

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

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Liu Mingkang Chairman

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Dear Mr. Caruana

I am very pleased to have the opportunity to provide our comments on the third consultative paper on the New Capital Accord (Basel II). Following the release of the document, we have engaged our banking industry in an extensive discussion of Basel II, largely from the perspective from an emerging market. To facilitate the discussion, we have posted the Chinese version of Basel II on our website for easy access by as many readers as possible. We all believe that this rewarding exercise will yield long-term benefits both in terms of improved capital regulation and most importantly, better management of risks in banking.

We, the banking supervisors in China, commend the Basel Committee for undertaking this extremely challenging project to revise the capital accord and reiterate our strong support for the objectives of Basel II. Basel II is based on the conceptual advances in regulatory theories and emerging best practices for risk management in the developed markets. To a large extent, we are convinced that Basel II is more about risk management than capital regulation, particularly for emerging markets. Thanks to Basel II, the risk management of our banks has begun to evolve at an accelerated pace. Large banks have launched ambitious projects to build a two-dimensional rating system in line with Basel II and small banks are also actively introducing elements of Basel II in the best way they can. Since it is until quite recently that Chinese banks have adopted the five-category loan classification system for both supervisory reporting and managing credit risk, this trend for improved risk management in the industry is most encouraging.

It is absolutely clear that by way of integrating minimum capital requirements with supervisory review and market discipline, Basel II aims to codify the successful supervisory approach to capital regulation that is already in place in major markets. However, Basel II may need to be revised and re-calibrated before its underlying principles and its essential provisions, in particular, can be consistently implemented by more countries out the G10 in the near future. Basel II addresses the need of "internationally-active banks" in G10 countries and has been negotiated as such accordingly. Were it applied in our jurisdiction, Basel II would only be marginally more risk sensitive than Basel I, but would increase the overall capital for our entire

banking system. In a global context, we share the concern that Basel II may have an adverse impact on the capital flows to less developed economies and disadvantage banks in emerging markets, particularly for their operations overseas conducted by their local branches and subsidiaries, if not just by market pressure.

Following extensive deliberation, we have concluded that we will remain on Basel I, at least for a few more years after the G10 implementation date of 2006. However, in an effort to improve capital regulation, we have revised the existing capital rules, incorporating Pillar II and III (enhanced supervisory review and disclosure of information) that we fully support. At the same time, we also stress that banks should improve their risk management beyond the narrow compliance with a minimum capital requirement. Specifically, in light of the nature and size of their operations domestically and overseas, large banks should build a robust internal rating system benchmarked to Basel II and small banks should introduce, the best they can, elements of best practices for managing credit risk. All banks should start collecting the necessary data for both borrower and facility, which serve the very basis for a more quantitative approach to measuring and managing credit risk. Over time we will consider the use of an internal ratings-based approach for capital regulation when banks are ready and provide incentives for banks to improve their sophistication in risk management accordingly.

In this context, we would highly appreciate it if the Basel Committee or other relevant international groupings could take the lead in disseminating the technical know-how for designing a well-developed internal ratings system for banks in emerging markets and less developed economies. At this moment, consultancy firms and rating agencies from major financial markets have embarked on a commercial campaign, offering a myriad of solutions (default model, mark-to-market model and neural network model etc.) that would supposedly meet Basel II requirements. However, it is not easy to decide on a right choice, not to mention the huge development cost and challenge for the supervisor to understand and oversee the applications of various systems later on.

We all acknowledge that when banks are adequately capitalized and well managed, they are better positioned to promote economic growth. In a broader context, when banking systems worldwide are adequately capitalized and well managed, the international financial system will become strong and stable and will be better positioned to promote sustainable growth and reduce poverty. Clearly, the use of a robust internal rating system by banks in emerging markets will make them better managed. The international supervisory community, in cooperation with the private sector, can have a significant role to play in the transfer of expertise and technical know-how in the design of internal rating systems to emerging markets. Such efforts would significantly reduce the development cost of internal rating systems by emerging markets and contribute to the safety and soundness of national and international financial systems. In fact, some technical assistance from international financial institutions has already been underway, but merely on a bank-specific basis.

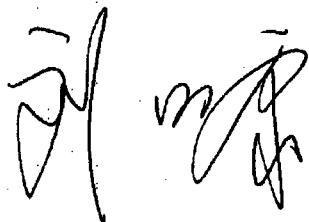
A more systematic approach is needed to make the assistance available for emerging markets as a whole.

It is encouraging to note that in this consultative paper, the Committee has referred to the work of a working group of supervisors from around the world, with IMF and World Bank participation, to develop a framework for assisting non-G10 supervisors and banks in the transition to both the standardized and foundation IRB approaches. As our banks point out, it would be impossible to introduce an IRB approach where the prerequisite internal rating systems of banks are not yet available. Support from the international supervisory community and enhanced cooperation with the private sector is essential to help banks developing their own internal ratings system and thus ensuring a successful transition to the New Accord over time.

