Basel Committee
on Banking Supervision

Regulatory Consistency Assessment Programme (RCAP)

Assessment of Basel large exposures regulations – China

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Contents

Glossary

BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
C	Compliant (grade)
CBIRC	China Banking and Insurance Regulatory Commission
CNY	Chinese renminbi (currency)
FSS	Financial Supervisory Service
LC	Largely compliant (grade)
LCR	Liquidity Coverage Ratio
LEX	Large exposures
MNC	Materially non-compliant (grade)
NC	Non-compliant (grade)
QCCP	Qualifying central counterparty
RCAP	Regulatory Consistency Assessment Programme
SIG	Supervision and Implementation Group
SOE	State-owned enterprise

Preface

The Basel Committee on Banking Supervision (Basel Committee) places a high priority on the implementation of regulatory standards underpinning the Basel III framework. The prudential benefits from adopting Basel standards can only fully accrue if these are implemented fully, consistently and in a timely manner by all member jurisdictions. The Committee established the Regulatory Consistency Assessment Programme (RCAP) to monitor, assess and evaluate its members' implementation of the Basel framework.

This report presents the findings of an RCAP Assessment Team on the domestic adoption of the Basel large exposures (LEX) standard in China. The assessment focused on the completeness and consistency of the domestic regulations in force on 31 July 2019, as applied to internationally active banks, with the Basel LEX standard. Issues related to prudential outcomes, the resilience of the banking system or the supervisory effectiveness of the Chinese authorities' were not in the scope of this assessment. The assessment relied on translated regulations and other information and explanations provided by the Chinese authorities and ultimately reflects the view of the Basel Committee.

The RCAP Assessment Team was led by Mr Seong Il Choi, Deputy Governor of the Korean Financial Supervisory Service (FSS). It comprised four technical experts, from Germany, Lebanon, Sweden and the Basel Committee Secretariat (see Annex 1). The main counterpart for the assessment was the China Banking and Insurance Regulatory Commission (CBIRC). The work was coordinated by the Basel Committee Secretariat with support from staff from the FSS.

The assessment began in January 2019 and comprised (i) a self-assessment by the Chinese authorities; (ii) an assessment phase (February to July 2019), including an on-site assessment involving discussions with the Chinese authorities; and (iii) a review phase (August to September 2019), including a technical review of the Assessment Team's findings by a separate RCAP Review Team, the Committee's Supervision and Implementation Group, the RCAP Peer Review Board and the Basel Committee. More information on the RCAP assessment process is available on the Committee's website.

The RCAP Assessment Team acknowledges the cooperation received from the CBIRC staff throughout the assessment process.

Executive summary

In the People's Republic of China (China), the large exposures (LEX) standard applies to all commercial banks. The LEX standard is implemented via the Rules on Large Exposure of Commercial Banks (Rules), which are further enacted under the Law of the People's Republic of China on Banking Regulation and Supervision, the Law of the People's Republic of China on Commercial Banks and other relevant laws and administrative regulations. The Rules were issued on 1 July 2018, with commercial banks required to implement the rules before 31 December, 2018.

Overall, as of 31 July 2019, the LEX regulations in China are assessed as compliant with the Basel LEX standard. This is the highest possible grade.

The assessment yielded two findings that were assessed as not material, as follows:

- The Basel LEX standard allows an exemption for sovereign exposures and their central banks as well as public sector entities treated as sovereigns. The China Banking and Insurance Regulatory Commission (CBIRC) regulation extends the sovereign exemption to "other entities". While this is a deviation from the Basel standard, it is not material because no "other entities" have so far been specified. The CBIRC asserts that this is done to allow provisions to be made if entities with sovereign characteristics emerge.
- The Basel LEX standard requires that a bank measures its exposure to non-qualifying central counterparties (QCCPs) as the sum of both non-clearing and clearing exposures, which is subject to the large exposure limit of 25% of the eligible capital base. The CBIRC regulation applies this limit to each of clearing and non-clearing exposures, rather than the "sum" of such. Data confirmed that the bank with the largest exposure to the sum of non-clearing and clearing exposures is below 2% of the eligible capital base, which is well below the Basel limit. As such, these findings are not material.

