View metadata, citation and similar papers at core.ac.uk
brought to you by CORE
provided by Research Papers in Economics

ADBI Working Paper Series

What Regulatory Policies Work for Emerging Markets?

Luo Ping

No. 265
February 2011

Asian Development Bank Institute

The author is the director general of the training department of the China Banking Regulatory Commission. This paper is part of a forthcoming volume entitled *Financial Regulation and Reforms in Emerging Markets*, edited by Masahiro Kawai and Eswar Prasad (Brookings Institution Press).

The views expressed in this paper are those of the author and do not reflect the views of the commission and do not necessarily reflect the views or policies of ADBI, the Asian Development Bank (ADB), its Board of Directors, or the governments they represent. ADBI does not guarantee the accuracy of the data included in this paper and accepts no responsibility for any consequences of their use. Terminology used may not necessarily be consistent with ADB official terms.

The Working Paper series is a continuation of the formerly named Discussion Paper series; the numbering of the papers continued without interruption or change. ADBI's working papers reflect initial ideas on a topic and are posted online for discussion. ADBI encourages readers to post their comments on the main page for each working paper (given in the citation below). Some working papers may develop into other forms of publication.

Suggested citation:

Ping, L. 2011. What Regulatory Policies Work for Emerging Markets? ADBI Working Paper 265. Tokyo: Asian Development Bank Institute. Available: http://www.adbi.org/working-paper/2011/02/09/4380.regulatory.policies.work.emerging.markets/

Please contact the author(s) for information about this paper.

Asian Development Bank Institute
Kasumigaseki Building 8F
3-2-5 Kasumigaseki, Chiyoda-ku
Tokyo 100-6008, Japan

Tel: +81-3-3593-5500
Fax: +81-3-3593-5571
URL: www.adbi.org
E-mail: info@adbi.org

© 2011 Asian Development Bank Institute

Abstract

This paper discusses the banking regulatory and supervisory practices in People's Republic of China (PRC) with reference to the international standard for banking supervision, namely, the Basel Core Principles for Effective Banking Supervision (BCPs). While the PRC has incorporated many sound practices advocated by the BCPs, there are quite a few areas where significant differences can be observed with respect to qualification review of senior management, broader regulation at the product level, prescriptive rules, and guidance for risk management. Broadly speaking, the PRC adopts a rules-based approach to regulation; in many cases, regulations are prescriptive or even intrusive. In building a robust supervisory system, the PRC finds specific guidance more helpful than sole reliance on principles-based approaches.

The paper argues that general principles and a principle-based approach to regulation do not seem to work well for emerging markets. Indeed, the current financial crisis has revealed some shortcomings in the existing international standards on banking supervision. Perhaps this standard can be improved by greater specificity and by incorporating more aspects of the experiences in emerging markets.

JEL Classification: G20, G28

Contents

1. Introduction 1

2. Banking Sector Reform in PRC 1

3. Regulatory and Supervisory Practices in PRC........ 2

   3.1 Objectives, Independence, Powers, Transparency and Cooperation (Principle 1)........ 2
   3.2 Licensing and Structure (Principles 2–5)........ 3
   3.3 Prudential Regulation and Requirements (Principles 6–18) 4
   3.4 Methods of Ongoing Banking Supervision (Principles 19–21) 7
   3.5 Accounting and Disclosure (Principle 22)........ 7
   3.6 Corrective and Remedial Powers of Supervisors (Principle 23)........ 8
   3.7 Consolidated and Cross-Border Banking Supervision (Principles 24–25) 9

4. Conclusion 10

References 12

Appendix: Basel Core Principles for Effective Banking Supervision 13

1. INTRODUCTION

This chapter discusses the banking regulatory and supervisory practices in People's Republic of China (PRC) with reference to the international standard for banking supervision, namely, the Basel Core Principles for Effective Banking Supervision (BCPs).[1] While PRC has incorporated many sound practices advocated by the BCPs, there are quite a few areas where significant differences can be observed with respect to qualification review of senior management, broader regulation at the product level, prescriptive rules, and guidance for risk management.

The findings presented here are intended to further enhance the understanding of the international standard on banking supervision as well as its implementation in emerging markets. Based on this analysis, I argue that general principles and a principle-based approach to regulation do not seem to work well for emerging markets. Indeed, the current financial crisis has revealed some shortcomings in the existing international standards on banking supervision. Perhaps this standard can be improved by greater specificity and by incorporating more aspects of the experiences in emerging markets.

2. BANKING SECTOR REFORM IN PRC

Banking sector reform is the most important part of financial sector reform in PRC. It started as early as 1978, when the monobank system was replaced with a multilayered system that separates commercial lending operations and central banking. However, the most recent major reform initiatives to improve the functioning of the banking sector and banking regulatory system started in late 2003 when, after the success in corporate sector reform, the government decided to recapitalize all the state-owned banks and establish the China Banking Regulatory Commission (CRBC), which is devoted exclusively to regulation and supervision of the banking industry. By this time, PRC had completed the process of introducing an institutional approach to financial regulation while the central bank, the People's Bank of China, continued to be responsible for monetary policy.

