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The Current State of the Financial Sector and the Regulatory Framework in Asian Economies—The Case of the People's Republic of China

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Abstract

Reform of financial regulation is a priority on the international agenda. At the call of the Group of Twenty Finance Ministers and Central Bank Governors (G-20), a number of new international standards have been issued, most notably Basel III. As a member of the G-20, the Financial Stability Board (FSB), and the Basel Committee on Banking Supervision, the People's Republic of China (PRC) is now on a faster track in adopting international standards. However, the key issue for the PRC—as well as many other emerging markets—is to how to keep focused on the domestic policy agenda while adopting the new global standards. Fortunately, the PRC's financial system has proved resilient to the recent financial crisis. As a result, banks in the PRC find it quite easy to meet the new Basel III capital and liquidity standards. Basel III is only part of an effective regulatory framework. While phasing in Basel III, the PRC needs other prudential tools such as a new provision ratio, in addition to the provision coverage ratio. Activity restriction will be another effective tool with the potential to prevent banks from becoming too complicated for bankers to manage and for the regulator to supervise. As we work hard to improve the effectiveness of the regulatory system at both the global and national level, we should remind ourselves of the importance of keeping the balance between enhanced regulation and promoting financial innovation—without the pendulum swinging too far.

JEL Classification: E44, E52, E58, G18, G28

Contents

1. INTRODUCTION

The theme of this conference—The Role of the Financial Sector in Promoting Economic Growth in Asia—is very important. The financial crisis was born and bred in highly developed markets in the west, but it has affected emerging markets in Asia, including the People's Republic of China (PRC).

The PRC was hit hard by the global financial crisis, predominantly through trade channels. Its policy response—"quick, determined, and effective" (International Monetary Fund 2010) in the eyes of the international community—largely comprises measures in three areas. The first is a major fiscal stimulus. The public stimulus was concentrated in infrastructure spending. The government devoted an estimated 2%–3% of gross domestic product to higher social spending and incentives—largely on the tax side—to support private consumption. The second is an exceptional credit expansion. PRC banks extended new loans equivalent to 1% of gross domestic product in 2009. This outturn was largely a result of the removal of limits on credit growth, supported by a relaxation of restrictions on property lending and a reduction in both interest rates and reserve requirements. The third is re-pegging of the renminbi to the US dollar. In July 2005, the central bank began to allow the renminbi to appreciate against the US dollar, peaking at a rate of appreciation of about 1% per month. In response to increasing volatility in the world economy and global financial markets, the central bank returned to pegging the renminbi to the US dollar in July 2008 (International Monetary Fund 2010).

This policy package was instrumental in ensuring the PRC's growth of 9.2% in 2009 and contributes significantly to the global recovery. However, as the PRC has started to unwind the crisis response measures, the main policy challenge it faces is to calibrate the pace and sequencing of exit from the fiscal stimulus and credit expansion, while making further progress in reorienting the economy toward private consumption. For the banking sector, challenges include how to maintain credit quality in light of the unprecedented credit expansion in 2009[1], particularly with respect to lending to local government financing platforms and the real estate sector; and how to continue the regulatory and supervisory reform. In the post-crisis period, there is a clear need for both regulatory and monetary authorities to use prudential instruments effectively instead of quantitative credit control, while moving ahead to adopt new global regulatory standards.

The dynamic interplay of the financial sector and the real economy in the PRC sets the broader context for this paper. Instead of providing a full picture of the current state of the PRC's financial sector, the paper discusses the impact of the PRC's involvement in the international financial decision-making process on its domestic policy agenda; its approach to implementing new global standards, particularly Basel III; and some structural regulatory issues that are outside international regulatory convergence but are considered extremely relevant for the PRC.

While striving toward convergence in regulatory standards for a level playing field across different markets, we should recognize that the starting conditions and future challenges of developed and emerging markets differ significantly. Other emerging markets may have similar priorities to those of the PRC's financial and banking sectors, namely to continue building a strong baseline regulatory framework, addressing immediate regulatory concerns and challenges in support of economic growth, rather than recapitalizing banks or reducing leverage..

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[1] The latest data suggests that in 2010 total lending increased by CNY7.95 trillion at the rate of 19.7%, exceeding the target by CNY450 billion. See CBRC Annual 2010 Report.

