

**People's Republic of China: Detailed Assessment Report: Basel Core Principles for
Effective Banking Supervision**

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PEOPLE'S REPUBLIC OF CHINA

BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING
SUPERVISION

DETAILED ASSESSMENT
OF OBSERVANCE

MARCH 2012

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GLOSSARY

AMA	Advanced Measurement Approaches
AMC	Asset Management Companies
AML	Anti-Money Laundering
BCP	Basel Core Principles for Effective Banking Supervision
CAMELS	Capital Adequacy, Asset Quality, Management Quality, Earning, Liquidity, Sensitivity to Market Risk
CAMLMAC	China Anti-Money Laundering Monitoring and Analysis Center
CAR	Capital Adequacy Ratio
CBRC	China Banking Regulatory Commission
CCO	Chief Credit Officer
CDB	China Development Bank
CDD	Customer Due Diligence
CEOs	Chief Executive Officers
CFO	Chief Financial Officer
CIO	Chief Information Officer
CIRC	China Insurance Regulatory Commission
CPs	Core Principles
CPA	Certified Public Accountant
CPI	Consumer Price Index
CRO	Chief Risk Officer
CNAPS	China National Advanced Payment System
CSRC	China Securities Regulatory Commission
FATF	Financial Action Task Force
FIU	Financial Intelligence Unit
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FX	Foreign Exchange
HVPS	High Value Payment System
HKFRS	Hong Kong Financial Reporting Standards
IASB	International Accounting Standards Board
ICAAPs	Internal Capital Adequacy Assessment Processes
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IRB	Internal Risk Based
IRRBB	Interest Rate Risk in the Banking Book
IT	Information Technology
KRI	Key Risk Indicators
KYC	Know Your Customer

LEADS	Large Exposure Analysis Database & System
LGFPs	Local Government Funding Platforms
LTV	Loan to Value
LVTR	Large-Value and Doubtful Transaction Reporting
MIS	Management Information Systems
MoF	Ministry of Finance
MOU	Memorandum of Understanding
NAO	National Audit Office
NDRC	National Development and Reform Commission
NPLs	Nonperforming Loans
NPS	National Payment System
OSS	Off-Site Surveillance
PBC	People's Bank of China
RCSA	Risks and Control Self Assessment
REASS	Risk Early Warning Analysis Supporting System
RMB	Renminbi
ROA	Return on Assets
ROE	Return on Equity
ROSC	Report on Observance of Standards and Codes
RWA	Risk-Weighted Assets
SAFE	State Administration of Foreign Exchange
SMEs	Small and Medium Enterprises
SOE	State Owned Enterprise
SOX	Sarbanes-Oxley Act
STR	Suspicious Transaction Reporting
VAR	Value at Risk

I. SUMMARY, KEY FINDINGS, AND RECOMMENDATIONS

1. **Regulation and supervision of China's banking system has made impressive progress in the past few years, led by an activist, forward-looking regulator China Banking Regulatory Commission (CBRC), with a clear safety and soundness mandate that has been supported by banks and by the State.** Significant improvements in risk measurement and risk management have occurred. These improvements are backed up by a regulatory system that demands high-quality capital and liquidity, often through simple and basic regulatory requirements. However, as further opening up and innovation occurs, and China's banks expand, complexity and risks will increase. CBRC and banks must evolve quickly in the short term to be ready to meet those challenges. The framework of laws and guidance is generally of high quality, but much of it is relatively recent. Implementation by banks needs to be improved, in some cases materially. CBRC is widely-respected and has demonstrated its willingness to act in pursuit of its safety and soundness mandate. It urgently needs to have a plan to enhance its experience and expertise, ensure progress to date is sustainable, and needs continued support of government in that endeavor. Enhanced vigilance is required by banks and the regulator to keep risks under control in China's system, in which banks are looked on by the State to be heavily, directly involved in achieving economic and social goals.

2. **Less than fully compliant ratings in certain areas in this assessment generally reflect deficiencies in the legal framework, which can be amended, or that banks have yet to fully implement CBRC guidance.** CBRC itself is performing excellently in a challenging and fast-changing environment. It is on the right track with its reform agenda and needs to persevere in a sustained way in its current direction. It will need the full support of all other parties in the government to succeed in the goals it has set for itself.

A. Introduction

3. **This assessment of the current state of the implementation of the Basel Core Principles for Effective Banking Supervision (BCP) in China has been completed as part of a Financial Sector Assessment Program (FSAP) undertaken jointly by the International Monetary Fund (IMF) and the World Bank between June 7 and June 25, 2010, and reflects the regulatory and supervisory framework in place as of the date of the completion of the assessment.** An assessment of the effectiveness of banking supervision requires a review of the legal framework, both generally and as specifically related to the financial sector, and a detailed examination of the policies and practices of the institutions responsible for banking supervision. In line with the BCP methodology, the assessment focused more on the major commercial banks and their regulation and supervision, given their importance to the system.

B. Information and Methodology Used for Assessment

4. **The assessment team¹ reviewed the legal framework for banking supervision, held extensive discussions with the staff of the CBRC and two of its regional offices.** The assessors also met with officials of the central bank—the People’s Bank of China (PBC), the Ministry of Finance (MoF), the National Audit Office (NAO); several commercial banks, audit firms, rating agencies, and the China Bankers Association. The team examined the current practice of on-site and off-site supervision of the CBRC. The assessment team had the benefit of working with a comprehensive self-assessment completed by the CBRC, enjoyed excellent cooperation with its counterparts, and received the information it required. The team extends its thanks to the staff of the CBRC for their participation in the process and their comprehensive self-assessment.

5. **Reaching conclusions required judgments by the assessment team. Banking systems differ from one country to another, as do their domestic circumstances.** The banking system has undergone tremendous change in China in the recent period and this process is still ongoing. The CBRC is a relatively young agency, having been created in 2003 from the PBC as part of the major banking sector reform instituted by the Chinese authorities. In addition to the strengthening of financial sector regulation and supervision, these reforms have also led to the conversion of four large state-owned banks into joint-stock companies; consolidation of rural credit cooperatives; restructuring of joint-stock banks and securities companies; and reform of the insurance sector. Several Chinese banks now lead the list of global banks in terms of market capitalization and are gradually increasing their global footprint. Furthermore, banking activities are changing rapidly around the world after the crisis, and theories, policies, and best practices for supervision are swiftly evolving. The Basel Committee on Banking Supervision (of which China is now a member) is in the process of agreeing upon major reforms to the regulatory framework which, when implemented, will substantially impact the capital and liquidity regimes and how banks manage their risks. Nevertheless, by adhering to a common, agreed methodology, the assessment should provide the Chinese authorities with an internationally consistent measure of the quality of its banking supervision in relation to the Core Principles (CPs), which are internationally acknowledged as minimum standards.

6. **The assessment of compliance with each principle is made on a qualitative basis.** A four-part assessment system is used: compliant; largely compliant; materially non-compliant; and non-compliant. To achieve a “compliant” assessment with a principle, all essential criteria generally must be met without any significant deficiencies. A “largely compliant” assessment is given if only minor shortcomings are observed, and these are not seen as sufficient to raise serious doubts about the authority’s ability to achieve the objective

¹ The BCP assessment was conducted by Nicholas Le Pan (World Bank Consultant; ex-Head of the Office of the Superintendent of Financial Institutions, Canada and ex-Vice Chairman of the Basel Committee for Banking Supervision); Walter Yao (IMF Consultant; Senior Manager, Federal Reserve Bank of San Francisco); and Aditya Narain (IMF; Advisor, Monetary and Capital Markets Department).

of that principle. Under the BCP methodology a “materially non-compliant” assessment is given whenever there are severe shortcomings, despite the existence of formal rules, regulations and procedures, and there is evidence that supervision has clearly not been effective, that practical implementation is weak, or that the shortcomings are sufficient to raise doubts about the authority’s ability to achieve compliance. A “non-compliant” assessment is given when no substantive progress toward compliance has been achieved. In interpreting ratings, it is also important to note that for some CPs the assessment takes into account both compliance by banks and compliance of the supervisors.

C. Institutional and Macroeconomic Setting and Market Structure—Overview

7. **The macroeconomic environment is characterized by rapid growth, with concerns about overheating and asset price overvaluation.** The March 5, 2010 National People’s Congress meeting reiterated the Government’s proactive fiscal policy and moderately loose monetary policy. Cheap money and credit growth have facilitated output growth, but there are increasing concerns of a potential asset price bubble and increased inflationary pressures. Nonetheless, the government’s 2010 target for broad money growth is 17 percent, down from 30 percent set in 2009. The authorities have started adopting regulatory measures for tightening liquidity and credit to real estate sectors and have raised reserve requirements 3 times since the end of 2009. The 2010 GDP growth rate target was set at a moderate 8 percent (most forecasts are at about 10 percent) and the Customer Price Index (CPI) at 3 percent (in line with most forecasts). Efforts are being made to rebalance the economy, with measures to boost domestic consumption alongside creating rural and social safety nets. At the time the mission was in China, the authorities announced that they would move towards a greater market determination of the *Renminbi* exchange rate, simultaneously underscoring that any movements would be gradual.

8. **The Chinese financial system is dominated by the rapidly-growing banking sector, with nonbank financial institutions accounting for only a fraction of the system.** The banking system accounts for nearly 80 percent of the net new lending every year. China’s capital markets remain relatively shallow, and over 60 percent of outstanding bonds issued by the government and the majority of the remaining being issuances by the large financial institutions, with policy banks (which are state owned and provide a range of development finance services in support of infrastructure, agricultural development, export insurance, etc.) being the second largest issuers. The insurance sector, however, is rapidly growing, though, as are linkages between banks and insurance companies.

9. **Although the banking sector is extraordinarily large with assets over 200 percent of GDP, and a couple of banks are in the top three globally by market capitalization, the financial systems is still relatively new, simple and evolving.** Key financial prices remain regulated which distorts the incentives to save and invest, can limit the ability to price for risk, insulates banks from market risk and constrains the conduct of monetary policy. Despite gradual interest rate liberalization over more than a decade, retail interest rates remain partly regulated—deposit rates are subject to a cap and lending rates to a floor. Banks can price lending above the floor to a degree, and do so in practice.

10. **The reform of the banking system began in the 1980s, when commercial banking was separated from the PBC.** In the next decade, policy banks were created to separate policy lending from the commercial banks. The stock exchanges and the bond markets also date to the 1990s. Since then, the banking system has undergone an extraordinary consolidation with the number of banking entities having been reduced from more than 40,000 to fewer than 5,000 through a series of restructuring and mergers of credit cooperatives into commercial banks. The 4 state banks have also been restructured with capital injections from the state and purchases of nonperforming loans (NPLs) by state Asset Management Companies (AMCs) over time estimated to be in excess of 15 percent of 2001 GDP, and have since been listed. Bank assets have grown rapidly, with total banking sector assets growth around 20 percent in the last five years. Efforts are being made to improve access to bank finance by SMEs and households, and, at a local level indirectly to projects sponsored by the local governments, as bank finance in the past has remained largely limited to large corporates (typically state owned).

11. **Within the banking sector, the five large commercial banks account for just over half of the banking system assets.** The next Tier of banks are the joint stock commercial banks, followed by city commercial banks and rural commercial banks which have been formed by the merger of city credit cooperatives and rural credit cooperatives respectively. The next Tier of banks are deposit taking institutions such as rural and city credit cooperatives, postal savings banks, village and township banks. Despite over 200 branches and subsidiaries operating in China, foreign banks remain a small presence with assets less than 2 percent of the total. However, in recent years, overseas financial institutions have made significant equity investments in Chinese banks.

12. **The CBRC was established in 2003 as a stand-alone prudential authority and is widely credited with having made significant achievements in its short existence.** All the banks, auditors, rating agencies and other market participants that the mission interacted with were unhesitating in their regard for the role that the CBRC has played in driving professionalism, risk management and international recognition of the Chinese banking system. In particular, the mission observed that it has been the key driving force in driving improvements in risk management, corporate governance and internal control and disclosure in Chinese banks. The prudential ratios on capital adequacy, NPLs, and liquidity, for instance for the banking system have improved significantly. However, more than one third of the bank assets continue to be in exposures to the government or central bank (more if local government related vehicles are taken into account) and there remains scope for further gains to be made in wider intermediation.

D. Preconditions for Effective Banking Supervision

13. **The legal system in China brings together a number of distinct legal traditions within the overarching framework of a civil law system.** The structure of the legal framework has undergone a series of phased transitions, first to enable complete state ownership until the 1970s, and more recently to facilitate China's move towards a more market-oriented economy within a socialist political and economic framework. The main law-making bodies are the National People's Congress and its Standing Committee, the State

Council, Ministries, Commissions, Committees, provincial People's Congress, and provincial Governments, etc.

14. **The court system of China consists of:** (i) the Supreme People's Court; (ii) the higher courts instituted at the levels of provinces and autonomous regions as well as municipalities directly under the Central Government; (iii) the intermediate courts established at levels of prefectures (including autonomous prefectures), provincial capital (including cities under direct control of the provincial or autonomous region government), relatively big cities and within the municipalities directly under the Central Government; and (iv) others including basic courts, military courts, maritime courts; and railway transport courts. Chinese courts handle about 10.5 million cases annually. The presidents of courts and the procurator-generals of procuratorates (who exercise some degree of judicial power) are selected and appointed by the people's congresses on the same level. The judges and procurators are appointed by the standing committees of the respective People's Congresses, and assistant judges and assistant procurators are appointed by the respective courts and procurator-generals.

15. **The first source of law is the Constitution.** Then, there are other basic laws such as the General Principles of Civil Law of 1986, the 1979 Criminal Code (revised in 2009) and the 1991 Code of Civil Procedure (revised in 2007). Next come laws promulgated by the Standing Committee of the National People's Congress. Actual day-to-day law consists of regulations, orders, decisions, etc., promulgated by the State Council—in effect the administrative cabinet of the government. Regulations, orders and decisions enacted by provincial and municipal People's Congresses and equivalent legislative/executive authorities in autonomous regions are part of the legislative framework. Some international conventions and treaties endorsed by the National People's Congress are also part of the legal framework.

16. **There is no Commercial Code in China.** In its place, the government has legislated a series of distinct measures to regulate commercial relations, for example, through the Company Law (revised 2005), laws to regulate the participation of foreign investors in Chinese markets, secured lending (Security Law 1995), and negotiable instruments (Negotiable Instruments Law 1995). More recently, a number of symbolically and legally important measures have been passed, notably the Property Law of 2007, that further recognizes private property rights, as well as the Enterprise Bankruptcy Act 2007, which seeks to give greater protection to secured creditors than has otherwise been accorded under Chinese law (e.g., by giving secured creditors priority over worker's wages on winding up). There is little data with reference to enforcement of bank debts, but available data suggests that that enforcement of contracts in general by Chinese courts has improved dramatically in some urban centers to keep pace with economic reform. According to the annual working report of the Supreme people's Court, the number of contractual cases and financial cases completed by courts amounted to 3.15 million and 519 thousand respectively in 2009, up by 8.6 percent and 12.9 percent on a year-on-year basis. Other studies suggest that a significant portion of contractual cases are voluntarily withdrawn by the plaintiffs or settled through judicial mediation.

17. **China is gradually building up an infrastructure that promotes and supports market discipline.** With the deepening of China's reform and opening up, the market mechanism has been gradually developed. Information disclosure is required by various laws and regulations. The *Company Law*, *Law on Commercial Banks*, *Law on Banking Regulation and Supervision*, *Securities Law*, and *Insurance Law* all provide specified requirements on information disclosure. In practice, all banks are required to publicly disclose their information in their annual reports, including audited financial statements, corporate governance, capital adequacy, risk exposures, risk management strategies and practices, and other quantitative and qualitative information. In addition, the listed banks are subject to information disclosure requirements set forth by the China Securities Regulatory Commission (CSRC). Market discipline could be enhanced if the CBRC publishes a more uniform and more extensive bank performance data on a regular basis. Currently, the CBRC publishes basic aggregate financial data in its annual report and website. However, some key financial ratios such as net interest margin and trends in capital adequacy ratio (CAR) for various types of banks are not made available. In general a culture of disclosure is still evolving.

18. **Considerable efforts have been made by the financial regulatory agencies to improve the corporate governance of financial institutions.** On the basis of the corporate governance requirements provided by the *Company Law* and the *Commercial Bank Law*, specific rules and policies have been issued to promote corporate governance culture and practices. The CBRC recently issued *the Supervisory Guideline on Compensation Practices of Commercial Banks*, which requires banks to adopt deferred payment and clawback arrangements, and align the incentive package with the results of long term performance and risk control results. Under corporate governance rules banks have a dual board. There is a full-time board of directors. There is also a supervisory board which oversees the performance of the board and senior management. It is not involved in strategy formulation, but receives reports from audit and control functions to ensure that the board and management are performing as expected and following the board-approved strategy.

19. **Since 2005, China accounting standards have substantially converged with International Financial Reporting Standards (IFRS) and International Standards on Auditing, respectively.** In February 2006, the MoF which sets accounting and audit standards promulgated the *Accounting Standard for Business Enterprises*, which replaced the previous *China Accounting Standards* and became effective in January 2007. The new accounting standards consist of one basic standard and 38 specific standards, which have substantially converged with the international standards and were recognized by the International Accounting Standards Board (IASB). Currently, all listed companies, financial institutions and non-listed large and medium-sized enterprises have adopted the new accounting standards. The IFRS has been widely adopted internationally by many advanced economies and following a single set of internationally accepted standard would facilitate comparability of financial statements across borders and provides confidence to users of financial statements. Also, in 2006, the MoF issued a new set of auditing standards; one review engagement standard; two other assurance engagement standards; two related service standards; and one quality control standard, which have also converged with the international standards and were thus recognized by the International Federation of Accountants.

20. **Accounting and auditing professions have grown considerably, though certain areas need improvements.** Over the past three decades, China's Certified Professional Accountant (CPA) industry has been growing steadily. Currently, there are more than 6,800 accounting firms registered in China, with more than 92,000 CPAs in practice. In accordance with *the Law of the People's Republic of China on Certificated Public Accountants*, the MoF is responsible for regulating the accounting and auditing professions, with the regulatory responsibilities including qualification review and approval, professional performance supervision, and overseeing the activities of relevant industry associations. In the period January to October 2010, the MoF and the provincial finance departments conducted examinations on the professional performance of about 1000 accounting firms, and took enforcement actions against those found in violation of related rules.

21. **Coverage of bank audits is adequate as the CBRC requires banks with total assets exceeding RMB 1 billion to receive financial statement audits; however, some weaknesses exist.** In particular, while most of the major banks and listed companies are audited by the Big Four accounting firms, many smaller and medium sized banks and companies are audited by smaller accounting firms. Both the World Bank Report on Observance of Standards and Codes (ROSC) report and market participants interviewed by assessors have cited that the audit quality of smaller accounting firms needs improvements. The credibility of the audit profession would be enhanced if the authorities develop a standard auditor independence regulation and increase their oversight of the profession by performing regular and more frequent review of accounting firms' audit quality.

22. **Internal control attestation requirements will continue to enhance the robustness of banks' internal control system.** Currently, the CBRC encourages publicly listed banks to disclose their results of self assessments of internal control systems. *The Basic Standard for Enterprise Internal Controls*, which requires public companies (including banks) to assess the adequacy of their internal control systems and their external auditors to opine on the adequacy of their assessments, came into force on July 1, 2009 while the *Implementing Guidelines for Enterprise Internal Controls* are to be phased in for listed companies from January 1, 2011. The focus of this new standard extends beyond internal controls over financial reporting and includes other aspects of internal controls. While implementation of this standard appears to be a daunting task for publicly listed banks, the robustness of their internal control systems will likely be enhanced.

23. **In recent years, the PBC has carried out a major reform of the National Payment System (NPS), by launching the China National Advanced Payment System (CNAPS).** The CNAPS consists of the High Value Payment System (HVPS) and the Bulk Electronic Payment System. The HVPS is a real time gross settlement systems and mainly used for large value transfers. It is used to provide fast, efficient, secure and reliable payment clearing services to banking institutions, private and public entities and financial markets. Currently the system has more than 1600 direct participants. In 2009, the HVPS processed 248 million transactions amounting to RMB 804 trillion.

24. **China is also evolving to a more intensive use of non-cash payment instruments, especially cards.** The relationship of cash (M0) to GDP has been declining since the beginning of the 2000 from a level of 16.1 percent of GDP in 2001 to 11.4 percent in 2009.

Cards issuance has been increasing at a high pace and approximately 2.1 billion cards had been issued at end 2009, of which 1.88 billion were debit cards. The card industry estimates that—at a minimum—600 million Chinese possess at least one payment card. Bank cards have therefore become the primary non-cash payment instruments in China accounting for over 90 percent on the total non-cash volume in 2009. The PBC is working on a number of projects to further improve the safety and efficiency of the NPS. They include: the launch of a “second generation” version of the CNAPS; a reform of key aspects of the legal and regulatory framework; initiatives to further increase the penetration of retail payment services, in particular in rural areas.

25. **China does not have an explicit public safety net in the form of deposit insurance.** The central bank has authority to make lender of last resort loans to banks. Given the high level of government ownership of banks, there may be a public perception that the State would stand behind all depositors in the case of a closure.

26. **China is considering introducing explicit deposit insurance arrangements.** It will be important as it does so that it carefully consider the roles of the various organizations in a resolution and not dilute the responsibility and accountability of the bank regulator for determining whether a bank is solvent and viable. Nor should it dilute the responsibility and accountability of CBRC for ongoing regulation and supervision of banks. There also is the issue of whether the public perceives introduction of explicit deposit insurance (presumably with a cap on coverage) as increasing or decreasing protection from what the public perceives protection to be currently. The impact on the marketplace, and competitive position of different banks, can be affected by these perceptions.

27. **There have been restructurings of several banks with serious financial difficulties. These have tended to involve “whole bank,” going concern solutions whereby another bank has been convinced to take over the assets and liabilities of the problem institution (or at least the deposit liabilities).** There is no explicit resolution framework for such eventualities but the authorities have demonstrated the ability to achieve such solutions using the existing bankruptcy and other laws. There are several aspects of the bankruptcy laws that deserve consideration in order to increase systemic protection and reduce contagion risk in the event of bank failures. The first is that intra-day positions in the clearing and settlement system can be unwound in bankruptcy. The second is that netting and close-out of eligible financial contracts (certain derivatives contracts) between counterparties is not protected in bankruptcy, as it is in many other countries. This increases the chance of knock-on effects in the case of failures and increases risk for banks. The authorities should consider whether a separate insolvency regime for banks may serve them better especially given the increasing internationalization of the large banks and the current global focus on developing more compatible cross-border resolution frameworks.

E. Main Findings

Objectives, independence, powers, transparency, and cooperation (CP 1)

28. **The objectives and responsibilities of authorities involved in banking supervision are clear.** CBRC’s mandate has enabled it to focus on a single mission of safety and

soundness and that has helped it become a high-quality organization. Using this mandate, CBRC has been very successful in articulating to banks and the public the need to achieve both safety and soundness and the needs for economic and social progress through the banking system. Indeed, safety and soundness contributes to development goals. CBRC has pushed for high-quality risk management by banks as part of their delivering on economic and social objectives. Following its mandate, and as a result of observed or potential deficiencies in risk management practices, CBRC has recently introduced a range of prudential measures, including more stringent credit risk management of loans to local government platforms and real estate lending. It has also successfully pushed banks to hold more capital and more provisions in the face of rapid loan growth as part of the stimulus package.

29. **The potential conflict between safety and soundness objectives and other objectives exists in many countries but can be more acute in China because of the predominant use of the banking system, much of which is state owned, to achieve economic and social goals.** The 12th plan for the financial sector being developed as part of the 12th five year economic plan under the State Council for the NPC should reinforce the importance of safety and soundness and CBRC's early intervention to resolve potential problems before they become serious. It should also make a priority for continued improvement in banks' risk management with a focus on assuring all banks, not only the most advanced, make needed improvements and ensure that improvements already made are well entrenched in their operations. The importance of safety and soundness and high quality risk management to economic and social objectives should be explicitly recognized by the authorities. Current CBRC leadership has played a key role in promoting prudential goals and dealing with issues of possible conflict of safety and soundness objectives with national economic policies. It will be important to continue this.

30. **The arrangements for resourcing in CBRC leads to potential independence issues, and hampers effectiveness, particularly as banks become more complex and innovative, and expand abroad.** So does the potential ability for the State Council to override CBRC rules, though this has never been exercised. The CBRC law mandates it to take decisions free from interference from any party, and CBRC reports that no interference has occurred since its creation. However the existing arrangements could be problematic in future. The laws, rules and guidance that CBRC operates under generally establish a benchmark of prudential standards that is of high quality and was drawn extensively from international standards and the BCP themselves.

31. **However, much of the guidance is relatively new and the issues raised in assessment of various CPs are often ones of better implementation.** In many ways, the strength of CBRC's regulation to date lies in the deliberately simple, conservative approach it has taken, often relying on specific prudential ratios that banks must meet. This is true for liquidity and for capital adequacy, for example. The challenge going forward is that this approach, by itself, will not be sufficient as markets and banks evolve. CBRC is well governed within the constraints it faces and has steadily and materially increased its transparency. There is need for: more forward resource planning; an urgent government-supported strategy for material upgrading of skills especially specialist skills; and more

flexibility in budgeting and pay to support this strategy and attract and retain talent. CBRC's performance reporting has greatly improved but more is possible.

32. **The legal framework for banking supervision has been revised to incorporate legislation, guidelines and rules (which all have legal standing) based on international standards.** CBRC has authority to take a wide range of corrective and remedial actions, and is clearly willing to use them. CBRC staff is legally protected from the consequences of acts committed in good faith. CBRC also has the legal authority to share information with other regulators, domestically and internationally and does so through networks of Memorandum of Understanding (MOUs).

Licensing and structure (CPs 2–5)

33. **China defines the permissible activities of banks and operates an extensive licensing and approval process for banks.** Considerable staff is involved in approving new institutions, new branches or sub-branches of existing institutions, new products, as well as changes in ownership. Fit and proper criteria apply to board and senior management, but also extend to many other positions in a bank. The use of the name 'bank' is properly controlled and shell banks are not permitted. Minimum capital requirements to start a new bank depend on the type of bank and are in line with or higher than international norms.