The CBRC is fully committed to building up a strong and robust banking sector and an effective supervisory system. The bank restructuring over the years has been successful. At present the entire banking sector has restored its solvency, and banks have become financially sound and better managed financial institutions. A comparison of data from 2003 to 2008 reveals the remarkable change in the financial strength and resilience of the banking industry. Over this period, the total assets have increased by CNY 34.7 trillion, up 1.3 times; bank capital has increased by CNY 2.72 trillion, up 2.6 times; and profits have increased by CNY 521.8 billion, up 17 times. The nonperforming loan ratio of major commercial banks was reduced by 15.5 percentage points, while the number of banks in compliance with the minimum capital requirement of 8% has increased from eight to 204, with their assets accounting for 99.9% of the total banking assets. The average capital adequacy ratio is 12% for all commercial banks.

On the regulatory and supervisory side, ever since its establishment, the CBRC has benchmarked to international standards and sound practices in banking supervision and has worked hard to develop a clear roadmap for the future. In its early days, the CBRC provided significant inputs into the drafting of the Law of the People's Republic of China on Banking Regulation and Supervision (hereafter referred to as the Law), which was issued shortly after the CBRC began operation in late 2003. While recommending the Basel Core Principles for Effective Supervision as the most relevant framework for banking supervision,

[1] See Appendix.

the CBRC helped to ensure that the Law clearly defines not only the objectives of banking supervision and the responsibilities of the banking supervisor but also the detailed approaches to banking supervision. Indeed, over 50% of the provisions under the Law closely reflect various principles of the BCPs document.[2] Moreover, the BCPs document is included as an appendix in the interpretation notes of the above Law, together with other relevant rules and regulations issued by the government, which is rather unprecedented in the rule-making process in PRC.[3]

Although the BCPs have helped to shape in a very significant way the banking regulatory framework in PRC, there are quite a few areas where the regulatory and supervisory practices in PRC differ from the supervisory practices as endorsed by the BCPs.

Generally speaking, principles stand for a basic or general truth. Specifically, "the Core Principles are a framework of minimum standards for sound supervisory practices and are considered universally applicable. …The Core Principles are neutral with regard to different approaches to supervision, so long as the overriding goals are achieved."[4] Throughout the BCPs document, many principles are defined in very general terms. Indeed, many principles are phrased in such a way that they are close to the principles defined by the U.K. regulators in spirit, namely, a principle-based approach to regulation.

Such an approach has been well defined by the United Kingdom (UK) Financial Services Authority (FSA). In 2007 the FSA states in its report that "principles-based regulation means, where possible, moving away from dictating through detailed, prescriptive rules and supervisory actions how firms should operate their business. We want to give firms the responsibility to decide how best to align their business objectives and processes with the regulatory outcomes we have specified."[5] In contrast to the UK and, more broadly speaking, some other highly developed markets, supervisors in emerging markets continue to share a preference for adopting specific rules and regulations. PRC's approach to regulation and supervisor provides an example that clearly suggests that a rules-based approach is the most appropriate way to go for emerging markets for now and in the future.

3. REGULATORY AND SUPERVISORY PRACTICES IN PRC

Discussed below are some differences between the supervisory practices in PRC and sound practices advocated by the BCPs. The discussion follows the BCPs' framework for the sake of convenience and is intended to shed light on how international standards can be improved by incorporating more of the experiences from emerging markets.

3.1 Objectives, Independence, Powers, Transparency and Cooperation (Principle 1)

The objectives of banking supervision and powers of the supervisors are very important, and more often than not they are defined by the law. For emerging markets such as PRC, these issues must be made clear and specific. In the BCPs document, principle 1 states at the outset that "an effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks."[6] Here the principle 1 focuses on the clarity of the responsibility and objectives of supervisory agencies and is silent on the specific objectives of banking supervision. In contrast, the 1997 version clearly

[2] The Law contains six chapters and fifty provisions.

[3] People's Republic of China (2004).

[4] Basel Committee (2006a).

[5] FSA (2007).

[6] The Appendix lists the revised 2006 version of the Basel Core Principles (see also Basel Committee 2006a).

identifies the objectives of banking supervision: "The key objective of supervision is to maintain stability and confidence in the financial system, thereby reducing the risk of loss to depositors and other creditors."[7]

As a fundamental issue, the objectives of banking supervision should be clearly defined in specific terms for supervisors in all countries. In practice, a specific definition of objectives will help each authority involved in banking supervision to better define its role and responsibilities. In the law governing banking supervision in PRC, it is stated clearly at the outset that the objective of banking supervision is to protect the interests of depositors and other consumers. As PRC follows an institutional approach to regulating different sectors of the financial services industry, these objectives are critical as they provide clarity and a sense of purpose for the CBRC, as the sole government agency authorized for the pursuit of these objectives.

