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Chinese Banks and the Impact of Basel II

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As Chinese banks move to embrace elements of Basel II, what challenges do they face and what advantages do they stand to gain from this?

Less than three years ago, talk about the impact of the New Capital Accord (Basel II) was on the agenda for just about every large bank around the world, apart from in China. The world of Basel II and risk management was deemed as a low priority - the banks had more pressing issues to resolve: bad quality loan portfolios and poor governance standards to name just a few. The contrast between Chinese risk management standards and international best practice has progressively faded, although it has not yet disappeared.

Chinese banks have now cleaned up their balance sheets and improved their internal structures and governance standards. With the increasing integration of the Chinese banking industry into the world finance system, the growing influence of shareholders and the opening of the Chinese industry to the outside world, the old business model of Chinese banks is now under threat. Basel II presents the banks with an opportunity to change. Yet the challenges that Basel II brings to Chinese banks are numerous: Ba Shusong, a professor in risk management, lists issues ranging from capital and risk management to data and disclosure, as well as organisational structures, incentive compatibility between banks and regulators, market-oriented supervision and the fostering of financial innovation as the most important challenges.

The idea behind Basel II is, by acknowledging modern risk management techniques, to allow banks to calibrate capital in a more risk-sensitive manner based on the banks' own measurements of different risks incurred. Moreover, Basel II also requires higher disclosure and transparency, and gives regulators more teeth. Will such a framework free more capital in Chinese banks, allowing them to grow recklessly? Can the impact of Basel II be such that the greatest risk to Chinese banks, i.e. the interference of local and central authorities, is averted or at least diminished?

Progress of the CBRC

The China Banking Regulatory Commission (CBRC) took a big step in 2004 by publishing'Management Rule on Capital Adequacy for Commercial Banks', which required banks to basically implement the less risk sensitive Base I in terms of capital adequacy and at the same time apply the pillars 2 and 3 as required under Basel II. That was a strong departure from the original requirement to simply comply with a capital adequacy ratio of 8% without any details and that was never actually enforced. While Chinese regulators had frequently stated that implementation of Basel II would not be concurrent to that in Europe, the incentives for CBRC to implement it are clear: deeper and better understanding of the risks incurred in banks, better risk management overall and thus increasing the industry's risk withstanding ability and financial intermediation capacity, and responding to the fact that increasingly complex financial instruments have also found their way in China - thus rendering regulatory arbitrage possible and worthwhile.

So, finally, in February 2007, the CBRC published a notice on implementing Basel II in China. This was required to avoid putting Chinese banks at a disadvantage with their international competitors that would implement Basel II. Those internationally active Chinese banks should implement the new accord by 2010 (or 2013 at the latest) while other banks can choose between Basel II implementation by 2011 or remain on the current mixed framework adopted by the CBRC. All banks are encouraged to work towards the internal ratings based approach, but the decision over which approach to implement is theirs, and some of the largest Chinese banks have already started Basel II work. Capital adequacy can be calculated according to Basel II provided the bank has been recognised as compliant and that the coverage of internal ratings exceeds 80% of assets after three years. Until 2009, the CBRC will work on improving the regulatory framework and analyse the impact of the new accord.

The Basel Committee lists a number of requirements to be fulfilled in a banking system as a whole in order to implement the new accord without endangering a financial system. While the implementation rules have been laid down for China, one should consider that CBRC, while being relatively powerful, still lacks independence and that the rating industry is, at best, embryonic in China, and that creditor rights and bankruptcy proceedings (not bank bankruptcy however) are just beginning to be recognised and to become reality. Disclosure and corporate governance are, from a legal perspective, more or less in line with international standards, but the enforcement remains a weak point. Accounting and provisioning practices have been updated to reach best practice. The weakest points, however, concern human resources as well as the availability of required historical data. In fact, bankers and regulators alike lack the relevant banking and modelling experience, and the data collection has only just started.

The impact of Basel II will be felt by Chinese banks in quantitative and qualitative terms. From a quantitative point of view, two aspects need to be considered by banks: the price to be paid for implementation (administrative expenses but also debt and capital costs) and the change in capital needed. From a qualitative point of view, the impact will be felt by banks in a stand-alone basis and by the banking system as a whole as well as in the regulatory environment.