2. THE G-20 AND THE PEOPLE'S REPUBLIC OF CHINA

In an interconnected global system, major problems in one part of the system will eventually affect other countries directly or indirectly, by way of different channels. Developed and emerging markets, therefore, have a shared common interest in strengthening the resilience of the global financial system. This shared understanding provides the basis for developed and emerging markets to work closely together to design and implement new standards for the resilience of the global financial system and to secure strong and sustainable growth going forward.

Of all the recent global developments, the most significant one is the increasingly crucial role of the Group of Twenty (G-20) Finance Ministers and Central Bank Governors (G-20), which has brought an overhaul of the global governance structure. The G-20 has its origin in the 1997/1998 Asian crisis that began in the financial sector and threatened to spill over from one country to another. Despite the absence of a significant agenda, this group has kept functioning largely because it has a balanced membership, and finance ministers and central bank governors from all major developed and emerging economies have developed a close working relationship, making communications easier during the current crisis. The origin and structure of the G-20 made it an appropriate and (eventually) effective mechanism to deal with the recent financial crisis, which threatened to spiral into a deep global recession, and for international financial and economic cooperation in general.

The G-20 has taken a central role in fostering international policy dialogue and advancing reform initiatives. The concerted and decisive actions of the G-20 have helped the world deal effectively with the financial and economic crisis, and the G-20 has already delivered a number of significant and concrete outcomes (Gokarn 2010).

At the London Summit in April 2009, G-20 leaders transformed the Financial Stability Forum into the Financial Stability Board (FSB) to include major emerging economies, with an expanded mandate to promote financial stability—specifically, to coordinate and monitor progress in strengthening financial regulation. At the Pittsburg Summit in September 2009, G-20 leaders made it clear that going forward, the G-20 would be the premier forum for international economic cooperation.

At the call of the G-20, the membership of the Basel Committee on Banking Supervision—an institution set up by the Group of Ten (G-10) with exclusive G-10 membership—was expanded to include all major emerging markets. The Basel Committee's governance body was also enlarged to include the Central Bank Governors and Heads of Supervision from these new member organizations (Bank for International Settlements 2009). All these changes are very welcome, even though they seem to be overdue. For years, emerging markets have argued strongly for a change in representation on the Basel Committee and the status quo of the global financial decision-making process. It would be difficult to expect the Basel Committee to restructure itself if not for the pressure for change resulting from the crisis and the political momentum built by the G-20 leaders for legitimacy and more appropriate representation, although its core mission is to strengthen regulatory practices and standards worldwide Since it was established by the central-bank Governors of the Group of Ten countries at the end of 1974, the Basel Committee wrote up rules, presumably for the global banking industry—involving countries outside the G-10 for consultation at the last stage of the rule-making process. The Basel II Framework, published in 2004, is no exception. The recent crisis presents a window of opportunity to reach a consensus on reform initiatives that would be extremely difficult to reach under normal circumstances.

Following these changes in governance, a number of Asian emerging markets, including the PRC, have finally come to sit at the decision-making table with developed markets to decide a whole range of policies to tackle the financial crisis and secure a sustainable economic recovery. Thanks to its strong representation at the G-20, Asia is in a position to make valuable contributions to reshaping the global financial architecture, evidenced by the Republic of Korea hosting the G-20 leaders' summit in November 2010.

The PRC's membership of the G-20 (especially at the highest political level), the FSB, and the Basel Committee represents (i) the country's commitment to work together with the international community to tackle the crisis; and (ii) its obligations to implement various international reform initiatives, particularly with respect to international financial reform and specifically international regulatory reform. "Major failures of regulation and supervision, plus reckless and irresponsible risk taking by banks and other financial institutions, created dangerous financial fragilities that contributed significantly to the current crisis." This strong language of the G-20 Pittsburg statement reflects the political leaders' assessment of the root causes of the financial crisis and the fact that the regulatory system and supervision must take responsibilities for the crisis. The PRC goes along with this view and is committed, together with other G-20 members, to adopt and implement fully the new bank capital and liquidity standards and to address too-big-to-fail problems (G-20 2010).

Broadly speaking—as in other Asian countries, thanks to the significant structural changes made in the PRC's financial sector and the improved effectiveness of the regulatory system—the PRC's financial system has proved resilient to the recent crisis. As a result, the financial system and institutions in the PRC are facing much less pressure for financial restructuring and regulatory reform than in the developed markets at the epicenter of the crisis.

