中国银行业监督管理委员会
China Banking Regulatory Commission

LIU Mingkang Chairman

To: Dr. Nout Wellink
Chairman of Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland
Fax: +41-61-280-9100

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Dear Dr. Wellink,

I am writing to present you the CBRC feedback on the two documents issued by the BCBS on December 17^{th}, 2009, namely: *Strengthening the resilience of the banking sector* and *International framework for liquidity risk measurement, standards and monitoring*. After nearly three months' careful research and public consultation with domestic banking sector, we have produced a paper that summarizes all the insightful opinions and suggestions we have gathered, as you can see in the attached.

Generally speaking, the CBRC and China's banking industry highly appreciate the unremitting efforts by the BCBS in strengthening the resilience of the banking sector and we endorse the overall direction of the reform package for capital and liquidity regulation. We believe the proposals to strengthen global capital regulation framework can help enhance the loss absorbency capabilities of the banking system and mitigating the positive feedback effects between banking system and real economy. However, as different economies are quite varied in terms of the structures of financial system and maturity of financial market, it is understandable that different economies can hardly agree on all the details of the new standards. The CBRC also has some suggestions for revision regarding some technical issues in the documents. Hopefully, our paper can somewhat contribute to our further revisions.

Best Regards,

LIU Mingkang
Chairman
China Banking Regulatory Commission

Add:Jia No.15 Financial Street, Xicheng District, Beijing, China 100800 Tel: 8610-66279977 Fax:8610-66299099

CBRC Feedback on the BCBS Documents

Building on the agreements reached at the September 6th, 2009 meeting of the Basel Committee's (hereinafter referred to "the BCBS") governing body, the BCBS issued another two documents regarding proposals for capital and liquidity regulation reform in December 2009, namely: *Strengthening the resilience of the banking sector* and *International framework for liquidity risk measurement, standards and monitoring*. The first document aims to strengthen the global capital framework, the key elements of which includes: raising the quality, consistency and transparency of the capital base, enhancing risk coverage, supplementing risk-based capital requirement with a leverage ratio, reducing procyclicality and promoting countercyclical buffers and addressing systemic risk and interconnectedness. *International framework for liquidity risk measurement, standards and monitoring* aims to introduce global liquidity standards, one is the liquidity coverage ratio (LCR) and the other is net stable funding ratio (NSFR). The CBRC and China's banking industry attach great importance to capital and liquidity regulation reform, and provide feedback to the above-mentioned consultative documents based on our own practices.

I. General Viewpoints

The CBRC and China's banking sector as a whole highly appreciate the efforts by the BCBS in strengthening the resilience of the banking sector and endorse the overall direction and idea of the reform package for capital and liquidity regulation. The proposals to strengthen global capital regulation framework can help enhance the loss absorbency capabilities of the banking system and mitigating the positive feedback effects between banking system and real economy. While proposing LCR and NSFR is beneficial for individual banks to enhance their capabilities to deal with short-term liquidity pressure, to reduce liquidity mismatches, to go back to traditional core businesses and to improve their management of liquidity risk. However, the design of supervisory standards in these two documents mainly takes into consideration the banking practices in the European and US economies, while does not concern much about the actual situation of the emerging market economies like China. Therefore, considering that different economies are quite varied in terms of the structure of financial system and maturity of financial market, we suggest that the BCBS should not make too rigid and prescriptive rules for these standards. Here, the issue is how to well balance the international convergence and national discretions, so that national supervisory authorities have more flexibility to reflect the banking practices of their own country and enhance effectiveness of banking supervision.

II. Suggestions for the revision of *Strengthening the resilience of the banking sector*

1. Definition of capital

① **The Treatment of intangible assets.** In principle, we endorse the deduction of intangible assets due to the uncertainties in realizing their values. But because of the differences in accounting standards across jurisdictions, the recognition criteria and detailed scope of intangible asset are quite varied as well. In view of this fact, we suggest the BCBS take into account the differences in accounting standards, so as to avoid substantial differences occurring in supervisory standards. For instance, according to Chinese accounting standards, the right for land use is recognized as intangible asset, while for some other countries, such right is categorized as fixed asset. Under such circumstances, the deduction of this part of intangible assets will pose negative impact on Chinese commercial banks.