Until now, there has not been a full scale impact quantification for China, five Chinese banks representing 48% of the banking system assets participated in the third BIS-orchestrated QIS study and showed that their capital ratios would generally fall as their risk-weighted assets tended to increase by over 9% on average.

Assuming that no market and operational risks are taken into account, one can roughly estimate the capital ratio that would be the result of implementing Basel II based on the 2006 financial figures. The results should be viewed with caution as they do not fully reflect the reality (the structure of the portfolio and the operating environment play a strong role in determining PD and LGD for example), but they do give an understanding of what would happen. In fact, for all banks, implementing the foundation-IRB approach involves raising fresh capital to boost the capital ratio to required levels. Larger banks such as ICBC and CCB could choose to implement the standardised approach to escape costly capital raising exercises. Because the capital ratios are expected to fall with the more complex approach implemented, those with more capital cushion are likely to feel the financial impact. Shareholding banks as a group often show actual capital ratios close to the required level of 8%. Thus, capital increases will be on the agenda - even in a no-growth scenario. It should also be noted that a higher LDG (for example at 70%, i.e. closer to recovery rates of asset management companies) would reduce the capital ratios in the following table by around one-third and thus require even more capital.

Figure 1: Capital ratios under different Basel II implementation scenarios

	Bank	**ICBC**	**CCB**	**Minsheng**	**Industrial**	**Bank of Shanghai**
Actual	Total assets	7.509	5.449	700	618	240
	Total eligible capital	531	374	34	29	15
	Risk weighted assets (actual)	4.131	3.428	559	417	131
	Total actual Basel ratio	14,1%	12,1%	8,1%	8,7%	11,6%
Estimates		Basel I (CBRC)				
	Total capital ratio	12,9%	10,9%	6,1%	6,9%	11,1%
	Further capital needed	0	0	11	5	0
	Further possible growth	60,7%	36,4%	none	none	38,6%
		Basel II - SA				
	Total capital ratio	10,8%	9,4%	5,3%	6,1%	9,0%
	Further capital needed	0	0	15	7	0
	Further possible growth	43,7%	25,1%	none	none	19,4%
		Basel II - F-IRB				
	Total capital ratio	6,8%	5,9%	3,2%	4,3%	6,1%
	Further capital needed	98	130	51	25	5
	Further possible growth	none	none	none	none	none

Notes: In CNY bn or %, based on Basel II calculations and on banks' annual reports for 2006.Further assumptions: no derivatives, collateral haircuts or provisions - as each position can be assumed to be relatively minor for now; LGD as 45%, maturity as 2.5 years and PD as a weighted average based on publicly available data for other countries (nothing is yet available for China).
ICBC: Industrial and Commercial Bank of China, CCB: China Construction Bank, Minsheng: China Minsheng Banking Corp., Industrial: Industrial Bank.

Not only will the change in capital requirements drive the choice of approach to Basel II and its impact, but banks will also see changes to their borrowing costs and cost of capital. Assuming a European lender of Chinese banks aiming to reach a RoE of 15% and having 4-4.1% in refinancing costs, the cost of funds for Chinese banks, especially those better rated ones, could drop by 10-15% a year depending on their rating, the maturity and the type of exposure. But that would only have a small impact as the balance sheet structure of Chinese banks is largely influenced by deposits (making on average 83% of total assets - while equity makes up less than 6%). Based on this observation and the fact that deposits are relatively cheap (3.87% a year on one-year deposits as a benchmark), the cost of equity capital does not make up much of the total cost calculation. The weighted average cost of capital comes at around 3.6% currently. This could drop by up to 10bp if Basel II were implemented by the Chinese banks' counterparts.

Finally, the expenses of implementation will also drive banks' considerations. Comparing international estimates, the cost of implementation for Chinese banks could amount to US$50m per bank or to anything between 0.05% and 1% of a bank's assets. Due to their size, the four state-owned banks are likely to have the financial resources to implement costly Basel II solutions (and have already hired consultants to support their efforts). For smaller banks, such as city commercial banks with assets of CNY100bn on average, the costs would be far too high. Most of these costs will be divided between IT-related costs and personnel costs - but do not include costs that banks incur in bringing their risk management to a preliminary level for Basel II implementation. These are costs for restructuring internal processes, systems and procedures that apply to all Chinese banks, albeit to varying extents.