However, differences and divergences between the G-20 countries are significant and perhaps inevitable. Various reform initiatives and global standards that have been developed in an attempt to reduce the probability and severity of future financial crises are largely focused on developed markets. Many details of these standards are also calibrated for these markets. The issue for the PRC, and perhaps many other emerging markets, is to how to keep focused on the domestic policy agenda as a priority while adopting the new global standards to serve our own markets better. This can be considered a more general issue for us all as we engage in a global discussion on a set of issues where the implementation of global standards and the pursuit of domestic policy objectives need to be viewed together. But clearly, the G-20 process has accelerated the pace to adopt the global standards for its member countries and countries at large on a much faster track, and the case of the PRC is very typical.

3. BASEL III AND ITS IMPLICATIONS FOR THE PEOPLE'S REPUBLIC OF CHINA

Global financial sector reform is very comprehensive, covering a huge territory. From a banking regulator's perspective, the key development is the release of Basel III—the core deliverable by the standard setter for banking regulation and supervision. In December 2010, the Basel Committee finalized and issued the Basel III rules text, which details the global regulatory standards on bank capital adequacy and liquidity agreed by the central bank governors and heads of supervision, and endorsed by the G-20 leaders at their November 2010 Seoul summit. The chairman of the Basel Committee described the Basel III Framework as "a landmark achievement that will help protect financial stability and promote sustainable economic growth" (Bank for International Settlements 2010).

The rules text of the Basel III framework covers both microprudential and macroprudential elements. The framework sets out higher and better quality capital, better risk coverage, the introduction of a leverage ratio as a backstop to the risk-based requirement, measures to promote the buildup of capital that can be drawn down in periods of stress, and the introduction of two global liquidity standards. Not surprisingly, according to the rules paper the application of the Basel III framework follows the narrow scope of application of the Basel II framework—internationally active banks (which remains undefined)—rather than all banks.

Basel III is a major step forward in capital regulation. By raising minimum capital requirements substantially, stressing the loss-absorbing capacity of regulatory capital, and discouraging some risky activities, Basel III addresses a number of the weaknesses of Basel II. For example, capital levels for some Basel II banks in developed markets declined even from Basel I levels.

Basel III does not present the technical challenges posed by the advanced approach of Basel II. Easy as it may be to implement, emerging markets including the PRC should maintain some flexibility to adopt other prudential regulatory rules that work best for their national financial systems. While converging to a common set of global standards, such as Basel III, emerging markets are better off to use a mix of different policy instruments to achieve the safety and soundness of the PRC's financial system, tailoring the regulatory rules and practices to national circumstances.

The timing of Basel III works perfectly for the PRC—it was issued exactly when the PRC was entering a new 5-year planning cycle. While drafting its forward-looking strategy, the banking regulator in the PRC plans to align the domestic regulatory system more closely with international standards by incorporating Basel III to improve the effectiveness of banking regulation. The regulator strongly believes that in building a more resilient banking sector, the key is to continue the regulatory policies that have worked effectively in the PRC while adopting international standards. The regulatory framework going forward will in the same way cover both microprudential and macroprudential elements, more specifically a new capital standard, including a leverage ratio; the liquidity standard; and a new provision ratio, which is outside the Basel III framework and is intended to address the immediate supervisory concern for the credit quality of banks and the adequacy of the provision pool. A set of well-defined policies and procedures for the resolution of banks will be introduced, incorporating a bail-in mechanism. The strengthened regulatory system will be equally applicable for all banking institutions. However, some differentiation will be necessary to subject the systemically important banks to a set of more stringent requirements and to allow for a varying transition arrangement for different types of banks. In so doing, the regulator expects that any negative impact of following the new international standards will be reduced to its minimum for the sake of continuing support for the real economy (Appendixes 1 and 2 provide a simple comparison of the PRC's approach and Basel III requirements).

Reform of the international financial regulatory system is quite comprehensive and covers a huge territory. This paper is largely focused on Basel III reform initiatives. As such, it intends to provide a brief discussion of the main elements of the PRC's approach to adopting Basel III and a preliminary assessment of its impact on banks in the PRC, as the banking regulator is preparing to translate the entire Basel III framework into domestic regulations.

Quality of capital

First, the quality of capital will be raised with a much greater focus on common equity to absorb losses. Credit and market value losses come directly out of retained earnings and therefore common equity. Total regulatory capital will consist of tier 1 capital (common equity tier 1 and additional tier 1) and tier 2 capital.