Response from the CBIRC

As one of the largest emerging economies, China has a strong commitment to global regulatory reform and standards for the purpose of building a sound and resilient financial system. The CBIRC issued the Rules on Large Exposure of Commercial Banks (LE Rules) in 2018, benchmarking international norms to ensure a timely implementation of the LEX standard. The LE Rules reflect the CBIRC's continuous efforts to strengthen banking regulation and supervision. Compared with the Basel rules, the LE Rules have a wider scope of application and set higher requirements in selected areas in a more prudent way.

The CBIRC is in full support of the Regulatory Consistency Assessment Programme (RCAP) put in place by the Basel Committee, which comes at an important time to foster a consistent adoption of Basel standards and a level playing field for internationally active banks. As can be seen from this assessment and previous ones, it is useful in many ways for the authorities to take the necessary steps to refine their domestic regulations in line with the Basel framework. In return, the Committee can also take advantage of the dialogue with national supervisors to collect opinions for future improvements to the Basel standards.

We welcome the detailed assessment of large exposures regulatory framework in China and highly appreciate the professionalism of the Assessment Team, whose comments and recommendations have therefore been well received and carefully considered by the CBIRC. We will stay forward-looking and will continue to monitor the challenges for the banking sector and their implications.

The implementation of global regulatory standards is an evolving process that deserves ongoing commitment, hard work and coordinated efforts. So we look forward to further cooperation and collaboration with the Basel Committee.

1 Assessment context

1.1 Status of implementation of the large exposures framework

The LEX standard applies to all commercial banks. It is implemented via the LE Rules, which are further enacted under the Law of the People's Republic of China on Banking Regulation and Supervision, the Law of the People's Republic of China on Commercial Banks and other relevant laws and administrative regulations. The Rules were issued on 1 July 2018, with commercial banks required to implement the rules before 31 December 2018. The Rules further specify the consequences to banks of not meeting the 31 December 2018 implementation date, which apply over a one- to three-year transitional period.

1.2 Regulatory system

The CBIRC has been responsible for banking regulation and supervision in China since 2003. It reports directly to the State Council. Its objective is to promote a safe and sound banking industry by preventing and reducing banking risks while protecting the legitimate interests of depositors and other clients. The Law on Banking Supervision and Regulation, from which the CBIRC derives its powers, also applies to asset management companies, trust companies, finance companies, financial leasing companies incorporated in China and other non-bank financial institutions approved by the CBIRC.

Under its founding law, the CBIRC has the power to issue two types of legal instrument: regulations and regulatory documents. Regulations have the highest legal force and are used to implement the main elements of the prudential framework. Regulatory documents have a legal status subordinate to regulations and typically contain more detailed requirements. Both types of document constitute legally binding rules, of which non-compliance can be used as a basis for enforcement action against banks. Table 1 summarises the structure of prudential regulations in China.

Structure of Chinese laws and regulatory instruments	Table 1
Purpose	Type
Laws that empower the CBIRC as supervisor	Law on Banking Supervision and Regulation
Legal instruments issued by the CBIRC under the above law	Regulations: used for the main provisions in the prudential framework. There are various names and titles for regulations, including, provisions, measures and rules. Regulatory documents, including notices and circulars, issued to support regulations.

Notes: The CBIRC regulates its own rule-making process through the CBIRC Rule-making Provisions, which requires the CBIRC to review regularly the rules it makes to ensure their relevance and effectiveness.

Source: CBIRC.

1.3 Structure of the banking sector

The core business of the Chinese banking system remains relatively traditional, concentrated in domestic lending and services. As of end-2018, there were 1,637 banks operating in China. Over 1,000 of these banks are small independent rural banks, which mainly serve farmers in their local communities. However, the banking system has grown rapidly in recent years and the banks' structures have become more complex on both the liability and asset sides, while their off-balance sheet activities have grown significantly.