In reality, it could happen that a supervisory agency might define its responsibilities and objectives so as to simply justify its existence. In some countries, several supervisors are involved in banking supervision, and they all have a set of responsibilities and objectives, but this does not necessarily contribute to effective supervision and partly explains why an overview of world implementation of the BCPs indicates that compliance with this component of principle 1 is close to 90%, almost the highest level among all the principles (International Monetary Fund [IMF] and World Bank 2002). Therefore, it could be concluded that the revised statement "an effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks" is still too general to be considered a minimum standard (see Appendix). Ideally, the guidance on the issue should be as specific as possible by listing a number of commonly agreed objectives, such as protection of the interest of depositors and consumers, and ensuring the stability the banking system. Indeed, recently, following the current financial crisis, governments in a number of countries stated publicly that all bank deposits would be safe or that deposit insurance coverage would be unlimited. These actions were successful in avoiding retail bank runs and highlighted the importance of protection of depositors in maintaining financial stability. Given these developments, there is good reason to suggest that the BCPs need to be more specific with the objectives of banking supervision. The silence regarding the overall objectives of banking supervision may well be a way to accommodate differing national practices, but it also indicates a more principles-based approach to supervision, a characteristic that becomes increasingly evident in a number of principles concerning risk management.

3.2 Licensing and Structure (Principles 2–5)

The entire supervisory cycle starts with the definition of banks and permissible activities of banking institutions. It is in these areas where significant differences can be seen between PRC's approach and the practices endorsed by the BCPs document. In the BCPs, four principles relate to the permissible activities of banks, authorization of banking establishments, prior regulatory approval for transfer of significant ownership, and major acquisitions. The BCPs clearly state that the permissible activities of banks must be clearly defined, without suggesting whether there is any need for further regulation. This may well be typical of the general practices in developed markets, where "product regulation" does not exist.

For example, the UK FSA has been reluctant to accept the idea that it should regulate products in either retail or wholesale markets. Its regulatory philosophy is based on the following set of assumptions. First, firms must be subject to prudential regulation to ensure financial soundness. Second, firms must be subject to business conduct regulation,

[7] Basel Committee (1997).

including regulation of sales practices, to ensure that customers are treated fairly and are well informed. And finally, product regulation is not required because well-managed firms will not develop products that are excessively risky, and because well-informed customers will only choose products that serve their needs.[8]

In contrast, the Law on Banking Regulation and Supervision in PRC states that the banking supervisor is empowered to determine the business scope of banks (that is, permissible activities). Based on the Law, the CBRC has issued a set of detailed procedures governing the review of permissible activities. Under these procedures, banks need to have prior supervisory approval for all new products or services, such as foreign exchange transactions, issue of subordinated debt, derivative transactions, asset management, custodian services for investment funds, and offshore banking transactions. Moreover, any new activities that are not defined by the current regulations also will be subject to supervisory approval as specified in the future by the supervisor. Another example lies in how problems related to securitization are addressed: the CBRC recently ruled that banks should never use low-quality assets as underlying assets for securitization.

While the CBRC recognizes that such approval processes may have the potential to slow the pace of financial innovation, the supervisor strongly believes that such an approach does help to reduce the business risks of banks—particularly those that do not have sound risk management procedures and processes—and thus contributes to the system's stability.

It is interesting to note that supervisors in some developed markets also have come to recognize that "financial innovations can sometimes achieve economic rent extraction, rather than delivering valuable customer and economic benefits …contributing significantly to increased systemic risk."[9] One implication is that regulators may well need to consider the direct regulation of products at both the retail and wholesale level. This development is worth noting in the update of international guidance on banking supervision.

3.3 Prudential Regulation and Requirements (Principles 6–18)

Development of prudential rules and regulations as well as their implementation represent a large part of a supervisor's day-to-day activities. Among all supervisory tasks, capital regulation is the most important. There seems to be general agreement among emerging markets that as it stands now, principle 6 on capital regulation is too general to be really helpful in that it falls short in endorsing the Basel Accord of 1988 (Basel I) as the international standard for capital regulation, let alone the Basel Accord of 2004 (Basel II). Promoting international convergence for capital regulation has been the focus of the Basel Committee from the late 1980s to the present, with an emphasis on strengthening capital requirements for securitization and trading book exposures. In addition, the reference to "internationally active banks" in principle 6 remains unclear and further narrows the scope of application for "the applicable Basel requirement." The president of the Deutsche Bundesbank recognized the same issue recently when he stated, "The main achievements of the first Basel Capital Accord were that it represented a significant step towards international harmonization of banking regulation—it was later applied by more than 100 countries."[10]

Furthermore, according to one survey of non–Basel Committee countries, out of 115 jurisdictions in Africa, Asia, the Caribbean, Latin America, the Middle East, and Europe, 95 are currently planning to implement Basel II.[11] It is a bit difficult to understand why the Basel Accord has not been duly recognized in the BCPs—of course, with necessary modification—

[8] FSA (2009).

[9] FSA (2009).

[10] Weber (2009).

[11] Financial Stability Institute (2008).

as the de facto capital standard in light of its widespread adoption and clear support by some Group of Ten supervisors as well.