The change to the definition of capital alone is a substantial strengthening of the global capital standard. This is particularly true for banks in developed markets. In the PRC's case, the definition of capital has always been conservative. For example, tier 3 capital has never been recognized as part of regulatory capital because of the supervisory concern over the poor loss-absorbing capacity of short-term subordinate debt; and innovative capital instruments generally never find their place in the definition of tier 1 capital.

Broadly speaking, the core equity tier 1 capital of banks in the PRC represents above 80% of the total capital. The impact of deductions from common equity tier 1 is limited, as it will reduce common equity tier 1 capital by about 2%. Most of the deductions come from investments in financial institutions outside consolidation, intangible assets, and deferred tax assets. However, the size of eligible tier 2 capital will be reduced following the strict definition, as a large part of the long-term subordinate debt will be excluded from tier 2 capital. At present, almost no financial instrument in the market can meet the eligibility criteria set under Basel III for tier 2 capital. Under the new rule, any excess general provision over and above 1.25% of risk-weighted assets will not be included in tier 2 capital, which reduces the size of the tier 2 capital of banks. This is because the current rule allows all general provision to go into tier 2 capital, perhaps justifiably in the interest of providing an incentive for banks to set aside provisions adequately.

Risk Coverage

Second, risk coverage will be improved under the revised new capital rules, especially with respect to capital market activities. Trading book exposures will be subject to a stressed value at risk requirement. Banks must hold the appropriate capital for less liquid, credit-sensitive assets with much longer holding periods. Securitization exposures will be subject to capital charges more consistent with those for the banking book. The relatively simple balance sheet of banks in the PRC suggests that the improved risk coverage will have a limited impact on banks' capital. In light of concern among investors in the PRC, the issue of securitization has come to a standstill. Moreover, the regulator will require banks to retain 10% of credit risk for securitization schemes.

Level of capital

Third, the new regulatory capital minimum will be 5% for core tier 1, 6% for tier 1, and 8% for total capital. The higher capital requirement for core tier 1 reflects the supervisory focus on common equity and, perhaps more so, what can be called the default composition capital structure of banks. The capital conservation buffer follows the Basel III calibration of 2.5% and the countercyclical buffer follows the Basel III calibration of 0.0–2.5%.

The additional capital charge for systemically important banks will be for the time being set at 1%. All these changes will lead to overall higher capital requirements of 11.5% for systemically important banks and 10.5% for the rest of the banking sector, challenging banks to raise more capital within the 5-year planning cycle.

By the end of 2009, the capital adequacy ratio for banks in the PRC was 11.4%. In light of the higher capital standards, banks will still be under some pressure to raise more capital. However, given the lack of financial instruments for qualified tier 2 capital, banks will have to raise tier 1 capital, mostly in the form of common equity and retained earnings. This will constrain the growth of banks' balance sheets but the impact is likely to be manageable.

Leverage ratio

Fourth, there will be a new and higher minimum tier 1 leverage ratio of 4%. As under Basel III, the capital measure for the leverage ratio will be based on the new definition of tier 1 capital. The exposure measures on-balance-sheet exposures and off-balance-items as well as derivatives. Banks should calculate the off-balance-sheet items by applying a uniform 100% credit conversion factor and 10% for commitments that are unconditionally cancelable. However, given the lack of legal framework relating to some derivative transactions, the netting arrangement under Basel II for treating derivative transactions is not considered.

The new leverage ratio is simple, transparent, and independent of the measure of risk that is based on total exposure. As such, it provides some safeguard against model risk and measurement error. Moreover, it imposes a limit on the buildup of leverage in the banking system, which has proved effective in the cases of Australia and Canada. However, the advantages of a new leverage ratio may not be very significant for the PRC. A close correlation can be observed between the leverage ratio and the risk-based tier 1 capital ratio for banks in the PRC. In light of the lack of tier 2 capital instruments, at least for now, a high tier 1 capital ratio implies a high leverage ratio.

Despite a higher target ratio of 4%, the banking sector overall has already comfortably met the requirement—an indication of a major structural difference between banks in developed markets and emerging markets in terms of business model and portfolio structure. Perhaps the significant increase in off-balance sheet activities in the future may help to increase the relevance and effectiveness of this prudential tool.