34. **CBRC implements an appropriate approval process for changes in ownership and major acquisitions.** However, the Chinese system is evolving from a system of state ownership to more private ownership, opening up the possibility of more complex ownership structures for banks. In this context CBRC legal authority could impede their ability to review beneficial owners or indirect changes of control. They report that they do usually get information on beneficial/indirect owners through the direct acquirer or through other indirect means. The assessment team is not aware of instances where supervision effectiveness has been compromised because of this issue but this legal authority should be bolstered. Other CBRC rules that also involve potentially-more complex bank ownership structures (e.g., related party rules) should also be reviewed to ensure that such structures are clearly covered by the rules. Investments by banks, including in overseas branches, require approval as part of the general approval system. While banks are generally prohibited from investing in nonbank activities, in the recent past exceptions have been permitted for investment in financial leasing and asset management. Bank-insurance and bank-fund management company investments have not been allowed until recently, when four cross-ownership pilots are in process. In those cases CBRC imposes firewalls between the banks and the other entity. Among other considerations, there are also explicit provisions that these pilots must earn at least average industry returns or they are to be dissolved.

Prudential regulation and requirements (CPs 6–18)

35. **The capital adequacy rules are based on Basel I. Basel II is being introduced over the 2011–2013 period for 6 banks who must adopt it on a mandatory basis.** Some other banks have also decided to adopt it on a voluntary basis. Basel II was not formally assessed as it was not in place at the time of the mission. The choices China has made in implementing Basel I have generally been conservative, and result in Chinese banks

uniformly having capital ratios above the Basel minimum. Banks' capital is composed primarily (approximately three-quarters) of high-quality core capital. The minimum required capital is 8 percent. Recent measures have raised expected capital ratios above the Basel minimum to 11.5 percent for the five major banks and 10 percent for all other banks, as part of a move to counter-cyclical buffers. How these buffers will work in a counter-cyclical way has not been specified. CBRC needs to review and communicate what its ongoing expectations are for banks to hold capital above the minimum and the criteria it will use to decide how to alter the buffer. There are a few aspects of the rules that are less conservative than the Basel I provisions, that should be reviewed.

36. Risk management is evolving in Chinese banks. CBRC has played a major role in the significant and impressive improvements that have occurred. Less than fully compliant ratings in certain areas in this assessment generally reflect deficiencies in the legal framework, which can be amended, or that banks have yet to fully implement CBRC guidance. CBRC itself is performing excellently in a challenging and fast-changing environment. It is on the right track with its reform agenda and needs to persevere in a sustained way in its current direction. It will need the full support of all other parties in the government to succeed in the goals it has set for itself. Most major banks have developed risk management systems for each of the major individual risks they face, though improvements are required in certain cases. CBRC guidance is generally of high quality and was often developed directly from Basel documents. Framework guidance in some risk areas is relatively new, with some being issued as recently as the last half of 2009. A period of settling in is required for effectiveness to be enhanced, for those banks who are not the most advanced to catch up, and for CBRC to ensure that all banks have risk management systems commensurate with the risks they are assuming.

37. The new risk governance, risk measurement and risk management systems have not been tested under stress and some areas for material improvement are clearly evident. Board-approved strategies are often too focused on target loan growth in various sectors and not enough on targeted risk measures linked to the bank's own risk systems, as opposed to regulatory requirements. Comprehensive, enterprise-wide risk management that takes account of interactions between risks in measuring, managing and stress testing, and that relates capital to risk is at an early stage in some banks, including some major banks. For many banks the priority is not to move to this stage quickly, but rather to ensure that a sound risk management framework is fully in place, imbedded in their culture and group-wide operations, and sustainable. While much of banking in China is deposit taking and lending, major Chinese banks are some of the largest in the world, and the Chinese lending market is complex by virtue of its scope and diversity, and banks are getting into new areas of lending and other activities. So risk management needs to be commensurate with these realities.

38. Credit risk is the most important risk facing Chinese banks and will remain so for some time. It has received the most focus by banks and CBRC and is generally well controlled. However there is intense focus on NPL experience by banks, policy makers and by a considerable part of CBRC staff. This is understandable given the serious bad-loan experience in the early part of the decade. But this almost sole focus sometimes is at the expense of attention to other early, forward-looking measures of credit risk that need to be responded to. Senior leadership in CBRC and some banks understand the need for forward-

looking judgment but assessors sensed that this message has yet to flow fully through their organizations. The rules and practice for problem assets, provisioning for listed banks are otherwise adequate. They are based on IFRS-equivalent accounting rules and regulatory requirements for classifying loans. CBRC does regular, extensive and in-depth reviews of asset quality and replication of the provisioning system. Major audit firms audit the majority of listed banks. The regulatory system has encouraged additional provisions and requires further buffers to be held as part of firm's equity.

39. **Traded market risk in the Chinese banking system is low in aggregate and for major banks individually. This will likely increase as market liberalization occurs.** The exchange rate liberalization announced recently could increase foreign exchange (FX) risk for banks and their customers. Risk management tools, information technology (IT) and data infrastructure to support them are generally commensurate with the level of risk, though there are areas for improvement. However, sophistication will likely need to increase considerably in the near future. The move to Basel II will assist. Interest Rate Risk in the Banking Book (IRRBB) is a more-prevalent risk for a wide number of banks. This will also likely rise as further liberalization occurs. Tools need to move rapidly beyond the static gap analysis based on contractual maturities of assets and liabilities that many banks are now employing. CBRC could also enhance its outlier analysis for this risk. This affects more than just the listed banks, and the improvement does not require adoption of models.

40. **Operational risk has been a focus of banks for a number of years.** The two main operational risks have related to possible internal control breakdowns and fraud, and IT risk. These have received considerable focus at banks and they and other observers reported that such incidents have trended down significantly in recent years. The challenge now is to put in place more comprehensive frameworks to deal with all elements of operational risk relevant to individual banks, which has started. More bank business units should be doing regular risk and control self assessment (RCSA) and developing, monitoring and refining key operational risk indicators. Again, a move to complex Advanced Measurement Approaches (AMA) models for capital purposes is not required to make improvements.

Methods of ongoing banking supervision (CPs 19–21)

41. **Supervisory approaches are increasingly risk focused.** However, use of the CAMELS+ rating system and various other aspects of the supervisory methodology (including its newness in some respects) mean that supervisory assessments are not as forward looking as desirable. As well, heavy reliance on the few basic simple ratios, while appropriate, may discourage more judgment-based assessment of inherent risk and the quality of individual bank's risk management and governance. There is need to maintain the benefits of simple basic indicators while reinforcing banks complying with CBRC guidance which requires use of more sophisticated approaches than some banks are using. That would also encourage more of a risk culture in banks as well, rather than them relying excessively only on complying with regulatory requirements.

42. **More attention may need to be placed on mid-size and smaller banks to ensure that they upgrade their risk management and governance performance.** CBRC has all the necessary tools of on-site and off-site supervision. There is an extensive system to

capture frequent and periodic information from banks. However, disclosure by banks or CBRC of important safety and soundness information, such as capital and liquidity position is less than in a lot of other markets. This should be examined and improved.

Accounting and disclosure (CP 22)

43. **China has developed an accounting system that has substantially converged with the IFRS.** A recent World Bank study also commended China's effort though certain areas of improvements were identified. Continued attention will need to be given to the development of the private accounting and audit profession in China to ensure that financial statements are professionally prepared and audited. The CBRC should be empowered to reject and rescind the appointment of an external auditor who is deemed to be unfit to perform a reliable and independent audit.

Corrective and remedial powers of supervisors (CP 23)

44. **CBRC has the authority and demonstrated willingness to act to resolve problems.** Dealing with problem banks has been on the basis of going concern solutions. Capability to close institutions may need to be enhanced going forward.

Consolidated and cross-border banking supervision (CPs 24–25)

45. **Consolidated supervision of banks and their direct subsidiaries and branches on the mainland or offshore is of high quality.** However, existing laws may permit more complex structures where consolidated supervision may not be possible. On occasion, CBRC has used indirect and informal means to deal with the situation and bring about needed changes in structure. The mission's recommendations (CP 4) to amend laws to formally require CBRC approvals of ultimate beneficial ownership and indirect changes in control would also help address this issue. Reliance by one supervisor on the work of others in mixed corporate groups (bank/insurance/fund management /pilots) may not always work well in practice and has yet to be tested. In terms of home-host relationships, CBRC has a wide network of formal and informal arrangements and has used these effectively as both a home and host.

Table 1. China: Summary Compliance with the Basel Core Principles—Detailed Assessments

Core Principle	Grading	Comments
1. Objectives, independence, powers, transparency, and cooperation		
1.1 Responsibilities and objectives	C	CBRC has clear safety and soundness goals in legislation, but the authorities have recently also emphasized loan growth, particularly in certain sectors to assist development and macroeconomic recovery. The CBRC message of balancing this growth with prudence needs to be continuously emphasized. The 12 th plan for the financial sector being developed as part of the 12 th five year economic plan under the State Council for the NPC should reinforce the importance of safety and soundness. CBRC leadership should continue to emphasize that banks follow sound practices in implementing national economic policies.
1.2 Independence, accountability and transparency	MNC	Budgeting arrangements, external headcount approval requirements and authority (though not used to date) for State Council overrides of CBRC rules and decisions compromise CBRC effectiveness and could affect operational independence. CBRC needs to continuously upgrade its staff, including developing more specialist expertise to be effective in the emerging more complex, more innovative and more international environment. It needs government support for a targeted strategy to achieve this goal that will have to include more flexibility in budgeting and salaries and incentives to attract and retain the people it needs to supervise increasingly complex banks, and meet its other objectives. A more forward-looking approach to resource planning and greater transparency around performance measures is also desirable.
1.3 Legal framework	C	The legal framework for banking supervision has been revised to incorporate sound practices based on international standards. Some legal provisions (mentioned elsewhere) need strengthening and some overlaps clarified in the next round of amendments.
1.4 Legal powers	C	CBRC has been empowered to take a wide range of corrective and remedial actions to deal with non-compliance and imprudent actions by banks
1.5 Legal protection	C	CBRC staff is protected from the legal consequences of actions taken in good faith.
1.6 Cooperation	C	There exist a plethora of agreements and arrangements for sharing information and coordination between the domestic agencies but the Interagency Financial Coordination Meetings led by the State Council are viewed by many as being the most effective.

Core Principle	Grading	Comments
2. Permissible activities	C	The permissible activities of banks are well defined and the authorities lay particular emphasis on preventing unauthorized deposit taking. While banks are prohibited from undertaking nonbank activities, some pilots have been permitted to test the waters. Banks' transactions with trust companies, which manage individual and institutional wealth have increased significantly in recent times and are believed to reflect both a search for yield and a sale of loans to meet regulatory ratios.
3. Licensing criteria	C	The CBRC devotes significant resources to the licensing and approvals regime which is comprehensive and covers prior authorization for all activities, services and products.
4. Transfer of significant ownership	LC	CBRC is inhibited in its formal legal ability to identify the ultimate beneficial owner or controlling shareholder while approving transfers of significant ownership in banks and employs indirect and/or informal approaches towards this end.
5. Major acquisitions	C	More clarity to be provided on the criteria by which to judge major acquisitions of domestic banks by other domestic banks.
6. Capital adequacy	C	CBRC has adopted a generally conservative approach to implementing Basel I with few exceptions. There are expectations of banks holding capital above the Basel minimum with three quarters of capital required composed of core capital. CBRC's recent adoption of their expectation of a capital buffer as a counter-cyclical measure could be further articulated to be effective. There is a lack of a permanent well-understood cushion above minimum required capital. Implementation of Basel II is pushing major banks to further improve risk management but resources within CBRC for effective implementation on the current timetable may be strained.

Core Principle	Grading	Comments
7. Risk management process	MNC	<p>While much of banking in China is deposit taking and lending, major Chinese banks are some of the largest in the world, and the Chinese lending market is complex by virtue of its scope and diversity, and banks are getting into new areas of lending and other activities. So risk management needs to be commensurate with these realities. CBRC has put in place high-quality internationally-compliant guidance (some relatively recently). Banks have not yet fully complied, the gaps are material for some banks, and practice will likely take time to be in place. Major banks and mid-size banks have processes for management of credit/market/operational risks. However, true enterprise-wide risk approaches that integrate strategy setting, monitoring, management and stress testing in ways that consider interactions among risks are at an early stage in some banks, including some major ones. Guidance on some risks is recent and so could not be expected to be complied with as yet (e.g., comprehensive risk management, liquidity risk, reputation risk). A period of settling in is required for existing and newly-developed processes to be fully effective and be assessed by the supervisor.</p> <p>Processes for banks to relate the capital they hold to their risks are at an early stage in banks and the supervisor. For major banks this will be enhanced over time by the move to Basel II. Some further more-detailed guidance for smaller banks on relating capital to risk may be needed.</p>
8. Credit risk	LC	<p>This is the key risk in the Chinese banking system and will remain so for some time. Recent success in cleaning up banks portfolios is impressive. But credit risk is likely rising. CBRC guidance is appropriate. Credit risk management in many banks has improved greatly recently, and assessors saw many examples of excellent practices. However assessors saw clear evidence that the enhancements in governance related to credit risk and credit risk management is not fully embedded across all banks (and have not been tested under stress). Many banks appear to be relying more on the regulatory NPL ratios in setting credit strategies. CBRC has had to take a variety of action to push banks to improve underwriting and credit-risk management processes that would not have been necessary if bank risk management practices were more fully reliable.</p>

Core Principle	Grading	Comments
9. Problem assets, provisions, and reserves	C	Assessors spent considerable time reviewing this principle. Most banks follow relevant accounting principles in determining loan loss allowance and comply with regulatory minima set by CBRC. A lot of efforts are made by CBRC and auditors of major banks to ensure that provisioning meets accounting and regulatory requirements. Smaller banks appear to face challenges in following accounting principles relating to determining individual and collective impairment. Banks' ability to write off loans in a timely way has been negatively impacted by the strict -write-off criteria laid out by MoF.
10. Large exposure limits	LC	CBRC lays great emphasis on identifying large exposures through a dedicated off-site system. However, it should also consider developing a more comprehensive framework for assessing risk across connected/related-parties.
11. Exposure to related parties	LC	While a robust regime is prescribed for identifying related parties and requiring that transactions with them be undertaken at arm's length and be subject to limits, it does not take into account common ownership by local governments, which may be a risk factor for some banks owned by local governments.
12. Country and transfer risks	LC	Country and transfer risks are gaining in materiality for Chinese banks. While the major banks with the bulk of the exposure have systems in place, this is still work in progress for the others. CBRC has recently consolidated its supervisory expectations in this regard and is monitoring progress in implementation.
13. Market risks	C	The extent and complexity of market risk is low given market structure and absence of approval for complex products, and banks strategies being more client-driven than proprietary. While existing risk management approaches are reasonable for the current environment, there are weaknesses in execution and a material upgrade will be needed if any further interest rate or exchange rate liberalization occurs or if banks adopt more aggressive strategies.
14. Liquidity risk	C	Use of simple regulatory rules such as maximum loan/deposit ratio and minimum current assets ratio, as well as reserve requirements, mean banks are highly liquid. Banks should be encouraged to adopt more sophisticated liquidity risk management methods to prepare for further market liberalization.

Core Principle	Grading	Comments
15. Operational risk	LC	Banks and the supervisor have considerable history of detailed high-quality internal control processes (focused on reducing fraud) and attention to IT risks. The current challenge is to move beyond that to a more-complete measurement and management of operational risk. Progress is occurring but this varies across larger banks. Guidance that covers all elements of the CP is recent and upgrading of specialist skills in CBRC will be required. Practice of banks doing RCSA across businesses or developing key risk indicators (KRI) for various business lines needs further development.
16. Interest rate risk in the banking book	LC	This is a risk that is meaningful for a wide variety of banks of all sizes. The need for active management will likely grow as and when further interest rate liberalizations occurs. Currently many banks are using static gap analysis based on contractual maturities to measure and manage this risk. It is desirable to move to more dynamic analysis based on projected cash flows, non-parallel shifts in interest rates and incorporating assumptions about how the behavior of various categories of assets and liabilities might be affected in these scenarios. There is room for CBRC to enhance its analysis of possible outliers.
17. Internal control and audit	C	Internal control awareness has been heightened and the CBRC has strong supervisory focus in this area. Publicly listed banks will face the challenge of implementing “C-SOX” which requires external auditors to opine on the adequacy of their self assessments of internal controls.
18. Abuse of financial services	LC	The supervisory responsibilities for addressing the abuse of financial services in (and by) banks are divided between the PBC and the CBRC. There are opportunities for improving cooperation and information sharing between the two as they carry out this shared responsibility. CBRC is making material strides in dealing with fraudulent practices in banks but some work remains to be done. A few Anti-Money Laundering (AML) related recommendations relevant for banks as identified in the 2006 Financial Action Task Force (FATF) assessment are to be addressed.
19. Supervisory approach	C	While the supervisory approaches are increasingly risk-focused and incorporate good practices, supervisors should consider focusing on incorporating more examiner judgment in ratings and lessen reliance on quantitative formulaic approaches.

Core Principle	Grading	Comments
20. Supervisory techniques	C	To further the risk based approaches in place, CBRC should reconsider its focus on examination of branches which are largely compliance focused. Resources could then be allocated to other higher priority supervisory activities.
21. Supervisory reporting	C	There is an extensive system to capture frequent and periodic information from banks and CBRC should consider making banks' quarterly financial information available to the public to foster greater transparency in the banking industry.
22. Accounting and disclosure	LC	The CBRC does not have the authority to reject or rescind the appointment of an external auditor who is deemed unfit to perform a reliable and independent audit. The October 2009 <i>World Bank Report on the ROSC—Accounting and Auditing</i> identifies weaknesses in the audit quality of the smaller and mid-sized accounting firms and the oversight of the accounting profession. The lack of published financial data on aggregate and individual bank data reduces the transparency of the banking system.
23. Corrective and remedial powers of supervisors	C	CBRC has the ability to act to take corrective action if prudential rules are not observed and data on enforcement actions suggest that it also has the willingness to act in this regard. Bank closing experience has been very limited though there have been large scale mergers as part of banking system consolidation in which CBRC has been involved.
24. Consolidated supervision	LC	Consolidated regulation and supervision of groups composed of banks and their mainland or offshore subsidiaries and branches is of high quality. Laws and rules permit more complex structures where CBRC would be challenged to meet the key elements of the principle. With cross ownership by banks of fund management companies and insurers (pilots exist) reliance on firewalls and institutional regulation by each regulator of their part of the group may not be sufficient.
25. Home-host relationships	C	CBRC has laid emphasis on developing and maintaining a wide network of formal and informal arrangements with overseas supervisory authorities and has used these effectively as both a home and a host. It has also launched a supervisory college for one large international bank and will shortly launch a second one.
<p><i>Aggregate:</i> Compliant (C) – #, Largely compliant (LC) – #, Materially noncompliant (MNC) – #, Noncompliant (NC) – #, Not applicable (N/A) – #</p>		

Table 2. China: Detailed Assessment of Compliance with the Basel Core Principles

<p>Principle 1.</p>	<p>Objectives, autonomy, powers, and resources. 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.</p>
<p>Principle 1(1).</p>	<p>Responsibilities and objectives. An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks.</p>
<p>Description</p>	<p>EC1: The authority, responsibilities and objectives of banking supervision in China are set out in <i>the Banking Supervision Law (Article 3)</i>. The objectives of banking regulation and supervision are “to ensure the safety and soundness of the banking industry and maintain public confidence in the banking industry. Toward these objectives, banking regulation and supervision shall promote fair competition in the banking industry and improve the competitiveness of the banking industry.” In discussion with the assessors, CBRC staff clearly demonstrated that they see safety and soundness as their primary responsibility.</p> <p>Articles in <i>the Banking Supervision Law (Chapter III)</i> provide for the CBRC’s responsibilities in the establishment of prudential rules and guidelines, licensing, on-site examinations and off-site surveillance (OSS). <i>The Commercial Bank Law</i> and <i>the Banking Supervision Law</i> are publicly available. The CBRC makes public its regulatory and supervisory objectives and activities through its official website and annual reports.</p> <p>The PBC has legal authority to inspect and supervise financial institutions with respect to such matters as reserve requirements, inter-bank borrowing, exchange control, settlement management and AML. The PBC also has the legal authority (<i>Law on the People’s Bank of China Article 33</i>) to request CBRC to perform certain supervisory tasks for financial stability, and the CBRC must respond to that request within 30 days. This article is intended to ensure that PBC works through CBRC in pursuing these objectives. Such requests have not occurred in practice.</p> <p>The CBRC objectives do not include an explicit objective for early intervention.</p> <p>However, CBRC is required by law to have an early warning system, has powers to intervene at an early stage to prevent bank capital falling below the minimum, and has taken a number of actions that were designed to intervene early to deal with emerging risks.</p> <p>In the Chinese system of government the policies of the State Council (some of which are approved by the National People’s Congress which also approves laws) play an important role in setting overall direction for various agencies. The 11th five year plan for economic and social development refers to <u>orderly</u> (emphasis added) development of the financial services sector and to <u>orderly</u> regulation. The 12th five year plan is expected to be released later in 2010. CBRC indicated to the assessment team that there would be an update of the national development plan for the financial sector in 2010, and it was under active discussion.</p> <p>In China there is a potential conflict between safety and soundness goals and other objectives. While that potential conflict exists in various countries, it is more acute in China because of the way policy direction is exercised, including the use by government of the banking system to achieve economic and social development objectives.</p>

The commercial banking law (Article 4) makes clear that commercial banks shall work under the principles of safety and efficiency, with full autonomy and assume sole responsibility for their own risks, profits and losses. Commercial banks are to carry out business in accordance with laws free from any interference by entities or individuals.

The commercial banking law also makes clear (Article 34) that commercial banks must carry out their loan business “upon the needs of national economy and the social development and under the guidance of the state industrial policies.”

National development goals do not always conflict with safety and soundness objectives. For example, building up small and medium sized enterprise portfolios which has been a national goal that CBRC has been promoting, can aid in diversifying loan portfolios of banks, if done with appropriate risk management and not just for the sake of growing the portfolio without regard to risk characteristics of the borrowers.

CBRC clearly sees that their objectives are also to support China’s economic and social development, provided it is done in a safe and sound manner. As indicated in CBRC’s 2009 annual report, released while the assessment team was in China, during 2009... “CBRC instructed all banks to take into account the macroeconomic adjustments in providing credit support for the real economy, while holding firmly to risk controls in the course of credit supply.”

In supporting national development goals, CBRC has consistently emphasized that safety and soundness goals should never be compromised.

The CBRC has participated, under the overall national development strategy of the State Council, and in concert with the PBC and other agencies, in various measures to enhance credit provision to various sectors such as SMEs or to promote development and access to financial services in under-served regions and rural areas.

CBRC has generally required in its guidance to banks that lending directed to achieving national economic and social goals be pursued in a safe and sound manner. In a number of cases it has put in place specific requirements to achieve this end.

Assessors discussed with senior CBRC management how the possible conflicts between this work and prudential supervision are managed. The balance between achieving national development goals and safety and soundness of the banking system are relevant for many countries, not just China. Various countries use different means to achieve this balance. What is important is that this balance works effectively.

CBRC believes that pursuit of economic and social goals depends on having a safe and sound banking system. CBRC experience is that there need not necessarily be a conflict between national development goals and prudent bank practices. CBRC has participated in various high-level policy discussions, including at the State Council level, and has issued guidance, to ensure that prudential goals are taken into account in implementing economic policies. What is important is that banks and CBRC react quickly to check imprudent practices that may result in certain cases. There are recent examples of CBRC acting, both in advance to ensure prudential goals were met in implementing national economic policies, and when it subsequently became clear that the appropriate balance might not be achieved.

CBRC staff also indicated to the assessors that having commercially-viable banks with sound and effective risk management systems is a necessary precursor to, and can assist in permitting further opening up of Chinese financial markets and expanding access to financial services.