Current capital regulation in PRC is based largely on a modified version of Basel I with some elements of Basel II, replacing the club approach of the Organisation for Economic Cooperation and Development with a more sensible alternative. By the end of 2008, the average capital of banks in PRC is 12%, with 82% of the regulatory capital being tier 1, without allowing for innovative capital instruments one way or another. In fact, the supervisor did not consider inclusion of short-term subordinated debt as tier 3 capital since such an approach intuitively does not make any sense given its very limited power to absorb losses resulting from the trading book (in addition to the lack of such instruments in the market).

Furthermore, in contrast to Basel I, the current capital rule does not place any constraint on the amount of provisions that may count as part of capital. Given that general provisions are not tax deductible and no different than retained earnings, they are included in tier 1 capital rather than tier 2 capital and, more important, subject to no limit. This approach has gained more acceptance nowadays. Recently, the Financial Stability Board (FSB) noted that the Basel Committee should consider the allocation of general provisions in banks' regulatory capital and examine whether the removal or modification of the caps that limit the amount of provisions that may count as capital is warranted.[12]

The FSB also suggested that the Basel Committee should further enhance capital regulation by making it more risk sensitive and by raising the quality, consistency, and transparency standards for the capital base, as well as introducing a leverage ratio, a minimum global standard for funding liquidity ratio, and a framework for countercyclical capital buffers.[13] Many of these issues will need to be harmonized internationally. As the role of capital has become increasingly important following the current financial crisis, the international supervisory community may need to revisit the international guidance on capital regulation as presented in principle 6.

All supervisors agree that capital regulation is not a panacea; sound risk management is just as important. The BCPs document is right in devoting a large share of its content—namely, principles 7 to 16—to guidance on risk management, covering credit risk, market risk, liquidity risk, operational risk, and interest rate risk on banking book. By stressing that banks and banking groups have in place a comprehensive risk management process for all material risks, subject to supervisors' satisfaction, the BCPs again demonstrate a clear preference for a principle-based approach to supervision.

As discussed earlier, PRC's approach is rules based and in most cases is prescriptive and even intrusive, covering not only licensing but also all risk management related issues. Indeed, there are no general principles in PRC governing banking supervision, although the idea of a principles-based approach has been adopted in a limited way for licensing requirements for innovative financial products only.[14] In some cases, the risk management rules and regulations are highly prescriptive, yet they are well accepted by the industry. For example, a set of rules governing bank financing of fixed asset investments was recently issued and went into effect as of November 2009. The rules provide specific guidance on processing of loan requirements, loan evaluation, signing of contracts, disbursement of loan proceeds, and loan monitoring after disbursement. One provision is so specific that it requires that all disbursement of loan proceeds over 5% of the investment, regardless of the size of investment, or higher than CNY 5 million be wired by banks directly to service providers instead of to the borrowers as the beneficiary. The rationale for such a specific approach is to help strengthen banks' credit risk management in addition to addressing the

[12] FSB (2009).

[13] FSB (2009).

[14] The Principles on Loan Classification, issued in 1998 and revised subsequently, are basically very specific rules governing banks' practice for valuation of loans rather than a set of general principles.

immediate concern of using loan proceeds for purposes outside the loan covenants. Noncompliance will result in supervisory sanctions. The feedback from the industry so far has been positive.

Undoubtedly, one of the weaknesses of a principles-based approach is that it makes the assessment of compliance rather subjective and difficult, both at the national and international level. Indeed, “experience has already shown that the Principles may be interpreted in widely diverging ways, and incorrect interpretations may result in inconsistencies among assessments.”[15] With this in mind, the Basel Committee at its October 1998 meeting took the initiative to have a document prepared for use in compliance assessments. This document, *The Core Principles Methodology*, introduces a more rules-based approach to assessing the effectiveness of banking supervision, providing more specificity and partly addressing the weakness of the principle-based approach in the main document. This shift in the approach to supervision can be seen mostly clearly in essential criterion 10, relating to principle 7, which requires that “the supervisor issues standards related to, in particular, credit risk, market risk, liquidity risk, interest risk in the banking book and operational risk.”[16]

A set of clear rules has always been important for emerging markets. As far as PRC is concerned, the very starting point is for the supervisor to issue rules and guidance for all material risks, and then check banks’ compliance as the next step, so as to ensure compliance with the rules, both in spirit and to the letter. In light of the lessons learned from the current financial crisis, a global trend has begun toward establishing regulation that is more prescriptive and intrusive. This will have implications for the approach to banking supervision when the time comes for updating the international guidelines.

This shift in emphasis is occurring in some developed markets as well. For example,

> The UK FSA’s regulatory and supervisory approach, before the current crisis, was based on a sometimes implicit but at times quite overt philosophy which believed . . . that the primary responsibility for managing risks lies with the senior management and boards of the individual firms, who are better placed to assess business model risk than bank regulators and who can be replied on to make appropriate decisions about the balance between risks and return.[17]

However, the FSA’s new approach is significantly different and underpinned by a different philosophy of regulation. This new approach is more intrusive than before, to say the least.

