CLIFFORD CHANCE

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China's implementing rules on the new regulatory standard for the banking industry – stricter than Basel III

In order to implement the new international regulatory standard under Basel III, the China Banking Regulatory Commission (CBRC) published the *Guiding Opinion on the Implementation of the New Regulatory Standard by China's Banking Industry* (*《关于中国银行业实施新监管标准的指导意见》, 银监发[2011]44 号*) (**Guiding Opinion**) on 27 April 2011. The Guiding Opinion sets out the general principles, main objectives, transitional arrangements and working requirements for such implementation.

On 1 June 2011, CBRC further published the *Administrative Measures on the Leverage Ratio of Commercial Banks* (*《商业银行杠杆率管理办法》, 银监会令 2011 年第 3 号*) (**Leverage Ratio Measures**), which will come into effect on 1 January 2012. The Leverage Ratio Measures aim to control the extent of leverage used by commercial banks to ensure the effective operation of their business. The Leverage Ratio Measures implements the rules on the leverage ratio of commercial banks under the Guiding Opinion by setting out the principles and details regarding the calculation and monitoring of the leverage ratio.

More recently, on 15 August 2011, CBRC published the *Administrative Measures on Capital of Commercial Banks (Consultation Draft)* (*《商业银行资本管理办法(征求意见稿)》*) (**Capital Measures**) for public comments to ensure the new standards are implemented as scheduled. Each banking financial institution will be required to calculate and measure its regulatory capital in accordance with the Capital Measures when they become effective on 1 January 2012.

Background to the Guiding Opinion

On 16 December 2010, the Basel Committee on Banking Supervision (**BCBS**) issued Basel III. Basel III establishes a new financial regulation model combined with microprudential and macroprudential regulation, including improvements to bank capital requirements and the introduction of minimum standards on liquidity and leverage at a global level.

In preparation for its implementation, Basel III requires that each member country of the BCBS completes the formulation and amendment of their respective legal and regulatory framework within two years. Under Basel III, the new standards will be phased in from 1 January 2013 with full implementation required by 1 January 2019.

Key Issues

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The twelfth five-year plan confirms that China will participate in Basel III's new round of amendments on international financial rules to improve the stability of China's financial industry. To fulfil its obligation as a member of the BCBS and the Financial Stability Board (FSB), China has begun to formulate comprehensive plans on the implementation of the new regulatory standards. The Guiding Opinion constitutes a set of overall guidelines on how the new regulatory standard for China's banking industry will be implemented. Detailed rules on prudential regulation and risk management for the banking industry will be published in the near future.

Objectives and principle

The Guiding Opinion combines macroprudential regulation with microprudential regulation to introduce countercyclical regulatory requirements which reflect individual and systemic risks faced by banking financial institutions as required by Basel III. In order to maintain fair competition in the banking industry, a unified regulatory standard has been established for all types of banking financial institutions. However, BCBS recommends and CBRC has imposed, a higher regulatory standard for systemically important banks (**SIBs**) because of the global (cross-border) reach of their business and the negative effect this may have on the global economy in times of crisis. Separate phase-in arrangements for different institutions have been set up to ensure that they transition smoothly in complying with the new regulatory standards.

Four supervisory instruments

CBRC circulated a discussion draft of the chart on the *Implementation Requirements for Four New Regulatory Instruments* (*新四大工具实施要求简表(讨论稿)*) (**Discussion Draft**) to various financial institutions in September 2010. The Discussion Draft introduced four regulatory instruments namely, capital adequacy ratio (**CAR**), leverage ratio, liquidity ratio and loan loss provisions. These four regulatory instruments have been officially set out in the Guiding Opinion.

Capital requirements

Regulatory capital

Regulatory capital is divided into three categories which are Core Tier 1 Capital, Additional Tier 1 Capital and Tier 2 Capital, in contrast to the original classification which only has two categories, namely Tier 1 Capital and Tier 2 Capital. Banking financial institutions must strictly comply with the deduction rules on capital. The risk-weighted assets include credit risk-weighted assets, market risk-weighted assets and operational risk-weighted assets. In addition, different credit risk weighting methods will be utilised and formal capital requirements for operational risks will be formulated. The risk weights for transactional business, asset securitisation business, over-the-counter derivative transactions and other complex financial instruments will be raised as well.

