CHINA's ECONOMY & POLICY

Insiders' insights

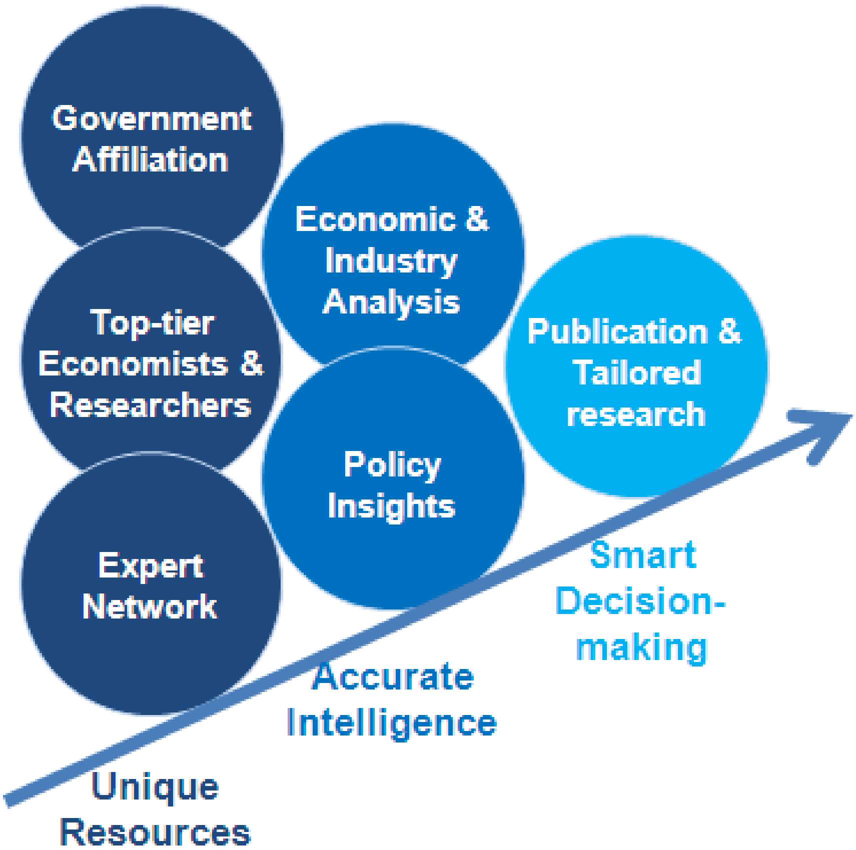
New Capital Regulations for Commercial Banks?

China's Economy & Policy (CEP) *places unparalleled knowledge and insider expertise at your finger tips. It provides critical economic and industry analysis, policy insights and expert advice to support business decision-making in China. Please visit www.china-economy-policy.com or write to CEP@thegateway-group.com for more information.*

published by Gateway International

June 2012 — *Single report edition*
Strategic Partner — *Research Base for Industrial Finance (RBIF), Chinese Academy of Social Sciences (CASS)*
Chief Economist — **YANG Tao**, *Director General, RBIF*
Executive Editor — **G. Bin ZHAO**

CHINA's ECONOMY & POLICY
Insiders' insights



New Capital Regulations for Commercial Banks in China

Contents

Abstract: *At the executive meeting of the State Council on June 6,* Commercial Bank's Capital Management Approach (Trial Implementation) *was issued, and it is to be implemented next year. It can be concluded that a capital regulatory system is being established to meet new international regulatory standards in this new management approach, which better integrates the current banking developments in China and strives to reach the goal of serving the real economy while reflecting the localization and improvement of Basel III. This article will provide an analysis of its positive significance and upcoming challenges.*

Since the China Banking Regulatory Commission (CBRC) issued the *Capital Adequacy Ratio Management Approach for Commercial Banks* in February 2004, China has established a prudent capital regulatory system and ensured that it has the core capital regulations in place for judicious bank supervision. In recent years, while their assets have grown, the return on these assets for the domestic commercial banks has reached a "good" level as measured by international banking standards; the capital adequacy ratio has improved significantly, with all banks over 8% as set by the regulatory requirements; both the rate and the amount of non-performing loans have been reduced; some banks established a systematic internal rating system and a risk management process for the implementation of the New Basel Capital Accord (Basel II). In 2009, China was admitted as a full member of the Basel Banking Supervision Committee, and became the first nation worldwide to implement Basel III. The reduction in the non-performing loan rate for domestic banks is related to the rapid rise in total loans, a one-time divestiture of non-performing loans, and other policies, but it is also closely related to the continuous implementation of improved banking supervision rules.