② **Treatment of deferred tax assets.** The CBRC supports that the deferred tax assets which rely on future profitability of the bank should be deducted from common equity; however, due to the complexity in the formation of deferred tax assets, we suggest that the BCBS grant a certain degree of discretions to national supervisory authorities, or the BCBS should set a limit for the deduction of deferred tax assets, that is to say, not all deferred tax assets should be deducted, but just the part exceeding the limit should be deducted. In the case of Chinese commercial banks, deferred tax assets mainly come from the differences between regulatory requirement and taxation requirement for loan loss provisioning (the loan loss provisions based on regulatory requirement is higher than the one stipulated by taxation authority); if deducting the deferred tax assets resulting from such differences, it would be harmful for banks' prudential charge for loan loss provisions, thus, compromising banks' capabilities of absorbing losses.

③ **Treatment of minority interest.** Paragraph 90 of *Strengthening the resilience of the banking sector* proposes that "minority interest will not be eligible for inclusion in the common equity component of Tier 1", but it has not clearly stated the way to treat minority interest. We suggest the minority interest coming from the common equity held by minority shareholders of the subsidiaries should be included into the additional going concern capital under Tier 1 of the banking group.

④ **Incentives to redeem of the Tier 2 capital instruments.** Paragraph 90 of *Strengthening the resilience of the banking sector* proposes that one of the criteria for inclusion in Tier 2 capital should be "may be callable at the initiative of the issuer only after a minimum of five years", but "a bank must not do anything which creates an expectation that the call will be exercised". For the latter part "a bank must not do anything which creates an expectation that the call will be exercised", the statement is somewhat ambiguous and may not provide convenience for operability. Furthermore, even if a bank does create a certain degree of expectation, it does not necessarily mean the bank's loss absorbency capability under gone concern conditions will

decrease; this is because paragraph 90 stipulates that "banks must not exercise a call unless they replace the called instrument with capital of the same or better quality… The bank demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised and the bank must receive prior supervisory approval…". We suggest the BCBS cancel the criterion "a bank must not do anything which creates an expectation that the call will be exercised", or clarify the connotation of this criterion.

2. Counterparty Credit Risk

Paragraph 135 to 139 in *Strengthening the resilience of the banking sector* proposes that the asset value correlations (AVCs) for large financial institutions (total asset should be at least 25 billion US Dollars) should be increased by 25%. In view of the fact that such proposal may have significant impact on the capital requirement for financial institution exposures, we suggest that the BCBS rationally determine the threshold for large financial institutions and the extent to adjust upwards the AVCs based on the outcome of the QIS.

3. Leverage ratio

① **Treatment of high quality liquid assets.** According to *Strengthening the resilience of the banking sector*, the denominator to calculate leverage ratio should include all on-and-off-balance sheet exposures. On-the-balance sheet assets should include such high quality liquid assets as cash, government bonds and central bank bills. This kind of assets have rather small risk exposures, are highly liquid and do not produce "discount effect" from the fire sale of assets; therefore, we suggest that all the high quality liquid assets applying to 0% haircut should be eliminated, and commercial banks should be provided with incentives to maintain liquidity.

② **Treatment of off-balance sheet items (non-derivative items).** According to *Strengthening the resilience of the banking sector*, some off-balance sheet items should be incorporated into risk exposures and should use a 100% credit conversion factor (CCF). Such proposal is conducive to capturing the maximum leverage effect of individual banks and containing the excessive expansion of off-balance sheet businesses; however, the proposal has neglected the differences in extent of risk of the off-balance sheet items, which may lead to capital arbitrage of commercial banks. When banks enter the alert zone of the leverage ratio, banks may retain items with high risks for the sake of higher returns; this is against the original intention of leverage ratio supervision and has overestimated the leverage ratio level of the banking system. We suggest that the off-balance sheet items should be treated on a differentiated basis according to the essence of risks; risk exposures should be calculated based on the CCF of different kinds of off-balance sheet items (non-derivatives) stipulated by standardized approach under Basel II; and lending commitments that are unconditionally cancelled anytime should be eliminated.