	<p>On the other hand, they also indicated that they do not see an issue in CBRC endorsing (public) goals for banks having their small business lending grow at least as fast as the average for the bank's overall lending. And they expect national goals to be reflected in bank lending policies.</p> <p>EC2: The benchmark of minimum prudential standards is contained in laws, regulations, guidelines, supervisory guidance and notices. Laws are set by the National People's Congress (highest legislative body) and administrative regulations are set by the State Council (highest administrative body). The CBRC has delegated authority under various pieces of legislation to set administrative rules which have the force of law. CBRC guidance, and some notices fall into this category. <i>The Commercial Bank Law</i> contains various statutory requirements and limits which banks must comply with. Non-compliance is subject to various supervisory penalties ranging from fines to limitations on business expansion, to revoking of licenses.</p> <p>In many ways CBRC sees itself as having adopted simple basic useful approaches to regulation and supervision, using a limited number of key financial ratios that banks must meet. These include required ratios on liquidity and provisioning, simple conservative capital rules, limits on adopting complex businesses models and products, and firewalls between banks and certain affiliates. In part this was a view of the appropriate way to run regulation and supervision during a time of rapid development, and the best way to achieve prudential goals.</p> <p>Article 21 of <i>the Banking Supervision Law</i> provides that prudential rules and guidelines applied to banks may be stipulated in laws or administrative regulations, or formulated by the banking regulatory authority under the State Council (CBRC) in accordance with applicable laws and administrative regulations. Prudential rules and guidelines cover, among others, risk management, internal controls, capital adequacy, asset quality, loan loss provisioning, risk concentrations, connected transactions and liquidity management. By virtue of this arrangement they have the force of law.</p> <p>With its statutory rule-making powers vested under <i>the Banking Supervision Law</i>, the CBRC has developed a framework of rules and guidelines to ensure the safety and soundness of the banks in China. These rules and guidelines cover, among others, corporate governance, capital adequacy, credit risk management, market risk management, operational risk management, liquidity risk management, reputation risk management, compliance, internal controls, consolidated supervision, related party transactions, loan classification, lending to corporate groups, and stress testing. While the law has potential overlap between PBC's and CBRC's authority to inspect, this needs to be managed, and that has occurred to date.</p> <p>The high-level guidance is often taken from international best-practice Basel documents and from criteria in the BCP.</p> <p>This high-level guidance sometimes does not contain certain elements of international guidance but express general objectives. The missing elements are sometimes picked up in more detailed, non-public rating criteria for CBRC examiners. CBRC often issues multiple pieces of focused prescriptive topical, specific guidance during a year. In 2009, for example, there were over 25 material notices, rules and guidance issued.</p> <p>EC3: The Commercial Banking Law was enacted in 1995 and updated in 2003. The Banking Supervision Law was enacted in 2003 and updated in 2006. While there is no provision mandating regular assessment, the laws have been changed when necessary. The CBRC assesses and amends rules and guidelines on a regular basis in response to changes and developments in the banking and regulatory environment. The CBRC regulates its own rule-making process through <i>the CBRC Rule-making Provisions</i>, which states explicitly that the regulatory and supervisory rules formulated by the CBRC should be reviewed on a regular basis, and those becoming outdated should be amended or repealed in time to ensure relevance</p>
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	<p>and effectiveness. There are annual rule making plans and the policy and research department was recently established to enhance the policy function.</p> <p>EC4: Under the banking supervision law the CBRC requires banks to make publicly available information on their financial condition risk management practices and corporate governance within 4 months of their year-end. The CBRC also publishes on its web site current information (not historical or trend) on basic banking statistics. The CBRC annual report also provides comparative and trend analysis for certain key variables such as the number of banks meeting minimum CAR ratios and level and trend information on asset quality, such as the NPL ratio.</p> <p>Certain information that would normally be found in other jurisdictions can, however, be difficult to find. CBRC summary statistics do not cover important information on the capital adequacy position of banks (e.g., levels and trends of CAR, major components of capital and Risk-Weighted Assets (RWA), by type of bank). The degree of capital adequacy information disclosure by banks can vary materially. This is also the case with certain risk information— (e.g., there is no uniformity in disclosure of high-level IRRBB information. Some banks disclose the results of 25 bps shock, some 100, some 200 (see CP 21).</p> <p>AC1: In terms of determining supervising programs and allocating resources relative to risks <i>the Banking Supervision Law (Article 27)</i> provides that the CBRC shall establish a supervisory rating system and an early risk warning system, and based on the rating and risk profile of each individual bank, determine the frequency and scope of on-site examinations as well as other supervisory measures that may be deemed necessary.</p> <p><i>The CBRC Guidelines on Supervisory Rating of Commercial Banks</i> requires that supervisory ratings (CAMELS+) shall serve as the main determining factor for supervisory planning and allocating supervisory resources.</p> <p>The CBRC has designated chief supervisors for banks. Each chief supervisor of large and medium-size banks is responsible for one bank, while a portfolio approach is used for small banks. <i>The CBRC OSS Manual</i> explicitly requires off-site supervisors, in line with the risk-based principle, to formulate supervisory plans with a focus on major potential risks. <i>The Manual</i> also requires off-site supervisors to allocate supervisory resources (on-site and off-site) based on the risk profile and systemic importance of the banks under supervision. The CBRC establishes on-site examinations programs according to the results of OSS, setting up examination tasks and allocating resources in line with a risk-based supervisory approach. The Chief examiner is responsible for supervisory plans, risk assessment overall findings and ratings.</p> <p>In practice, a risk assessment is performed annually, by type of risk, on the level of risk inherent in a bank’s business (high, medium, low), and quality of a bank’s risk mitigants (strong, acceptable, weak). This risk assessment is an input into supervisory planning, along with other matters such as thematic or targeted reviews the CBRC decides to conduct each year.</p> <p>Assessors reviewed planning documents related to resource allocation and discussed this process with CBRC staff and front-line supervisors. CBRC indicated that in practice the resource levels are approximately the same between major banks. Risk considerations appear to be more important in affecting the choice of what on-site work to perform in any year. For example in 2009/2010 more resources were put into on-site review of lending to local government financing platforms and somewhat less into other areas of credit risk or to market and operational risks. For smaller banks risk assessments do seem to affect more the allocation of resources between banks in a year.</p>
Assessment	Compliant
Comments	Assessors sensed that the clarity of CBRC’s objectives has been an important factor in its

	<p>achievements. It will be essential to continue to look for every opportunity of reinforcing the importance of those objectives internally and with the public at large. Current CBRC leadership has played a key role in promoting prudential goals and dealing with issues of possible conflict of safety and soundness objectives with national economic policies. It will be important to continue this. The updated five year plan being prepared by the State Council for approval of the National People’s Congress, provides an opportunity for high-level reinforcement of those goals.</p> <p>Some aspects of goal setting by policy makers and CBRC can encourage an approach to lending by banks that is more based on loan growth targeting. Assessors saw a number of examples of this culture in operation. Clear emphasis by the State Council, in support of CBRC, on strengthening the risk management culture in banks is essential to lessen the chance of cyclical boom-bust behavior of the banking system.</p> <p>As with other supervisors, CBRC will need to find ways to reinforce understanding among policy makers and the general public that its safety and soundness mandate contributes to general economic and social goals. As China considers introducing deposit insurance, it will be important not to dilute the safety and soundness focus of CBRC, nor set up a system with material overlap and duplication of risk assessment and supervision. That would risk compromising clarity of CBRC’s mandate, which is a key driver of its success and its conformity with international standards.</p> <p>While there is a comprehensive framework of laws and regulations and guidelines that provide a high-quality minimum benchmark, the framework is often expressed at a high level. High level criteria for what is a “sound” credit risk system, for example, are not contained or not complete in guidance. The general guidance is then supplemented by a quite detailed periodic guidance dealing with specific topical issues. Some of this is clearly reactive. These can be quite numerous in a year. As a result, expectations of banks and supervisors may not be as clear as they could be with negative consequences for banks’ compliance. That may also mean that banks approach guidance more as a compliance matter than as an aid in developing their own risk management capabilities. Assessors saw evidence of that attitude among banks. And, it could be a challenge for the CBRC being satisfied that its supervision staff is operating as desired in their assessments and interventions. The CBRC should consider adding more high-level criteria as it amends guidance in future.</p> <p>While information about the financial strength and performance of industry is provided in the CBRC annual report, this could be materially enhanced, and be readily available in usable form as other leading supervisors have done (see recommendations in CP 21).</p> <p>While a risk assessment by type of risk and quality of a bank’s risk mitigants is an input into supervisory planning, this link appeared weak in the examples reviewed by assessors. As the CAMELS+ rating is often backward looking in practice, its use in determining supervisory frequency should be reconsidered (see CP 20).</p>
Principle 1(2).	Independence, accountability and transparency. Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties.
Description	<p>EC1: CBRC is an institution (a commission) directly under the State Council (the highest executive organ of State power, as well as the highest organ of State administration). The Chair of the CBRC is a Minister, and attends the State Council for discussion of all economic and financial matters.</p> <p>The law provides that the CBRC and its staff are protected by law while performing supervisory responsibilities in accordance with laws and regulations; and that there should be no interference by local governments, government departments at various levels, public organizations or individuals—see <i>the Banking Supervision Law (Article 5)</i>. CBRC reports no issues of interference by State Council in supervisory decisions. As is other countries, CBRC</p>

	<p>seeks input from other state entities before implementing certain new policies and rules.</p> <p>Under the Chinese constitution the State Council has the authority to alter or annul “inappropriate” orders, directives and regulations issued by the ministries or commissions. It also has the authority to lay down the tasks and responsibilities of the commissions and has general high-level authority to issue decisions and directions to ministers and commissions. Presumably, these authorities could be used with respect to CBRC operations, though that has not occurred.</p> <p>The legislation law sets out the hierarchy of legislation, regulations and rules, and also indicates the circumstances in which administrative regulations or rules can be altered or annulled. (<i>Legislation Law, Articles 78, 79, and 87</i>). This includes the circumstances normally contemplated in many countries where regulations or rules exceed a bodies’ legislative authority, where lower-level legislation contravenes higher-level legislation, or where there are inconsistencies in rules governing the same matter. However, it also includes circumstances “where the provisions of administrative rules (such as those CBRC sets) are considered inappropriate” (<i>Article 87 Legislation law</i>).</p> <p>Article 12 of the banking supervision law also provides that the CBRC shall make public its supervisory process and procedures, and put in place a supervisory accountability system and an internal compliance monitoring mechanism. Article 14 provides that the CBRC shall be subject to the oversight by relevant government agencies such as the NAO and Ministry of Supervision under the State Council.</p> <p>The State Council and government agencies under it do not interfere with the daily operations of the CBRC. The CBRC has the legal authority to promulgate and implement supervisory rules and guidelines independently.</p> <p>Assessors discussed with the CBRC the role of various government authorities and the CBRC interaction with them.</p> <p>The CBRC headquarters directly governs its provincial offices, which in turn manage the CBRC’s offices at city levels throughout China. Assessors discussed the internal CBRC governance structure and monitoring process. There is a well-developed process for assessing groups and divisions in the regions and regional offices. This system appears to be based more on compliance with CBRC policies and with the number of supervisory penalties imposed and the speed of clearing them, than on assessment of the quality of supervisory risk assessments.</p> <p><i>Accountability</i>—The CBRC reports to the State Council and regularly answers to inquiries from the National People’s Congress, and operates under the oversight of the NAO and Ministry of Supervision under the State Council. The NAO review is an assessment of financial controls. The NAO officials who assessors met viewed the CBRC as having high-quality controls and internal management.</p> <p><i>Governance structure</i> – In addition to the Chairman, the State Council also appoints the five Vice Chairmen, with input from the Chairman. The governance of the CBRC emphasizes effective decision-making as well as checks and balances. Responsibilities and authorization are clearly defined among the top management of the CBRC. Reporting lines and decision-making mechanisms for regulatory and supervisory work are clearly defined; major regulatory initiatives and supervisory issues are thoroughly discussed and decided at the Chairman’s Meeting attended by the top management and department heads.</p> <p>The head of the CBRC is appointed for a five year term specified in legislation (renewable once). Reasons for removal are specified in law (<i>Public Servant Law Article 102</i>). The law does not require public disclosure of the reasons for dismissal, but State Council orders applying to all senior officials do include requirements for disclosure of reasons for dismissal.</p>
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EC2: CBRC makes public its regulatory objectives, principles, measures, as well as regulatory standards via its website and annual reports. It also regularly discloses major regulatory initiatives and supervisory actions through the same channels. The transparency of the CBRC through its annual reports and other means, has improved continuously over the past few years. The CBRC annual report, which is generally of high quality, has limited disclosure of performance measures related to CBRC activities. It does not include information on CBRC budget or resources. Nor does it have much forward looking information on strategic priorities. Budgeting is done on a one-year forward basis. The CBRC does not have a multi-year strategic plan.

EC3: Article 9 of *the Banking Supervision Law* provides that the supervisory staff of the CBRC shall have the professional skills and work experience as required for performing their duties. Article 10 provides that the staff of the CBRC shall perform their duties with integrity and in accordance with laws and regulations, and shall be prohibited from taking advantage of their positions to seek inappropriate gains, or concurrently holding any position in any bank. The CBRC has an internal ethics code.

The quality and credibility of the CBRC staff are ensured through:

- transparent and open recruitment and promotion policies and processes, where entry and senior level staff are recruited through a rigorous examination process and staff are promoted through a competitive process;
- ongoing training for staff to enhance skills and performance;
- seconding staff to both domestic and foreign banks; and
- an effectively enforced internal *Code of Conduct*, which requires that the CBRC staff shall not, among others, interfere with banks' employment or procurement decisions unless out of supervisory concern, accept gratuities of any kind from banks that they examine, own stock in any CBRC regulated entity, have close relatives working at entities under their direct supervision, etc.

Where deficiencies are identified in terms of integrity and credibility of the CBRC staff, the CBRC requires the relevant staff or functional departments/local offices to take corrective measures. Industry is asked to evaluate CBRC branch offices annually, and this (once verified) is an input into their assessment.

CBRC staff that assessors met displayed high professionalism. Banks that assessors met noted the remarkable increase in professionalism since CBRC's creation and were uniformly highly positive about the abilities of CBRC staff.

EC4: In terms of financing The CBRC is funded by the MoF, according to *the Provisional Regulations Governing the Financial Management of the CBRC, the CSRC and the China Insurance Regulatory Commission (CIRC)*. The MoF collects supervisory fees from banking institutions. The CBRC's funding is subject to the governmental budget process applying to all agencies.

The institutional supervision fee is charged in two components, one a percentage of the paid-up capital of each banking institution at the end of the previous year and the other a percent of assets. As per MoF requirements, the specified percentage for the asset-based part of the fee declines by approximately 10 percent a year, which is a partial offset to the growth in fees due to growth in assets. In 2009 fees collected were RMB 6.34 billion. CBRC's budget allocation is some RMB 5.29 billion in 2009. It has grown by some 9 percent over the 2006–2009 period, while the assets of the banking system have grown by 79 percent. MoF also approves the budget for specific categories of CBRC expenditure, in particular for on-site supervisory budget. A separate agency under the State Council approves CBRC headcount, including minor headcount changes during the year resulting from reorganizations. The MoF-approved on-site supervision expenditure increases by a small amount each year to cover expected staff

	<p>increases. Like the other agencies, CBRC budget request has been regularly cut back by authorities.</p> <p>As of 2009 CBRC had some 23,900 staff in headquarters and 36 regional offices. Between 2006 and 2009 the number of on-site staff has increased by 2.8 percent to 9,580. The number of off-site supervisory staff is some 5,920, and has increased by 10.8 percent over the 2006–2009 period. Of these, the number of offsite staff for large banks has remained constant.</p> <p>On-site staff operates in a pool system. There has not been an explicit allocation of additional staff to implement Basel II.</p> <p>Since its establishment, the CBRC believes it has been able to attract qualified staff for effective supervision and oversight. Among them, 90 percent have a college degree or above; 10 percent hold a master degree or above. In recent years, the CBRC has been able to recruit a significant number of staff with overseas educational and work experience in the financial industry.</p> <p>In terms of resources, the CBRC reports that efficiency and quality of the staff have improved substantially in recent years due to continuous recruiting and development efforts. Efficiency of supervisory work is also enhanced through greater use of IT. However, the size of China’s banking industry has almost tripled in terms of assets since the establishment of the CBRC and the industry environment has become increasingly complex.</p> <p>Headcount constraints on government agencies have become an obstacle for the CBRC in increasing regulatory resources to deal with a rapidly increasing supervisory workload and budget and pay constraints hinder their ability to build and attract necessary expertise and specialist skills.</p> <p>CBRC does not have an explicit specialist support group with expert staff for each of the major risk categories (credit, market operational, liquidity). There are some 10 market risk specialists in the innovation division who are available to supervision staff (as well as for policy and other work), and the on-site division reported to the mission that it had some 40 staff for large banks with market risk experience (divided into three levels of expertise).</p> <p>A large bank off-site supervision team would have approximately 30–40 members in both head office and in relevant regions. Certain Chief examiners the mission met estimated that on-site resources for such a bank from the on-site pool could be approximately 500–600 FTE. For a medium-size, joint stock bank the off-site staff would be some 3–4 and the on-site staff some 20–30.</p> <p>Compared with other government agencies, the salary level at the CBRC is slightly above-average. The prestige of working at the CBRC and a strong culture of meritocracy serve as important sources of attraction for recruiting and retaining qualified supervisory staff. But it can be multiples lower than private sector opportunities in China.</p> <p>The turnover rate at the CBRC has increased in recent years due to slow increases in salary levels relative to the banking industry. The challenge of recruiting, developing and retaining high-quality front-line staff has increased in the face of a fast changing industry environment.</p> <p>The CBRC reported it has the ability to and is financially capable of commissioning outside experts and consultants when and where needed, to assist in regulation and supervision under necessary confidentiality arrangements.</p> <p>Sufficient resources are available for staff training. The CBRC has an internal Training Department that is responsible for career-long professional development for the CBRC staff. The Training Department organizes extensive training programs for staff in different areas,</p>
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	<p>including on-site examinations, OSS, policy research and analysis, administration, various specialist expertise training, according to the annual training plan.</p> <p>AC1: The head of the CBRC is appointed for a minimum five year term.</p>
Assessment	Materially Non-Compliant
Comments	<p>The accountability and budget arrangements, and the outside control on CBRC headcount, could compromise the independence of the CBRC. Other more-detailed matters such as the CBRC having to recommend to MoF to remove unsatisfactory bank auditors rather than being able to do so itself, are also a concern from an independence perspective (see CP 23). Recently, CBRC has demonstrated very high levels of independence in fact, in its response to challenges in the Chinese banking system. CBRC leadership report wide support from government. Industry has been supportive of the overall CBRC and government approach to emphasize safety and soundness. They see that approach as benefiting them compared to experience in some other countries.</p> <p>CBRC has clearly been very effective in building a high-performance organization and disseminating the desired transformation throughout the organization. This is serving the CBRC well in meeting its mission. However achieving that that mission will likely be an increasing challenge. Complexity is rising, as may be the risks in a range of institutions. There will be a need for more assessments of the quality of banks' risk control systems which may require increasingly-complex judgments and may require staff to develop different skills. Basel II implementation will require additional expertise. Material assessors reviewed suggest that consistency of risk assessment and intervention may need to be enhanced (see CP 20). The assessors believe that specialist expertise of CBRC needs to be enhanced. The constraints on the CBRC budget and detailed headcount control are major issues that need to be resolved. CBRC needs a strategic plan, supported by State Council to build expertise. This will require flexibility by the State Council regarding the CBRC budget and more flexibility in pay/incentive arrangements in order to attract and retain people with expertise.</p> <p>The potential for the State Council to override certain CBRC rules or decisions adds to independence concerns. In addition the requirement to disclose reasons for dismissal of CBRC leadership is not contained in legislation but in an interim rule on tenure of senior government officials promulgated by the State Council.</p> <p>CBRC might also adopt internally a more-forward-looking approach to resource planning that goes beyond a one-year forecast. That might help it identify major upcoming challenges and plan better for them.</p> <p>There is opportunity to enhance public information on CBRC resourcing and budgeting, medium-term priorities and performance reporting, which is weak compared to other leading international regulators. In light of Basel II implementation, and the increasing complexity of banks, CBRC should develop a plan for further building expertise.</p>
Principle 1(3).	Legal framework. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their ongoing supervision.
Description	<p>EC1: The CBRC supervises the banking sector and derives its authority for this purpose from the <i>Law of the People's Republic of China on Banking Regulation and Supervision</i> (Banking Supervision Law) which was promulgated in 2003 and came into force on February 2004. The <i>Law of the People's Republic of China on Commercial Banks</i> (Commercial Bank Law), which was adopted in 1995 and amended in 2003, sets out the framework for the conduct of banking and includes in its objectives the strengthening of supervision and management and thus ensuring the sound and stable operations of commercial banks.</p> <p>CBRC is the licensing authority for all commercial banks, policy banks and urban and rural credit cooperatives. In addition, CBRC also licenses those nonbank institutions that are supervised as commercial banks under the Banking Supervision Law (Article 2) i.e., AMC,</p>

	<p>trust companies, finance companies and financial leasing companies. The legal authority for licensing is drawn from the Banking Supervision Law (Article 16) which provides that the banking regulatory authority under the State Council will authorize the establishment, changes, termination and scope of business of banking institutions. The scope of licensing extends to the establishment of branches and to changes in the scope of business. Article 39 empowers CBRC to close institutions in cases of violation of law, committing of unsafe and unsound practices and thus threatening financial order and public interest.</p> <p>EC2: There are three levels of legal instruments applicable to banking business. Laws, such as the <i>Banking Supervision Law</i> and the <i>Commercial Banking Law</i> are enacted by the National People's Congress and its Standing Committee. Administrative regulations, such as Foreign Bank Regulations are promulgated by the State Council in accordance with the law. At the lowest level are the supervisory rules and guidelines which are promulgated by the CBRC. While rules carry specific legal provisions to address violations, non-observance of the guidance results in supervisory demands for corrective action. In recent period, CBRC has issued prudential rules and guidelines on corporate governance, capital adequacy, stress testing, operational risk management, compensation etc. A conscious attempt has been made to benchmark much of the provisions in the guidance to the BCP, while retaining some perspectives on issues more relevant in the Chinese context.</p> <p>In addition to these, CBRC on occasion also uses, with effect, the issue of 'supervisory notices' which are used to convey supervisory expectations and appear to carry the power of moral suasion rather than legal authority. The recently enhanced requirements for capital and provisioning buffers were conveyed by such notices, which annexed a speech by the Chairman laying out CBRC expectations in this regard.</p> <p>CBRC solicits comments from industry on important introductions and changes in regulations through written submissions and consultation meetings. Some rules and guidelines are also consulted more widely with the public and comments are sought on drafts which are made available on the CBRC website.</p> <p>There is an industry association with 130 plus members, but this currently sees itself more as a forum to primarily facilitate implementation of CBRC rules among members.</p> <p>EC3: The Banking Supervision Law (Article 33) empowers the CBRC to obtain required information from banks, including financial statement data, financial and statistical reports and other information concerning their business and management, as well as audit reports prepared by external auditors. This authority is also contained in the Commercial Bank Law (Article 61) which requires commercial banks to report this data to the CBRC. The CBRC has a regular schedule of periodic off-site returns through which it obtains comprehensive data from banks. It has also done so on ad-hoc basis as and when required.</p>
Assessment	Compliant
Comments	<p>The legal framework for banking supervision has been considerably strengthened with the promulgation of the Banking Supervision Law in 2003 to specifically incorporate good practice provisions, including from the BCP. However, there are some areas of overlap and omission between the various laws that may provide scope for inconsistent interpretation. At the time of the next round of amendments, it would be useful to take a comprehensive look at the laws together and provide for a more coherent framework.</p> <p>In recent times, CBRC has consulted extensively with the industry (and on occasion with the public) and is responsive to incorporating the comments received. For public comments, it could consider further strengthening this good practice by providing some feedback on the comments received and how they have been dealt with.</p>
Principle 1(4).	Legal powers. A suitable legal framework for banking supervision is also necessary, including powers to address compliance with laws as well as safety and soundness concerns.
Description	EC1, 3: The Law provides CBRC with sufficient legal authority and adequate discretion to

	<p>address non-compliance with regulations as well as to address any safety and soundness concerns. Both the Banking Supervision Law and the Commercial Bank Law empower the CBRC to take a range of corrective actions including the imposition of monetary penalties against the bank and individuals; requiring changes in the Board and senior management; and restricting activities that the bank may engage in. In addition, the Punishment Regulations lay out in detail the actions to be taken for a variety of situations. In practice, there is sufficient evidence to show that the CBRC uses the powers available to impose necessary sanctions and require corrective action from banks. In the year 2009 alone, the CBRC imposed RMB 11.5 million in penalties, issued over 4000 sanctions or corrective actions (significant number of which pertained to suspension or restrictions of activities) and revoked the qualifications of 86 senior managers.</p> <p>EC2: The CBRC has the needed legal authority to access bank staff, senior managers, directors and records and this underlies its on-site examination process—in the year 2009, for instance, the CBRC conducted over 58,000 examinations of supervised institution and their branches. The <i>Banking Supervision Law (Article 34)</i> provides the CBRC with the needed authority to access the Bank staff and Board and its internal records. It may (a) to enter banks for on-site examinations; (b) to interview the staff of banks and require them to provide explanations on issues of concern; (c) to have full access to and make copies of the banks' documents and materials related to the on-site examinations, and to seal up documents and materials that are likely to be removed, concealed or destroyed; and (d) to examine the bank's IT technology infrastructure for business operations and management. The Law also empowers them to hold discussions with the directors and senior managers of banks on its business operations and risk management. The <i>Banking Supervision Law (Article 46)</i> and the <i>Commercial Bank Law (Article 75)</i> reinforce this by laying out penalties for banks that do not comply with these requirements.</p> <p>CBRC staff that the mission interacted with reported that banks fully cooperated with their requests for access to information and records.</p>
Assessment	Compliant
Comments	The <i>Punishment Regulations</i> were issued prior to the formation of the CBRC and still show the PBC and State Administration of Foreign Exchange (SAFE) as the administrative organs for implementation. Although CBRC is able to use these provisions by virtue of having taken over the function of regulation and supervision (with some exceptions) from PBC, it may be desirable to explicitly include the mention of CBRC among the implementing organizations.
Principle 1(5).	Legal protection. A suitable legal framework for banking supervision is also necessary, including legal protection for supervisors.
Description	<p>EC1: <i>The Bank Supervision Law (Article 5)</i> provides that the CBRC and its staff will be protected by law while discharging their supervisory duties in good faith. Furthermore, <i>The Administrative Procedure Law (Article 25)</i> indicates that the government agency undertaking the specific actions will be the defendant if one party initiates legal action against that agency. Therefore, the supervisory staff will not be subject to litigation for carrying out their supervisory responsibilities.</p> <p>EC2: The CBRC and its staff are adequately protected against the cost of defending their actions taken and/or omissions made while discharging their duties in good faith. The CBRC can fund the cost of litigation if necessary under the current funding arrangement. In essence, there is no circumstance under which the supervisory staff will need to bear the cost of legal defense while discharging their duties in good faith. During a meeting at a CBRC branch, a senior official described a lawsuit that was brought against the CBRC. During the hearing, he appeared in the court of law to defend his agency against the lawsuit but he was never subject to the litigation. The CBRC finally won the case.</p>
Assessment	Compliant
Comments	
Principle 1(6).	Cooperation. Arrangements for sharing information between supervisors and protecting the

	confidentiality of such information should be in place.
Description	<p>EC1: The <i>Banking Supervision Law</i> (Article 6) provides that the CBRC shall establish supervisory information sharing mechanisms with the PBC and other regulatory authorities. The <i>PBC Law</i> (Article 9) provides that the State Council shall establish a coordinating mechanism for financial regulation and supervision. Cooperation and information sharing among domestic financial authorities form an integral part of the banking supervisory process in China. There are a number of formal and informal mechanisms for cooperation and information between domestic authorities responsible for the soundness of financial system: (1) Supervisory MOUs; (2) Inter-agency Financial Coordination Meeting under the State Council; (3) Monetary Policy Committee Meetings; and (4) Coordination and information sharing during supervision. The extent and frequency of information sharing and cooperation increase in crisis situations. In June 2009, the CRBC, the PBC, and the SAFE jointly established a liquidity contingency scheme for foreign banks, which helped to maintain stability in the Chinese banking sector during the global financial crisis. These formal and informal information sharing and cooperation have played a crucial role in enhancing supervisory efficiency and maintaining the safety and soundness of the financial sector.</p> <p>EC2: The <i>Banking Supervision Law</i> (Article 7) provides that the CBRC may establish supervisory cooperation mechanisms with the banking supervisory authorities in other countries or regions for the supervision of cross border banking. As of year-end 2009, the CBRC has signed 36 MOUs with supervisory authorities other countries and regions. In practice, the CBRC maintains a close working relationship with other supervisors abroad. It holds bilateral meetings with counterparts and participates in working groups under the Basel Committee on Banking Supervision and others international organizations. The CBRC has also established supervisory colleges for China's largest internationally active banks: it hosted the first supervisory college in November 2009, and plans to do the same for another bank in 2010.</p> <p>EC3: The <i>Banking Supervision Law</i> (Article 6) provides that the CBRC establishes supervisory information sharing mechanisms with the PBC and other domestic regulatory authorities. Article 7 provides that the CBRC may establish supervisory cooperation mechanisms with supervisory authorities in other countries for cross border supervision purposes. The CBRC maintains regular contacts with domestic and overseas supervisors to share information regarding supervised banks and the CBRC requires that such shared information should be used for supervisory purposes and should be treated as confidential. The MOUs signed between the CBRC and other supervisory authorities contain explicit provisions on the confidentiality of information.</p> <p>EC4: The <i>Banking Supervision Law</i> (Article 11) requires CBRC staff to protect information that is considered confidential in accordance with laws and regulations. Article 43 includes both criminal and administrative penalties that will be imposed on banking supervisors who engage in leaking confidential information.</p>
Assessment	Compliant
Comments	The Interagency Financial Coordination Meetings led by the State Council were held in 2008 and 2009. The heads of PBC, CBRC, CSRC, CIRC, SAFE, and other government agencies with macroeconomic functions met every ten days during that time period. Discussions with CBRC indicated that these meetings were very useful and the meetings have continued to act as a high level forum for the discussion of financial stability issues even after the impact of global financial crisis has receded. It may be desirable to formalize these arrangements.
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.
Description	EC1: Commercial banks are defined in the Commercial Bank Law (Article 2) as enterprises that are established to take public deposits, make loans and arrange for settlement of accounts although it does not specify whether any or all of these activities qualify to meet the definition. The Banking Supervision Law (Article 2) sharpens this definition by defining banking institutions as those that take deposits from the public and maps them on to institutional forms

to include commercial banks, urban and rural credit cooperatives and also policy banks. It extends the application of the provisions of the Act that pertain to supervision and regulation to other non-bank financial institutions including AMC, trust and investment companies, finance companies, other financial leasing companies and other financial institutions established in the PRC as authorized by the regulatory authority.