Finally, we would like to see that the implementation of Basel II in the G10 would not adversely impact on the operations of non-G10 banks in G10 markets. We understand that the Accord Implementation Group is already developing a set of principles to facilitate closer cooperation and information exchange among supervisors. We welcome the Committee's statement that outside the G10 moving to the new framework in full in the near future may not be the first priority for all supervisors in terms of what they need to do to strengthen their supervision. The challenges for both non-G10 banks and supervisors to implement Basel II are enormous. Even if the implementation of Basel II were identified as the first priority, most of the non-G10 banks and supervisors would not have the resources to ensure a successful implementation, let alone the full benefits from adopting Basel II. Certainly, as non-G10 banks continue to improve their risk management and build up a strong capital base, so will non-G10 supervisors to strengthen their supervisory capacity, but the gap between G10 and non-G10 banks and supervisors will stay. In full recognition of this reality, it would be appropriate, therefore, for G10 supervisors in the national rule making process and its implementation not to pressure non-G10 banks with branches in G10 markets and their home supervisors to migrate to Basel II or restrict their operations even if they need to remain on Basel I in light of their market conditions and supervisory priorities. Basel I may not be compatible with Basel II, but Basel I is likely to remain as a valid option for emerging markets for some time to come.

We hope that our comments (see also the attachment) will be helpful and look forward to a close cooperation with the Basel Committee on Banking Supervision.

Yours sincerely,

A handwritten signature in black ink, consisting of several loops and strokes, appearing to be a personal name.

Comments on the third consultative paper on the New Capital Accord

Increase of overall capital for the banking sector

The new proposals, as they stand now, will increase overall capital for the Chinese banking sector. We note there is debate about the quality and reliability of QIS3 among G10 supervisors. Some conclude that QIS3 is comprehensive and accurate, while others argue that QIS3 is seriously flawed. Although our banks also use estimates for QIS3 in some cases, we generally accept the findings of our QIS3 result.

Our QIS3 findings are largely in line with findings for non-G10 countries, ie., 12% increase of capital requirements for Other Group 1&2 under the standardized approach. Five Chinese QIS3 participating banks, varying in size though, represent 48% of the total assets of all financial institutions in the country. Under the standardized approach, the total risk-weighted assets increase by 9.02%, whereas the contribution of credit risk is 5.19% and that of operational risk 3.83%.

Indeed, in the QIS3 overview paper, the Basel Committee rightly concludes that the QIS3 results are generally in line with the Committee's objective: minimum capital requirements would be broadly unchanged for large internationally-active banks taking into account the fact that they are likely to use the IRB approaches. However, the use of IRB would not be a practical option for a majority of non-G10 countries and the transition from the standardized approach to IRB, as the Committee expects, would be long. Therefore, in recognition of the difficulty of many countries to use other options, Basel II also contains a simplified approach as an alternative to the standardized approach for less developed markets. But in any case, there would not be reduction in credit risk capital charge to offset the new operational capital charge and an increase of overall capital would be unavoidable.

Related to the discussion on the overall level of capital in the banking system is the capital charge for operational risk. Banks and supervisors all accept that with the current state of the art techniques, operational risk is still difficult to measure and the proposal to apply an explicit capital requirement under Pillar I is controversial. What matters most for many non-G10 countries is that capital charge for operational risk is simply an add-on to overall capital.

We also believe that the basic indicator approach, ie, capital charge for operational risk equal to a fixed percentage of average annual gross income over the previous three years, is not risk sensitive. As much, this approach is not likely to provide impetus for banks to measure and manage operational risk, particularly in light of the scarce resources and banks' primary focus on credit risk. In our view, the decision of some G10 countries not to apply Basel II (including operational risk) to small banks

seems to directly challenge the Committee's assumption that Basel II proposals are suitable for a wide range of banks in different countries.

Market conditions in non-G10 countries

It is natural that since Basel II targets internationally-active banks in the G10, the Committee may not have either the resources or the time to fully examine the market conditions in non-G10 countries in order to ensure that Basel proposals are truly suitable for application. If Basel II proposals remain unchanged, they would have to be revised significantly when implemented by many countries outside the G10. The following example may highlight our point.

Basel II continues to provide that at national discretion, a lower risk weight may be applied to banks' exposures to their sovereign (or central bank) of incorporation denominated in domestic currency and funded in that currency. Where this discretion is exercised, other national supervisory authorities may also permit their banks to apply the same risk weight to domestic currency exposures to this sovereign (or central bank) funded in that currency. This implies that a higher risk weight for banks' exposures to their sovereign (or central bank) of incorporation denominated in foreign currencies.