Capital Adequacy Requirements (CAR)

Under the Capital Measures, the CAR is defined as the ratio between a bank's regulatory capital and its risk-weighted assets. Under the current regulatory regime, Tier 1 Capital must be no less than 4% of risk-weighted assets, and total capital must be no less than 5% of risk-weighted assets. The Guiding Opinion sets out the following revised requirements relating to a bank's CAR:

(i) the minimum capital requirements for Core Tier 1 Capital, Tier 1 Capital and Total Capital must be no less than 5%, 6% and 8%, respectively, at any time;

(ii) the capital conservation buffer is set at 2.5% and the countercyclical buffer at 0-2.5%; and

(iii) an additional capital requirement for SIBs is temporarily fixed at 1%.

After the new standard has been introduced, under normal conditions, the CARs for SIBs and non-SIBs must be no less than 11.5% and 10.5%, respectively, which are the same as the current domestic regulatory requirements on CAR (11.5% for large-sized banks and 10% for small and middle-sized banks). If any excessive growth of credit occurs, commercial banks must comply with the countercyclical buffer. In addition, CBRC may, under the Capital Measures, raise other prudential capital requirements within the framework of the second pillar in respect of a particular asset portfolio or a bank.

The domestic regulatory requirement on capital is generally consistent with that set internationally under Basel III. CBRC indicates that China's departures from Basel III on capital could be summarised as follows. Firstly, the minimum requirement for Core Tier 1 Capital (common equity, share premium and retained earnings) is set at 5%, which is 0.5% higher than that required by Basel III. The main reason is that China has focussed on capital quality for a long time and Core Tier 1 Capital of banks in China is already markedly higher than 4.5% as required by Basel III. This suggests that the new 5% requirement for Core Tier 1 Capital will not have a significant negative impact on banks in China. Secondly, while the BCBS and the FSB have not reached any agreement on the additional capital requirement for SIBs, it is now temporarily introduced at 1% under the Guiding Opinion.

Transitional arrangement

Basel III proposes that new capital regulatory requirements must be phased in as of the beginning of 2013 with full compliance by the end of 2018. China's new regulatory capital requirements would take effect from the beginning of 2012, and would be fully implemented for SIBs by the end of 2013 and for non-SIBs by the end of 2106, both dates being ahead of the schedule set by Basel III. If necessary, and after obtaining approval from CBRC, the deadline for a SIB and a non-SIB to fully comply with the new capital requirements may be extended to the end of 2015 and the end of 2018 respectively. At the end of the relevant transition periods, banks must disclose their CAR in accordance with the new regulatory standard. As a matter of fact, the average CAR of all banks in China has reached 12.2% and Core Tier 1 Capital has reached 10.1% by the end of 2010, indicating that most banks would be able to meet the new regulatory standard on capital going forward.

Table 1: Capital requirements

Rule	Bank	Minimum capital requirements			Conservation capital buffer	Countercyclical buffer	Implementing date	Full compliance date
		Core Tier 1 capital	Tier 1 capital	Total capital				
Guiding Opinion	SIBs	8.5%	9.5%	11.5%	2.5%	0-2.5%	1 January 2012	End of 2013
	Non-SIBs	7.5%	8.5%	10.5%	2.5%	0-2.5%	1 January 2012	End of 2016 (End of 2018 for village and town banks)
Basel III	Banks	4.5%	6%	8%	2.5%	0-2.5%	1 January 2013	End of 2018

Leverage requirements

Leverage ratio

The calculation method of the leverage ratio and the disclosure requirements under the Leverage Ratio Measures is consistent with Basel III. Under the Leverage Ratio Measures, the leverage ratio must satisfy the following requirements:

(i) Tier 1 Capital must be at least 4% of the adjusted balance of on-balance sheet and off-balance sheet assets. Under Basel III, there will be a period of testing the leverage ratio of Tier 1 Capital at 3%, which is 1% lower than that required by CBRC;

(ii) key terms of the Leverage Ratio Measures are consistent with those used in the Capital Measures. For instance, cross-reference is made to the Capital Measures with respect to the definition of Tier 1 Capital, the consolidated scope and calculation method of consolidated leverage ratio; and

(iii) reporting must at least cover the following: leverage ratio, Tier 1 Capital, deductible items of Tier 1 Capital, adjusted balance of on-balance sheet assets, adjusted balance of off-balance sheet items and adjusted balance of on-balance sheet and off-balance sheet assets, etc. Information disclosure must comply with the provisions of the *Administrative Measures on Information Disclosure of Commercial Banks* (*《商业银行信息披露办法》，银监会令2007年第7号*), which require commercial banks to disclose information within four months after the end of each fiscal year.