EC2: The Commercial Bank Law (Article 3) lists thirteen categories of permissible activities that banks can engage in and also empowers the CBRC to approve other businesses that banks may undertake. The listed categories include the standard commercial banking activities including deposit taking, making loans, arranging settlement of accounts, accepting and discount of negotiable instruments, issuing bonds, dealing in government and financial bonds, offering guarantees, etc. At the time of licensing, CBRC specifies those activities from among this list that the bank or branch can engage in at the time of licensing, and any additions or changes in scope of business require fresh approval to be obtained. An important omission in the list is that of dealing in corporate bonds and financial instruments and CBRC staff deal with this under the 14th category of any other business that they may approve. New products and innovations also require to be approved by the CBRC, as well as any changes in terms and conditions of these products after approval. Undertaking any activity without CBRC approval attracts the provision of the *Punishment Regulations* (Article 9) which explicitly prohibit banks from undertaking financial activities beyond the scope approved and lays out the penalties that would apply which could include either administrative punishment or criminal liabilities.

EC3: The Commercial Bank Law (Article 11) specifically prohibits any entity from using the word “bank” in its name without the approval of the CBRC. It also empowers (Article 79) the CBRC to take corrective action against any commercial bank that breaches this requirement; requires that any illegal gains be confiscated and specifies the monetary penalties to be imposed. While the law does not specifically prohibit unapproved use of derivatives of the word “bank” such as “banking,” CBRC staff informed the assessors that in practice this issue has not arisen and that they anticipate no legal challenges to any actions that may have to be taken in this regard.

EC4: The authorities lay particular focus on preventing illegal deposit taking and there is a separate department in the CBRC for this purpose. There are several provisions in the law dealing with the prohibition of the unlicensed taking of public deposits. Such activity constitutes criminal activity and is covered by the Criminal Law (Article 176) which provides for imprisonment and/or a fine for illegal or disguised deposit taking activities. The Commercial Bank Law (Article 81) provides that those who set up a bank without the approval of the banking regulator or take public deposits illegally or in any disguised form, shall be subject to criminal liabilities; and the bank (that has been so set up) shall be banned by the banking regulator. The Banking Supervision Law (Article 19) prohibits any institution or individual from establishing a bank or engaging in banking business (which includes the taking of public deposits) without approval of the CBRC and also empowers the CBRC to ban any banking business conducted without its approval and lays out the action to be taken (confiscation of illegal gains) and monetary penalties that should be imposed.

EC5: The Commercial Bank Law (Article 23) requires the CBRC to announce the establishment of any bank or a new branch and also to announce if a bank ceases banking business or its license is revoked. In practice, the CBRC announces these through national newspapers in keeping with the *CBRC Rules on Financial Licenses* (Article 11) and also publishes a list of all licensed banks and branches on its website. The assessors perused the website which displays two lists: (i) a list of links to those banks which have websites and (ii) another which displays the list of every license issued, whether branch or bank, which is periodically updated. It may be helpful to supplement this with a list of only all licensed bank entities. In addition, under the *Rules* (Article 13) banks are required to display banking licenses prominently in public venues with each permissible activity listed one by one.

Assessment	Compliant
Comments	<p>Since the last quarter of 2008, there has been a significant growth in the assets under management of trust companies. Some of this activity pertains to transactions with banks which are in the nature of loan sales. Supervisors, banks and market participants that the assessors met suggested that the growth was prompted by a rising demand for wealth management coupled with a search for yield in an environment of low and controlled deposit rates, and an aversion for the volatility in domestic capital markets. CBRC is aware of the potential for higher risk loans being sold to trusts and the consequent reputation risk for banks (especially if there is implicit recourse). True sales of loans can be beneficial for banks ability to manage their portfolios. Of the 1 trillion assets of trust funds, some are purchase of bank assets and some are wealth management on behalf of banks but precise data is not collected. CBRC should improve its monitoring of the transactions and obtain data more regularly for this purpose.</p> <p>The list of permissible activities should be updated to include other typical activities carried out by banks, e.g., buying and selling corporate financial instruments other than government and financial bonds.</p>
Principle 3.	<p>Licensing criteria. The licensing authority must have the power to set criteria and reject applications for establishments that do not meet the standards. 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.</p>
Description	<p>EC1: CBRC is the administrative licensing authority for all commercial banks, which includes urban and rural credit cooperatives and village banks. In addition, CBRC also licenses those non-bank institutions that are supervised as commercial banks under the Banking Supervision Law (Article 2), i.e., AMC, trust companies, finance companies and financial leasing companies. The legal authority for licensing is drawn from the Banking Supervision Law (Article 16) which provides that the banking regulatory authority under the State Council will authorize the establishment, changes, termination and scope of business of banking institutions.</p> <p>In addition to being established as de-novo banks, licenses are required for branches and also for changing the scope of business. Licensing applications are dealt with by the HQ of CBRC as well as by its local offices. The licensing function resides within each supervisory department in HQ. In addition, there are licensing divisions in each provincial and major local office, which process the applications and recommend the decision. The decisions for branches of domestic banks and sub-branches of foreign banks are taken in local offices; decisions on all others are taken in HQ. Once the license is issued, the applicant can get registered with the bureaus for commercial and industrial administrations and obtain a commercial license. In practice, only one de-novo bank has been licensed in the past ten years. However, several rural commercial banks and city commercial banks have been established in this period through the mergers of rural credit cooperatives and city credit cooperatives respectively. The legal entity licensing work in recent periods pertains mainly to these new banks as well as the establishment of village and township banks; and foreign banks. In addition, licensing also covers applications for branches and sub-branches of domestic banks; licensing of foreign bank branches; and licensing of nonbanks such as trust companies and financial leasing companies and their branches.</p> <p>EC2, 3: The overall framework for the licensing of institutions and their activities is provided by the Law on Administrative Licensing, 2003 which covers all activities for which a permit is required from an organ of the State and which lays out in detail the procedures and processes to be followed in the application, consideration and approval or rejection of the license. CBRC has in turn issued rules implementing the law on licensing to cover its supervision over banking activities (<i>CBRC Rules on the Procedures for the Implementation of Administrative Licensing, 2006</i>). For operational purposes, it has issued two detailed licensing manuals, one for domestic</p>

commercial banks and the other for foreign banks. Detailed criteria for the licensing of banks are laid out in these rules and licensing manuals issued by the CBRC in 2006. The licensing criteria mainly include requirements for bank shareholders, capital, board members and senior managers, organizational structure, risk management and internal control policies and procedures, business venues, etc. and are consistent with the requirements applied in ongoing supervision.

In their discussions with CBRC, the assessors observed that licensing forms a significant portion of the work at both HQ and branch level. In 2009 alone, CBRC and its local offices handled 52,715 administrative licensing matters including 28,720 matters concerning establishments, changes and termination of banking institutions; 2,881 matters concerning new business review and approval and 21,308 matters concerning the qualification review and approval of board of directors and senior management. There may exist opportunities for better allocation of supervisory resources by rationalizing the requirements for branch licensing as has been done in many other countries, where banks which meet specified criteria can open branches based on their view of feasibility.

EC4: The authority to reject licensing applications that are incomplete or insufficient is drawn from the Law on Administrative Licensing, which empowers the licensing authority to refuse to accept an application for administrative license or to refuse to grant one in case the applicant conceals any relevant information or provides false information. The CBRC Rules on Licensing lay out the time period for processing a complete application and further requires the CBRC to provide a written notice of approval or rejection within 10 days of the decision to approve or reject has been taken.

EC5: Shell banks have not been licensed in China though there are no explicit requirements prohibiting their establishment. In processing applications for banks, CBRC is guided by the *Commercial Bank Law* (Article 12) which provides basic requirements to be met regarding the organization, management and legal structure to be fulfilled in establishing a bank and that that provisions of *the Company Law* shall be applicable to the organization form and setup of a bank (Article 17). These requirements are further detailed in the Licensing Manuals for domestic banks (Articles 6 and 19) and foreign banks (Article 9). These include Articles of Association in line with the *Company Law*, and having qualified directors and senior managers, sound organization and management systems, good corporate governance structures and sound risk management systems.

For the wider group to which a proposed bank belongs (the proposed owner), Article 15 of *the Commercial Bank Law* provides that for the establishment of a bank, relevant materials shall be submitted including draft articles of association, name list of shareholders and the proposed amount of capital contributions and shares, certificates of credibility and relevant documents of the shareholders who intend to hold 5 percent or more of the proposed capital.

In reviewing applications, the CBRC examines materials submitted by applicants, use supervisory information and draw on any other information available. Among the documents that are solicited are draft articles of association and organizational structure of the proposed bank; list of names and evidence of credibility of proposed shareholders. In the case of foreign bank subsidiaries and joint venture banks, CBRC examines materials on organizational structures of the shareholder or its wider group, list of main shareholders, overseas offices and affiliates. Foreign owners are required to be banks in jurisdictions which have a supervisory cooperation relationship with the CBRC.

EC6: The laws and regulations impose the duty upon the CBRC to submit major shareholders to suitability requirements. The *Banking Supervision Law (Article 17)* requires that the source of capital, financial strength, ability to replenish capital and integrity of the shareholders be reviewed and assessed at the time of applications for the establishment of a bank or changes of shareholders. The documentation to be submitted for this purpose is outlined in the *Commercial*

	<p><i>Bank Law</i> (Article 15) and includes the list of shareholders, their capital contributions and shares, and certificates of capital issued by a relevant authority, references, etc. Article 24 extends the requirement of review to any changes in shareholders who hold 5 percent or more of the capital or shares. The Licensing Manuals lay out guidance on the criteria to be met in the evaluation process, which also cover the requirement of transparency in structures. Conditions for disapproval include (a) material weaknesses identified in the structure and functioning of corporate governance; (b) having too many related firms, an excessively complex and nontransparent ownership structure, and frequent and abnormal related party transactions; (c) having an excessively diversified business spectrum without a core business; (d) having a cash flow sensitive to fluctuations of economic conditions; and (e) having a higher asset/liability ratio and leverage ratio than the industry average, etc. However, CBRC ability to scrutinize suitability is restricted by the absence of legal authority to penetrate the structures and identify ultimate beneficial owners. Indirect changes in ownership are also not covered in the legislation. While the large proportion of state ownership had rendered the need for such ability less necessary in the past, this is an important issue in a system opening up to acquisitions and investments in bank equity.</p> <p>EC7: The Commercial Bank Law lays out the minimum initial capital requirements for national commercial banks (RMB 1 billion); city commercial banks (RMB 100 million) and rural commercial banks (RMB 50 million).</p> <p>EC8: The Banking Supervision Law (Article 20) requires the CBRC to conduct a fit and proper test for directors and senior managers of banks and authorizes it to formulate specific rules and procedures for this purpose. In turn, CBRC has laid out detailed procedures and criteria for this purpose in the licensing manuals for both domestic and foreign banks. These criteria include: record of compliance with the law, track record of sound performance, qualification and experience reflecting expertise, experience and management ability suitable for the proposed positions and good character i.e., being honest, credible, diligent and dutiful. These requirements apply both to appointments at the time of licensing the institution as well as for any changes subsequent to initial appointments. Among the criteria laid out that would disqualify the candidate are: criminal record, record of misconduct or having been disciplined; evidence of leadership failure or being held responsible for material losses; applicant or spouse having unpaid debts, etc.</p> <p>CBRC expects all important management positions to be covered by the approval regime such as Chief Risk Officer (CRO), Chief Financial Officer (CFO), Chief Information Officer (CIO), and Chief Credit Officer (CCO). The work of evaluating fitness of board members and senior managers is conducted both at HQ and the provincial offices and involves background checks, scrutiny of documentation, interviews with supervisors as well as in some cases, written tests. The assessors reviewed several applications for approval and noted that the fit and proper qualification procedure was diligently followed, although the quality of the interview that assessors saw could be made more substantive.</p> <p>EC9: As laid out in the <i>Licensing Manuals</i> CBRC's processing for a license covers the evaluation of a sound governance structure, an adequate risk management and internal control system, and an effective management information system (MIS). The Manuals lay out in detail the required materials to be submitted and the criteria for evaluation. In reviewing an application, the CBRC evaluates whether a proposed bank has a viable plan, including a sensible market analysis, a clear business strategy compliant with laws and regulations, adequate resources financially and in terms of management. Relationship of the proposed bank with any related parties is also considered to determine the soundness of the structure and functioning of corporate governance. However, as mentioned elsewhere in this report, the CBRC is inhibited in not being able to legally identify ultimate beneficial ownership. In perusing license applications that had been dealt with, the assessors observed that a variety of documents were obtained by CBRC for evaluating financial strength and project feasibility, but did not see the associated working papers. However, through their discussion with CBRC staff</p>
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	<p>they determined that a fairly comprehensive analysis was performed for this purpose at both the bank and branch level.</p> <p>EC10: The Commercial Bank Law stipulates that (Articles 14 and 15) feasibility report and business policies and plans be submitted along with a licensing application for a bank, and that financial statements for the past two years accompany an application for a branch. In addition, the <i>Licensing Manual</i> lays out guidance for conducting such a feasibility study and requires that it include an analysis on market prospects, a description of business strategy and plans, projections on assets and liabilities, earnings, liquidity, capital adequacy, Return on Assets (ROA) and Return on Equity (ROE) for the first three years of business. CBRC reviews these documents to assess the source of capital, financial strength, and ability to replenish capital of the shareholders, as required under the Banking Supervision Law (Article 17). CBRC also evaluates financial conditions of proposed shareholders holding 5 percent or more of the proposed capital, focusing on the integrity of financial information, qualification of proposed shareholders and the ability of proposed shareholders to provide sustained support for the proposed bank.</p> <p>EC11: In keeping with the provisions of <i>Foreign Bank Regulations</i> (Article 9) CBRC requires the application to be approved by the home regulatory authorities and evaluates whether cross-border activities are under their effective consolidated supervision (See CP 25). The assessors saw examples of correspondence exchanged with cross-border supervisors in this regard.</p>
Assessment	Compliant
Comments	<p>There is a very extensive licensing regime in China which requires approval to be obtained from the CBRC for legal entities, branches and products. The overall framework for licensing is provided by the Law on Administrative Licensing which covers all activities for which a permit is required from an organ or agency of the State. This law lays out in detail the procedures and processes to be followed by the licensing agency. Being an omnibus law, some of its provisions are not suited for banking, e.g., the requirements regarding inspection reports being public and licensing hearings being held in public. CBRC has attempted to address this by in turn issuing rules implementing the law on licensing for commercial banks and institutions supervised as banks. It has also issued detailed licensing manuals, one for domestic and another for foreign banks to guide how applications should be dealt with.</p> <p>As mentioned above, a significant amount of resources are focused on the process of approvals and licensing which includes the licensing of branches and sub-branches. Going ahead, CBRC should look for opportunities to relegate sub-branching and then branching decisions to well-performing banks which meet high performance, risk management and control standards (with specific verification of banks meeting the standards on a selective basis).</p>
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.
Description	<p>EC1: The <i>Banking Supervision Law</i> does not contain an explicit definition of either “significant ownership” or “controlling interest” but requires the CBRC to review the financial strength and integrity of all shareholders or changes in shareholders that hold capital above a certain percentage of the total shares or total capital, as stipulated in applicable laws or regulations (Article 17). Among the applicable laws is the <i>Commercial Bank Law</i> (Article 15) which requires all applicants for a banking license who hold more than 5 percent of the registered capital to submit required information and documents. Article 24 further prescribes that any change in shareholders of an existing bank who hold more than 5 percent of the total capital or shares should be subject to the approval of the CBRC. Article 28 extends this requirement of prior approval to any entity or individual who intends to acquire 5 percent or more of the total amount of shares of a bank. Hence, for all practical purposes, CBRC considers the 5 percent of total amount of capital to be the trigger for “significant ownership.” Indirect changes in ownership (e.g., of upstream companies) are not covered under the legislation.</p>

	<p>The <i>Company Law</i> (Article 217) provides for the definition of “controlling shareholders” and “actual controllers.” The former is defined as one whose capital contribution accounts for more than 50 percent of the capital or shares, or the shareholder with more than 50 percent of the capital or shares, or the shareholder who by virtue of its voting right, has a significant impact on the decision of the general meeting of shareholders regardless of a percentage lower than 50 percent. “Actual controller” is defined as a person who is not a shareholder of the company but has virtual control over corporate actions through investment in, agreement or other arrangements with the company. For foreign banks, the <i>Foreign Bank Regulation Implementation Rules</i> (Article 4) follows this definition and defines “major shareholder” as a person who holds over 50 percent of the capital or shares of a bank, or possesses over 50 percent of the voting rights, or any person who has the power to control the financial and operational policies of a bank.</p> <p>EC2: The <i>Commercial Bank Law</i> (Article 24) read with the Banking Supervision Law (Article 17) requires that ownership changes proposed by an existing bank involving any shareholder holding or intending to hold 5 percent or more of the capital or shares of the bank shall be subject to the CBRC’s approval. There is no requirement in legislation that beneficial ownership also be considered or that changes in actual control which may not be reflected in shareholding be taken into account. While CBRC staff mentioned that they extend the concept of ownership to beneficial owners and obtain needed information from available sources using, for example, the requirement of transparent structures, they acknowledged that there could be situations where this legal lacunae could hamper their ability to gain a full knowledge of ultimate beneficial / controlling owners.</p> <p>EC3: The Licensing Manual (Article 64) lays out that in reviewing an application for a change in shareholding, the qualification of the proposed shareholders should be as those applied for promoters in the case of an application for setting up a new bank. These qualification criteria are laid out in Articles 9–13 of the Manual, but do not extend mutatis mutandis to significant beneficial ownership. The CBRC can reject the application for change in shareholding under the Licensing Rules. However, there is no explicit authority for reversing or modifying a transfer of ownership or control that has taken place without the approval of the CBRC.</p> <p>EC4: The CBRC obtains a report annually on the names and shareholding of all shareholders above the 5 percent limit. It follows up on this in the course of a full-scope examination. However, banks are not required to report significant beneficial ownership in the case of shareholdings through nominees, custodians and through other vehicles though the CBRC examiners seek to obtain this information during on-site visits to form conclusions on this basis.</p> <p>EC5: <i>The Commercial Bank Law (Article 74) and the Banking Supervision Law (Articles 45 and 46)</i> provide general powers to CBRC to take administrative actions or initiate criminal action as appropriate in case a commercial bank does not apply for approval where required by regulations or otherwise meet prudential requirements. Article 79 extends this to reach the investor and specifically empowers the CBRC to direct commercial banks in case of an acquisition of shares greater than 5 percent of the total shares of the bank without authorization to correct such action and confiscate any illegal gains arising from such actions. While there is no explicit mention of the ability to revise or modify such action, this prescribed ability should cover such a situation, which has so far not arisen.</p> <p>AC1: <i>The Foreign Bank Regulation Implementation Rules</i> (Article 95) require foreign banks operating in China to report to the CBRC any material financial and operational changes of its significant shareholders. There is no similar explicit requirement in the case of domestic banks.</p>
Assessment	Largely Compliant
Comments	Both financial and non-financial corporations can, and do, acquire significant stakes in banks. Some local governments own banks, though dilution is in progress in some cases. A key vulnerability in the legal framework is the lack of authority or requirements for the CBRC to

	<p>identify and evaluate the ultimate beneficial owner. However CBRC does adopt informal or indirect means to make such evaluations in many cases, including working through acquirers who are covered under the present legal regime, and using other sources of information including tax and registration records. While CBRC's intention is that ultimate controllers of banks are included in these rules, and assessors are not aware of instances in which effective supervision has been hampered, CBRC should clarify the law to ensure it covers beneficial ownership and indirect control in all cases. Given that there is, and likely will continue to be, significant activity in the acquisition and transfer of bank ownership as the system continues to privatize and internationalize, ensuring fitness of all of the owners will be instrumental to their ability to support these institutions and also to guard against reputation risk.</p>
<p>Principle 5.</p>	<p>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.</p>
<p>Description</p>	<p>EC1: There are no explicit provisions in the laws stipulating the types, amounts or limits for acquisition and investments by banks that require supervisory approval. However, there are specific provisions governing what businesses and activities banks can engage in and a provision that any changes in the scope of permitted business activity require supervisory approval. In addition, undertaking any non-bank activity by banks is expressly prohibited though in recent times some banks have been allowed to buy into insurance, financial leasing and fund-management business on a pilot basis with the approval of the State Council under the provisions of Article 43 of the Commercial Bank Law. Domestic banks may acquire other banks or invest in them with prior approval of the CBRC, though there are no express limits on the investments they can make. Overseas investments or acquisitions by banks are also subject to the prior approval of the CBRC.</p> <p>EC2: In the case of acquisition of a Chinese bank by overseas banks, the criteria for judging individual proposals for strategic investment are set out in Article 10 of <i>the CBRC Licensing Manuals</i> which include minimum asset size, long term rating, profitability, capital adequacy, internal controls, sound home supervision, and sound home country macro environment. A single overseas investor cannot invest in more than 20 percent of the proportion of the shares of a single Chinese bank, and total overseas investors cannot exceed 25 percent. Article 60 of the <i>Manual</i> lists the criteria for domestic banks to meet in order to conduct overseas investments or acquisition, which include the CAR, earnings, asset size and corporate governance, etc. The <i>Licensing Manual for Foreign Bank</i> lays out the criteria for the establishment of foreign-funded institutions. There are no explicit criteria laid out in the law or regulations for the acquisition of significant interests in domestic banks by domestic banks, and the CBRC staff the mission met stated that the criteria in Article 9 which apply to the financial institution promoters of a domestic banks would, inter alia, be applied in the case of financial institution acquisitions of significant interest. These include: (a) CAR shall be above 8 percent; (b) equity investment shall be less than 50 percent of its net assets; (c) positive earnings for three consecutive fiscal years; (d) sound corporate governance; and (e) having met other prudential requirements.</p> <p>The criteria for banks investing in or acquiring fund management companies, financial leasing companies and insurance companies in China are set out in the <i>CBRC Rules on Establishing Fund Management Companies by Banks</i>, <i>the Rules on Establishing Financial Leasing Companies by Banks</i> and <i>the Rules on Establishing Insurance Companies by Banks</i>, etc. These criteria include requirements on prudential ratios, corporate governance, internal controls, capital or shares investment exposures, financial strength, managerial capacity, strategy of growth and diversification; feasibility study and business plan; firewall arrangements; and other prudential considerations.</p> <p>EC3: Generally, CBRC does seek to ensure that acquisitions by banks do not expose them to undue risk or lead to complex structures which inhibit effective supervision. Banks are not permitted to acquire non-bank businesses, though a few pilots of banks undertaking insurance and fund management have recently been permitted with the approval of the State Council. In</p>

	<p>addition, a few banks also have major shareholding interest in trust companies and financial leasing companies. Banks are required to obtain approval from the CBRC for any change in scope of permitted activities and this also covers any acquisitions of major interest in financial activities. The criteria for evaluating banks ability to manage the risks of acquisitions are drawn from the <i>Licensing Manuals</i> as well as the <i>Guidelines on Consolidated Banking Supervision</i> and include capital adequacy, limit on equity investment by a bank, earnings ratios, soundness of corporate governance and internal controls, as well as other prudential ratios. In addition, the <i>Guidelines (Article 55)</i> also require CBRC to take into account corporate governance structures and oversight capacity on a consolidated basis in reviewing of a bank’s application. For foreign acquisitions, CBRC is required to assess host country’s regulatory environment (Article 65) and to prohibit banks from acquiring or investing countries where this is deemed insufficient. If the investment or acquisition has already been made, the CBRC may require the bank to close its relevant overseas operations though there have been no such occasions. The CBRC may prohibit banks from doing businesses if the organization structure or legal environment hinders information flow.</p> <p>EC4: The <i>CBRC Licensing Manuals</i> lay out the criteria for approving acquisitions of banks including prudential ratios and requirements, such as CAR, corporate governance, internal controls, capital or shares investment exposures, etc.; financial capacity, such as total assets, earnings, ROA, ROE, adequacy of liquidity; managerial capacity, i.e., leadership, human resource; track record of compliance; infrastructure, i.e., IT, settlement; strategy of growth and diversification; feasibility study and business plan; firewall arrangements; and other prudential considerations.</p> <p>EC5: As mentioned in EC1, banks are not permitted to acquire or invest in nonbanks. No specific limits have been laid out for banks investment in other domestic banks, nor is it specified that such investments require specific approval. However, the requirement for CBRC prior approval of such an acquisition would be covered under (i) the criteria of a change in scope of business activity and (ii) the requirement for the acquired bank to report any proposed change in significant shareholding.</p> <p>EC6: CBRC is aware of the risks posed by nonbanking activities and the law prohibits banks from undertaking non-banking business though, as mentioned in EC1, some pilots have been approved. Guidelines have been issued by CBRC for the conduct of such activities by banks, as mentioned in EC2. Such activities can be conducted only through subsidiaries and the CBRC requires banks to set up fire walls (See CP 24) between its banking and non-banking activities to prevent risk contagion and conflict of interest.</p> <p>AC 1: The <i>Guidelines on Consolidated Banking Supervision (Article 65)</i>, requires the CBRC to assess host country’s regulatory environment periodically or on an ad hoc basis. If banking supervision in the host country is regarded as inadequate, the CBRC may prohibit banks from making investments or acquisitions in such country. If the investment or acquisition has already been made, the CBRC may require the bank to close its relevant overseas operations or restrict the scope of such operations.</p>
Assessment	Compliant
Comments	
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.
Description	EC1: China has adopted a uniform capital regulation regime, which applies to all banks (including large commercial banks, joint stock commercial banks, city commercial banks, rural commercial banks and foreign banks). Policy banks (China Development Bank (CDB), EXIM Bank, and Agricultural Development Bank of China) are also subject to the general capital rules.