I. Basic Features of the New Capital Management Approach

After being discussed and adopted by the State Council, the CBRC issued *Commercial Bank's Capital Management Approach (Trial Implementation)* (hereinafter referred to as the *Approach*) on June 8. The *Approach*, which will be implemented from January 1, 2013, is mainly concerned with the following.

First, a unified regulatory system for the capital adequacy ratio is established. By referring to the provisions of Basel III, the *Approach* divides capital regulatory requirements into four levels. The first level refers to the minimum capital requirements: the core level-I capital adequacy ratio, the level-I capital adequacy ratio, and the capital adequacy ratio, which should be 5%, 6%, and 8%, respectively. The second level is the reserve capital requirement and the counter-cyclical capital requirement, which should reach 2.5% and 0 to 2.5% respectively. The third level is an additional 1% capital requirement for systemically important banks. The fourth level is the second pillar capital requirement. After the *Approach* is implemented, the capital adequacy ratios for systemically important and non-systemically important banks will be required to be 11.5% and 10.5% respectively during normal periods of operation. The multi-level capital regulatory requirements not only reflect the new requirements for international standards, but are also basically consistent with the regulatory requirements of the existing capital adequacy ratios for commercial banks in China.

Second, capital is clearly defined. In accordance with uniform international rules, the *Approach* clearly defines criteria for accepting various types of capital instruments and increases their capacity to absorb losses.

Third, the scope of risk covered by capital is expanded. The scope of risk covered will include credit risk, market risk, and operational risk; capital regulatory rules regarding asset securitization, over-the-counter (OTC) derivatives, and other complex investment transactions are clearly defined guiding commercial banks to carefully carry out financial innovations.

Fourth, scientific classification and differentiated regulations are stressed. The *Approach* divides commercial banks into four categories according to the level of the capital adequacy ratio. Those commercial banks meeting minimum capital requirements but failing to reach the capital requirements of other levels are subdivided, thus clarifying the corresponding regulatory measures for various types of banks and enhancing the effectiveness of capital constraints. At the same time, the risk weights of various types of assets are re-designed to be more prudent. Risk weights for small and micro enterprise loans and personal loans will be reduced, and commercial banks will be guided to expand the number of these loans, thus serving the real economy more effectively. Risk weights for public sector debt will be reduced and the risk weights for interbank financial claims by commercial banks will rise moderately.

Fifth, a reasonable transition period will be allowed to reach the capital adequacy ratio standards. The *Approach* will be implemented on January 1, 2013; commercial banks should fully meet the regulatory requirements before the end of 2018, and qualified banks are encouraged to meet these standards in advance. Meanwhile, the *Approach* has set annual standard objectives for the capital adequacy ratio during the transition period.

Compared with the previous *Draft for Comments*, the new *Approach* made modest adjustments in some areas. First of all, a longer transition period will be given to commercial banks, the implementation time has been postponed and the compliance deadlines were relaxed from 2013 - 2016 to 2016 - 2018. Second, the risk weighting coefficient has been fine-tuned; risk weights of businesses in the same trade, off-balance sheet businesses, and some loan types (such as personal housing mortgage loans) are reduced to some extent. Third, the coefficient for calculating operational risk capital requirements is reduced. Fourth, the standards for secondary levels of capital have been relaxed; the excess loan loss reserve threshold level is reduced from 150% to 100% of the loan provision coverage ratio.