Currently, the leverage ratios of most banking financial institutions have already reached 4%. Only a few banking financial institutions with rapid capital expansion are unable to meet this requirement, yet the shortfall is relatively small. The Leverage Ratio Measures are aimed at preventing excessive growth of leverage and ensure control over systemic risks of commercial banks. By setting a higher leverage ratio than Basel III, CBRC hopes to encourage commercial banks to improve the quality of their business and deter them from expanding their business models too rapidly.

Transitional Arrangement

The CBRC requires the leverage ratio to be phased in from 1 January 2012 and commercial banks must meet the requirements by the end of 2013 (for SIBs) or the end of 2016 (for non-SIBs).

Table 2: Leverage requirements

Rule	Bank	Leverage ratio	Implementing date	Full compliance date
Guiding Opinion	SIBs	4%	1 January 2012	End of 2013
	Non-SIBs	4%	1 January 2012	End of 2016
Basel III	Banks	3%	Supervisory monitoring from 1 January 2011	Parallel run period from 1 January 2013 to 1 January 2017 and migration to Pillar 1 during 2018

Liquidity requirements

Regulatory indicators

The liquidity coverage ratio (LCR) (i.e. the ratio between stock of high-quality liquid assets and total net cash outflows over a period of 30 calendar days) and net stable funding ratio (NSFR) (i.e. the ratio between the available amount of stable funding (i.e. funding with more than one year to maturity) sources and the required amount of stable funding sources) must not be less than 100% for the LCR and the NSFR in each case. These liquidity standards are the same as those under Basel III. Other regulatory and monitoring indicators, such as the liquidity ratio, the deposit loan ratio, the liquidity gap ratio, the concentration of clients' deposits and concentration of inter-bank debts, that CBRC uses on a regular basis will be maintained and optimised. Meanwhile, banks will be encouraged to establish internal monitoring systems on liquidity risk.

CBRC will guide banks to strengthen their effective governance framework and management process over liquidity risks, identify and prudently evaluate their liquidity risks at the product level as well as the institutional level, enhance their foundation of data and information systems for liquidity risk management and improve their testing methods of liquidity risk.

The comprehensive quantitative impact study conducted by CBRC indicates that most domestic banks have already satisfied or could, within a short period, satisfy the new liquidity regulatory requirements. Only a few banks are expected to be unable to satisfy the LCR and NSFR due to their special financing structures.

Transitional arrangement

LCR and NSFR, together with the expanded monitoring system, will be phased in as of 1 January 2012. CBRC requires that the LCR and NSFR be subject to an observation period of two years and five years respectively. Banks must meet the LCR by the end of 2013 and the NSFR by the end of 2016.

Table 3: Liquidity requirements

Rule	Bank	LCR	NSFR	Implementing date	Full compliance date
Guiding Opinion	SIBs	100%	100%	1 January 2012	End of 2013
	Non-SIBs	100%	100%	1 January 2012	End of 2016
Basel III	Banks	not less than 100%; observation period begins on 1 January 2011 and introduce minimum standard on 1 January 2015	not less than 100%; meet minimum standard by 1 January 2018		

Loan loss provisions requirements

Ratio requirements

In principle, the regulatory requirement for loan loss provisions will be set at the higher of the following:

(i) the loan loss provisions ratio (i.e. the ratio between the loan loss provisions and the outstanding loans) which must be no lower than 2.5%; or

(ii) the loan coverage ratio (i.e. the ratio between the loan loss provisions and the total non-performing loans (NPL) coverage ratio) which must be no lower than 150%.

CBRC will adjust the rules on loan loss provisions according to the different economic cycles and the differences between the loan quality and profitability among banking financial institutions. The loan loss provisions will be raised in rising markets and reduced in falling markets based on loan write-off conditions and adjusted in line with the loan quality and profitability of each banking financial institution.