In order to identify banks that are internationally active, the CBIRC applies different criteria like size, exposure to international markets and business activities. CBIRC does apply both thresholds and supervisory judgment to identify the Chinese internationally active banks. On this basis, the CBIRC has identified six Chinese banks as internationally active, including four that are designated as global systemically important banks (G-SIBs). These six banks have a combined share of about 44.5% of Chinese banking system assets. The combined overseas assets of these six banks is CNY 13.8 trillion and 13% of these banks' total assets. The Chinese banking system's total overseas assets comprise around CNY 15.3 trillion and 7% of the banks' total assets.

In evaluating the materiality of its findings, the RCAP Assessment Team generally focused on a sample of 12 of the largest banks in China. Together, these 12 banks comprise about 63% of the Chinese banking system's assets.

1.4 Scope of the assessment

The Assessment Team considered the LEX limits applicable to all commercial banks in China as of 31 July 2019. The assessment had two dimensions:

- a comparison of domestic regulations with the Basel LEX framework to ascertain that all the required provisions have been adopted (*completeness* of the regulations); and
- whether there are any differences in substance between the domestic regulations and the Basel LEX framework and, if so, their significance (*consistency* of the regulations).

In its assessment, the RCAP Assessment Team considered all binding documents that effectively implement the Basel LEX standard in China. Annex 2 lists the Basel standards used as the basis for the assessment.

As set out in the RCAP methodology, the Assessment Team evaluated the materiality and potential materiality of identified deviations between the Basel LEX standard and the Chinese regulations. The quantification was limited to a sample of banks. In addition, the Assessment Team reviewed the non-quantifiable aspects of identified deviations and applied expert judgment as to whether the Chinese regulations meet the Basel framework in letter and in spirit. The materiality analysis is summarised in Annex 3, which also lists banks in the sample.

The Assessment Team noted that, in some areas, the Chinese rules go beyond the minimum Basel standards. Although these elements (listed in Annex 4) provide for a more rigorous implementation than the Basel framework, they have not been taken into account for the assessment of compliance.

The outcome of the assessment is summarised using a four-grade scale, both at the level of each of the three key components of the Basel LEX standard and the overall assessment of compliance. The four grades are: compliant (C), largely compliant (LC), materially non-compliant (MNC) and non-compliant (NC).

2 Assessment findings

2.1 Assessment grades and summary of findings

Overall, the Assessment Team finds the implementation of the LEX standard in China to be compliant with the Basel LEX standard. This grade is based on the materiality assessment as summarised in Annex 3.

Assessment grades

Table 2

Component of the Basel LEX framework	Grade
Overall grade	C
Scope and definitions	C
Minimum requirements and transitional arrangements	C
Value of exposures	C

Assessment scale: C (compliant), LC (largely compliant), MNC (materially non-compliant) and NC (non-compliant).

2.1.1 Scope and definitions

This component was judged to be compliant with the Basel standard. No findings were identified.

2.1.2 Minimum requirements and transitional arrangements

This component was judged to be compliant with the Basel standard. No findings were identified.

2.1.3 Value of exposures

This component was judged to be compliant with the Basel standard. Two non-material findings were identified:

- The Basel LEX framework allows an exemption for sovereign exposures and their central banks as well as public sector entities treated as sovereigns. The CBIRC regulation extends the sovereign exemption to "other entities". While this is a deviation from the Basel standard, it is not material because no "other entities" have so far been specified. The CBIRC asserts that this is done to allow provisions to be made if entities with sovereign characteristics emerge.
- The Basel LEX framework requires that a bank measures its exposure to non-QCCPs as the sum of both non-clearing and clearing exposures, which is subject to the large exposure limit of 25% of the eligible capital base. The CBIRC regulation applies this limit to each of clearing and non-clearing exposures, rather than the sum of such. Data confirmed that the bank with the largest exposure to the sum of non-clearing and clearing exposures is below 2% of the eligible capital base, which is well below the Basel limit. As such, these finding are not material.

2.2 Detailed assessment findings

2.2.1 Scope and definitions

No findings were identified.