	<p>The capital regime is based on the 1988 Basel Accord and the 1996 market risk amendment (Basel I).</p> <p>CBRC has identified six banks (the big four plus two others) who are to implement Basel II in the 2010–2013 period, and are expected to submit applications by the end of 2010. The Basel II regime was not formally assessed, as it was not in place at the time of the mission.</p> <p>Deviations from the Basel I regime tend to be conservative requiring more capital or acting to increase the quality of capital that qualifies under the rules.</p> <p><i>The Commercial Bank Law (Article 39) and the CBRC Rules on Capital Adequacy (Article 7)</i> provide that a bank must maintain its CAR of no less than 8 percent, with its Tier 1 CAR no less than 4 percent and such requirements apply to all banks on a solo and consolidated basis. In January 2010 CBRC issued a notice that the five major banks are to maintain capital ratios of at least 11.5 percent and small and medium-size banks must maintain capital above 10 percent. These supervisory expectations are effective for year-end 2010. CBRC has styled this as a “counter-cyclical capital buffer.” CBRC has not indicated in what circumstances, if any, it would consider reducing the required ratio, or adjusting it further upwards.</p> <p><i>The CBRC Rules on Capital Adequacy</i> clearly defines the components of capital, capital deductions, CAR calculation method, and the risk weights of various assets. The definitions signify that capital requirements cover not only credit risk but also market risk.</p> <p>The CBRC has applied its statutory rule-making authority to make sure that the capital adequacy requirements emphasize on those elements of capital that are loss absorbent. Among others, the CBRC requires:</p> <ul style="list-style-type: none"> • the regulatory capital consists of Tier 1 capital and Tier 2 capital, while Tier 3 capital is not allowed; • banks should prioritize on common equity due to its strongest loss absorbency feature; • the calculation of CAR should be based on adequate provisioning. Any provisioning shortfall shall be deducted from Tier 1 capital (see Article 4 of <i>the CBRC Rules on Capital Adequacy</i>); and • Banks that intend to raise Tier 2 capital by issuing long-term subordinated debts are subject to stringent requirements, including the minimum Tier 1 CAR (7 percent for nation-wide banks and 5 percent for other banks). (See Articles 6, 7, and 9 of <i>the CBRC Notice on Improving the Capital Raising Mechanism of Commercial Banks</i>). <p>In practice, the rules operate so that core (Tier 1) capital is some 75 percent of total capital.</p> <p>The CBRC closely monitors the changes in the capital adequacy and core capital adequacy of each bank. The CBRC requires banks to submit quarterly reports on CAR and Tier 1 CAR on a solo basis, which covers such information as the capital components, deductions and RWA. The consolidated CAR report is required to be submitted on a semi-annual basis. Levels and trends in banks CAR ratios as assessed by off-site monitoring drive risk ratings and the “C” component of the CAMELS rating, which is an important component (20 percent) of a banks composite supervisory rating.</p> <p>The CBRC conducts on-site examinations and supervisory review process on capital adequacy to ensure bank’s capital management and CAR calculation are in compliance with regulatory requirements. The examinations focus on bank’s policies and procedures on capital management, its ability to identify, measure and mitigate credit risk and market risk, as well as its CAR.</p> <p>CARs of the five major banks at the time of the assessment average 11.1 percent and range from 11–12 percent for the four who report publically. For medium-size banks the total capital</p>
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	<p>ratio averaged 10.3 percent, for city commercial banks the average was 13 percent, and for rural banks the average was 12 percent. As of year-end 2009, (when the required total capital ratio was 8 percent) all 239 commercial banks met the capital adequacy requirements.</p> <p>EC2: The definition of capital meets Basel I definitions, with some deviations. A number of these are more conservative (no Tier 3 capital, no hybrid instruments, deduction of inter-bank holdings of sub-debt). Some are less conservative. Collective (general) provisions (which are not tax deductible) are allowed to count in Tier 2 capital but without the limit of 1.25 percent of risk weighted assets under the Basel 1 rules. CBRC indicated that provisions included in Tier 1 capital amount on average to 1.2 percent currently, so some outliers are above the Basel I, 1.25 percent limit.</p> <p>Banks must maintain an appropriation of surplus (that cannot be distributed to shareholders) of 1 percent of assets. This also acts like a top-up to what CBRC may consider as insufficient provisions under accounting rules. This “reserve” is included in allowable capital.</p> <p>Minority interests count fully in total capital, though this policy is under review. The amount involved is not significant.</p> <p>Starting in 2009, cross-holdings by banks of each others’ subordinated debt issued after July 1, 2009 are also deducted from available capital.</p> <p>Equity investments in commercial real estate and business enterprises are deducted from both total and core capital. Investments in nonbank financial institutions (e.g., insurance companies/fund management firms) are also deducted.</p> <p>In terms of risk weights, the standard Basel I risk weights generally apply. For country risk, CBRC, sensibly, uses the Basel II standardized approach determined by the external risk weighting of the borrower’s home country, rather than the OECD criteria as specified under Basel I.</p> <p>As in other countries, bank exposures to the central government are risk weighted at 0 percent. No special capital treatment applies to banks’ exposures to local governments or their financing entities. For SOE’s the general principle in the CBRC rules is to apply normal risk weights to those that are commercial/compete with private enterprises. Exposure to central government invested public utility enterprises receives a risk weight of 50 percent. CBRC has not developed a list of such enterprises. Some of these treatments are different than in other countries including other emerging markets. In particular, commercial banks’ loans to policy banks are risk weighted at 0 percent, instead of the normal 20 percent for inter-bank lending, despite the fact that policy banks compete with other banks (the amount involved is not large). Inter-bank exposures of less than 4 months are also zero weighted. Loans to and obligations of CDB bank also attract a zero risk weight, rather than the normal 20 percent, even though CDB is transitioning to a commercial bank and accepts deposits from its lending and investment banking customers. This favorable treatment was supposed to be eliminated at year-end 2010, but has been extended.</p> <p>Overall, CBRC advised that zero-RWA amount for some 37 percent of total assets of the major banks. The predominant part of these assets are claims on the central government and the central bank.</p> <p>Only banks with trading positions exceeding 10 percent of on-and off-balance sheet assets or more than RMB 8.5 billion are required to compute capital for market risk. At the time of the assessment the market risk rules applied to 28 banks, 11 of whom were foreign banks. While banks are allowed to use internal models to compute market risk capital, no banks were approved at the time of the assessment. The risk in this approach is that smaller banks are using the credit rules for trading book assets. These may well be zero-rated for government paper, though there is market risk in the investment.</p>
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	<p>EC3: <i>CBRC Rules on Capital Adequacy (Article 37)</i> provides that the CBRC has the authority to increase the capital requirement on individual banks based on the assessment of the banks' risk profile and risk management. This authority is not used in practice. In individual cases CBRC prefers to place limits on a bank's exposures.</p> <p>EC4: Consistent with the Basel I rules, the minimum capital requirements under Pillar 1 cover credit risk and market risk for both on-balance sheet and off-balance sheet items. In terms of the required capital ratio reflecting the risk profile of individual banks, CBRC is aware that Basel I was not designed to apply to specialized banks with lumpy portfolios such as those of certain of the current or former policy banks. However, no special adjustment in the required capital ratios is made by CBRC for those banks, and their capital ratios are slightly above the general regulatory requirements.</p> <p>EC5: In general, CBRC is targeting to have capital requirements that are a higher level and higher quality capital than the minimums set out in the 1988 Accord. Recently CBRC has embarked on setting counter-cyclical capital buffers. In January 2010 CBRC raised the minimum capital expected from 8 percent to 11.5 percent for the five large banks and 10 percent for other commercial banks, effective year-end 2010. While this increase does not have the precise legal status of the previous minimum, CBRC indicated that banks not meeting the new threshold would not get various other CBRC approvals. CBRC indicated these moves were in view of macro-economic conditions and that the purpose of these policies was to ensure that credit expansion of banks was based on sufficient capital. There was no indication of how CBRC might adjust these buffers in future.</p> <p>In response to high loan growth and these requirements, banks have raised significant capital recently.</p> <p>EC6: The CBRC has clear authority to take action should a bank fall below the minimum capital ratio. Article 37 of <i>the Banking Supervision Law</i> provides, when a bank fails to meet prudential rules (including capital adequacy rules), the CBRC has the authority to require it to take corrective actions within a given period. If the bank fails to correct the deficiencies within the given period, the CBRC has the authority to take further enforcement actions. The assessment team discussed with the CBRC the use of this power and saw examples of it acting in practice (see CP 23).</p> <p>Article 75 of <i>the Commercial Bank Law</i> provides, when a bank fails to meet the regulatory capital requirement, the CBRC has the power to require it to take corrective actions and impose a fine within the range of RMB 200,000 and RMB 500,000, if the case is serious or the correction is not made within the required timeframe, the CBRC has the power to close its business for rectification or revoke its license.</p> <p><i>The CBRC Rules on Capital Adequacy</i> provides for the supervisory authority to categorize banks as "adequately capitalized," "undercapitalized" and "significantly undercapitalized," with each category clearly defined (see Article 38). For an adequately capitalized bank, the CBRC has the authority to take pre-emptive measures to prevent bank capital from falling below the minimum levels (see Article 39 for details).</p> <p>For an undercapitalized bank, the CBRC has the authority to require the bank to submit and implement an acceptable capital restoration plan, reduce risk assets, restrict asset growth and restrict or suspend dividend or other forms of payment to shareholders (see Article 40 for more details).</p> <p>For a significantly undercapitalized bank, the CBRC has the authority to take further actions such as ordering the banks to replace the board member or the senior management, taking over or closing the bank (see Article 41 for more details).</p>
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<p>In practice, the CBRC requires each bank to submit and implement feasible plans to maintain adequately capitalized. Through on-site examinations and OSS, the CBRC closely monitors the changes in the banks' capital adequacy, and takes pre-emptive measures, requires corrective actions or take other measures accordingly. The CAR is also one of the most important factors that the CBRC takes into account in reviewing and approving the bank's new business and branch or subsidiary applications.</p> <p>EC7: <i>The CBRC Rules on Capital Adequacy</i> permits banks to use internal models to calculate the regulatory capital requirement on market risk subject to the approval of the CBRC. However, by the end of 2009, the CBRC has not received any application from banks for using internal models.</p> <p>While the mission did not formally assess Basel II implementation, it did discuss progress toward Basel II with the CBRC and with some banks. The banks going to Basel II in the 2010–2013 period are generally targeting AIRB, with coverage phased in over several years (50 percent by 2011 rising to 80 percent by 2013). CBRC mandated Internal Risk Based (IRB) and is not adopting standardized approach for credit risk. Banks are targeting standardized approach for operational risk (with a move to AMA a few years afterward for a few banks).</p> <p>CBRC has indicated that its strategy is to use Basel II as a means of pushing for enhanced risk measurement. However, the mission's view is that accurate, effective implementation will likely be challenging for some banks due to data limitations, the need to adequately take account of downturn conditions, and due to the fact that certain risk measurement and risk management systems are in flux. For CBRC, effective implementation is putting additional demands on specialist resources. Banks implementing Basel II will also face implementation of the Chinese version of SOX internal control attestation in the same time period. There also may be changes in key accounting rules (such as for loan provisioning) and parts of the Basel framework will be changing. Banks finance and control systems may be overly stretched by this combination of new measures.</p> <p>A number of banks have recently started using IRB models in their current management decision-making and risk measurement. However discussion with banks about Board approaches to setting risk appetite and risk strategy did not reveal use of much Basel-II-like metrics in those decisions. Several observers indicated to assessors that a material number of such models have not been validated thoroughly, and so may not be calibrated accurately for the Chinese market.</p> <p>AC1/2: China's rules do not distinguish between internationally active and non-internationally active banks. As a result, all banks in China, regardless of their size and scale, are subject to a set of uniform capital rules as described above. These rules include the requirements for banks to calculate and measure their capital adequacy on both a solo and consolidated basis (see Article 6 of <i>the CBRC Rules on Capital Adequacy</i>); the requirements with respect to the scope of consolidation (see Article 10 of <i>the CBRC Rules on Capital Adequacy</i> for details); and the requirements on risk weighting and capital deductions when calculating the consolidated CAR of a banking group (see Section I of Chapter III of <i>the CBRC Guidelines on Consolidated Banking Supervision</i>).</p> <p>AC3: As discussed above, the CBRC has the statutory authority to increase the CAR requirement on individual banks, and set forth capital adequacy requirements by taking into account the changes in economic and market environment as well as the conditions of individual banks. In 2009 the CBRC imposed a two percentage point capital buffer for banks in China in view of rapid credit growth.</p> <p>In 2009, as part of the move to Basle II, CBRC initiatives further moved toward a more forward-looking capital management approach at major banks (see <i>CBRC Guidelines for CAR Supervisory Review</i>). These included requiring major banks to establish International Capital</p>
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	<p>Adequacy Assessment Processes (ICAAPs) to ensure their capital planning is commensurate with their business operations, complexity, risk exposures and long-term strategy and requiring banks to integrate stress testing into the ICAAPs. Progress is continuing at major banks and CBRC to implement these new rules.</p> <p>AC4: CBRC requires banks and banking groups to calculate and measure their capital adequacy on both a solo basis and consolidated basis. All bank subsidiaries within the consolidated group must meet the minimum capital requirement and have the distribution of sufficient capital from the group.</p> <p>AC5: As discussed in EC3, EC5, and AC3, the CBRC has the statutory authority to increase the CAR requirement on individual banks and banking groups by taking into account the conditions of individual banks/ banking groups.</p>
Assessment	Compliant
Comments	<p>The capital adequacy rules, taken overall, provide for a simple, prudent regime. A few further improvements are required to address deviations that are less conservative than Basel I. Many policy banks appear to compete with other commercial banks to some degree. The capital relief for bank loans to policy banks and for purchases of their debt should be reviewed to ensure that it is not distorting. The capital relief for CDB debt purchased by banks needs to be eliminated. The 1.25 percent limit on provisions counting in Tier 2 capital should be put in place.</p> <p>The size threshold for applying the market risk rule appears to be at a considerably higher level than in a range of other countries. CBRC should periodically review market risk exposure of selected banks below the threshold to reconfirm their assessment that the thresholds remain appropriate</p> <p>In a number of the major banks the overall risk and complexity is rising. Other major banks around the world (often more complex than major Chinese banks, though not always) would hold total and core capital buffers, on an ongoing basis, regardless of macroeconomic conditions, that are materially above the previous 8 percent CBRC minimum. CBRC rightly required banks to hold a material buffer over the 8 percent Basel minimum, but this was in view of macro-economic conditions (and counter-cyclical purposes). CBRC indicated it wanted credit expansion to be based on sufficient capital. However, this increase in capital requirements occurred after much of the recent major loan growth had already occurred (which started abating significantly, according to the CBRC, in Q1 2009).</p> <p>CBRC has not made decisions on how to adjust the capital (or provisioning) ratio in future. While this increase in capital requirements has been considered a counter-cyclical measure, CBRC should consider what <u>ongoing</u> buffers major banks should be expected to hold above the 8 percent minimum in the rules. This issue is, of course, being discussed internationally. If it is to adopt a policy of counter-cyclical capital adjustment, it should also consider the timing of increases and decreases to achieve the desired effects and further describe the framework for decisions it plans to use.</p> <p>It is desirable for CBRC to consider ways to draw out the implementation of Basel II, if necessary, to ensure success. CBRC could consider a longer parallel run period and use of further capital floors. CBRC should review its resource complement and ensure it is reasonable for both the approval phase and ongoing phase of Basel II implementation. More specialist resources will likely be required. Also moving to IRB may well lower capital on loans to certain types of borrowers or sectors and raise it on others. This could introduce distortions with non-Basel II banks, which might undercut achievement of other objectives. CBRC needs to review its decision not to introduce the Basel II standardized (or simple standardized) approach to ensure a reasonable competitive balance is maintained.</p> <p>As noted elsewhere in this assessment, disclosure by banks of capital adequacy-related information is also uneven and should be improved. CBRC should also materially expand its</p>

	published information on the capital adequacy position of banks.
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.
Description	<p>EC1/EC10: Banks are required to establish sound risk management and internal control systems (see <i>the Commercial Bank Law (Article 59)</i>).</p> <p>Banks are expected to establish sound policies and processes of risk management (see <i>the CBRC Guidelines on Internal Controls (Article 11)</i>). Under these guidelines the risk management system is to cover all business lines within the whole bank. The guidelines call for banks to develop and utilize the methods and models of quantified risk evaluation, as well as to continuously monitor and control various risks including credit risk, market risk, liquidity risk, and operation risk.</p> <p>The CBRC has requirements for consolidated oversight of banks (see <i>the CBRC Guidelines on Banking Consolidated Supervision</i>). These were promulgated in 2008. Under those guidelines (<i>Article 73</i>) the parent bank and its subsidiaries shall have in place comprehensive risk management systems based on their organizational structure, operational scale and complexity that are able to facilitate the effective identification, measurement, monitoring and controls of various risks such as credit risk, market risk and liquidity risk, and shall identify and manage various cross-sector risks in a timely manner in order to enhance the efficiency in capital allocation.</p> <p>Certain of these guidance documents set requirements for board and senior management oversight.</p> <p>The CBRC has also issued supervisory guidelines to address the management of specific types of risks. These guidelines specify the high-level expectations for sound risk management. These guidelines also emphasize that the risk management function should be sufficiently independent from the business lines. Certain of these guidelines are relatively new in the past few years. Some were issued in 2009 (Liquidity Risk, IRRBB, Reputation Risk).</p> <p>During OSS, supervisors review banks' policies on risk management and risk management reports, as well as material adjustments or updates of these documents. Supervisors also follow the developments of risk management practices of banks or banking groups on an ongoing basis, by interviewing board members, various levels of the management, and other employees. Based on the findings gained from both on-site examinations and OSS, the CBRC assesses the quality of risk management of the bank or banking group. The assessment is articulated in the annual supervisory report of each bank.</p> <p>During on-site examinations examiners evaluate the quality of risk management of banks or banking groups in accordance with the above rules and guidelines.</p> <p>This can occur during targeted examinations of risk management, full-scope examinations, or as part of examinations of particular business lines. This can include considering risk management strategy, organizational structure, policies and IT system, and the extent to which policies are being followed in the branches and operations of the bank. CBRC assesses whether the bank's risk management process is proportionate to its size and complexity, and whether the process has been adjusted to changes in its risk profile and external market developments.</p> <p>CBRC also conducts periodic targeted examinations of corporate governance and internal controls. Assessors talked with CBRC staff about the challenges in these reviews, which are similar to those that other supervisors face. These reviews tend to consider board minutes, material being provided to the Board, and compliance matters such as the approval of related</p>

party transactions. Interviews with board members and senior management are designed to assess the openness of board discussion, the performance of board members and senior management in risk governance and other areas of corporate governance.

Assessors reviewed examples of examinations, discussed with examination staff, reviewed public documents from major banks on their risk management practices, and discussed risk management organization and development with selected banks and observers.

Chinese authorities view their banking system as much less complex and interconnected than most other developed markets. In part this is due to a policy on segregation under which banks may not get into non-banking businesses, and in part due to other aspects of the financial system such as lack of a convertible currency which limits direct financial shocks from abroad. The main businesses of Chinese banks are still deposit taking and lending. However, Chinese banks are now among some of the world's largest, are starting to expand abroad, and the Chinese banking market is quite diverse with different risks as a result of its size and varying economic and financial conditions in different parts of the country. Certain areas such as use of credit/debit cards and some lending areas are expanding rapidly.

Major banks are at different levels of evolution of their risk measurement and risk management systems. Progress has been rapid over the past few years. Large and mid-size banks have processes to manage major risk categories. Some have moved, relatively recently, to set up comprehensive oversight of risks and move away from a more-siloed approach (including management risk committees on an enterprise-wide basis being set up only recently at some banks). Banks reported differences in the evolution of their IT and data systems necessary for enterprise-wide risk management. Some banks are considerably advanced in this regard while others have considerable more work to do.

Even banks with comprehensive governance and systems tend to think of risk in categories—credit, market, liquidity and so on, rather than being true enterprise-wide approaches that consider interactions between risks in measurement, monitoring, modeling and stress testing.

In practice, major banks have headquarters-based risk management functions. They also often have risk management operations in business units (down to the branch level) that report both to the business line head and to risk management. Some major banks reported that they need to continue to improve this dual-reporting system to ensure clarity of responsibility and timeliness of risk reporting.

CBRC reported that banks and banking groups need to pay more attention to the potential impact of correlations of risk exposures across business lines or arising from affiliated institutions (including banking and non-banking affiliates), and enhance their firm-wide risk management capabilities in line with the increase in size and complexity.

Relating capital to risk is not currently performed in an organized way in many banks. Supervisory requirements play a major role in banks' capital planning. Assessors were told that stress tests sometimes focus on impact on NPLs and not as much on impact of stresses on capital. Banks assessors met were not generally doing reverse stress tests—designed to determine what type of scenario could lead to capital breaching regulatory expectations. Currently, modeling techniques have not been widely adopted in enterprise-wide risk management practices by banks. That is changing as economic capital and Risk Adjusted Return on Capital have started to play a role in formulating and implementing some major banks business plans. As more and more banks apply modeling techniques to measure risks, the CBRC should make further efforts to ensure the independence and effectiveness of model validation, and place more emphasis on relevant on-site examinations. CBRC development of its ability to assess economic capital techniques, which some banks are starting to use, is at an early stage. On the other hand pushing banks to adopt economic capital models should not be a priority at this stage.