Another important concept of the BCPs, one that runs through the entire document, is proportionality. This concept first appears in principle 7 with the reference that “these [risk management] processes should be commensurate with the size and complexity of the institution.” This concept is extremely relevant for PRC’s banking sector. To some extent, the current banking sector is a reflection of a dual economy where the level of development between various regions, sectors, and industries diverges significantly. In such a dual banking sector, almost all large banks are publicly listed and are aggressively introducing sophisticated statistical analytical tools for risk management, while many small banks are still having difficulty establishing traditional risk management procedures and processes. Against this background, the enforcement of supervisory rules naturally has to be differentiated or proportionate. In fact, a differentiated supervisory approach or the use of the proportionality concept (分类监管 or *fen lei jian guan*—different supervisory treatment of different banking institutions) has been very popular among supervisors, and previously, separate rules were even issued to accommodate financial and operational differences

---

[15] See Basel Committee (1999).

[16] Basel Committee (1999).

[17] FSA (2009).

among banks depending on their status of incorporation, that is, foreign, state-owned, shareholding, or city commercial banks. It is until quite recently the supervisor had clearly indicated that there should be a uniform set of rules applicable to all banks, irrespective of incorporation and other factors. Increasingly more and more rules and regulations have converged to cover the entire banking sector while only the rural credit cooperative sector remains largely under a different set of rules, given its sector challenges and target client group. The concept of proportionality is revisited in the conclusion with regard to international assessments of compliance.

3.4 Methods of Ongoing Banking Supervision (Principles 19–21)

Among both emerging and developed markets there is a lot of commonality in the way supervisors conduct both on-site and off-site supervision. This may be attributed to the nature of banking supervision, namely, the need to enforce rules and check compliance. Principle 20 states that "an effective banking supervisory system should consist of on-site and off-site supervision" and also requires specifically that the supervisor keep "regular contacts with bank management." The language of this principle is a big improvement over the previous version, namely, "an effective supervision should consist of some form of both on-site and off-site supervision." The earlier version does not give due weight to on-site examination by supervisors in order to accommodate the practices of some highly developed markets.

While maintaining regular contacts may well be an important issue for some developed markets, it does not appear to be so important as to constitute part of an international standard for banking supervision. In PRC the banking supervisor expects to have regular contact with management since such an arrangement is clearly embedded in the supervisory process. As a general practice, the supervisor calls for regular meetings with banks on general supervisory issues, and at least once a year, there are tripartite meetings among supervisors, banks, and external auditors as well as meetings with the board members and supervisory board members. Under the rules-based system in PRC, lack of regular contact with banks is totally out of question.

Interestingly enough, one of the lessons from the current financial situation is that supervisors should seriously address the lack of regular contact with bank management. Such "light-touch" supervision is a factor in the problems associated with some developed markets. Going forward, the right approach is probably to balance the practices in emerging markets and developed markets so that "regular contact" is treated as an essential criterion and thus receives the emphasis it deserves.

3.5 Accounting and Disclosure (Principle 22)

PRC's experience supports the view of the assessors that principles on loan classification and provisioning should be complemented with more precise guidelines on loan evaluation, income recognition, collateral valuation, establishment of loan loss allowances, and credit risk disclosure.[18] This issue has gained attention following the adoption of international accounting standards. Recently, the revision of international accounting standards by the International Accounting Standards Board has reflected, to a large extent, the concerns of banking supervisors. However, although the revised asset impairment rules are likely closer to the expected loss concept advocated by supervisors, these accounting rules still fall short of supervisors' expectations because of the differences between the accounting profession and prudential regulation. Therefore, there is a great need for more and specific supervisory

[18] IMF and World Bank (2002).

guidance on loan loss provisioning to encourage banks to recognize losses as early as possible and to provision sufficiently for loan losses.

At the present, the most urgent task for the supervisor in PRC is to ensure that banks build up their provisions and reserves in good times so as to strengthen the resilience of the individual banks and the banking system in general. Such an initiative was introduced last year when banks had reported high profits and low levels of nonperforming loans. However, before a more rules-based system is put in place—such as the Spanish dynamic provisioning system supported by a powerful database of bank loss experience—the supervisor in PRC exercises discretion and judgment in urging banks to build strong provisions buffers. Taking into account the average loss of around 75% for nonperforming loans disposed by asset management corporations, the supervisor has asked banks to increase the provisioning coverage ratio. From a 2009 value of 130%, the ratio is expected to reach 150% by the end of 2010, reflecting both forward-looking and countercyclical considerations, even though the underlying supervisory provisioning rules remain unchanged. Clearly, more specific guidance from the international supervisory community would help national supervisors in further strengthening their provisioning policies, especially given the need to develop a set of countercyclical supervisory standards covering both capital and provisions. Standard setters should give due consideration to alternative approaches to recognizing and measuring loan losses that incorporate a broader range of available credit information, including a fair value model, an expected loss model, and dynamic provisioning.[19] However, an expected loss model and dynamic provisioning are extremely data intensive and may prove to be quite difficult for emerging markets, while a fair value model can hardly be an option for the foreseeable future. The overall direction is rather clear: provisions for loan losses should cover estimated loan losses that have been identified for individual loans, as well as estimated losses for loans in a company's portfolio that have likely been incurred but not yet been individually identified. Estimation of loan losses that have not yet been individually identified is a subjective process and therefore requires judgment. Such judgment factors could include changes in relevant economic and environmental trends, lending policies and procedures, and changes related to new loan segments and products. It is advisable to stress the importance of exercising supervisory judgment in light of the market conditions for emerging markets rather than emphasizing