The quantitative impact study shows that, under the current conditions of the Chinese banking industry, the average loan loss provision ratio is approaching 2.5% and the provision coverage ratio has reached 230%. In addition, the Chinese commercial banks that have satisfied these two ratio requirements represent over 50% and 85%, respectively, of all the banks in China. Therefore, it should not be difficult for banks in China to meet the new standards before 2018. In any case, as some institutions may still have problems satisfying these standards simultaneously within a short period of time, the Guiding Opinion provides a relatively long transition period.

Transitional arrangements

The new regulatory standards relating to loan loss provisioning will be phased in as of 1 January 2012. SIBs must meet these standards by the end of 2013. For non-SIBs, CBRC will set up tailored transitional arrangements – those with higher profitability and lower loan loss provisions must meet the standards by the end of 2016, and those with lower profitability and higher loan loss provisions must meet the standards by the end of 2018, both of which are ahead of Basel III's suggested timeframe.

Table 4: Loan Loss Provisions Requirements

Rule	Bank	Loan loss provisions ratio	NPL coverage ratio	Implementing date	Full compliance date
Guiding Opinion	SIBs	2.5%	150%	1 January 2012	End of 2013
	Non-SIBs	2.5%	150%	1 January 2012	End of 2016 or end of 2018
Basel III	Banks	General provisions eligible for inclusion in Tier 2 limited to a maximum of 1.25% of credit risk-weighted risk assets	No such term		

Regulation on SIBs

Definition and assessment

The regulator will clarify the definition of SIBs and the assessment of SIBs will focus principally on four factors, namely, the scale, relevancy, complexity and substitutability of these banks. The method and framework of a continuous assessment of SIBs will also be established.

Firewalls regime

The firewalls regime between the banking system and capital market, between banks and their controlling shareholders, and between banks and their affiliates, will be maintained and the proactive supervision of market access will be improved. CBRC will adopt the following measures:

(i) maintain the current firewalls regime to prevent risks from expanding cross-border and cross-industry;

(ii) restrict banks from engaging in transactions with complex structures and high leverage; and

(iii) promote the pilot comprehensive business scheme. A formal evaluation regime will be established for banks involved in this scheme, while for banks conducting cross-industry business, if its profitability cannot reach the industrial average level within a reasonable period, such a bank will be forced to exit from the industry.

Prudential regulatory requirement

Apart from additional capital requirements, CBRC will impose stricter prudential regulation requirements on SIBs, which include the following:

(i) requiring SIBs to issue "self-rescue bonds" to improve their loss absorbency;

(ii) raising liquidity requirements;

(iii) imposing tighter restrictions for large risk exposures, and loosening the restriction on loan concentration of a single client or group clients of SIBs; and

(iv) raising the standards regarding consolidated supervision on risk management at the group level.

In addition, SIBs will be supervised under more regulatory resources and local CBRC officials will have broader powers to supervise SIB's decision-making and operation. In respect of cross-border cooperation, an assessment system regarding the capacity of foreign regulatory authorities will be set up alongside a regulatory joint meeting regime for SIBs. Meanwhile, in respect of cross-industry cooperation, CBRC will cooperate with the People's Bank of China, the China Securities Regulatory Commission and the China Insurance Regulatory Commission to establish a "seamless" financial regulatory regime.

Relationship with other rules

In June 2004, BCBS promulgated the *International Convergence of Capital Measurement and Capital Standards: A Revised Framework* (**New Capital Accord**, known as **Basel II**). In February 2007, CBRC issued the *Guiding Opinion on the Implementation of the New Capital Accord by China's Banking Industry* (*《中国银行业实施新资本协议指导意见》*) (**Guiding Opinion on New Capital Accord**), which clarified the objectives, principles, scope, method and schedule for implementing the New Capital Accord in China.

CBRC plans to propose a synchronised roll-out of Basel II and Basel III. The implementation of Basel III will be based on the three pillars and risk weighting method set by Basel II. After four years of study and analysis, CBRC has finally formulated and published supporting rules and regulations in accordance with Basel II and the major domestic banks have long prepared for its implementation. Basel II will be applied to a selected first batch of banks this year.