	<p>Some banks and observers indicated to assessors that certain cross-category risks, such as counterparty credit risk (which is at the intersection of market and credit risk) appear to be at an early stage of development. While there are not a lot of derivative transactions in China, counterparty credit risk is relevant for inter-bank lending, repo and securities lending markets, which are important in China.</p> <p>There were targeted reviews of the consolidated management of three of the large banks in 2009. (This was in addition to targeted reviews of other specific businesses for these banks).</p> <p>EC2: The CBRC has issued a number of rules and guidelines on corporate governance, internal controls, capital adequacy of banks, in which the responsibilities of the Board and senior management on risk management, especially the oversight duties conducted by the Board are emphasized (see Articles 42, 51, 52 of <i>the CBRC Guidelines on Corporate Governance</i>, Article 8 of <i>the CBRC Guidelines on Internal Controls</i>, and Article 32 of <i>the CBRC Guidelines for CAR Supervisory Review</i>).</p> <p>In the risk management guidelines with respect to credit risk, market risk, liquidity risk, operational risk, the CBRC also articulates expectations for the responsibilities of the Board and senior management on managing each type of risks.</p> <p>According to Article 68 to 70 of <i>the CBRC Guidelines on Consolidated Banking Supervision</i>, the Board of the parent bank is responsible for setting strategy, approving and overseeing the implementation of consolidated risk management plans, and reviewing and evaluating of the quality of the firm-wide risk management practices. The senior management of the parent bank is responsible for the implementation of risk management strategies on a consolidated basis.</p> <p>The board of directors is a bank's decision making body responsible for, among other things, deciding on strategy, business plans and material investments. The supervisory board (which is typically smaller than the board and includes representatives from employees) is responsible for overseeing the bank's financial activities and the compliance of the board of directors with laws, regulations, and the bank's articles of association together with certain other matters. It provides a public report on these matters. As such, it is the bank's board of directors that is responsible for overseeing issues such as balancing of risk, return and other objectives. CBRC conducts on-site examinations focused on corporate governance and performance of the Board and senior management. It also meets with board members individually or the board collectively, or with its main committees, as necessary.</p> <p>Supervisors assess the Board's and senior management's performance in accordance with the guidelines outlined above. They review the minutes of board meetings (including the risk management committee of the Board), as well as documentation of policies, businesses, and reports, or interview the board members, senior managers and other employees. They verify that the Board approves risk management strategy; the senior management takes the steps necessary (such as developing policies and processes for risk-taking, and establishing appropriate limits) to monitor and control all material risks consistent with the approved strategy; and the Board provides clear guidance and imposes necessary oversight to ensure that the senior management implements the procedures and controls to achieve the approved strategy.</p> <p>Assessors discussed the nature of board-approved risk management strategies and the CBRC assessment process. They also reviewed published bank material and discussed board oversight with banks. As with banks and supervisors in other countries practice is evolving. There is considerable variation, including whether there is a board-approved risk appetite, and the extent of use of high-level quantitative measures in the board-approved risk strategy.</p> <p>Strategies appear often to be based on limits by sector or by type of lending, with minimum acceptable risk characteristics, or linked to supervisory ratios for key risks such as liquidity</p>
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	<p>risk, rather than being closely linked to banks' risk assessment systems.</p> <p>Board level consideration of linking capital to risk will require further development, as in other countries. Moving to ICAAP under Basel II for some banks will assist in better relating to capital to risk.</p> <p>CBRC on-site reviews of compliance with policies will provide information on how internal control and risk management systems are operating in practice. CBRC naturally requires banks to fix identified deficiencies.</p> <p>CBRC board assessments have often focused on review of minutes and discussion with board members on their performance in risk governance and other areas of corporate governance. CBRC reports generally high-quality, hands-on involvement by boards and supervisory boards in oversight of major banks.</p> <p>EC3: According to the guidelines on internal controls, such as <i>the CBRC Guidelines on Internal Controls</i> and <i>the CBRC Guidelines on Internal Controls Assessment</i> banks must have in place written policies and procedures to continuously identify and evaluate all material risks, and to identify, report and deal with any weaknesses and exceptions to these policies, including breach of limits, according to the procedures specified in these policies.</p> <p>Implementation of these risk management policies, procedures and limits has been a focus of on-site examinations. Examiners review banks' risk management policies, and interview the board members, appropriate levels of management, and other employees, so as to confirm that these policies, procedures, and limits are properly documented, reviewed, updated, and adhered to in practice. Examiners also review records of business activities to identify exceptions to policies or limits, and make sure that these exceptions have obtained prior approval of appropriate level of management or the Board.</p> <p>With respect to lending programs that are expressly linked to certain state-supported programs the NAO also conducts audits of bank practices and compliance with policies and procedures and publishes the results of these audits.</p> <p>EC4: According to <i>the CBRC Guidelines on Corporate Governance</i>, the Board members and senior management of banks or banking groups must be qualified in terms of knowledge, experience and competence to fulfill their responsibilities.</p> <p>Banks and banking groups must have in place effective and efficient risk reporting process to ensure that the Board and senior management understand the nature of the business and risks being taken (see Article 25 of <i>the Guidelines on Internal Controls</i>).</p> <p>When conducting fit and proper tests, the CBRC assesses whether the board members or senior managers have appropriate understanding of risk-taking, as well as of the relationship between risk profile and capital adequacy.</p> <p>The CBRC provides training programs for board members and senior managers, such as courses on risk management and capital management, and courses on how to maintain adequate capital above the regulatory minimum to prepare for any potential losses that may not be adequately covered by the regulatory capital.</p> <p>During ongoing supervision, supervisors keep on updating their judgment on the Board's and management's capability to understand risk and capital adequacy by such means as on-site examinations and supervisory interviews, etc.</p> <p>Requirements for banks to assess their overall capital adequacy in relation to their risk are included in the guidance for Basel II implementation. That is not yet fully implemented and</p>
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	<p>will apply initially only to some banks, though all the major ones.</p> <p>EC5: Guidelines requiring Basel II banks to have a process for relating capital to risk came into force at the beginning of 2010. Banks reported that these processes were under development. This guidance indicates that non Basel-II banks are supposed to follow the Basel II guidance “by analogy,” that is determine what parts are relevant for them. CBRC staff indicated that approach to guidance is sometimes used to set general direction for smaller or mid-size banks.</p> <p>EC6: In terms of independent testing and validation of models, guidance and supervisory practice have been less important as banks were not using models for regulatory capital purposes. As a result, models that are being used for risk management may not have had to meet rigorous validation standards as would be required if they were also used for capital adequacy purposes. Certain banks that assessors met reported that internal audit has been involved in validating models being used for wholesale and retail lending and market risk. But some observers suggest that validation has not been as robust as will be needed and some banks report that they will do further fully independent outside validation for Basel II applications.</p> <p>EC8: The Board and senior management of banks are expected to evaluate and approve the policies of financial innovations and the limits for risk exposure of new products, so as to ensure risks arising from financial innovations are under effective control (see Article 15 of <i>the CBRC Guidelines on Financial Innovations of Commercial Banks</i>).</p> <p>When conducting on-site examinations, examiners review the policies and processes of introducing new business or products, and the minutes of the Board or the committee of the board. Examiners verify that banks have policies and processes in place to ensure that new products and major risk management initiatives are approved by the Board or a specific board committee. CBRC’s approval process for new products also affords it an opportunity to assess the adequacy of banks’ processes.</p> <p>Assessors’ discussion with certain banks indicated that the new product approval process is thorough and extensive in both banks and CBRC.</p> <p>EC9: Banks and banking groups are expected to establish dedicated units to perform risk management duties which include formulating and implementing the policies, processes and methodologies for identifying, evaluating, monitoring and controlling risks (see Article 10 and 32 of <i>the CBRC Guidelines on Internal Controls</i>). Requirements on segregating risk evaluation, monitoring, and control or mitigation functions from risk-taking functions are also specified in the respective guidelines on management of credit risk, market risk, operational risk, and liquidity risk. As noted earlier, the practice at banks that the assessors met was to have a senior person responsible for risk management (though this was not uniform) with dedicated staff and dual-line reporting staff in the business operations of the bank.</p> <p>Assessors were told that relating compensation of key individuals to risk is not an established practice in Chinese banks. This can be a useful tool to assist in further developing a risk culture. In China, guidelines related to the Financial Stability Board (FSB) initiative on relating compensation to risk have just been issued.</p> <p>The CBRC’s on-site examinations place significant emphasis on the independence of risk management functions. Examiners look into the organizational structure and description of each unit’s duties to ensure that the units responsible for evaluating, monitoring, controlling and mitigating risks are segregated from the business lines, and that conflict of interest is avoided. Examiners look through the reporting lines of risk management units to check whether risk management units provide independent reports directly to senior management and the Board. For those banks that do not have independent risk management functions, the CBRC requires them to take corrective actions.</p>
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	<p>AC1: Larger banks all have dedicated risk management units. All functional units, including the risk management unit, are subject to internal audit review.</p> <p>AC2: <i>The CBRC Guidelines on Stress Testing by Commercial Banks</i> sets forth requirements for banks to conduct forward-looking stress testing. Stress testing scenarios are supposed to include light stress, moderate stress and serious stress. Assessors discussed stress testing practice. There has been a considerable increase in stress testing over the past two years pushed by CBRC and by global developments. As in other markets this is evolving. A key challenge is getting the stress scenario severe enough to be useful without being implausible so that it is disregarded.</p> <p>In that regard, the fundamental approach of having banks do mild, medium and severe stresses is good. Certain recent stress tests such as that on the property market (10/20/30 percent drop in property values) do not appear to be adequately severe—particularly for banks that may have some degree of geographic concentration of this lending.</p> <p>Assessors did not hear of widespread use of reverse stress testing, in which banks are asked to come up with plausible scenarios that would lead them to breach, or come close to breaching, important ratios such as capital adequacy requirements.</p>
Assessment	Materially Non-Compliant
Comments	<p>It is important to judge the quality of risk management under this CP in relation to the size and nature of the Chinese banking system. Chinese authorities view their banking system as much less complex and interconnected than most other developed markets. In part, this is due to a policy on segregation under which banks may not get into nonbanking businesses, and in part due to other aspects of the financial system such as lack of a convertible currency which limits direct financial shocks from abroad. The main businesses of Chinese banks are still deposit taking and lending. However, Chinese banks are now among some of the world's largest, are starting to expand abroad, and the Chinese banking market is quite diverse with different risks as a result of its size, and varying economic and financial conditions in different parts of the country. Certain areas such as use of credit/debit cards and some lending areas are expanding rapidly or are new. In stress periods there could well be interaction between risks that banks have to understand. So the Chinese banking system is far from simple.</p> <p>There is clear evidence that large banks and mid-size banks have risk management processes for each of the major risks (credit, market, liquidity, and IRRBB), though there is room for improvement in some of these, as noted in other CPs. But the meaning of comprehensive goes beyond that. It is intended to mean a capability to look at risk on an enterprise-wide basis that integrates risk management and understands and looks for interactions among risks, including in stress testing. The practice of comprehensive risk assessment, in this sense is evolving in China. There have been major improvements in risk management in the last several years. Progress is impressive and CBRC initiatives have been leading industry in many areas to improve practice. Senior management at banks that assessors met, were strongly committed to these improvements. This is a sound strategy.</p> <p>But solidly embedding a risk management culture, and getting the balance right between growth and risk takes time, and reinforcement. Far too often some banks, including some large ones, appear to be relying on CBRC requirements as their primary metrics in board and management strategy development and implementation. It will be several years at least until this process of embedding risk measurement and risk culture is stable.</p> <p>CBRC guidance for risk management is generally in good shape. The issue is practice. Some of the guidance is relatively recent so implementation is understandably not fully in place. For a number of banks there remain important areas for improvement in management of individual risks (as noted in other CPs). Not all major banks that assessors met had a fully functioning enterprise-wide risk governance structure. A period of settling in is likely required for the new</p>

	<p>enterprise-wide approaches and governance arrangements that are in place to be properly embedded in banks operations and culture. That will tend to increase effectiveness.</p> <p>Settling in is also required of how the natural tension and desired balance should be managed, in practice, between achieving economic and social goals through the banking system and operating banks in a prudent fashion. That should involve more targeting of risk indicators as opposed to growth indicators in some banks' strategies.</p> <p>The new risk management systems have not been tested in a stressed environment.</p> <p>Banks appear to be transitioning from a more-siloed approach to a more-integrated, enterprise-wide approach, though there appears to be significant variation in bank progress in this regard, even among the major banks. As noted in CPs on other risks, certain major banks need more IT development in order to reach their desired ability to aggregate exposures and liquidity positions across their world-wide consolidated operations in a timely manner.</p> <p>Guidance for relating capital to risks has just come into effect for Basel II banks, and supervisors have not had time to assess, nor banks to implement. Practice of assessing overall capital adequacy relative to risks is also at an early stage in banks and in the supervisor. It will take a major advance with the introduction of Basel II over the next few years. Capital planning for a number of banks (including some large ones) tends to be driven off meeting the regulatory ratios. Clarity of expectations for how smaller banks and mid-size banks are supposed to relate their capital to risk will likely be necessary, as detailed guidance in this area is not available.</p> <p>CBRC is evolving its practice of using information from the wide variety of on-site reviews conducted in a year to form an overall assessment of the quality of risk governance and decide whether more fundamental improvements in a bank's systems and processes may be required.</p> <p>CBRC should review stress testing practices to ensure adequate severity. It should also encourage all banks (not just Basel II banks) to relate stress results to their capital position not only to other key indicators such as NPLs. It should consider having banks do reverse stress tests.</p>
Principle 8.	<p>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.</p>
Description	<p>EC1: Credit risk is the major risk for virtually all Chinese banks, and is likely to remain so for some time. The adequacy of credit risk governance and management practices of banks, and the adequacy of CBRC regulatory and supervisory processes have to be assessed relative to the environment. Despite substantial decline in NPLs, and despite CBRC and banks rating credit risk low for many banks (and asset quality high), the assessment team believes credit risk is material and likely rising. (Further analysis of the credit environment is provided in the comments section below).</p> <p>Banks are subject to credit risk management requirements pursuant to a set of laws, rules and guidelines. <i>The Commercial Bank Law</i> sets forth essential criteria of banking activities, including credit extension, investment and inter-bank lending. Rules and guidelines issued by the CBRC further specify the requirements for risk governance, underwriting process, asset quality, loan loss provisioning, large exposure limits, related party transactions and credit extension to high-risk sectors. These rules and guidelines include but are not limited to the following: <i>the Guidelines on Corporate Governance, the CBRC Guidelines on Board Due Diligence Performance, the CBRC Guidelines on Internal Controls, the Guidelines on Credit Extension Activities of Commercial Banks, the CBRC Guidelines on Due Diligence in Credit Extension by Commercial Banks, the CBRC Guidelines on Risk-Based Loan Classification, the CBRC Guidelines on Corporate Group Lending Risk Management, the CBRC Rules on</i></p>

Exposures to Shareholders and Other Related Parties, the Guidelines on Loan Loss Provisioning, the CBRC Guidelines on Risk Management for Real Estate Loans and the Derivative Rules.

Certain of the more-specific guidance has been issued in 2008 and 2009, in part in response to issues arising from the build up of loan growth.

The rules and guidelines cited above provide that the Board shall assume the ultimate responsibility for credit risk management, and thus, shall determine bank's risk appetite, examine and approve the credit risk management strategies, policies and procedures to ensure effective identification, measurement, monitoring and control of credit risk. The senior management is required to implement credit risk management policies and procedures approved by the Board. It shall also ensure that the bank has adequate resources, an appropriate organizational structure and MIS for credit risk management.

The CBRC Guidelines on Board Due Diligence Performance sets forth the responsibility of the Board in establishing appropriate risk management and internal controls to effectively identify, measure, monitor, and control risks faced by banks. *The Guidelines* also requires the Board to establish a risk management committee responsible for monitoring senior management's performance in risk control, regularly assessing the risk profile of the bank, evaluating the process and results of the internal audits and making recommendations on how to improve risk management and internal controls (see Articles 7 and 14).

Board risk committees are chaired by independent directors.

The CBRC conducts on-site examinations to assess the performance of the Board and senior management as well as the effectiveness of the bank's credit risk management, and whether they implement the approved strategy.

Assessors discussed with the CBRC, and with banks, the nature of credit risk management strategy and significant policies and processes that the CBRC expects the Board to approve and/or review. Banks differ considerably in the degree of detail in board-approved strategies and how much they are based on explicit risk information as opposed to portfolio limits and growth targets. The latter seem to predominate. Not all major banks have what could be called credit risk appetite statements. Strategies are often expressed in targets for overall loan growth and lending to various sectors or types of exposures (residential/SME, by industry, by region, etc). In some cases elements of strategies are tied to achieving and maintaining the supervisory mandated ratios (such as NPL coverage ratio being above 150 percent, concentration of top ten borrowers less than 50 percent of capital and an NPL target). CBRC staff indicated that when national development goals are expressed by the State Council, they expect to see those goals reflected in some ways in banks' lending strategies. At the same time CBRC has consistently emphasized that these goals are to be achieved without compromising safety and soundness, which is its primary supervisory objective.

Bank strategies often do not seem to be based on risk indicators such as target credit underwriting standards linked to the bank's risk assessment process, target internal ratings or loss rates over a cycle. Minimum ratings for underwriting may be set (e.g., loans have to be rated at least BBB). A number of banks take account of risk at a sectoral level (as well as national economic goals) in setting their loan growth targets. Some banks indicated they set minimum loan growth targets for certain sectors.

EC2: Supervisors need to require and periodically confirm that bank policies and processes establish an appropriate credit risk environment. The rules and guidelines cited above (and the commercial banking law) provide the supervisory requirements on policies, procedures and standards for credit risk management. They are generally comprehensive and cover such matters as appropriate policies and processes, approval authorities, continuing analysis of

<p>borrowers' ability and willingness to repay, and policies and processes for identifying problem assets. There are a few notable missing elements. For example, there is no requirement in guidance for at least annual review of the credit assessment of corporate and commercial borrowers, though that appears to be many banks practice.</p> <p>Assessors also discussed the process the CBRC uses to assess senior management's implementation of the board-approved strategy.</p> <p>The CBRC regularly carries out on-site examinations to review banks' credit risk management and credit granting process. The major focuses in on-site examinations are as follows:</p> <ul style="list-style-type: none"> • adherence to strategies and risk appetite approved by the Board. • credit approval authorization: whether banks have set credit approval authorization for functional departments, branches and subsidiaries and establish processes to ensure that they are adhered to in practice. • credit risk limits system: whether banks have set limits, under the overall credit risk appetite approved by the Board, for customers, products, sectors and geographic regions, and adopted differentiated credit policies to control the associated risks; and whether the adherence to limits has been closely monitored and exceptions to limits have been properly dealt with. • credit underwriting: whether banks follow the due diligence requirements set out in <i>the CBRC Guidelines on Due Diligence in the Credit Extension by Commercial Banks</i>; whether they adequately assess the borrower's ability and willingness to repay and ensure that credit granting adheres to their internal credit approval authorization and various credit limits. • credit administration: once a credit is granted, including effective monitoring • credit risk concentration control. • risk reporting process: whether banks have established clear reporting lines for credit risk management; whether credit risk reports adequately reflect banks' credit risk profile and propose risk control measures, which can enable the Board and senior management to obtain a good understanding of the banks' credit risk exposures. <p>CBRC reviews also assess the internal controls for credit risk management: whether banks' credit risk management is independent of credit origination functions with an independent reporting line; whether proper segregation of duties has been maintained and a system of accountability has been established.</p> <p>Assessors discussed banks' practices with CBRC staff, reviewed banks published material on credit risk management and met with several banks. They also reviewed results of CBRC's risk assessment of banks' inherent credit risk and credit risk management, and the methodology and examples of CBRC's ratings of asset quality in the CAMELS system. Assessors saw examples of CBRC examination reports.</p> <p>Many large banks adopted a more granular single dimension rating system (of 10–15 grades) for credit underwriting in the 2003–2007 period (depending on the bank). Prior to that they used the regulatory five-fold classification. CBRC and other observers indicated that medium size banks have also adopted their own internal loan rating systems, though this was recent for some (some smaller banks tend to use the supervisory-specified five-fold classification (pass, special mention, sub-standard, doubtful and loss). Two-dimensional rating systems (exposure and facility) are under development currently as part of the movement to Basel II among the top banks.</p> <p>Major banks have also moved to centralized risk management approval for corporate loans in headquarters or the Tier 1 branches as a means of increasing underwriting quality and quality of follow-up and ongoing loan assessment. This process is largely complete, though for some</p>
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	<p>that is quite recent.</p> <p>Banks report that the Chinese credit register is very useful.</p> <p>Assessors discussed with CBRC their approach to credit risk examinations. These will often be integrated into business line reviews. Corporate lending reviews do replication testing. They focus on deviations in loan classifications relative to the five-category supervisory classification which drives impairment decisions (not the bank's own rating system, though it may also be looked at). A typical sample at a major bank would be 30 percent of corporate loans (which could easily be 2–3,000 loans, using 200 examiners. Examiners at bank headquarters would consider policies, procedures and loan classification. Examiners at branches would look at adherence to policies and actual practice.</p> <p>Examiners have a very low tolerance for errors affecting NPL classification. There does not seem to be an internal tolerance threshold feedback for rating system error beyond which CBRC would indicate to senior management and boards that the risk rating system lacks integrity and has to be revamped.</p> <p>For retail loans the use of credit scoring models is generally in early stages of adoption. Some have come from external vendors. It is not clear that models now in use have been validated for the Chinese market to the standard needed for capital purposes.</p> <p>CBRC rates inherent credit risk and the quality of risk management in its risk assessment process. This is a key driver of supervisory focus. Currently CBRC staff have rated credit risk as low at major banks and credit risk management as acceptable. Assessors also reviewed the recent pattern of asset quality (A) ratings in the CAMELS+ rating system. Ratings for major banks have been relatively high (i.e., good) and rising. Discussions with CBRC staff indicated that the main reasons for this pattern are related to quantitative indicators used in ratings such as declining proportion of NPLs and low levels of loan migration through the supervisory rating classification, as well as increased capitalization by banks to fund loan growth.</p> <p>The CBRC periodically briefs the banks' Chairmen and Chief Executive Officers (CEOs) of its views on the changes in macroeconomic situations and potential risks in the banking sector, and provide window guidance on banks' lending activities.</p> <p>CBRC has also been active in dealing with credit risk issues arising from macro developments. The most current example is that of the Local Government Funding Platforms (LGFPs). They were set up in 2005 to provide finance for local infrastructure since local governments were prohibited from borrowing by law. In 2009, a substantial portion of the loans associated with the fiscal stimulus went to LGFPs (though precise figures are unavailable and different authorities have different definitions of what constitutes this lending.) Banks do not report this lending separately. According to CBRC areas of stimulus spending included infrastructure, welfare programs, environmental protection and post-earthquake construction. This lending growth tailed off in Q2 2009.</p> <p>According to CBRC, supervisory concerns include possibility of lax loan review, high concentration risk and inadequate loan monitoring and administration.</p> <p>Actions by the CBRC and others included: risk alerts to certain individual institutions starting in 2005; guidance in 2006 together with PBC, National Development and Reform Commission (NDRC), MoF and Ministry of housing re package loans; setting up a task force in 2008 to review LGFP lending with a report provided to the State Council. Actions in 2009 included selected surveys of LGFP practices in different localities and 'triple bottom line' guidance forbidding package loans, prohibitions on contracts with little or no commercial viability and restrictions on lending to LGFPs with insufficient equity, governance risk management, fund</p>
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	<p>utilization or internal controls. This effort by CBRC and other agencies culminated in requiring banks to reevaluate all LGFP loans by mid-year 2010 and reclassify them if necessary.</p> <p>During the on-site assessment the State Council released high-level policy direction ordering stronger management of LGFPs, strengthened lending practices by banks, prohibiting unauthorized guarantees by local governments and strengthened government coordination.</p> <p>EC3: The commercial bank law provides that no organization or individual may force a bank to provide loans or guarantees. CBRC related party rules (see CP 11) generally require such transactions to be on an arm's length basis and on no more favorable terms than with unrelated parties. Dealing with potential conflicts of interest in an economy where banks are owned by various government bodies which also have extensive commercial interests can be challenging. CBRC and banks report that the move to listing banks which represent the majority of the system assets has assisted in this regard.</p> <p>EC4: <i>The Banking Supervision Law</i> provides that, when conducting on-site examinations, the supervisory agency shall have the right to access banks' documents and materials, interview the banks' staffs and require them to provide explanations on matters under review and examine the banks' IT infrastructure of business operations and management (see Articles 33 and 34 of <i>the Banking Supervision Law</i>).</p> <p>During on-site examinations, the supervisors have full access to information and full access to board members, senior management and staff.</p> <p>AC1: The CBRC reviews banks' policies and procedures to ensure that credit approval authorization are clearly and appropriately defined, which should be differentiated according to the type, amount and risk level of credit exposures. The major credit exposures exceeding a certain amount or highly risky exposures need to be approved by the senior management or the Board. The supervisors pay close attention to whether these policies and procedures are followed in practice, and whether any exceptions have been properly dealt with according to the banks' internal procedures.</p> <p>AC2: <i>The CBRC Guidelines on Internal Controls</i> requires banks to establish limits on counterparty credit exposures based on the prudent assessment of counterparty's financial strength. Banks are expected to comply with these limits on an ongoing basis and ensure that the limits capture all the credit exposures to the counterparty (see Article 60).</p> <p>For derivatives transactions, <i>the CBRC Derivatives Rules</i> requires that banks should establish policies and processes to identify, measure, monitor and control counterparty credit risks, for which they can use proper credit risk mitigates such as collateral and/or guarantee (see Article 20).</p> <p>The CBRC evaluates, through on-site examinations, whether banks have established an adequate risk management process that allows them to effectively identify, measure, and monitor counterparty credit risk exposures.</p> <p>Certain banks and observers that the assessors met indicated that counterparty credit risk is an area with considerable variation in practice and where improvements are underway.</p> <p>AC3: <i>The CBRC Guidelines on Internal Controls</i> requires that banks should establish a comprehensive customer information system to facilitate credit risk identification, measurement, monitoring and control. The system should maintain information about the financial strength, debt repayment capability and creditworthiness of borrowers, which should be regularly updated (see Article 55).</p>
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	<p>The CBRC evaluates the effectiveness of banks' customer information system through on-site examinations. Banks are expected to use this system to obtain a good understanding of the financial strength and credit quality of borrowers, to consider the total indebtedness of borrowers in credit decision-making, and to have policies and processes to determine the appropriate credit limits for a single borrower and a group of related borrowers.</p>
Assessment	Largely Compliant
Comments	<p>Much of banking in China is classic commercial banking. It is clear that many banks have strong, on-the-ground skills in credit underwriting. However with such high loan growth it is likely that credit risk is rising. Many commentators agreed, yet many kept coming back to taking comfort from recent good NPL performance, or from the strong capital position of banks.</p> <p>Banks, policymakers and commentators have focused a lot on the NPL ratios of banks. In part, this is because very high NPL ratios of some banks in the early part of the decade were a clear indicator of serious problems that required major efforts to deal with, as well as the commitment of public resources.</p> <p>Understandably, regulators, banks and the authorities do not want to repeat this experience. So regulators, policymakers, and bankers that the assessment team met often talked about their NPL experience and the success in the recent "double reduction" of both NPL ratios and absolute amounts of NPLs. This success is truly impressive. But the challenge now is to improve credit risk management going forward. Some used the low NPLs ratio currently as an indicator that credit risk was currently "low."</p> <p>A system with better credit risk management and credit culture would not have been as focused on growing loans as fast, regardless of credit quality. It would have permitted robust loan growth with more assurance of credit quality. It would not have required so much reactive guidance and supervisory effort from CBRC to verify that lending standards were being met.</p> <p>As a result of the focus on NPLs, focus on other credit risk indicators and judgments appear to receive less attention than is desirable. Those indicators and judgments by banks and supervisors could be more forward looking and help support a proactive approach to managing credit risk that would lessen the chance of major future problems. They would also support a more-forward-looking supervisory rating assessment.</p> <p>Excessive focus on decreasing NPLs or maintaining them low can neglect the truism that in a sound risk management system NPLs should rise in a downturn. So if high rewards are given for low and declining NPLs, banks can have an incentive to manage them down in one way or another, instead of focusing on credit risk management more broadly. NPLs are also a backward measure of inherent credit risk. Identification of the early stage of inherent credit risk rising would support action to forestall or reduce credit risk problems before they emerge.</p> <p>Assessors discussed with banks about the board-approved credit strategy and related risk appetite. These discussions indicate that, often, these strategies are determined as loan growth targets by sector, region or type of customer with little relation to more granular risk characteristics. Often, NPL rates are the most prominent "risk" indicator in the strategies.</p> <p>All programs by governments to promote infrastructure, or other sectors, in countries will result in some funds being poorly targeted. However, LGFP experience seems to indicate that credit risk management practices at banks are not as uniformly as sound as they should be. LGFP experience also raises the issue of whether processes are sufficiently robust so that important government policies for economic and social development can be meshed with sound prudential policies. It is not a question of one or the other, but how the authorities have balanced implementation to achieve both aims in a harmonious way. One-off management of such situations with across-the-board measures may occasionally be necessary as problems emerge. But across-the-board measures can also undermine the goal for banks to ensure regular</p>