3.6 Corrective and Remedial Powers of Supervisors (Principle 23)

As stated in principle 23, "Supervisors must have at their disposal an adequate range of supervisory tools to bring about timely corrective actions." The guidance from the BCPs is very definitive in this regard and to some extent supports at least some form of product regulation, as referred to in the discussion of the permissible activities of banks. Such supervisory actions include "restricting the current activities of the banks, withholding approval of new activities or acquisitions and restricting or suspending payments to shareholders."[20] Supervisory practice in PRC confirms the importance of taking various supervisory actions, and again, the supervisor in PRC is in a much better position to do so as it is prescribed by the Law as part of the authorization process for new products. This approach complements other supervisory sanctions, making another useful weapon readily available to the banking supervisor. Therefore, there may be a need to recognize at the global level that approval of new activities, in addition to approval of acquisitions, is important, be it part of the authorization process or part of the corrective actions that the supervisor may have at his or her disposal.

[19] Financial Stability Forum (2009).

[20] Basel Committee (2006a).

3.7 Consolidated and Cross-Border Banking Supervision (Principles 24–25)

Consolidated supervision is clearly set to a high standard. It does not come as a surprise that many emerging markets would show weak compliance in this area, as shown the IMF's 2002 report.[21] Similar to other emerging markets, PRC has just recently issued a set of rules governing consolidated supervision. Enforcement of these rules will take time as it is both a challenge for banks to manage their operations on a consolidated basis and for the supervisor to conduct consolidated supervision, covering all aspects of the business conducted by the banking group worldwide.

On the cross-border issue, principle 25 states, "Banking supervisors must require the local operations of foreign banks to be conducted to the same standards as those required of domestic institutions." Of course, the legal responsibilities of national supervisors will remain unchanged with respect to the regulation of their domestic institutions or the arrangements for consolidated supervision already put in place globally. However, this statement does not seem to recognize the differences in national supervision due to institutional, historical, legal, or other factors, and as a result, it may not actually work in the best interests of emerging markets.

In terms of the compliance record, the gap between developed and emerging markets can be, not surprisingly, quite significant.[22] Although a supervisor in an emerging market may require local operations of foreign banks from developed markets to conform to the same standards as apply to domestic institutions, these foreign banks are likely subject to a set of less robust standards than they would be in their home country. This will remain a reality as long as differences in supervision exist between developed and emerging markets. Perhaps, the language of principle 25 is better viewed as a reference to the policy direction or, more accurately, an endgame result where, in the distant future, both developed and emerging markets will have equally robust supervisory systems. Perhaps a more balanced approach is to state that the supervisor should expect foreign banks to be subject to both the standards of the home supervisor and the standards of the host supervisor, particularly when the latter is considered less robust. Alternatively, the principle could directly refer to the source documents by stating that "all international banking groups and international banks should be supervised by a home country authority that capably performs consolidated supervision," or that the supervisors should ensure "that all cross-border banking operations are subject to effective home and host supervision."[23]

PRC's experience also supports this argument. The country began to open up its banking sector to other countries in 1979 and committed itself in 2001 to removing all geographic and customer restrictions on foreign banks. However, as far as the prudential regulatory framework is concerned, the loan classification rules were issued in 1998 while the provision policy was introduced 2002, and a well-defined capital standard was not made available until 2004. In this context, a requirement to subject foreign banks to a set of less robust rules does not seem to be in the interest of foreign banks, for the sake of sound banking practice. In fact, the idea underlying an open policy for PRC and for its banking sector in particular is to leverage the expertise of foreign banks to improve the operations of the local banking market and the local supervisory system as well. At the present, while the supervisor is committed to a set of uniform rules applicable to all banking institutions, rules governing foreign banks continue to differ from those governing local banks in certain aspects. Despite increasing local incorporation of foreign banks and subsidiarization in PRC, one can not

[21] IMF and World Bank (2002).

[22] IMF and World Bank (2002).

[23] See Basel Committee (1992) and Working Group on Cross-Border Banking (1996), respectively.

overlook the role of the home supervisor, especially in light of the implementation of Basel II on a consolidated basis, which has yet to be introduced in PRC.

One last point relates to financial deregulation and the desirable business model for commercial banks. Many people, both in government and academia, strongly believe that the repeal of Glass-Steagall Act fueled the crisis. The Glass-Steagall Act was introduced in the United States in 1933 as a response to the unsound banking practices and public anger after the stock market crash in 1929. The act prohibited commercial banks from underwriting, holding, or dealing in corporate securities, either directly or through their subsidiaries in the securities industry. Glass-Steagall had a significant impact on the business model of financial institutions and the regulation of banks, both in the United States and in other countries, including PRC.

At the present, despite some enhancements to Basel II, there has been strong resistance to shifting from universal banking to narrow banking. It is the view of some major developed markets that large complex banks providing a wide range of activities will remain a feature of today’s world financial system. Therefore, it does not seem at all practical to work on the assumption that there can or should be complete institutional separation of utility banking and investment banking.