2.2.2 Minimum requirements and transitional arrangements

No findings were identified.

2.2.3 Value of exposures

Two non-material findings were identified.

Section grade	**Compliant**
Basel paragraph number	61: Treatment of sovereigns and entities connected with sovereigns
Reference in the domestic regulation	Article 13(4) and 15
Finding	The Basel LEX framework allows an exemption for sovereign exposures and their central banks as well as public sector entities treated as sovereigns. The CBIRC regulation extends the sovereign exemption to "other entities" subject to approval of the CBIRC. Exempting "other entities" could allow a broader scope of application of the sovereign exemption. While the exemption of such "other entities" is a deviation from the Basel standard, it is considered neither material nor potentially material as the CBIRC has not designated or approved such "other entities" so far and has no specific plan to do so in the near future. The CBIRC indicated that this "other entities" category exists as a miscellaneous provision to allow, subject to approval of the CBIRC, that provisions be made if entities with sovereign characteristics emerge as a result of any future potential review by the Basel Committee of the definition of sovereign exposures.
Materiality	Not material
Basel paragraph number	85: Treatment of clearing and non-clearing exposures
Reference in the domestic regulation	Article 12
Finding	The Basel LEX framework requires that a bank measures its exposure to non-QCCPs as the sum of both non-clearing and clearing exposures, which is subject to the large exposure limit of 25% of the eligible capital base. The CBIRC regulation applies this limit to each of clearing and non-clearing exposures, rather than the sum of such. Applying the limit to these elements separately could result in clearing and/or non-clearing exposures exceeding the limit set by the Basel framework. Data confirmed that any individual bank's exposure to the sum of non-clearing and clearing exposures is below 2% of the eligible capital base, which is well below the Basel limit. As such, this finding is not material.
Materiality	Not material

2.3 Observations on the implementation of the large exposures framework in China

The following observations highlight certain special features of the regulatory implementation of the Basel LEX standard in China. These are presented to provide additional context and information. Observations are considered compliant with the Basel standard and do not have a bearing on the assessment outcome.

2.3.1 Minimum requirements and transitional arrangements

Basel paragraph number	93: Implementation date and transitional arrangements
Reference in the domestic regulation	Annex 6

Observation	The Basel LEX framework provides an implementation date of 1 January 2019, which corresponds to the CBIRC implementation date. The five state-owned banks and 12 joint-stock banks in China met the requirements of the CBIRC LEX guideline by the required implementation date of 1 January 2019. As such, no transition has been granted to these banks. In the remaining banks, for some that were unable to meet the 1 January 2019 implementation date (eg small- to medium-sized banks), the CBIRC grants a three-year transition period for interbank exposures. The transition requires the small- or medium-sized bank to gradually reduce its exposures to interbank counterparties over the transition period. The transition period allows the provisions on interbank counterparties, as set out in the LEX framework, to be applied to small- and medium-sized banks in a proportionate manner. In addition, the CBIRC grants a one-year transition period for exposures to unknown clients.

2.3.2 Value of exposures

Basel paragraph number	64: Exposures to counterparties providing credit protection to exempted entities
Reference in the domestic regulation	Article 23
Observation	As per Basel's LEX framework, where a bank has an exposure to an exempted entity that is hedged by a credit derivative, the exposure to the counterparty providing the credit protection is recognised, notwithstanding that the original exposure is exempted. The CBIRC regulations do not include this requirement because its capital framework does not recognise credit derivatives as an eligible credit risk mitigation technique. The CBIRC confirmed that its banks operating under the internal ratings-based (IRB) approach do not have exposures to exempted entities that are hedged by credit derivatives.

Annexes

Annex 1: RCAP Assessment Team and Review Team

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Annex 2: List of Basel standards and implementing regulations issued by Chinese authorities

The following Basel standards were used as the basis of this RCAP assessment:

- *Supervisory framework for measuring and controlling large exposures*, April 2014
- *Frequently asked questions on the supervisory framework for measuring and controlling large exposures*, September 2016

Table A.1 lists the regulations issued by the CBIRC to implement the LEX standard in China. Previous RCAP assessments of China's implementation of the Basel standards considered the binding nature of regulatory documents in China. This RCAP Assessment Team did not repeat that assessment, but instead relied on the previous assessments' findings.