Impact of Basel II Implementation

Set against all these costs are the gains that banks can expect from implementation. The gains in terms of higher productivity and efficiency are difficult to assess. One observer gauges that profitability could potentially be raised by 10bp of total assets for each bank - in general. This analysis has clearly shown that in quantitative terms, Basel II is going to be expensive for Chinese banks - probably well above the expected quantifiable gains.

The impact of Basel II implementation felt by Chinese banks will not only be quantitative in nature, but also qualitative. Micro-level impact will be felt by banks in a number of areas, such as human resources, corporate governance, disclosure, credibility, IT systems, decision-making processes, credit culture, risk management, internal controls, NPLs management and risk mitigation.

A few years ago, the loan/deposit ratio reigned supreme in China, the basis for calculating incentives and rewards of managers and bank staff is going to shift towards the modern risk/return equation. Responsibilities could become more closely defined and segregated. This will also be concurrent to changes in internal structures with clear walls and different reporting lines between risk management and assessment and clients' relationship. Corporate governance will not only be perfected in terms of structures but also in terms of disclosure. Greater transparency can only encourage greater outside scrutiny and rewards in terms of a better reputation for the compliant organisations. Transparency will also improve in the face of more complex system designs and higher requirements as well as more demanding investors. Internally, the banks can then make timely and informed decisions based on the findings of risk management departments (determining limits for sectors, etc. or defining strategic development areas for example). Risk management and resources allocation can then be fully integrated and promoted at a bank level.

Potentially, one of the most profound implications of Basel II is the changes in mindset in the credit culture - something that Chinese banks have completely lacked before. At the same time, the incentives for staff will be greater to analyse creditworthiness based on cash flows rather than on provided collateral and to grant loans according to needs. Internal control functions and monitoring is likely to be strengthened as a result. That will also be true for NPL treatment departments. Dealing with NPLs could become faster and more thorough and the creation of NPLs in the first place could be reduced.

It is impossible to determine in monetary terms the value of such an impact - but in the long term this would be deep-rooted. Basel might also have an impact on the business mix of banks - with some of them preferring the lower weighted business lines such as mortgages or SME or retail lending.

Conclusion

As a whole, the Chinese banking industry faces a largely positive impact from Basel II, with a higher systemic safety and soundness. With a system showing a higher propensity to withstand crises and a higher financial intermediation capacity, the financial system will be more stable and more efficient. Borrowers and government can only gain from that. Higher and more efficient financial intermediation capacity and a stronger banking system could allow much higher GDP growth (McKinsey Global Institute estimates that China has foregone GDP growth at 13% a year through the lack of true reforms). But market discipline will only become fully efficient if the authorities refrain from meddling in an institution's affairs. Oversight by creditors will only become a reality once they realise that the state will not step in at every corner.

The influence of Basel II on Chinese banks, on the banking system and on the environment overall will be largely positive - despite the high implementation costs - as the gains will be mostly on the soft side. Maybe even in the long term, Chinese banks will be able to risk manage their different exposures and be able to withstand the meddling of authorities. Bringing risk and capital in line with one another will ensure that banks refrain from lending recklessly - but that they will also need improvements in the regulatory environment to include true bankruptcy, for example.

Posted by:	Post
19 Mar 2008 - 04:07 Bank, India	Kindly enlighten us as to how to specifically evaluate the qualitative aspects of Basel II implementation and similarly the micro-level impact.Thanks. B.Venkat,Chennai
29 Mar 2008 - 08:25 Bank, Germany	To evaluate the qualitative impact of Basel II, you basically have to compare the current way of lending in China with international best practices as set down by the Basel II document. For details of how banks work in China, please refer to my book. It is clear that lending in China was principally done on a policy basis where business conditions did not play a role. This is something inherited from the years of communist rule. That would concern the micro-level impact (i.e. at the level of each bank individually - consider that in this article I do not consider any bank in particular but for each they would be small discrepancies).

	Concerning the macro-level impact, you can infere that from the results of the micro-level impact. A best practice bank would have a better chance to withstand a crisis and if this spreads to other banks then it would in effect also impact the whole system. Hope I have answered your question. Should you have more questions, please do not hesitate. Violaine Cousin