to implement the New Standards.

Second, it takes the view that each bank's board of directors should discuss and approve key policies and plans for implementing the New Standards, and require management to update it regularly and to monitor progress.

Third, it takes the view that the banks should formulate plans for implementing the New Standards and take responsibility for putting them into practice.

3) Formulation of feasible implementation plans by the banks

When formulating feasible implementation plans, banks are required to include, at the very least, an asset growth plan, an asset composition adjustment plan, a profitability plan, an explanation of how they calculate their risk assets, a capital replenishment plan, the sources of their liquidity, an explanation of how they intend to replenish their loan-loss provisions, and a timetable (with interim targets) for complying with the new regulatory requirements.

Each bank will have to finalize its implementation plan by the end of 2011 and have it approved by the CBRC.

4) Strategic and serious efforts to modify focus of business

The CBRC wants banks seeking to change their business model to move from an extensive model of development that seeks to increase the size of a business to an intensive model of development that seeks to improve its quality. Furthermore, the

CBRC has issued the following guidelines to encourage banks to both deepen and broaden their lending operations in order to provide a more efficient service and better-quality loans on the assumption that they will stick to a traditional business model.

First, banks should restructure their business in order to develop a medium- to long-term strategy for their lending operations. Furthermore, they should seek to restructure the customers, sectors and regions they lend to in order to ensure the sustainability of these operations.

Second, banks should manage their risk management tools better and constantly seek to improve them. They should also have risk management policies and risk management flow charts, and seek to improve their risk control mechanisms.

Third, they should offer their customers new services. They should expand their businesses by offering new services such as Internet banking, telephone banking, and credit cards, extend the coverage of their financial services, offer their asset management customers low-risk products, reduce management costs, and increase their sources of revenue.

2. Distinctive features of Chinese risk management

The CBRC's policies on implementing the New Standards include, in addition to the above, sustained improvement of risk management and improving inspections and regular assessments related to implementing the New Standards (Figure 1 above). In particular, the former ("sustained improvement of risk management") contains proposals to modify the way Chinese banks manage risk.

Reflecting concern about the sharp increase in local government financing vehicles (LGFVs) and property loans produced by the government's efforts to boost domestic demand from the autumn of 2008 onwards, the CBRC wants the banks to improve staff incentives and assessment, devise performance assessment and compensation schemes that strike a better balance between risk and reward, and seriously consider a risk management model that combines both systemic and specific risks. The CBRC's aim is to create a foundation on which to build and improve a capital assessment process, and ensure that the banks' capital is capable of withstanding any risk.

It hopes that performance assessment and compensation schemes that strike a balance between risk and reward will also be able to deal with the major credit risks posed by the economic adjustment process entailed by the 12th Five-Year Program, which starts in 2011 and is aimed at increasing the rate of change of the country's economic development model.

3. Conclusion

As was mentioned above, the Chinese government has been implementing Basel II and Basel III in parallel, and hopes that, by adopting the aforementioned rules for

SIBs, China's banking system will catch up with global financial regulations at a single stroke. In addition, the CBRC's desire to promote a healthy banking sector and to give China a greater say at international financial forums such as the G20 is evident from (1) the fact that the New Standards' capital adequacy requirements and leverage ratio are more stringent than those of Basel III, (2) the fact that, if it introduced dynamic provisioning, China would be only the second country to do so (the first being Spain), and (3) the fact that China is planning to adopt Basel III before the official deadline.

On the other hand, a number of issues remain unresolved, including the fact that, although the CBRC has been trying to induce the banks to change their business model, it wants to preserve traditional banking. This raises the question how banks are trying to, or should be trying to, generate revenue while still subject to restrictions on interest rates and exchange rates. At the same time, the CBRC's citing of Internet banking, telephone banking, and credit cards as possible new sources of revenue may give overseas financial institutions either operating in, or thinking of expanding into, China an incentive to market the latest financial technology and products. However, even if that proves to be the case, we would expect the CBRC to make compliance with the new standards a requirement for licenses to engage in these new areas and thereby avoid excessive competition.

It will therefore be interesting to see what becomes of China's moves to adopt Basel III.