Implementation schedule

Fifth, the PRC will be on a slightly faster track for the implementation of these capital standards—targeting January 2012—1 year earlier than the Basel III timetable. Systemically important banks will be required to meet the standards in 2016 while other banks will gradually phase them in.

Liquidity standards

Sixth, the global liquidity standard will be introduced to supplement capital regulation. In addition to the current loan-to-deposit ratio, liquidity coverage ratio, the net stable funding ratio will be enforced while the regulator will monitor other liquidity ratios (such as dependence on core liability, liquidity gap, customer deposit concentration, and concentration of interbank fund).

Liquidity regulation will be introduced in January 2012 following a 2-year observation period during which the regulator will assess the impact of the standards on banks' operation. All banking institutions are expected to meet the standards by 2013.

The new liquidity standard will have a similar impact on banks in the PRC as for Group 2 banks (basically small and medium-sized banks as opposed large banks), as suggested by the quantitative impact study conducted by the Basel Committee released in December 2010 (Basel Committee on Banking Supervision 2010). Many banks in the PRC already comply with the liquidity standard, which is attributed to the business model. Only a few banks with special target client groups and business strategies have problems meeting the liquidity rules in the short term. However, banks' difficulty in compiling liquidity returns shows that banks in the PRC have a huge challenge in improving liquidity risk management—from setting up policies and procedures for liquidity management; collecting data electronically; developing, measuring, and monitoring cash flow and maturity mismatch to liquidity stress testing; and developing contingency plans accordingly. The abundance of liquidity in the system and the readiness of the central bank to provide liquidity support also weaken the incentive for banks to invest the liquidity risk management. The banking regulator believes that in the long run, implementation of the liquidity standard should encourage commercial banks to improve liquidity risk management while remaining focused on their core businesses and away from excessive reliance on wholesale financing.

Provisioning

Work on designing a forward-looking provisioning system is still in progress at the international level. At the London Summit, G-20 leaders called on the accounting standards setters to work urgently with supervisors and regulators to improve standards on valuation and provisioning and to achieve a single set of high-quality global accounting standards. In August 2009, the Basel Committee published a set of high-level guiding principles to assist the International Accounting Standards Board (IASB) in addressing issues related to provisioning and fair value measurement. In an attempt to address particular concerns about procyclicality, the principles called for valuation adjustments to avoid misstatement of both initial and subsequent profit and loss recognition when there was significant valuation uncertainty. Moreover, loan loss provisions should be robust and based on sound methodologies that reflect expected credit losses in the banks' existing loan portfolio over the life of the portfolio. In addition, the Basel Committee has developed a concrete proposal to operationalize the expected loss approach to provisioning proposed by the IASB. The dialogue between the Basel Committee and the IASB on this topic is still under way.

Before the IASB develops and finalizes its proposal for a more forward-looking provisioning system, presumably with input from the Basel Committee, the regulator in the PRC largely will exercise supervisory discretion and judgment in urging banks to build strong provisions buffers. The objective for such a policy is to strengthen current provisioning by enforcing a new provision ratio (measured by total provisions over total loans) in addition to the current provisioning coverage ratio (measured by total provisions over total classified loans). The provisioning ratio is set at 2.5% and the provisioning coverage ratio is set at 150.0%. The regulator may adjust these ratios taking into account the business cycle, the credit quality of banks' loan portfolios, and profitability to ensure that banks have a higher level of provisions during the economic upturn and a lower level of provisions during the economic downturn.

The backdrop of introducing these two ratios is the excessive expansion of lending, low levels of nonperforming loans, and increasing profitability reported by banks since 2008. The lower level of nonperforming loans could suggest that the provision coverage can be very high and well above the regulatory benchmark while the size of the overall provision can be quite small. The provision ratio is focused on the size of provision in total and serves the purpose of raising the standard for general provision to recognize potential credit loss early. As banks build up their provision base, they are also expected to enhance their data system to reflect their loss experience in a better manner, hopefully putting in place a system similar to Spanish approach to dynamic provisioning. No need. The paper is not meant for people outside the financial Industry.

4. SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS AND BUSINESS MODELS

Although the G-20 works hard to advance the goals of international regulatory reform, it is not possible or even necessary to harmonize all regulatory policies let alone supervisory practices. The passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 in the United States (US) is a typical national initiative to strengthen its financial sector. As a comprehensive package of domestic financial reforms, many elements of the act align closely with efforts of the G-20 leaders, the FSB, and the Basel Committee. However, some aspects of the Dodd-Frank Act are outside the global regulatory framework. Specifically, the act generally prohibits US banking firms (and the US operations of foreign banking firms) from engaging in proprietary trading and from investing in or sponsoring private investment funds. The act also prohibits US depositary institutions from entering into certain types of derivatives transactions (Tarullo 2010).

Since the 1980s, activity and affiliation restrictions have been loosened in the US. At present, US regulators seem to be very comfortable in welcoming back activity and affiliation restriction as an important part of the bank regulatory regime, which serves to (i) constrain risk-taking by banking firms, (ii) prevent the spread of market distortion caused by the safety net to other parts of the economy, and (iii) mitigate potential conflicts of interest generated by the combination of banking and certain other businesses within a single firm.

In contrast, there has been no clear regulatory distinction between commercial banking and investment banking in most of continental Europe. Universal banks have been involved in securities-related activities and in some cases in the direct holding of large industrial interests. In the United Kingdom (UK), there has been no clear regulatory prohibition on clearing banks becoming continental style universal banks. The UK regulator thus concluded that it does not seem practical to work on the assumption that we can or should achieve complete institutional separation of utility banks from investment banks. In its view, large complex banks spanning a wide range of activities are likely to remain a feature of the world's financial system (Financial Services Authority 2009). As a result, despite efforts to minimize the incentive for regulatory arbitrage—featuring a higher capital charge on the trading book and securitization—at the global level there has been no rethinking of the need for regulatory distinction between investment and commercial banking. The measures introduced so far are intended primarily to reduce risk-taking by large banks rather than require disintegration into separate institutions.

Discussion of the pros and cons of universal banking remains an open issue in the PRC. The current laws for the banking (1995), securities (1998), and insurance (1995) industries are consistent in prohibiting universal business practices and corporate affiliation across industries. However, all legislations have a carve-out provision, giving the government (i.e., the State Council) the flexibility to approve applications for universal banking business practices and diversification into other financial and nonfinancial industries on a case-by-case basis. Under this arrangement, large banks have become well diversified in terms of business scope. For example, the Bank of China projects itself publicly as the most international and diversified bank in the PRC. In addition to commercial banking, the Bank of China is involved in investment banking, insurance, fund management, direct investment, and aircraft leasing, among others. The appropriate regulation of large complex banks is, therefore, also an issue for the banking regulator in the PRC.

From a banking regulator's perspective, the major contributing factors to the problems relating to systemically important financial institutions are interconnectedness and complexity. Size is, at most, a minor issue while substitutability may not be relevant for the PRC. Interconnectedness causes risks to spread from one individual institution and geographic location to another and across different industries, thus paralyzing the entire financial system. Complexity poses enormous challenges not only to management but also to the regulator. Systemically important banks need to be identified and this can be achieved in practice without difficulty. As a result, a set of new policies governing these banks should also be put in place.

The regulator's focus is to stop banks from becoming too complex and reducing the contagion risk in the financial industry. The current approach to place restrictions on banks' business activities will continue. On permissible activities, the regulator will allow, following a stringent screening process, qualified commercial banks to diversify into nonbank activities. Regulatory approval will be required for conducting complicated structural products, highly leveraged operations, or high-risk nonbank activities in general. The current firewalls will continue to be applicable between the banking and capital markets, banks and their controlling shareholders, and banks and affiliations. The regulator will review banks' performance in universal banking experience and may ask banks to divest if their affiliations in diversified businesses fail to remain profitable—measured by the industry average within a reasonable time frame. Similar to the Basel initiatives, the large banks will be subject to a higher capital charge. They will be required to issue bail-in debt to enhance loss-absorbing capacity. This will also require changes for securities regulation to ensure loss absorbency at the point of non-viability (Bank for International Settlements 2011).

The regulator in the PRC takes a view on banks' business models, stressing that commercial banks should focus on their traditional core banking business activities such as deposit taking, loan granting, and payments services as well as asset management services, primarily in fixed-income products. Complicated business models would pose serious challenges to banks' adequacy in risk management. Banks are better advised to identify their niche market with tailor-made products and services to serve the target customers. Banks should fund their lending activities and other traditional businesses with a strong retail deposit base and limited market-based funding. Given the supervisory concern for liquidity mismatch, banks are not allowed to rely on capital markets as a major funding source for their banking operations. Market-based financing should not be seen as a norm for prudent management of financial operations either by banks or other nonbank financial institutions.