II. Main Highlights of the New Capital Management Approach

First, it is integrated with the international regulatory principles. In the *Approach*, a capital regulatory system meeting new international regulatory standards is established. This is not only reflected in the fixed targets, such as the regulatory requirements of the capital adequacy ratio, but also in principles and regulatory orientation. In addition, the capacity to absorb losses by secondary bonds and other capital instruments is improved, and operational risk is included in the capital regulatory framework, further reflecting integration with the new international regulatory standards. Furthermore, by drawing on international experience, the acceptability criteria have been clearly defined for all types of capital instruments, loss absorption capacities are improved, and a 10-year transition period is allowed for those unqualified capital instruments issued by banks. At the same time, the scope of risk which is covered is expanded. In addition to credit risk and market risk, operational risk is also included in the capital regulatory framework. Including the operational risk is not only consistent with international regulatory standards, but also very necessary. In recent years, banking related criminal cases have frequently occurred, so more emphasis must be given to operational risk.

Second, capital regulatory rules on asset securitization, OTC derivatives, and other complex investment transactions are clarified, guiding domestic banks to prudently carry out financial innovations. Recently, the central bank and other ministries and commissions jointly issued *Notice Regarding Related Issues of the Pilot Program for Further Expanding Credit Assets Securitization*, which indicates that the second attempt at asset securitization reform has started as a follow-up to the pilot from early 2005. Asset securitization can activate stock credit assets for banks to effectively alleviate the pressure of capital constraints, improve the term structure of credit assets, and enhance capital liquidity. Therefore, under the present circumstances, various types of banks have a positive attitude towards this process. Moreover, China has accumulated a large amount of bank credit assets, but has not established a corresponding secondary market, leading to problems in that the efficiency and effectiveness of the credit asset market cannot be fully released. Therefore, corresponding regulatory rules are clarified in the *Approach*, enabling asset securitization to get basic institutional support for its healthy development.

Meanwhile, with the rapid economic and social development of China, it becomes more difficult for financial development and innovation to meet the needs of the real economic sector. In this regard, accelerating the innovative use of derivatives has become a core link in enhancing economic and financial viability. Regulatory rules related to OTC derivatives trading are clarified, indicating the intention of policy to encourage banks to participate in developing innovative derivative products in a more standardized way. It should be noted that while taking into account the current situation in China's financial institution system, regardless of transactions on exchanges or OTC transactions, commercial banks will be the major institutions used to promote financial innovation over a long period of time. Faced with new trading rules, commercial banks should continue to strengthen their ability to develop new products, especially those that are derivative related. While stimulating commercial banks to be innovative in the use of OTC derivatives trading, attention must be given to the fact that the amount of trading on the main exchange market is far smaller than the number of OTC transactions in the current global derivatives market. At the initial stage of financial innovation, China needs to focus on improving basic derivatives trading on the main exchange market, which will also require the commercial banks to be more attentive to participating in derivatives trading on this exchange.

III. Major Risks and Challenges of the New Capital Management Approach

The main challenge for the *Approach* is to reduce the risk weights for public sector claims and loans to small and micro enterprises and individuals. It is believed that reducing the risk weight for personal loans can help to guide the banking industry to better serve the general public and to accelerate the development of consumer finance products and services. Among the elements which can stimulate China's economic growth, such as investment, consumption, and exports, the future positive effect of investment and consumption will gradually be weakened; the large Chinese economy will eventually need to focus on domestic consumption. Therefore, the *Approach* actually benefits the banking industry by encouraging it to better serve China's economic restructuring and sustained growth.

However, it is worth considering that reducing the risk weights for loans in the public sectors and for small and micro businesses may help to solve some current economic difficulties for a short term, but it also may bring some other problems. For local governments that are facing the problem of readjusting local financing platforms in recent years, this means that a more relaxed environment will allow bank credit to be of greater support for local construction; but the government must question whether potential credit risks will appear in a new round of maintaining growth, as well as whether the momentum for local governments to promote bond marketization reform will be weakened. Meanwhile, for the Ministry of Railways, the Ministry of Transportation, and other public sectors of the central government which will have more financing facilities, there should also be questions about the effect on market-oriented reforms in these sectors, as well as on all the types of funds (including finance and credit) controlled by these public sectors; in other words, whether inefficiency and rent-seeking in the field of investment will continue to be strengthened.