This proposal is neutral for G10 countries as they enjoy the highest ratings by external agencies and further in the case of the United States dollar for example, the currency distinction make is not meaningful as the dollar is both an international and domestic currency. In a similar way, this proposal does not seem to affect EU members as EU rules imply that there must be an equal treatment among all EU members, regardless of the sovereign ratings. In the non-G10 countries, the case would be quite different. This proposal would be difficult for implementation, to say the least. Everyone will share the Committee's view that country risk or transfer risk needs to be taken into account in international transactions. However, the proposal overlooks the political reality in the non-G10 and their supervisors' role to maintain financial stability. In our case, it is not possible for us to assign a higher risk for our government securities denominated in foreign currencies on one hand and a lower or zero risk weight for the government securities denominated in local currency on another hand. Otherwise, it would destabilize the development of our financial market by undermining the reputation of the government and directly set the supervisor on the course of conflict with the fiscal authorities. It is a common knowledge that supervisors do not and cannot operate in vacuum. Thus we suggest that more flexibility should be provided at the national discretion on this issue to better reflect conditions in non-G10 markets.

Risk sensitivity and treatment of small and medium-sized enterprises

The removal of the OECD club is a welcome development. However, the full use of ratings for regulatory purposes is pre-mature for emerging markets. As we noted

before, the penetration of ratings in emerging markets is very limited. In our market, only 7 banks and 12 companies are rated by Standard and Poor's, for example, while domestic rating agencies have yet to increase their sophistication to calculate such risk factors as probability of default. Therefore, the full use of ratings is not practical for emerging markets and will not increase risk sensitivity for capital regulation. With respect to the Simplified Standardized Approach, this approach retains all the essential provisions of the standardized approach but does not offer any additional benefits for overhauling the existing capital rules.

In similar way, the treatment of small and medium-sized enterprises (SMEs) does not seem to recognize the banking market in non-G10 countries and will rather reduce the risk sensitivity of Basel II. The issues surrounding for the proposed favorable treatment of small and medium-sized enterprises (SMEs) under the standardized and IRB approaches are well understood. The criteria for the regulatory retail portfolio (ie, orientation, product, granularity and size) are easy for implementation. Further, exposures to large corporations are different than smaller enterprises and banks view the lending to them differently. Empirical evidence from some G10 countries suggests that most banks' lending to SMEs benefit from a greater degree of diversification than the lending to larger corporations. Such diversification in turn helps to reduce a bank's exposure to the credit risk posed by SME lending and the amount capital required. However, findings in our market point to a different conclusion.

Based on our definition with a much lower threshold as compared with Basel II definition, out of 157,000 business firms in one big bank, 141,000 firms fall under the category of SMEs, accounting for 90% of the total. The statistics of one large bank suggest that based on Basel II definition for SMEs, ie, 50 million Euro of sales, 50% of the loans outstanding are for SMEs. However, The size effect is absolutely clear in our market. SMEs are riskier measured both in terms of the size of non-performing loans and default rate. Banks and supervisor all accept that the lending to SMEs is definitely riskier than lending to larger corporations. It is true that most of the lending to SMEs is secured. Yet, the collection of default SME loans is also more difficult as compared with the collection of loans for large companies. A lower risk weight would comprise prudential regulation and discourage prudent lending behavior. We believe that many other countries would have the situation. Thus, the adoption of Basel II in emerging markets would imply undoubtedly deviation of some major provisions of Basel II.

The possible adverse impact on Basel II on capital flows to developing economies

We have followed closely the debate on the possible adverse impact on Basel II on capital flows to developing economies. We believe that the debate highlights an important issue which concerns the well-being of millions of people in these countries. Specifically, there is concern that Basel will significantly increase the regulatory capital for sovereign borrowers rated below BB, thus discouraging international banks

capital for sovereign borrowers rated below BB, thus discouraging international banks to engage in such lending (although this proposal is not likely to affect China with a sovereign rating of A3 and BBB respectively. Please note the impact of split ratings for a sovereign and the issue of rating consistency relating to external credit assessment institutions and export credit rating agencies).

In our view, the discussion among academics and policy makers so far has not been completed yet. On one hand, some argue in favor of lower risk at portfolio level of having an internationally diversified loan portfolio, which includes a range of developing and developed country borrowers. Others argue that people in favor of such international diversification fail to produce evidence of benefits of this diversification that would justify lowering the capital requirements for developing country lending. The latter group also notes the statistical weaknesses of the former group, such as idiosyncratic returns of emerging markets, the lack of normal distribution of returns for developing countries etc..

We have asked our academics to look at the issue. While they support the well-established theory of diversification, they have identified some statistical issues for further analysis. For example, the advocates of international diversification should explain the procedures and index used to build the data of random superiority analysis based on the relativity of difference variables. The index chosen should reflect a full picture of the financial status of developing countries and the impact of diversification at the international loan portfolio level. There should be a clear assessment of the differences between various credit risk models and Credit Metrics.

We also believe in international diversification and benefits from such diversification for both bonds and bank lending, which could then potentially reduce the capital requirements for lending to developing countries in general. In our view, at this moment, the discussion on this issue remains inconclusive. Given its importance, it merits further discussion before Basel II is finalized. We understand the implication of this suggestion on the Basel II timeframe but hope that more efforts are needed to ensure that quality of Basel II proposal as well as a clear understanding of its impact on less developed countries.