Going forward, the policy is likely to remain conservative, largely because of prudential consideration, to the extent that experimental projects for business diversification will continue at a measured pace. A consensus is developing among regulators that all financial institutions are better advised to keep focused on their core business line. In addition, the banking regulator will continue regulation at the product level, considering it within its remit to prohibit specific products or product design features in both retail and wholesale markets.

5. CONCLUSIONS

Since the crisis began in August 2007, the world has gone through the most difficult years in the history of the modern financial industry. There has been a lot of soul searching regarding what caused this financial crisis and what needs to be done to reduce the incidence of future crises and mitigate their severity. Reform of financial regulation is a priority on the reform agenda.

As the premier forum for international economic cooperation, G-20 leaders have agreed upon the general principles and a detailed road map for regulatory reform, providing political support at the highest level for national regulatory authorities to implement a set of global standards in pursuit of financial stability in the interest of all countries. Building a stronger financial system is in the interest of all countries. Globalization has brought many benefits but it also means that weaknesses in one country's financial system can spread to others.

As a member of the G-20, the FSB, and the Basel Committee, the PRC is now on a faster track in adopting international standards. However, the key issue for the PRC—as well as many other emerging markets—is to how to keep focused on the domestic policy agenda while adopting the new global standards. Fortunately, the PRC's financial system has proved resilient to the recent crisis. As a result, banks in the PRC find it quite comfortable to meet Basel III's new capital and liquidity standards. Basel III is another important milestone for capital regulation, but it is only part of an effective regulatory framework. While phasing in Basel III, the PRC needs other prudential tools such as a new provision ratio, in addition to the provision coverage ratio, following the idea of a forward-looking provisioning policy—particularly to address the deterioration of credit quality following huge credit expansion in order to arrest the downturn of the economic activities indirectly affected by the financial crisis. Activity restriction will be another effective tool with the potential to prevent banks from becoming too complicated for bankers to manage and for the regulator to supervise. Before capital markets in the PRC become mature enough to help finance a significant part of the funding demand, indirect intermediation by banks will continue to be dominant in the PRC's financial landscape. Therefore, the challenge remains with respect to how to keep the balance between enhanced banking regulation and promoting financial innovation—without the pendulum swinging too far.

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APPENDIX

Table A1: Calibration of the Capital Framework:
Capital Requirements and Buffers (%)

	Common Equity (after	Tier 1 Capital	Total Capital
Minimum	4.5	6.0	8.0
Conservation buffer	2.5		
Minimum plus conservation buf	7.0	8.5	10.5
Countercyclical buffer range*	0-2.5		

Note: Common equity or other fully loss absorbing capital

Source: BIS Press release, Group of Governors and Heads of Supervision announces higher global minimum capital standards, September 2010

Table 2: Phase-in Arrangements (%)

	2011	2012	2013	2014	2015	2016	2017	2018	As of 1 Jan. 2019
Leverage Ratio	Supervisory monitoring		Parallel run 1 Jan. 2013_1 Jan. 2017					Migratio n to	
Minimum common equity capital ratio			3.50	4.00	4.50	4.50	4.50	4.50	4.50
Capital conservation buffer						0.63	1.25	1.88	2.50
Minimum common equity plus capital conservation buffer			3.50	4.00	4.50	5.13	5.75	6.38	7.00
Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs and financials				20.00	40.00	60.00	80.00	100.00	100.00
Minimum Tier 1 capital			4.50	5.50	6.00	6.00	6.00	6.00	6.00
Minimum total capital			8.00	8.00	8.00	8.00	8.00	8.00	8.00
Minimum total capital plus conservation buffer			8.00	8.00	8.00	8.63	9.13	9.88	10.50
Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital			Phased out over 10-year horizon beginning 2013						
Liquidity coverage ratio	**Observa-tion period begins**				**Introduce minimum standard**				
Net stable funding ratio		**Observa-tion period begins**						**Introduce minimum standard**	

CET1= common equity Tier 1 capital; DTAs= deferred tax assets; MSR=mortgage serving right.

Note: Shading indicates transition periods. All dates are as of 1 January

Source: BIS Press release, Group of Governors and Heads of Supervision announces higher global minimum capital standards, September 2010