Overview of relevant Chinese large exposures regulations — Table A.1

Domestic regulations	Type, version and date
Rules on Large Exposures of Commercial Banks	Regulation issued in April 2018 （came into force in July 2018）

Source: CBIRC.

Annex 3: Materiality assessment

The outcome of the RCAP assessment is based on the materiality of the findings described in Section 2.2 and summarised in Table A.2. Assessment Teams evaluate the materiality of findings quantitatively where possible, or using expert judgment when the impact cannot be quantified.

The materiality assessment for quantifiable gaps is based on the cumulative impact of the identified deviations on the reported large exposures of banks in the RCAP sample. These banks are listed in Table A.3.

Number of deviations by component

Table A.2

Component	Not material	Potentially material	Material
Scope and definitions	0	0	0
Minimum requirements and transitional arrangements	0	0	0
Value of exposures	2	0	0

RCAP sample banks

Table A.3

Banking group	Share of banks' assets in the total assets of the Chinese banking system (per cent)
Agricultural Bank of China	9.8
Bank of China	9.3
Bank of Communications	4.2
China Construction Bank	10.2
Industrial and Commercial Bank of China	12.1
China CITIC Bank	2.7
China Everbright Bank	1.9
China Merchants Bank	3.0
China Minsheng Banking Corporation	2.6
Industrial Bank	2.9
Ping An Bank	1.5
Shanghai Pudong Development Bank	2.7
Total	62.9

Notes: Banking assets are based on the measure of total exposures used in the leverage ratio, which includes both on- and off-balance sheet exposures.

Source: CBIRC.

Annex 4: Areas where the Chinese rules are stricter than the Basel standards

In several areas, the Chinese authorities have adopted a stricter approach than the minimum standards prescribed by the Basel Committee. These are listed below for information and have not been taken into account as mitigants for the overall or component-level assessment of compliance.

- Application: the Basel LEX standard applies to all internationally active banks (see Basel paragraph 11). CBIRC applies to all commercial banks (see CBIRC article 2).
- Definition of large exposure: the Basel standard's definition of a large exposure is 10% of Tier 1 (see Basel paragraph 14). The CBIRC definition is 2.5% of Tier 1 (see CBIRC article 4).
- Level of large exposure limit: the Basel standard sets a LEX limit of 25% Tier 1 and 15% Tier 1 for G-SIBS (see Basel paragraph 16). In addition CBIRC has a limit for outstanding loan balances to a non-bank single counterparty of 10% and for all exposures 15% of Tier 1. The limit to connected non-banks is 20% of net Tier 1 (see CBIRC articles 7–10).
- Recognition of financial collateral: regarding eligible credit risk mitigation (CRM) techniques, the Basel standard refers to qualification for financial collateral under the SA method (see Basel paragraph 36). In addition, the CBIRC requires a rating of A– or above for bonds issued by any commercial bank or public entity (see Annex 5 of the CBIRC regulation).
- Recognition of hedges with maturity mismatches in CRM: according to the Basel standard, a hedge is only recognised when the original maturity is at least one year and the residual maturity of a hedge is at least three months (see Basel paragraphs 39–40). The CBIRC states only that there is not a mitigation effect if the maturity of the collateral is shorter than the secured claim (see CBIRC article 23).
- On-balance sheet netting: According to the Basel standard, a bank that has in place a legally enforceable netting arrangement can calculate LEX according to capital calculations (see Basel paragraph 41). CBIRC regulations do not allow any on-balance sheet netting as a type of eligible CRM technique.
- The Basel LEX standard requires that a bank look through a relevant structure to identify those underlying assets for which the underlying exposure is equal to or above 0.25% of its eligible capital base. The CBIRC has implemented this more rigorously by including the lower limit of 0.15% of the eligible capital base.