③ **Treatment of derivatives.** We endorse that the notional value of written credit derivatives will be included in the measure of exposures, but for other off-balance sheet derivatives (e.g., interest rate derivatives, exchange rate derivatives), risk measure should not use the book value, and we suggest the adoption of the current exposure method of the Basel II framework. This is because: first, the fair value of interest rate or exchange rate derivatives contracts cannot fully reflect the actual risk exposures, and the fluctuation in the fair value of derivatives contracts may exacerbate procyclicality; second, it is quite common for banks to adopt current exposure method, therefore, the outcomes are comparable across different banks and within different time horizons.

4. Capital surcharge for systemically important banks

Paragraph 47 of *Strengthening the resilience of the banking sector* proposes some additional measures to supervise systemically important banks (SIBs), including the consideration of capital surcharge, liquidity surcharge and other supervisory tools. We support the general direction of the BCBS in supervising SIBs, but do not agree with the proposal to simply impose capital surcharge on these institutions. We suggest that the BCBS develop proper additional supervisory measures for SIBs, focusing on preventative supervision instead of simply raising capital requirement. Besides, if the regulatory capital requirement is too tough, the profitability and competitiveness of the SIBs could be harmed, thus, leading to instability of the institutions and financial system as a whole.

We think that "internationally systemic importance" and "domestically systemic importance" should be distinguished. As we still do not have in place a globally resolution framework for cross-border banks, the BCBS should impose capital surcharge on those internationally active banks that have large proportion of overseas assets, in order to prevent the potential cross-border spillover effect caused by the excessive risk-taking by globally SIBs like the Lehman Brothers. But for banks that only have domestically systemic importance, the home supervisors should choose their own measures.

5. Countercyclical buffers

Paragraph 247 to 261 and paragraph 260 to 262 of *Strengthening the resilience of the banking sector* propose the build up of conservation buffer and countercyclical buffer linked with excess credit growth respectively. We endorse the overall framework for countercyclical buffers proposed by the BCBS, but we think that conservation buffer and countercyclical buffer linked with excess credit growth should be consistent in logic, and they should be considered under the same framework instead of being treated separately. The building up of countercyclical buffer should not only consider the credit growth rate on the system level, but should also take into account factors on

the basis of individual financial institutions. By doing this, the non-prudent lending behaviors of individual banks can be contained, and mechanism can be put in place to prevent excess cyclical credit fluctuations from both macro and micro level.

Besides, due to the differences in financing structures across countries as well as the complexity of economic/ credit cycles, it is very difficult to identify variables that can capture the credit cycles of different economies and to establish globally converged countercyclical capital measurement models. We suggest the BCBS should set principles for countercyclical buffer regulation, but NOT to make detailed, prescriptive rules. The BCBS should provide more discretion to national supervisors for the sake of the actual status quo of their own countries.

III. Suggestions for the revision of *International framework for liquidity risk measurement, standards and monitoring*

1. The definition of high quality liquid assets

We agree with the characteristics that high quality liquid assets should have as mentioned in paragraph 28 to 32 of the *International framework for liquidity risk measurement, standards and monitoring*, and we agree with the narrow definition given in paragraph 34. We do not support to categorize highly rated corporate bonds and covered bonds into high quality liquid assets, because these two types of assets do not boast the feature of "low credit and market risk". In terms of credit risk, these two types of assets do not have any differences in essence from the corresponding credit assets.

We suggest the required reserves (at least part of the reserves) that commercial banks put in the central bank be calculated into high quality liquid assets. The reasons are: first, one of the core functions of the required reserves is to safeguard normal payment of the banks; when individual banks face liquidity pressures, commercial banks can get permission from the central bank to draw required reserves to pay the due debt. Second, from a global perspective, different countries are varied greatly in terms of required reserves ratio; if the required reserves are not recognized, emerging market economies like China will face unfair competition. Besides, we suggest that financial bonds issued by policy banks should be categorized into high quality liquid assets; this is because policy banks in China enjoy high rating, and the risk premium of policy banks' financial bonds is obviously lower than commercial banks.