Banks with a certain amount of assets and certain types of businesses must adopt the Advanced Measurement Approach (AMA) under Basel II. Other banks, while not mandated to do so, must formulate the implementation plans of the AMA as soon as possible if they choose to adopt the AMA voluntarily.

Since the Capital Measures will be officially rolled out this year, we understand that an existing CBRC circular, the *Measures for the Management of Capital Adequacy Ratios of Commercial Banks* (*《商业银行资本充足率管理办法》*) (**Capital Adequacy Measures**) will be supplemented by the Capital Measures then. If so, the standardised approach under the Capital Measures will be relevant to banking financial institutions that do not adopt the AMA by the end of 2011 in calculating and measuring regulatory capital for market risk and operational risk. These institutions must further set up an internal capital adequacy assessment process in accordance with the second pillar requirement, and identify, assess, monitor and report various major risks to ensure that their management ability corresponds to their capital level and risk status, their capital schemes match their business status, and their risks variation trend is compatible with their long-term development strategy. By the end of 2016, each banking financial institution must establish a comprehensive risk management framework and an internal CAR valuation process suited to its business scale and complexity.

Working requirements

As of 2011, the monitoring of the implementation of the new Basel III standard will fall under CBRC's mandate which will take action against any shortcomings. Each institution is required to appoint a specific department in charge to analyse the effects of and problems associated with the implementation, while providing timely reports to CBRC.

Each banking financial institution is now required to start preparing for the implementation of the new regulatory standard as follows:

(i) conducting an overall gap analysis to compare its current performance with that required by the new regulatory standard, and formulate feasible implementation plans for the new regulatory standard in accordance with the Guiding Opinion; the implementation plans must at least address the capital growth plan, asset structure adjustment plan, profitability plan, various risk-weighted assets measurement plan, liquidity source, loan loss provisions accrual plan and the time schedule and periodical objectives of all regulatory indicators; these plans must be formulated and filed with CBRC by the end of 2011; and

(ii) advancing its risk management mechanism and management ability according to its business profile as follows:

(a) completing an organisational structure of risk management by clarifying the roles and responsibilities of the board of directors, senior management, the chief risk officer, the risk management department and relevant business divisions;

(b) enhancing the management of databases through the implementation of the new regulatory standard, in order to solve the long-existing problems of missing data and low quality among domestic banking financial institutions;

(c) developing and promoting new risk measurement techniques to improve the identification of risks and accuracy in measuring risks;

(d) strengthening IT systems to support the formulation and execution of risk management policies as well as the utilisation and optimisation of the risk measurement techniques;

(e) strengthening internal control and auditing as well as cooperation with external auditing in order to establish an internal balancing mechanism; and

(f) improving evaluation and incentive systems for staff by setting up a "risk-profit" performance assessment and salary mechanism.

In addition, domestic banks must pay attention to pre-dominant risks, including major risks in local financing, real estate loans and economic restructuring, and explore the risk management model which combines systemic risks with individual risks.

Potential impact of implementing the new regulatory standard

By now, the major banks in China have already satisfied the new regulatory standard. The capital shortfall of most commercial banks is small and major capital raising exercises are unlikely to be required. In the long run, banks must supply continuous credit at a growth rate that could support economic growth in China. Therefore, commercial banks will need to supplement their regulatory capital in order to continuously satisfy their capital requirements. In particular, even if the new standards were not applied, CBRC indicates that there could be a certain amount of capital shortage for the banking industry in the next five years, and the banks would need to supplement this through earnings rather than other external channels. However, with the rapid development of the domestic capital market, CBRC estimates that the increasing financing demands on commercial banks imposed by the new regulatory standard should not create a significant impact on the domestic capital market.

In addition, the goals of CBRC in implementing the new regulatory standard is to adjust banks' loan portfolio and improve the quality of such loans. CBRC believes that the credit supply capability of China's banking system will not be influenced by the new regulatory standard. This is because most commercial banks have good capital quality, a relatively high CAR, and have already met the new capital regulatory standard. Meanwhile, with the use of transitional arrangements, any negative impact could further be mitigated.

Since the Guiding Opinion is only a general guideline to implement Basel III in China, more detailed rules are likely to be rolled out to elaborate on the implementation in the near future, in particular new or amended regulations on liquidity, loan loss provisions or other specific requirements relating to banking financial institutions.