	<p>ongoing attention to their risks and manage risk better.</p> <p>LGFP experience also demonstrates the willingness of the CBRC to act and to bring its concerns to policymakers. At the same time, some considerable part of the embedded losses in these portfolios was probably already there as of end 2008.</p> <p>Banks' more granular risk rating processes are also at relatively early stages of development. Neither CBRC nor auditors do much work in testing their robustness, as their focus is more on the five category rating system which is related to provisioning.</p> <p>CBRC's supervisory process indicates some considerable lag in reflecting credit risk in supervisory ratings. At the time of the assessment, it was not clear to assessors that supervisory ratings for asset quality, inherent credit risk and net credit risk fully reflected current conditions.</p> <p>Improvements in managing the balance between development and financial goals in such cases might include: ensuring sound monitoring mechanisms are in place; and, even-earlier intervention by regulators on a <u>cross-system</u> basis to review credit risk underwriting practices. CBRC may want to conduct a post mortem of this experience at some point to consider lessons learned.</p> <p>There are material credit concentrations in some banks. CBRC noted that a number of banks' loan structures are concentrated to big customers. This is borne out in the banks' published annual report data assessors reviewed where loans to the top ten customers often account for 25–30 percent of a bank's capital (against a regulatory limit of 50 percent). Many of these customers for individual banks appear to be in broadly the same sectors. This looks to be a potential problem. CBRC should consider this in its ratings of banks and in its assessment of the adequacy of bank capital relative to risk.</p> <p>Credit risk stress testing seems to be at a very early stage.</p> <p>Lastly, regulatory authorities and banks need to assume that, in the foreseeable future, authorities are likely to want to relax the limits on interest rates to some degree. That possibility needs to be part of their planning and they need to be enhancing credit risk management capabilities to assess and price loans in that environment. Indeed, progress in that regard could lead authorities to have higher confidence about their ability to manage such a relaxation in a way that would not add to risks, would promote enhanced access to lending, and would treat customers fairly.</p> <p>Authorities point to the fact that some of this credit growth related to the macroeconomic response to the worldwide crisis is the bringing forward of high-quality projects, that would otherwise only have proceeded over several years. They also point to the fact that government agencies including local governments will have significant incentives to ensure performance of the loans their related entities took out to support economic expansion. Some expansion of credit growth above GDP growth would naturally be expected as structural changes enhance access to financial services.</p> <p>On the other hand, CBRC's 2009 annual report notes that majority of loan growth were medium to long term loans, and concentrated in several industries/sectors. As the macroeconomic environment changes and economic restructuring speeds up, it points out that the possibility remains high of a rebound of credit risks or losses. In addition to infrastructure-related loans, concerns have been expressed about fast growth of property loans, though LTV requirements are substantial. CBRC's 2009 annual report notes rising credit risks in the real estate sector as property loans increased 38 percent year-on-year at end 2009.</p>
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	<p>CBRC has taken actions in 2009 to address material concerns regarding inherent credit risk such as raising LTV requirements on mortgage loans for residential real estate and limiting lending for second homes. They also reinforced guidance at several times over the past two years re strengthening underwriting and loan management practices for various types of lending including lending to local government financing platforms for infrastructure (which were a high proportion of the stimulus spending). CBRC also reinforced guidance on lending for one purpose not being diverted into the stock market or real estate market. They are also pushing banks to re-evaluate all their local government exposures by June 30, 2010. These actions are commendable, but over time CBRC should be able to rely on a better credit culture in banks.</p>
<p>Principle 9.</p>	<p>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.</p>
<p>Description</p>	<p>EC1 and EC2: There are rules and regulations governing banks' management of asset quality and the level of loan loss provisioning. The <i>Commercial Bank Law</i> provides that banks must establish provisions against NPLs in accordance with relevant regulations and to establish internal process to monitor the quality of the loan portfolio. The <i>CBRC Guidelines on Internal Controls</i> (Article 50) requires a bank to establish an asset quality monitoring and early warning system to monitor changes in asset quality and take timely corrective measures. The <i>CBRC Guidelines on Risk-based Loan Classification</i> (Articles 5, 14, and 16) requires a bank to classify its loans into at least five categories (pass, special mention, substandard, doubtful, and loss) and to review the adequacy of classifications regularly. Banks also are required to submit supervisory returns on asset quality to the CBRC, including information on loan classifications, provisioning, and write-offs. Through onsite examinations and offsite reviews, the CBRC supervisors assess the adequacy of a bank's loan loss allowance level and the adequacy of provisions.</p> <p>The <i>Guidelines on Loan Loss Provisioning</i> requires a minimum provisioning level for each category of loans, i.e., 1 percent of pass, 2 percent of special mention, 25 percent of substandard, 50 percent of doubtful, and 100 percent of loss (hereafter referred to as "regulatory benchmark"). In addition, a bank's loan loss allowance amount must cover 150 percent of NPLs (defined as the total of substandard, doubtful and loss). This requirement hereafter is referred to as "minimum loan loss coverage ratio."</p> <p>In addition, banks should follow the relevant accounting principles when determining the level of loan loss allowance. The <i>Accounting Standards for Business Enterprises—Recognition and Measurement of Financial Instruments</i> issued by the MoF discusses the principles pertaining to the calculation of loan loss allowance. Under the accounting standard, banks have to evaluate the collectability of their loan portfolios by following the individual impairment and collective impairment processes.</p> <p>Based on discussions with the CBRC, if the loan loss allowance amount determined in accordance with relevant accounting principles is less than the regulatory minima (i.e., the regulatory benchmark and minimum loan loss coverage ratio), the external auditors and the bank supervisors will engage in further discussions and that there is a strong desire for the bank involved to raise the level of allowance to the 150 percent coverage level. According to CBRC's 2009 annual report, the coverage ratio as of 12/31/09 stood at 155.4 percent. As of 12/31/2009, the average NPLs-to-total loans ratio was 1.6 percent, compared to 17.9 percent as of 12/31/2003. The drastic decline in NPLs over the years was partly due to sale of bad loans to AMC. Reportedly, sale of bad loans to AMCs amounted to US\$156 billion from 1999 through year-end 2005. Loan sales on commercial terms to AMCs and other vehicles such as trusts continue to occur making it challenging to fully interpret bank NPL statistics.</p> <p>Discussions with accounting firms suggested that in most cases, the difference between the levels as determined by relevant accounting principles and the regulatory minima is not considered significant. Under these circumstances, the regulatory requirements take precedence over the accounting principles and the auditors do not take issue with banks raising the level as</p>

long as the difference is not considered material. In practice, since there is a supervisory guidance in place that banks should attain a target 150 percent loan loss coverage of NPLs, external auditors also review the accuracy of loan classification during their bank audits.

The *MoF Rules on Writing off Bad Loans by Financial Institutions* (revised in 2010) lays out many conditions under which banks have to meet before they could write off a loan. Therefore, banks do not have the flexibility to write off their loans that they deem are uncollectible. A major bank's 12/31/09 financial statements indicated that loans past due more than 90 days comprise 1.4 percent of total loans. However, the majority of these past due loans (1.1 percent of total loans) are overdue more than a year. When assessors met with a rural commercial bank that was established in 2008 as a result of the merger of a number of rural credit cooperatives, bank officials indicated that the 3 percent NPLs on the bank's book were primarily legacy loans but they were unable to write off these loans due to the strict conditions set by the MoF. In some countries, there are statutory requirements to write off loans that are past due over a certain number of days. The past due situation of these two banks is an indication that Chinese banks' ability to write off loans on a timely basis has been adversely affected by those strict conditions.

EC3: The *CBRC Guidelines on Risk-based Loan Classifications* specifies that loan classifications and provisioning have to factor into the banks' off-balance-sheet items such as loan commitments and standby letters of credit. For reporting purposes, the allowance for credit losses associated with off-balance-sheet exposures is reported as a liability item (and not part of the loan loss allowance) in accordance with the *Accounting Standards for Business Enterprises No. 13—Contingencies*.

EC4: During onsite examinations, banking supervisors reviews the accuracy of loan classifications and the adequacy of provisions. In addition, the supervisors discuss with external auditors regarding whether the bank has appropriate policies and procedures to ensure adequate provisions and timely identification of loans that should be written off.

EC5: Credit quality review is a key supervisory focus of the CBRC during onsite examinations. The examination team determines the soundness of the asset quality system, the adequacy and competency of the resources dedicated to the credit administration function, the appropriateness of policies and procedures for early identification of problem credits, the timeliness of loan collection efforts and the soundness of the MIS to collect NPL information.

EC6: Banks are required to submit prudential returns to the CBRC that contain information on loan classification, loan migration, and loan loss provisions. When asset quality deterioration is noted, the CBRC will contact bank management and may request additional information for further monitoring purposes. During onsite examinations, bank supervisors have full access to loan files and other reports related to asset quality.

EC7 and EC8: The CBRC has the authority to require banks to increase their provisions if the existing level of loan loss allowance is considered inappropriate and/or the classification of the loan categories is determined to be inaccurate. Under this circumstance, the CBRC will also request the bank to improve its credit risk management process and the loan classification policies and procedures, and require the bank to deduct the provisioning shortfall from regulatory capital. If a bank fails to take corrective measures within a prescribed timeframe, the CBRC will take further supervisory actions, such as restricting dividend payments.

EC9: The *CBRC Guidelines on Due Diligence in the Credit Extension by Commercial Banks* (Article 41) requires banks to closely monitor all factors affecting the collectability of the loans, including collateral value. During onsite examinations, supervisors review the bank's policies for ongoing collateral valuation, the adequacy of the valuation, and the competence of external valuation agency, if any.

	<p>EC10: Accounting guidance on impaired loans is defined in the <i>Accounting Standards for Business Enterprises No. 22–Recognition and Measurement of Financial Instruments</i> and is in line with international definition. The <i>Accounting Standards for Business Enterprises</i> also provides guidance on individual and collective assessment of impairment.</p> <p>Based on discussions with audit firm personnel, since the adoption of the accounting standards relating to loan loss allowance a few years ago, many banks have been able to gradually comply with the individual and collective impairment concepts in determining their loan loss allowances. However, there have been some challenges in applying these standards. For example, some banks do not have sufficient historic loss data to supply the information necessary to support their estimate of an appropriate loan loss allowance. In addition, since smaller sized banks used to rely solely on regulatory benchmarks to determine the amount of loan loss allowance, they face difficulties with making judgment when analyzing the collectability of their loans and performing impairment analyses.</p> <p>EC11: The <i>CBRC Guidelines on Internal Controls</i> (Article 25) requires banks to have an effective mechanism for reporting timely information on a bank’s risk profile to the Board of Directors. The CBRC evaluates the timeliness and adequacy of asset quality related information provided to the Board through reviewing internal reports submitted and minutes of the Board of Directors meetings. If necessary, the CBRC supervisors hold meetings with board members to obtain a better understanding of whether they have been promptly and adequately informed about the asset quality condition of the bank.</p> <p>EC12: Relevant guidelines require banks to evaluate the performance of a large exposure individually and to determine the provisioning and classification on an individual basis.</p> <p>AC1: <i>The CBRC Guidelines on Risk-based Loan Classification</i> (Articles 8, 11, 12, and 15) provide guidance on the classifications of overdue and restructured loans:</p> <ol style="list-style-type: none"> 1. The overdue days shall be a major reference for asset classification; 2. Classification of retail loans shall be mainly based on the days in arrears; 3. A loan shall be classified at least as substandard, if it is overdue for a certain period of time and the interest ceases to accrue; and 4. A loan that needs to be restructured shall be classified at least as substandard, which cannot be upgraded within an observation period of at least six months. <p>Both overdue and restructured loans are the focus of CBRC’s onsite review of asset quality. For retail loans, the CBRC required banks to mainly refer to days in arrears for classification purposes. For other loans, the CBRC generally requires banks to focus on the borrower’s repayment capability, with past due status as one of the major references. The CBRC also pays particular attention to whether banks have unduly upgraded restructured loans. Discussions with market participants indicated that some banks have engaged in the practice of rolling over some loans in an attempt to keep the loans current. The CBRC indicated that onsite examiners have exercised close scrutiny of this practice and classified these loans accordingly.</p>
Assessment	Compliant
Comments	<p>(1) Writing off loans that are deemed uncollectible on a timely basis is an important aspect of sound credit risk management. In China, banks’ ability to write off loans on a timely basis has been adversely affected by the strict conditions set by MoF. As a result, some banks still have loans past due more than a year remaining on their books. The authorities in China may consider establishing a mechanism to facilitate the loan write-off process. In some countries, banks write off their loans as they consider them uncollectible and in accordance with their internal guidelines. If the tax authority has doubts about whether a bank is charging off a loan prematurely to obtain tax deductions, it will contact the responsible regulatory agency and seek its opinion or confirmation about the collectability status of the loan.</p>

	<p>(2) Assessors spent a considerable amount of time discussing the loan loss provisioning issue with the CBRC, external auditors, and market participants, to clarify the regulatory minimum requirements versus the requirements to comply with relevant accounting principles in the loan loss allowance determination process. Discussions indicated that despite some challenges, most banks have been able to comply with both relevant accounting principles when providing for loan losses. However, the smaller sized banks are lagging behind in this area. Therefore, they should strive to develop and maintain a comprehensive and consistently applied process for determining loan loss allowance in accordance with relevant accounting principles and management’s best judgment. This area should also be a supervisory focus for CBRC.</p>
<p>Principle 10.</p>	<p>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.</p>
<p>Description</p>	<p>EC1: The <i>CBRC Guidelines on Corporate Group Lending Risk Management</i> defines “a group of connected counterparties” as the corporate group that is composed of entities which meet one of the following conditions: (1) there are direct or indirect controlling relationship with other member corporations within the group in terms of equity ownership or business decision-making; (2) being controlled by the same corporation within the group; (3) being directly or indirectly controlled by another member corporation’s major natural person shareholders or key managers, individually or jointly with close family members; and (4) there are other forms of connections with other member corporations that may cause the transfer of assets or interests without following the “at-arms-length” principle. In China, banks are required to identify a group of connected counterparties in accordance with the principle of substance over form. According to the 4th criterion above, if two entities with common local government ownership have any form of economic relationships, they will be included in the definition of connected parties, but will not be included by virtue of local government ownership alone. The management of concentration risk relating to enterprises with common local government ownership is required to cover two aspects: name concentration and sector concentration. In terms of name concentration, banks are required to identify and control concentration risks based on inherent relationships between different enterprises. From a sector concentration perspective, banks are required to manage concentration risks resulting from LGFPs.</p> <p>During onsite examinations, the CBRC reviews banks’ policies and procedures, MIS, and other relevant documents to assess whether banks have proper definitions for corporate groups and whether they are identified and monitored on an ongoing basis.</p> <p>EC2: The <i>Commercial Bank Law</i> (Article 39) stipulates that a bank’s total outstanding loans to a single borrower should not exceed 10 percent of its capital. In addition, the <i>CBRC Guidelines on Corporate Group Lending Risk Management</i> requires that a bank’s total risk exposures to a corporate group should not exceed 15 percent of capital. These exposures also include off-balance-sheet exposures. During onsite examinations, the CBRC ensures that banks have the risk management systems to identify, control, measure, and monitor large exposures so as to confirm that these limits are not exceeded on a solo or consolidated basis. In addition, the CBRC has established the <i>Large Exposure Analysis Database & System (LEADS)</i> to collect information from major banks on large borrowers (mostly corporate groups) and connected parties. The information provided by the LEADS includes the largest five shareholders of the borrower, its largest five connected parties other than shareholders, basic financial information, credit exposures, loan quality and the bank’s judgment on the business operation and risk characteristics of the borrower. The LEADS improves information sharing among major banks with respect to borrowers of large exposures, and hence helping them to better identify and manage risks arising from concentrations in the credit portfolio.</p> <p>While the CBRC has the authority to lower the limit at its discretion for a particular bank on a case-by-case basis, it has not done so in practice.</p>

	<p>EC3: Banks are expected to have MIS to collect information on borrowers and identify corporate group counterparties and that they have the policies and procedures established for acceptable thresholds relating to concentration of credit. During offsite surveillance, the CBRC evaluates banks' MIS by reviewing the accuracy of information on large exposure indicators submitted by banks according to the CBRC's supervisory reporting requirements. Banks are required to participate in the LEADS and the national credit registry system, and to submit information of their own large exposures and getting access to large exposure information provided by other banks.</p> <p>EC4: Banks are also expected to establish effective communication channel to report material risk concentrations to the Board of Directors for review. The CBRC reviews the adequacy of banks' policies and procedures and assesses the effectiveness of banks' information systems to identify and aggregate exposures on a timely basis during its supervisory process.</p> <p>EC5 and AC1: Through both onsite review and regulatory reporting, the CBRC obtains information concerning banks' loan concentrations including information on sector, geographical and currency concentration. If concentrations are considered to present significant risks, the CBRC requires banks to take correction action and if necessary, take enforcement actions in accordance with the <i>Banking Supervision Law</i> (Articles 37, 46, 47, and 48).</p>
Assessment	Largely Compliant
Comments	<p>Although the CBRC aggregates exposure among related/connected parties for the purposes of measuring large exposure/concentration risk, it should consider developing a more comprehensive framework for assessing risk across related/connected parties. In particular, the operation of the general (4th) criterion on what constitutes connection should be elaborated and CBRC should recognize that (perhaps above a certain size threshold) the fact of common ownership by a local government by itself can lead to concentration risk. This is important particularly given the recent experience with bank exposure to local government vehicles.</p>
Principle 11.	<p>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.</p>
Description	<p>EC1: The definition for related parties is provided by the <i>CBRC Rules on Exposures to Shareholders and Other Related Parties (2004)</i>. The Rules (Articles 6–11) define related (connected) parties comprehensively to include connected natural persons, legal persons or other organizations. Among those covered by the definition are directors and senior managers of the bank and its branches and their close relatives; other employees who participate in credit decisions or other asset transfers; significant shareholders (who hold more than 5 percent of shares or voting rights); others who exert significant control over the affairs of the bank; sister companies; and companies controlled by connected persons or organizations. Two exclusions to this definition are commercial banks and AMC. However, though the connected lending definition does not apply in case of parent, subsidiary or affiliate banks, the guidance on consolidated supervision (Section III) addresses the need to undertake arms length transactions with intra-group companies.</p> <p>The definition of what constitutes a “related party transaction” is also broad and covers all transfers of resources or obligations between the bank and its related parties, such as granting credit, transferring asset, offering services, and other related party transactions prescribed by the CBRC.</p> <p>EC 2, 3, and 4: The Rules require banks to have a formal mechanism in place for dealing with risks of all connected transactions and the details of the policies and processes associated with this system are to be submitted to CBRC. At the Board level, banks have to set up a Transaction Control Committee which is to be staffed by at least three members and headed by</p>

	<p>an independent director. This Committee is responsible for the management of all approvals and for articulating the risk management practices. All connected transaction are to be divided into one of two categories (i) general, where the transaction amount is less than 1 percent of the net capital of the bank and after the transaction, the outstanding exposure to the connected party is less than 5 percent of the net capital and (ii) important, where the transaction amount is greater than 1 percent and the outstanding exposure after the transaction is more than 5 percent. All computations are to be done on a consolidated basis.</p> <p>The <i>Commercial Bank Law</i> (Article 40) prohibits banks from providing unsecured loans to related parties, and requires secured loans granted to related parties to be conducted on an arm's length basis. This is reiterated in the <i>Rules</i> (Article 4) which requires that such transactions be conducted on normal business terms and the terms are not more favorable than those for similar unconnected transactions. In practice, this determination may be challenging in the current interest rate environment where there is a floor on interest rates and banks are to charge risk premiums above the floor.</p> <p>The <i>Rules</i> (Article 22, 25) require that all general related party transactions should be reported to the transactions control committee/ department for examination and approval where required and that all significant related party transactions be approved by the Board. In the approval process of the Board or related party transaction control committee, all related individuals are to withdraw from the discussions (Article 26).</p> <p>EC 5: The <i>Rules</i> set general limits for the exposure to related parties. A bank or a banking group's exposures to a single related party shall not exceed 10 percent of its net capital; a bank or a banking group's exposures to a related corporate group shall not exceed 15 percent of its net capital; and a bank or a banking group's aggregate exposures to all related parties shall not exceed 50 percent of its net capital (the numerator of the CAR). Unsecured loans to related parties are prohibited (Article 29), and the CBRC has the authority to lower the above limits based on banks' risk profile (Article 33).</p> <p>EC 6: Under the <i>Rules</i>(Article 23), banks are required to establish internal policies and procedures for related party transactions, and should cover oversight by the Board, composition and responsibilities of the related party transaction control committee, related party information collection and management, identification of related parties, types of transactions allowed for related parties and pricing policies, approval process and standards, absence requirement to avoid conflict of interest, reporting lines and contents, internal audit, information disclosure and accountability, etc. The formal mechanism is detailed in the description of EC 2 above.</p> <p>CBRC supervisors conduct risk analysis based on banks' OSS schedules and quarterly reports on related party transactions, monitoring banks' adherence to the regulatory limits. Banks' policies and procedures on related party transactions are evaluated during on-site examinations and include review of the minutes of the Board, related party transaction control committee and credit review committee; internal audit reports; credit files for related party transactions and assess the approval process, reporting system and internal controls, and to confirm that the Board and senior management fulfill their tasks under the Rules.</p> <p>EC7: CBRC obtains information on related party transactions on a quarterly basis. Banks submit the OSS Schedule on Transactions with 20 Largest Related Parties which provides details on credit exposures to the 20 largest related parties, credit exposures to the largest related corporate group, and aggregate transactions with all related parties. Banks are also required to submit quarterly reports on the management of related party transactions.</p>
Assessment	Largely Compliant
Comments	While the definition of related party is broad, there are two exemptions in the definition—that of transactions with other affiliated commercial banks and AMCs related to banks. The former is to some extent mitigated by the fact that (i) currently the four AMCs are state owned and the latter is indirectly covered by the Guidelines on Consolidated Banking Supervision

	<p>(Articles 36–38) which require arms length principles to be applied to intra-group transactions within a banking group. In addition, though there are no specific exemptions, ownership by the state government—whether central or local—is not treated as a trigger for related party reporting, limits or approvals. Thus in theory, a commercial bank owned by the local government, as is the case with some city commercial banks, can lend to LGFPs without being covered by the extra diligence required for related parties. Given that lending to this segment is a cause for concern at this time, it is imperative that this issue be reviewed and such transactions be brought under the discipline of enhanced diligence and limits are applicable to related parties and thus be covered by the elevation in internal governance and supervisory focus that comes from being recognized as a related party transaction. This could be done above a threshold.</p>
<p>Principle 12.</p>	<p>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.</p>
<p>Description</p>	<p>EC1: According to CBRC estimates, the country and transfer risk exposures of their banking system is relatively insignificant, estimated to be equivalent to 3.6 percent of total banking assets, with about the majority (two-thirds) of the exposures being to Hong Kong and Macau. The exposure consists mainly (around 70 percent) of overseas lending and direct investments. The five large banks account for the majority (92 percent) of the total country risk exposure, which in turn accounts for about 6 percent of their assets. However, as commercial banks are increasingly taking on cross-border exposures directly and indirectly, the risk is expected to gain in materiality and relevance in the coming years.</p> <p>Prior to 2008, some aspects of the requirements for managing country risk exposure were incorporated in credit risk guidance e.g., the 1999 Guidelines on Credit Extension Activities of Commercial Banks and 2004 Guidelines on Due Diligence in the Credit Risk Extension. However, detailed supervisory expectations in this regard were not spelt out till the issuance of the Guidelines of Consolidated Banking Supervision in 2008 (Article 30) and then further consolidated in the comprehensive Guidelines on Managing Country and Transfer Risk in 2010.</p> <p>The 2010 Guidance provides a comprehensive guidance to banks on managing country and transfer risks. CBRC has since finalized its guidance, which was issued on June 8, 2010 when the assessment was in progress. These Guidelines on Managing Country and Transfer Risks require banks to integrate country and transfer risk management into their overall risk management systems. Banks are expected to establish a sound country risk management system consistent with their strategies and commensurate with their size and complexity, which should have the following elements: (a) effective board oversight; (b) appropriate policies and procedures; (c) comprehensive identification, measurement, monitoring and controlling of risks; and (d) effective internal controls and internal audit. The Guidelines also provide that banks should adequately identify measure and monitor potential country risks by country on a solo and consolidated basis and enhance their monitoring of country and transfer risks in case country or region stresses warrant. While some banks have introduced systems in place to monitor exposures on a country basis, this is still work in progress.</p> <p>EC 2: The Guidelines provide that banks should establish appropriate country risk limits in terms of business line, counterparty and maturity. The overall country risk limits should be approved by the board of directors, reviewed at least annually and adjusted to the change of the conditions of countries. Banks will also be required to have in place procedures to monitor country exposures, report and deal with breach of limits according to established policies and procedures. Banks will also have to establish adequate and reliable MIS to identify, measure, monitor and control country risks and to establish comprehensive country risk internal control systems. Banks' internal audit departments will be expected to independently review the effectiveness of country risk management systems, assess banks' adherence to country risk management policy and limits on a regular basis.</p>

	<p>Banks' practices vary in this regard. The large banks which account for the bulk of the country risk exposure have set up separate teams or divisions to focus on country risk and instituted relatively more comprehensive systems for measuring, monitoring and managing country risk exposures and use a mix of qualitative and quantitative factors to determine country risk ratings which are in turn linked to internal limits. A couple of banks are also in the process of developing internal systems to complement the external ratings based inputs. For the medium and smaller banks, this is still work in progress.</p> <p>EC3: In terms of the 2002 guidelines on credit extension, banks have been expected to make specific provisions on a quarterly basis which should also incorporate provisions according to the risk profile and historical losses of country and sector exposures (Article 6). In practice, when making provisions for an individual asset, the major banks take into account a range of country risk factors such as sovereign risk, transfer risk, political risk and macroeconomic conditions. If there is evidence that those factors may affect borrowers' repayment capability, additional provisions are set aside based on the potential losses that may arise from country and transfer risk factors</p> <p>Provisioning requirements have been further clarified in terms of the June 2010 Guidelines - Banks should have written policies for provisioning against country and transfer risks and they should set aside provisions for each country or specific provisions against certain types of risk taking into account country and transfer risks. These provisioning methods are to be assessed by qualified external auditors to assess their provisioning methods and evaluate the adequacy of provisioning against country and transfer risks.</p> <p>EC4: Currently there are no separate requirements for banks to report information on their country and transfer risks. The CBRC requires banks to submit OSS Schedules on credit risks periodically, which have included information on banks' country exposures. CBRC also makes ad-hoc requests for information on country risk and any also request such information in the course of on-site examinations. The Guidelines seek to strengthen reporting requirements by requiring banks to (i) submit their country risk management policies and procedures to the CBRC (ii) report their country risk exposures and provisioning to the CBRC on quarterly or annual basis depending on significance.</p>
Assessment	Largely Compliant
Comments	<p>Country and transfer risk exposures have been increasing as Chinese banks increase their presence in overseas financial systems and finance more overseas projects as well as trade finance. So far, while the large banks which account for most of the country risk exposure have moved towards adopting relatively comprehensive approaches to country and transfer risk management, this is still work in progress for other banks. Supervisory expectations for managing this risk, which were earlier expressed in different settings (e.g., in guidance on loan loss provisioning and on consolidated supervision) have been consolidated, amplified and reissued in June this year as this risk is expected to gain in materiality. Some of the banks that the mission met with acknowledge that they have some work to do in full adoption of the new guidance. CBRC is aware of the gaps in implementation and is working with the industry to address them. Going forward, CBRC should get major banks to submit plans (with timelines) by year-end to upgrade their policies/practices for country-risk to meet the new 2010 guidance and conduct a targeted review in the next 12–18 months.</p>
Principle 13.	Market risk. 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.
Description	<p>EC1: Market risk in Chinese banks is not as large as in a number of other financial systems. Trading book assets are a relatively smaller share of total assets (roughly 5 percent of assets for major banks that have material capital markets businesses). Foreign banks' trading assets are a very small share of the total market. A number of foreign banks conduct trading business for Chinese clients offshore, so the risk is not in their Chinese-regulated entity.</p>