2. Estimation of cash inflows

When calculating denominator of the LCR, commercial banks should calculate the net cash outflows in accordance with the inflow-outflow ratio proposed in the *International framework for liquidity risk measurement, standards and monitoring*. This framework provides details for all kinds of cash outflows, but only has very

rough proposal for cash inflows. Therefore, it cannot fully reflect the differences in cash inflows of all kinds of funding sources; we suggest the BCBS further specify the parameters for each kind of cash inflow.

3. Run-off rate of retail deposit

When calculating LCR under this proposed framework, the run-off rate for retail deposits covered by effective deposit insurance scheme is 7.5%, while the run-off rate for those not covered by effective deposit insurance scheme is no lower than 15%. Although China does not have in place deposit insurance scheme, government provides implicit guarantee for the retail deposits. In fact, for some other economies without deposit insurance scheme, they all have similar arrangement like China, therefore, we suggest the BCBS treat all the retail deposits with the same run-off rate and adjust the ASF factor in the NSFR correspondingly. According to the empirical analysis of one of our large commercial banks, from 2000 to 2009, the maximum monthly run-off rate of personal (retail) deposit is 2.25%, which is a lot lower than 7.5%. If the run-off rate of retail deposit is too high, banks would suffer from higher costs of liquidity management and lower profitability.

4. The run-off rate of small business deposit

Paragraph 48 to 50 provides preferential treatment for the run-off rate of small business deposit, which is different from the treatment for other wholesale funding sources; and adopts criteria under the IRB approach of Basel II to classify small businesses. In view of the fact that different economies adopt different criteria to categorize businesses, we suggest the BCBS allow national discretion when defining small businesses. The CBRC criteria to define small businesses under the IRB framework are also different from the criteria under Basel II.

5. The run-off rate of wholesale funding sources

For wholesale funding sources, this proposed liquidity framework classifies them into three types, namely: sovereignty (including sovereignty, central bank and public sector entities), corporate customers and financial institutions, and assigns run-off rates of 25%, 75% and 100% respectively to the three categories of unsecured wholesale funding. But such categorization is too simple and fails to capture the differences in characteristics of funding within these three types of customers; moreover, the run-off rate criteria in this document is obviously higher than historical experience, so we suggest more flexibility given to national supervisors.

6. Currency-based liquidity measurement

During the liquidity crisis, the conversion among different currencies may encounter big problems; we suggest the BCBS clearly stipulate that for those banks with high

proportion of foreign currency businesses, their calculation of LCR and NSFR should be currency-based.

7. The RSF factor of the sovereign and central bank bonds

According to paragraph 34, when calculating LCR, the bonds issued by sovereignty, central banks, BIS, IMF and multilateral development banks can be categorized into high quality liquid assets. But according to paragraph 89, when calculating NSFR, the RSF factor for these assets is 5%. We can see some inconsistencies in logic between paragraph 34 and 89.

IV. About the Transitional Period and Grandfathering Arrangement

We endorse kicking off new regulatory standards by the end of 2012 and set a transitional period to ensure smooth transition. But we think in the press release dated December 17th, 2009, the descriptions of the transitional period and grandfathering arrangement are not clear enough and might send wrong signals to the market. We suggest the BCBS clearly define the length of the transitional period as well as the scope of application for grandfathering arrangement. In our opinion, when setting a transitional period, three factors should be taken into account, specifically including: first, the implementation of new regulatory standards should not pose significant negative impact on credit growth and real economy; second, commercial banks should be given certain grace period to adjust their behaviors and prepare in the technical aspect, so as to ensure a reliable implementation of the new standards; third, the transitional period should not be too long, and it should produce pressures on commercial banks; otherwise, banking reform will gradually lose momentum when the crisis is over. In view of this, we suggest the BCBS set a transitional period that is no longer than 5 years and ask supervisory authorities to set phase-in target within such transitional period. In addition, we suggest the BCBS clearly define the scope of application for grandfathering arrangement as soon as possible, so as to provide clear policy expectations for the industry.