In full recognition of the desire of the developed markets to maintain the status quo of universal banking and its related regulatory framework, the supervisor in PRC has no intention of repeating the same process of deregulation that occurred in some developed markets. Instead, the presence of firewalls will effect a clear separation between operations basically engaged in commercial banking and those that perform investment banking activities. Such a regulatory distinction has served PRC well in preventing the contagion of risks between the banking and capital markets. Experience has shown that the erosion of these firewalls will likely expose the banking sector to the irrationality of capital markets, to the detriment of the depositors that supervisors are supposed to protect in the first place as a legal obligation.

4. CONCLUSION

As an emerging market, PRC has used international standards such as the Basel Core Principles for Effective Banking Supervision as a benchmark to improve the effectiveness of banking supervision. The BCPs document has played a significant role in shaping the regulatory framework in PRC. While PRC has incorporated many sound practices endorsed by the BCPs, there are still quite a few significant differences.

Broadly speaking, PRC adopts a rules-based approach to regulation; in many cases, regulations are prescriptive or even intrusive. In building a robust supervisory system, PRC finds specific guidance more helpful than sole reliance on principles-based approaches.

Adherence to international standards is an important agenda item globally. At present, the Financial Stability Board is working hard to promote a race to the top in standards implementation, with FSB members leading by example in disclosing their degree of compliance with these standards. PRC’s banking supervisor has conducted a self-assessment of the implementation of the BCPs every two years since 2003. The third self-assessment in 2007 was performed using the BCPs of 2006.[24]

The IMF–World Bank Financial Sector Assessment Program is expected to evaluate PRC soon. Without any intention to preempt the result of the forthcoming FSAP, perhaps one can expect that PRC’s compliance with international standards on banking supervision, which is an essential part of the FSAP, will be similar to its Asian peers and presumably below that of

[24] CBRC (2008).

many developed markets. However, PRC's banking supervisory system has ensured the safety and soundness of the individual banks and the banking system in PRC, which is the basic objective of successful and effective banking regulation and supervision.

International financial institutions have assessed countries' compliance with the BCPs either on a stand-alone basis or increasingly as part of the FSAP. Based on their extensive experience, it is easy for assessors to formulate an overall view of a country's compliance with relevant international standards. However, the challenge is to formulate a clear view as to what level of compliance or effectiveness of banking supervision would be most appropriate for a given country in light of that country's particular circumstances, such as the level of development, sophistication of the banking system, and institutional capacity of the supervisor. In essence, this relates basically to the concept of proportionality. On one hand, given the gaps and weaknesses of the supervisory system, emerging markets need to continue improving the effectiveness of banking supervision. On the other hand, despite an impressive compliance record, some developed markets, as the center of the international financial system, may need to do more in order to close gaps revealed by the current financial crisis so as to improve the effectiveness of banking supervision beyond mere compliance with the international standards. The extent of supervisory actions should be in keeping with the stated supervisory objectives and be judged accordingly as well.

REFERENCES

Basel Committee on Banking Supervision. 1992. Minimum Standards for the Supervision of International Banking Groups and Their Cross-Border Establishments. Basel, Switzerland: Bank for International Settlements.

______. 1997. The Core Principles for Effective Banking Supervision. Basel, Switzerland: Bank for International Settlements.

______. 1999. The Core Principles Methodology. Basel: Bank for International Settlements.

______. 2006a. The Core Principles for Effective Banking Supervision (revised). Basel: Bank for International Settlements.

______. 2006b. The Core Principles Methodology (revised). Basel: Bank for International Settlements.

China Banking Regulatory Commission (CBRC). 2008. 2007 Annual Report (http://zhuanti.cbrc.gov.cn/subject/subject/nianbao2007/english/ywqb.pdf).

Financial Services Authority (FSA). 2007. Principles-Based Regulation: Focusing on the Outcomes That Matter. London.

______. 2009. Turner Review: A Regulatory Response to the Global Banking Crisis. London.

Financial Stability Board (FSB). 2009. "Financial Stability Board Meets in Paris." Press release. September (www.financialstabilityboard.org/press/pr_090915.pdf).

Financial Stability Forum. 2009. Report of the Financial Stability Forum on Addressing Procyclicality in the Financial System. Basel: Bank for International Settlements.

Financial Stability Institute. 2008. 2008 FSI Survey on the Implementation of the New Capital Adequacy Framework in Non-Basel Committee Member Countries. Basel: Bank for International Settlements.

International Monetary Fund (IMF) and World Bank. 2002. "Implementation of the Basel Core Principles for Effective Banking Supervision." Washington DC.

People's Republic of China. 2004. "The Interpretation Notes of the Law of the People's Republic of China on Banking Regulation and Supervision." Beijing.

Weber, Axel. 2009. "The Future of Banking Regulation." Speech at the Conference on the Future of Banking Regulation. Frankfurt am Main, 24 September (http://www.bis.org/review/r090929a.pdf).