Even if the major banks declare their support for the development of small and micro enterprises, in actual operation, loans for these businesses are usually of high frequency and small size. Therefore, management costs for the lending bank will be greatly increased, so the bank will tend to support projects for large and medium-sized enterprises. Relying on large and medium-sized commercial banks to support small and micro enterprises is not only inconsistent with the business principle of the banks, but it is also not consistent with international practices. Small financial institutions, capital markets with low entry thresholds, and supportive fiscal policies would be better choices for solving the financing difficulties of small businesses. Therefore, in the *Approach*, reducing the risk weight for small and micro enterprise loans cannot fundamentally solve the problem, but may stimulate potential risks for large and medium-sized banks, and this needs to be carefully considered.

CHINA's ECONOMY& POLICY

Service & Price

www.china-economy-policy.com

Publications of China's Economy & Policy	1-10 users (US$)	11-40 users (US$)
Single report	100	200
Single issue (10 -12 reports)	800	1,600
Annual subscription (12 issues/monthly)	4,800	9,600
Annual subscription (12 issues/ monthly) + Advisory*	9,600	19,200
Annual subscription (6 issues/bi-monthly)	2,400	4,800
Annual subscription (4 issues/quarterly)	1,600	3,200

*ADVISORY services include brief answers to questions and requests for clarification, opinions, suggestions, and consultations by our economists or editors. Advisory services are limited to discussing or clarifying four issues per client each month.

NOTE: We offer a great discount for non-profit and academic institutions, please contact us for details.

Tailored Research & Consulting	Start from (US$)
Tailored Report (similar format to CEP publications)	3,500
Research Project	10,000
Research + seminar with economists	25,000
Research + seminar with economists & policy makers	50,000

Conference Calls & Interviews	Start from (hourly rates/US$)
Conference call with an economist	1,000
Face-to-face interview with an economist	2,000
Conference call with a policy maker	1,000
Face-to-face interview with a policy maker	2,000

PAYMENT: We accept payment by bank transfer only. Our bank account details will be provided once you email us the order to cep@thegateway-group.com

MONEY BACK GARANTEE: If a client is not satisfied with the subscription during the first two months of subscription, we will refund the unexpired portion.

Industry & Topics

Industry Coverage

Financial service	New energy automobile	Electrical power	Healthcare
Renewable energy	High tech	Iron and steel	Metal and mining
Strategic emerging industries	Real estate	Equipment manufacturing	Public sector
Low carbon economy	Energy (oil,coal,natural gas)	Railway	Social sector

Topic & Project Focus

Macro economy	Fiscal policy and taxation reform	Financial supervision reform	Regional development
Monetary policy	Private capital and investment	International/overseas investment	Rural economy
Foreign reserves	Going global strategy	Financial and banking risk	Income distribution and social welfare
RMB exchange rate and internationalization	Hot money	Capital markets	

CHINA's ECONOMY & POLICY

Insiders' insights

www.china-economy-policy.com
CEP@thegateway-group.com

Published by
Gateway International
www.thegateway-group.com

Shanghai Office
16F Feidiao Building, 1065 Zhaojiabang Road,
Shanghai, 200300, China

Beijing Office
Room 212, No.1 Building, 5 Jianguomennei Street,
Beijing, 100732, China

Hong Kong Office
C1-Room 1708 Nan Fung Tower, 173 Des Voeux
Road C., Hong Kong

Toronto Office
Suite 403, 133 Richmond Street West,
Toronto, Ontario, M5H 2L3, Canada

__Gateway International__ is a consulting firm which operates in two major fields by providing top-quality research and consulting as well as professional financial services, relying on the solid economic and policy research capabilities of our staff. We support our clients, both in China and overseas, by enabling them to not only follow the fast-changing Chinese business trends but also to thoroughly understand how to adapt to the country's dynamic market environments. For more information please visit www.thegateway-group.com or write to cep@thegateway-group.com

published by Gateway International