Working Group on Cross-Border Banking, Basel Committee on Banking Supervision and the Offshore Group of Banking Supervisors. 1996. The Supervision of Cross-Border Banking. Basel: Bank for International Settlements.

APPENDIX: BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

The following is taken from The Core Principles for Effective Banking Supervision (Basel Committee 2006a).

Principle 1—Objectives, Independence, Powers, Transparency, and Cooperation

An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks. Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

Principle 2—Permissible Activities

The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word “bank” in names should be controlled as far as possible.

Principle 3—Licensing Criteria

The licensing authority must have the power to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the ownership structure and governance of the bank and its wider group, including the fitness and propriety of Board members and senior management, its strategic and operating plan, internal controls and risk management, and its projected financial condition, including its capital base. Where the proposed owner or parent organization is a foreign bank, the prior consent of its home country supervisor should be obtained.

Principle 4—Transfer of Significant Ownership

The supervisor has the power to review and reject any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties.

Principle 5—Major Acquisitions

The supervisor has the power to review major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and confirming that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

Principle 6—Capital Adequacy

Supervisors must set prudent and appropriate minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the applicable Basel requirement.

Principle 7—Risk Management Process

Supervisors must be satisfied that banks and banking groups have in place a comprehensive risk management process (including Board and senior management oversight) to identify, evaluate, monitor and control or mitigate all material risks, and to assess their overall capital adequacy in relation to their risk profile. These processes should be commensurate with the size and complexity of the institution.

Principle 8—Credit Risk

Supervisors must be satisfied that banks have a credit risk management process that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor, and control credit risk (including counterparty risk). This would include the granting of loans and making of investments, the evaluation of the quality of such loans and investments, and the ongoing management of the loan and investment portfolios.

Principle 9—Problem Assets, Provisions, and Reserves

Supervisors must be satisfied that banks establish and adhere to adequate policies and processes for managing problem assets and evaluating the adequacy of provisions and reserves.

Principle 10—Large Exposure Limits

Supervisors must be satisfied that banks have policies and processes that enable management to identify and manage concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties.

Principle 11—Exposures to Related Parties

In order to prevent abuses arising from exposures (both on balance sheet and off balance sheet) to related parties and to address conflict of interest, supervisors must have in place requirements that banks extend exposures to related companies and individuals on an arm's length basis; these exposures are effectively monitored; appropriate steps are taken to control or mitigate the risks; and write-offs of such exposures are made according to standard policies and processes.

Principle 12—Country and Transfer Risks

Supervisors must be satisfied that banks have adequate policies and processes for identifying, measuring, monitoring and controlling country risk and transfer risk in their

international lending and investment activities, and for maintaining adequate provisions and reserves against such risks.

Principle 13—Market Risks

Supervisors must be satisfied that banks have in place policies and processes that accurately identify, measure, monitor, and control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.

Principle 14—Liquidity Risk

Supervisors must be satisfied that banks have a liquidity management strategy that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor, and control liquidity risk, and to manage liquidity on a day-to-day basis. Supervisors require banks to have contingency plans for handling liquidity problems.

Principle 15—Operational Risk

Supervisors must be satisfied that banks have in place risk management policies and processes to identify, assess, monitor, and control/mitigate operational risk. These policies and processes should be commensurate with the size and complexity of the bank.

Principle 16—Interest Rate Risk in the Banking Book

Supervisors must be satisfied that banks have effective systems in place to identify, measure, monitor, and control interest rate risk in the banking book, including a well-defined strategy that has been approved by the Board and implemented by senior management; these should be appropriate to the size and complexity of such risk.

Principle 17—Internal Control and Audit

Supervisors must be satisfied that banks have in place internal controls that are adequate for the size and complexity of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

Principle 18—Abuse of Financial Services

Supervisors must be satisfied that banks have adequate policies and processes in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.

Principle 19—Supervisory Approach

An effective banking supervisory system requires that supervisors develop and maintain a thorough understanding of the operations of individual banks and banking groups, and also

of the banking system as a whole, focusing on safety and soundness, and the stability of the banking system.

Principle 20—Supervisory Techniques

An effective banking supervisory system should consist of on-site and off-site supervision and regular contacts with bank management.

Principle 21—Supervisory Reporting

Supervisors must have a means of collecting, reviewing and analyzing prudential reports and statistical returns from banks on both a solo and a consolidated basis, and a means of independent verification of these reports, through either on-site examinations or use of external experts.

Principle 22—Accounting and Disclosure

Supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with accounting policies and practices that are widely accepted internationally, and publishes, on a regular basis, information that fairly reflects its financial condition and profitability.

Principle 23—Corrective and Remedial Powers of Supervisors

Supervisors must have at their disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability, where appropriate, to revoke the banking license or to recommend its revocation.

Principle 24—Consolidated Supervision

An essential element of banking supervision is that supervisors supervise the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential norms to all aspects of the business conducted by the group worldwide.

Principle 25—Home-Host Relationships

Cross-border consolidated supervision requires cooperation and information exchange between home supervisors and the various other supervisors involved, primarily host banking supervisors. Banking supervisors must require the local operations of foreign banks to be conducted to the same standards as those required of domestic institutions.