<p>Products with market risk are generally not as complex as elsewhere, and a high proportion of trading is for clients rather than proprietary. Until recent pilot projects were approved, banks were not allowed to own fund management companies (and the long term policy is not finalized in this regard). Chinese macroeconomic policies can also act to reduce the market risk in various markets for FX and interest rates. However market risk can be expected to rise over the next few years as more innovation occurs and as several banks follow their announced strategy of getting more into these businesses (even if those strategies are temporarily on hold because of the financial crisis).</p> <p>The <i>CBRC Guidelines on Market Risk Management</i> provides requirements for establishing an effective market risk management system. <i>The CBRC Derivatives Rules</i> sets out specific risk management requirements on derivative transactions.</p> <p><i>The Guidelines</i> require banks to establish a sound and reliable market risk management system commensurate with the nature, scale and complexity of their businesses. It must include five basic elements: effective board and senior management oversight, adequate policies and procedures, effective risk identification, measurement, monitoring and management, sound internal controls and independent external audit, and appropriate market risk capital allocation mechanism (see Article 6).</p> <p><i>The Guidelines</i> provide explicitly that the Board should assume the ultimate responsibilities for the oversight of market risk management, including, among others, reviewing and approving market risk management strategies, policies and procedures, determining the bank's market risk appetite, and ensuring that the senior management take the steps necessary to effectively identify, measure, monitor and control various types of market risks inherent in various businesses. The senior management should establish, periodically review and ensure effective implementation of market risk management policies and procedures (see Article 8).</p> <p>Supervisors confirm that banks' policies and procedures are adequate, consistent and compliant with regulatory requirements through on-site examinations. During the examinations, supervisors review banks' written documents and reports, and hold meetings with board members, senior management, and relevant staff.</p> <p>Banks public reports on their market risk management indicate that major banks are using historical simulation Value-at-Risk (VAR) to measure and manage market risk with limit systems. However, the VAR engines are reported to be 99 percent confidence interval one day holding period. While banks are not using models for market risk capital in China the universal standard for VAR engines would be a minimum 10 days holding period. The difference in measured VAR is significant. And in times of extreme volatility and reduced liquidity a ten days holding period would not be adequate to measure potential losses. Certain banks have moved to a 99 percent confidence limit from a lower level only relatively recently. Certain banks only recently elaborated their market risk management process at the branch level domestically and in their overseas branches.</p> <p>Board strategies and risk targets in a number of banks that assessors talked to are often not clearly linked to market risk measures. CBRC has approximately 10 people in its innovation department with market risk experience who are not specialists but are available to examination teams (but also are involved in Basel II and policy development re market innovation and modeling more generally). Within the on-site group for large banks there are approximately 40 people with different degrees of market risk expertise.</p> <p>CBRC did a targeted review of a number of banks market risk management in 2006 and issued further guidance after that review. Follow-ups occurred for several banks re deficiencies identified. Assessors talked with CBRC staff about examination activity since 2006. While an updated cross-bank targeted review has not occurred, certain bank on-site examinations over the last few years that were focused on specific businesses in individual banks (e.g., FX) have</p>

<p>covered the market risk in those businesses. CBRC reported that, recently, examination focus has shifted somewhat to credit risk, given developments in the market place and as some banks have reduced their market risk exposure.</p> <p>Progress on Basel II development is allowing certain banks to upgrade their market risk analytical capability.</p> <p>EC2: Supervisors believe that a well constructed limit system is critical to effective market risk management, and take it as an important element for on-site examinations. Supervisors review written policies and procedures to confirm that the overall limit system is approved by the Board, which covers major business activities and is allocated to business units, portfolios, instrument types and/or types of market risk. Banks are expected to regularly review and update the limits according to internal and external developments.</p> <p>Supervisors also check the adherence to limits. By reviewing reports on exceptions to limits, and interviewing senior management, market risk management and trading desks, supervisors confirm that adequate policies and procedures are in place to monitor, control and deal with limit exceptions. If exceptions to limits have been found, supervisors will determine whether they have obtained prior approval of appropriate level of management or the Board.</p> <p>CBRC reported that no bank in China has suffered significant losses due to limit-breaching. On the other hand some banks have not had stress limits until very recently. Nor is it clear that market risk models used to measure exposure relative to limits have been adequately validated for the Chinese market and more robust validation is occurring as part of the move to Basel II. Not all banks with market risk are using VAR models to measure the risk in their limit system (though the five major banks are). Data systems to use that approach in the second Tier banks may not be fully developed.</p> <p>EC3: According to <i>the Guidelines</i>, banks should mark to market their trading positions on a daily basis. Such function shall be undertaken by the middle office, back office, finance and accounting department or other functions that are independent of the front office. The pricing factors used for revaluation should be obtained from sources independent of the front office or should be independently verified. The valuation methodology and assumptions used by the front office, middle office, back office, finance and accounting department and department in charge of market risk management should be as consistent with each other as possible. If not, there should be a means of reconciling differences. In the absence of market prices for market value revaluation, banks shall determine the criteria for selecting and the channel for obtaining alternative data, and the method for calculating fair prices (see Article 18).</p> <p>Revaluation has been a focus of on-site examinations. Since the recent global financial crisis, the CBRC has required banks to increase the frequency of revaluation (including that for the banking book), and report to supervisors more frequently.</p> <p>Not all major banks are currently marking <u>all</u> positions to market daily, (some banks report less frequent valuation for RMB positions).</p> <p>EC4: <i>The Guidelines</i> provide that banks use appropriate methods, consistent with the scale, nature and complexity of their activities, to measure different types of market risks. Market risk measurement methods include, but are not limited to, gap analysis, duration analysis, FX exposure analysis, sensitivity analysis, scenario analysis and internal models approach. Regular evaluation of assumptions and parameters is required, as is independent model validation.</p> <p>During ongoing supervision, supervisors confirm that banks perform scenario analysis and stress testing for market risk management and assess the sufficiency of such approaches, by reviewing the results of stress tests and scenario analysis and having discussions with the management at various levels. Banks are expected to prove that they have integrated these</p>

	<p>approaches into risk management policies and process, and take into account the results in limit-setting, contingency planning and other risk-taking strategies. Supervisors also confirm that the systems used to measure market risk are periodically validated.</p> <p>Banks appear to be progressing in these areas. They report enhancements of stress testing approaches with some indicating more work to do. For example, some major banks are currently adding <u>daily</u> stress testing limits to their risk management systems, which is a best practice.</p> <p>Assessors reviewed an example of a market risk on-site review. They also talked with CBRC staff who appeared to have a sound appreciation of market risk issues.</p>
Assessment	Compliant
Comments	<p>CBRC rules and market risk management practice of banks have been broadly appropriate until now, given the state of the market. As noted above, several matters are clearly not best practice in at least some banks. The major issue is the need for banks to continue to build on progress to date in market risk measurement monitoring and management, and to develop increasingly robust approaches as market risk evolves. Regulatory standards and expectations internationally for market risk are rising. CBRC may need to enhance its efforts over the next few years to keep pace.</p> <p>A step-by-step move to Basel II may assist in this regard provided it is based on sound market risk measurement and management systems and quality data. The challenges for banks and CBRC using models for market risk capital purposes should not be underestimated. CBRC staff assessors met were knowledgeable and of high quality. CBRC may also be challenged to attract and retain the expertise they need in sufficient quantity. CBRC needs an effective strategy to increase its specialist expertise in this area. And while market risk is likely to remain low in the Chinese system for some time, it is important enough to justify more-frequent, cross-bank targeted supervisory reviews than have occurred.</p> <p>As noted in CP6, CBRC should also do periodic reviews of market risk for banks with exposures below the asset threshold CBRC has set to compute market risk capital to ensure the exemption is still appropriate.</p>
Principle 14.	<p>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.</p>
Description	<p>EC1: <i>The Guidelines</i> issued by the CBRC in 2009 requires banks to establish an effective liquidity risk management system, as a component of their comprehensive risk management system, and commensurate with their size, nature and complexity. The guideline suggests that liquidity risk management policies should be consistent with the banks' development strategies and proportionate to their financial strength. Undrawn commitments, other off-balance sheet liabilities, as well as on-balance sheet liabilities are to be included in the requirements.</p> <p>The liquidity ratios described below are specified in rules and are given prominence by banks and CBRC in assessing and managing liquidity risk.</p> <p>Basic CBRC policies such as requiring a bank's loan to deposit ratio to be less than 75 percent and limits on the ratio of current assets/liabilities (above 25 percent) mean that banking system overall is quite liquid. Limits on inter-bank borrowings and inter-bank loans reduce contagion risk. Central bank reserve ratios add to available liquidity.</p> <p>CBRC, and banks' that assessors met, noted that banks and regulators in China are giving more attention to liquidity risk as a result of experience observed during the crisis. Certain aspects of the Chinese financial system, such as policies discouraging foreign funding also reduce liquidity risk. On the other hand, given the state of development of capital markets, banks in China have fewer funding sources in case of difficulty than elsewhere. Without explicit deposit</p>

	<p>insurance, depositors may be relying on implicit state support in the case of major stress in the banking system. It is unclear to what extent this is a good assumption in the case of weakness at an individual bank.</p> <p>EC2: Supervisors assess the overall liquidity situation and liquidity risk management through on-site examinations, OSS and regular contacts with the Board and senior management. CBRC sets required liquidity standards. The two most important are that current assets must be at least 25 percent of liabilities, and that the ratio of loans to deposits must not exceed 75 percent. These produce an environment where liquidity risk, including funding risk in banks is not high. Other macro policies such as high central bank reserve requirements also contribute.</p> <p>Key elements of examinations include:</p> <ul style="list-style-type: none"> a) whether the bank establishes an overall strategy and policies for liquidity risk management; b) whether the strategy and policies are clearly communicated throughout the bank; and c) whether the strategy and policies are comprehensive and appropriate, and clearly define the objectives, criteria, risk appetite and limits for liquidity risk management. <p>The performance of the Board in a bank's liquidity risk management is included in on-site examinations. Key elements of examinations include:</p> <ul style="list-style-type: none"> a) whether major policies for liquidity risk management are approved by the Board; b) whether the Board ensures that the senior management take the steps necessary to effectively manage and control liquidity risks; c) whether the Board monitors the liquidity conditions on an ongoing basis, and is timely informed of any current and potential material changes in liquidity risks; and d) whether the Board reviews the liquidity risk contingency plan and the bank's ability to timely get adequate funding with reasonable cost. <p>There do not appear to have been any targeted examinations of liquidity risk at major banks over the last two years, though targeted exams of certain business areas would have included liquidity risks in those businesses.</p> <p>EC3: <i>The Guidelines on Liquidity Risk (Article 10)</i> provides that the senior management must oversee the daily management of liquidity risk in line with the objectives and risk appetite set by the board of directors. It specifies various tasks that senior management should perform. The guideline does not specify major criteria for what CBRC will consider appropriate policies and practices though some of that is included in criteria for supervisors to rate liquidity in the system.</p> <p>CBRC assesses the performance of the senior management in liquidity risk management through on-site examinations, OSS and regular contacts with the senior management. The CBRC also conducts assessment of the overall liquidity risk profile and liquidity risk management. CBRC places considerable reliance on adherence to the specified regulatory ratios in assessing individual bank's liquidity risk.</p> <p>Assessors discussed with several banks the progress in development of their liquidity risk systems. Published bank reports, and discussions with banks and observers, indicate extensive use of static gap analysis to measure and manage liquidity risk. Observers report medium-size and smaller banks making extensive use of adherence to regulatory ratios as their main approach. The use of more-dynamic approaches based on forecast cash flows, is varied. Explicit consideration or modeling of behavioral reactions to changes in business or financial environment, and how that might affect liquidity pressures a bank faces, appears rare.</p>
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	<p>Banks that assessors talked to differed in their ability to aggregate data on a real-time basis to assess their liquidity position, with this clearly being a challenge for some banks. Funds transfer pricing within banks often do not charge for liquidity/funding costs, which limits ability to do risk adjusted returns.</p> <p>EC4: <i>The Guidelines</i> requires banks to carry out effective liquidity risk management by taking into account the correlations between liquidity risk and other types of risks and coordinate liquidity risk management policies and procedures with those of other risks, specifying that the impacts of credit risks, market risks, operational risks, reputational risks, etc. on the liquidity of assets and liabilities shall be prudently evaluated (<i>see Article 38</i>). Discussions with banks did not suggest this was well advanced, as is also true in other jurisdictions.</p> <p>The degree of correlation may be less in the Chinese market because of various market controls. While major banks the assessors talked to are clearly aware of the correlation issue, progress in taking account of this in an organized way is clearly understood to be needed.</p> <p>Article 36 of <i>the Guidelines</i> requires that banks' asset and liability management follow the principle of diversification. Article 37 of <i>the Guidelines</i> requires banks to set up concentration limits for on- and off-balance-sheet assets and liabilities.</p> <p>Section 3 of <i>the Guidelines</i> requires liquidity stress testing. Routine stress testing must be conducted at least once a quarter. In the event of extreme market fluctuations or as required by the CBRC, the bank shall carry out stress testing under specific stress scenarios. CBRC advised that in the recent turmoil in global markets it required much more regular stress testing from some banks and daily information.</p> <p>With regard to the liquidity concentration, the CBRC regularly monitors the large-amount fund providers, mainly the percentage of the top ten largest depositors and top ten inter-bank lenders in the total funding, and examines whether banks set deposit (or inter-bank borrowing) limits. There is a trigger ratio for off-site supervision which leads to more intensive supervision and corresponding contingency plans.</p> <p>Banks are also required to set a survival period of not less than one month, for withstanding stressful conditions in the event of liquidity crisis, and take effective measures to maintain its funding capacity in such period to ensure that the net cash flow during this period is positive under different stress scenarios. Banks report the assumptions for this test are reasonably prudent.</p> <p>EC5: Article 69 of <i>the Guidelines</i> requires the CBRC to conduct separate analysis for a particular currency given the bank's scale of FX business and its market influence.</p> <p>The CBRC assesses banks' overall liquidity risk on the consolidated basis and evaluates banks' liquidity risk by separating domestic currency exposures from aggregate foreign currency exposures.</p> <p>In addition, the CBRC requires that banks differentiate the contingency plan at group level from that at legal entity level and formulate contingency plan for the potential liquidity difficulties of major currencies and certain regions. Regulatory limits are expressed in aggregate not by currency. CBRC does monitor ratios for RMB liquidity separately from other foreign currencies as a group. The most important other currency for Chinese banks is the USD.</p> <p>Banks must establish liquidity gap analysis for foreign currencies and CBRC off-site analysis makes this distinction and uses gap analysis to determine banks with material foreign currency liquidity risk.</p>
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	<p>For major banks there is some variation in liquidity ratings under the CAMEL system. Generally, CBRC sees liquidity risk as low.</p> <p>EC6: Banks are required to submit their contingency plans to the CBRC. Key elements in assessing the effectiveness of contingency plans include:</p> <ul style="list-style-type: none"> a) whether banks formulate contingency plans for normal market conditions and stress situations respectively, covering both temporary and long-term liquidity difficulties, and set trigger conditions and implementation procedures; b) whether the contingency plans include liquidity management strategies on both the asset side and liability side; c) whether the contingency plans cover the banking group as well as the legal entity; d) whether contingency plans are formulated for the potential liquidity difficulties of major currencies and certain regions; and e) when there are legal restrictions in certain countries or regions which prevent banks from implementing centralized liquidity management, whether the branches or subsidiaries in these countries or regions formulate separate contingency plans. <p>AC1: Banks with relatively large-scale foreign currency business conduct liquidity risk stress testing by separating domestic currency exposures from foreign currency exposures.</p> <p>AC2: During on-site examinations, supervisors review the arrangements banks have established with depositors and counterparties related to the stability and diversification of liabilities, and whether banks have the ability to predict funding requirements under both normal and stressed conditions.</p> <p>The CBRC is developing a set of liquidity standards, including the net stable funding ratio (NSFR), based on the most recent BCBS proposal. CBRC reported that, as a result of its existing liquidity standards, major banks already broadly meet the new tests.</p>
Assessment	Compliant
Comments	<p>Liquidity risk is managed overall through relatively-simple and conservative limits on holdings of liquid assets and high deposit funding requirements relative to loans. The authorities also have a broad policy to discourage offshore funding of banks. So the broad goals of this CP are being met through these approaches, rather than having banks adopt more sophisticated approaches (though some are doing). However, in a stress scenario for an individual bank, deposits may not be sticky as is being implicitly assumed in the regulatory metrics.</p> <p>Moreover, as a result of the approach using simple regulatory metrics, it is likely that banks are moving less rapidly than desired to develop more sophisticated liquidity measurement and management systems. These could be needed as innovation occurs, markets liberalize, and as regulators internationally put more importance on this risk. Some banks reported that some market enhancements, such as allowing FX options and the Chinese market coalescing around one funding curve, would assist risk management practices.</p> <p>Chinese banks are not completely immune from market shocks and may become less so as they expand internationally and diversify in future. So assuming that the direction of diversification and expansion is a policy priority for the authorities (as it is for some banks) more sophistication in liquidity management should be a priority, on a step-by step basis. Guidance could make clear, for example, that liquidity risk measurement monitoring and management should be commensurate with the liquidity risk that banks assume. To encourage major banks to adopt more sophisticated techniques, with the IT systems to support them, CBRC should consider more guidance on the <u>high-level</u> criteria it considers important for a</p>

	<p>sound liquidity risk system. Ongoing requirements for more frequent stress testing should be put in place.</p> <p>New liquidity guidance from CBRC that reflects international standards is recent, and banks could not be expected to have adopted it fully immediately. The introduction of new guidance is an opportunity for CBRC to conduct a cross-bank targeted review of liquidity measurement and management, which would benchmark current practices, identify areas for improvement and provide more detailed feedback to individual banks and the industry on needed improvements. More liquidity risk expertise may be required.</p>
Principle 15.	<p>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.</p>
Description	<p>EC1: Banks are required to have in place risk management policies and procedures commensurate with their business nature, size and complexity, in order to effectively identify, assess, monitor, and control/mitigate operational risk (see Article 5 of <i>the Guidelines on operational risk management</i>). These guidelines were put in place in 2007. Prior to that there was guidance covering internal controls (released in 1997 and updated in 2002 and 2007), a notice in 2005 on strengthening operational risk management, and guidance in 2006, updated in 2009, on IT risk management. CBRC guidance for the regulatory capital requirement for operational risk for Basle II banks was released in 2008.</p> <p>Banks are also required to have effective process to regularly monitor and report operational risk events. The threshold for reporting is quite low. The CBRC requires banks to establish an early-warning system so that timely measures could be taken to control/mitigate risks and to reduce the frequency and scale of losses (see Article 15 of <i>the Guidelines</i>).</p> <p>In order to identify the business areas with higher operational risks, banks are required to phase in the tools such as RCSA and KRI and take appropriate measures to monitor and control the risks. Basel II banks have progressed faster than others. In the meantime, the CBRC encourages large and complex banks to adopt quantitative measurement of operational risk, collect loss data, and tailor the risk management measures to different business lines with different features, with special attention paid to business areas with higher operational risk or in the period that operational risk is likely to rise (e.g., economic downturn, seasonal booms of transaction volumes).</p> <p>EC2/3: CBRC guidance requires board involvement in strategy setting and approval of policies/procedures. Targeted supervisory reviews are directed to assessing management implementation.</p> <p>Bank practice is progressing in this area but has a considerable way to go. Until recently banks' practice was focused on internal control regarding fraud and on IT systems risk. CBRC reports that some banks are moving forward more quickly. Based on assessor's visits to banks, and discussions with CBRC and others involved in this risk area, it appears that a number of banks (but not all the major ones) have moved from a compliance/internal control framework with specific policies for IT risk and fraud risk to a more comprehensive operational risk framework. Major banks and a portion of the medium-size banks are reported to have adopted a governance framework for operational risk (though at least one does not include operational risk as a risk management category in its published 2009 annual report). Loss data are being collected by the major banks, some of which are able to access external data and conduct scenario analyses. Some major banks have also started to allocate economic capital for operational risk to business lines and branches, though this is at an early stage.</p> <p>Only some banks are developing a RCSA and monitoring KRIs at this time. This is an essential precursor to an operational risk management framework, but can be beneficial to a bank by itself. The role of the historic compliance department in Chinese banks changes as this evolution occurs. Data systems can be challenged to produce data in a comprehensive and</p>

	<p>timely way to permit this development.</p> <p>Within CBRC, a small operational risk specialist group exists. It is available to assist supervisory teams or do targeted exams itself. It also plays a role in Basel II operational risk assessments. There is a separate IT risk specialist team that is larger.</p> <p>EC4: According to Article 19 of <i>the Guidelines</i>, a bank should formulate business resumption and contingency plans commensurate with its size and complexity, put in place back-up arrangements for business recovery, and regularly check and test the disaster recovery function and business continuity plan, so as to assure that business can operate properly in the event of catastrophe or severe disruptions</p> <p>During on-site examinations, the CBRC reviews the quality and comprehensiveness of banks' business resumption and contingency plans, through interviewing the senior management and relevant staff, reviewing working documents and conducting on-site system testing.</p> <p>EC5: According to Article 14 of <i>the CBRC Guidelines on IT Risk Management</i>, a bank must have in place IT strategy, operation and risk assessment plans to fit into its overall business strategy. The bank should ensure adequate financial and human resources to maintain a stable and safe IT environment. It should also improve governance and control functions so as to integrate risk management into the process of IT system development, testing and maintenance.</p> <p><i>The CBRC On-site Examination Manual on IT Risk Management</i> provides detailed information regarding 300 key risk factors, covering information security and system development, and establishes detailed methods and procedures of the examinations to confirm whether the information security and system development are in line with the CBRC's rules and banks' policies and procedures.</p> <p>The CBRC has strengthened its supervision of operational risk and IT risk in recent years, evidenced by setting up the CBRC IT risk supervision team and improving the methods and procedures of on-site examinations. The CBRC conducted on-site examinations of 48 banks in 2008 and 90 banks in 2009, covering almost all major IT risk factors in various sizes of banks.</p> <p>EC6: <i>The Guidelines</i> also lists what banks are required to report to the CBRC. <i>The Emergency Reporting Procedures</i> issued by the CBRC also lists the reporting requirements for major operational risk events.</p> <p>EC7: According to Article 3 of <i>the Guidelines</i>, operational risk includes legal risk. On site examinations focus on legal and compliance matters.</p> <p>EC8: According to Article 20 of <i>the Guidelines</i>, a bank should establish risk management policies to ensure the safety, soundness and legitimacy of outsourcing activities. These policies should address contract or service agreements, and clarify responsibilities between outsourcing providers and the bank.</p> <p>According to Chapter 8 of <i>the CBRC Guidelines on IT Risk Management</i>, a bank's IT outsourcing contract should be approved by its IT risk management department, legal department and IT Management Committee. A bank should have processes in place to regularly review and revise the service agreement, and maintain appropriate oversight over outsourcing activities. It should maintain confidential of any sensitive data such as those about customers, and establish a contingency plan to minimize losses associated with emergency situations such as outsourcing providers' losses in resources, finance, changes in key staff or unexpected termination of the contract. A bank should file an official report to the CBRC about significant outsourcing activities such as those in terms of IT infrastructure and database. <i>The CBRC Guidelines on IT Risk Management</i> provides explicitly that IT risk management function should not be outsourced.</p>
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	<p>When examining the outsourcing management process, the CBRC ensures that banks establish outsourcing scope and contents, evaluate outsourcing risk, set up comprehensive policies, and have a risk management mechanism. The supervisory approach to scope of examinations of outsourcing is comprehensive (but the frequency of targeted examinations of outsourcing is not high).</p> <p>AC1: The CBRC requires banking groups to conduct operational risk management on a consolidated basis and implement operational risk management policies and processes on a group-wide basis.</p>
Assessment	Largely Compliant
Comments	<p>Operational risk management is evolving in Chinese banks and there is good progress. But there is material variation in practice and effectiveness and more progress is needed in basic developments such as RCSA and use of KRI. The transition from an internal control/IT risk approach/culture to a broader operational risk approach (that is more risk sensitive than a compliance approach) is still in progress. Basel II implementation will push further improvement in some banks. Supervisors need to ensure they focus not only on banks moving to Basel II. More operational risk specialist resources in CBRC will be required. CBRC should also consider integrating its operational risk and IT risk specialist groups.</p> <p>However, CBRC should recognize that the two key areas of operational risk in China are already being addressed by the longstanding commitment by banks and CBRC to sound internal control, and by the IT risk supervision program. So, moves to the broader operational risk framework need not be the number one priority compared to other initiatives suggested in this assessment.</p>
Principle 16.	IRRBB. Supervisors must be satisfied that banks have effective systems in place to identify, measure, monitor and control IRRBB, 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.
Description	<p>In recent years, along with the gradual liberalization of interest rates, the impact of interest rate movements on banks' earnings and economic value has been increasing. Hence, banks have enhanced their asset/liability management with an increasing awareness of IRRBB. IRRBB tends to be larger than other forms of market risk for many banks. CBRC reported that some banks have large open positions but the IRRBB is mitigated by the likely small movements of controlled rates.</p> <p>Effective management of IRRBB is important as it is reasonable to expect that further liberalization of official interest rate policies is likely to occur.</p> <p>EC1: <i>The CBRC has issued Guidelines on Market Risk Management</i> which cover IRRBB and trading book. <i>The Guidelines</i> provide that the board of directors should assume ultimate responsibility for the oversight of market risk management. The Board shall review and approve market risk management strategy, policies and procedures, determine risk appetite, and ensure that the senior management takes the steps necessary to effectively identify, measure, monitor and control various types of market risks inherent in various businesses. There is a requirement to regularly inform the Board of the market risk exposures of the bank in order to assess monitoring and control, and performance of senior management.</p> <p>The senior management is required to establish, periodically review and ensure the implementation of market risk management policies and procedures. In practice, a number of banks the assessors met indicated that the board approves the overall limits for IRRBB based on acceptable changes to income and economic value for various scenarios. During on-site examinations, supervisors review written documents and interview board members, senior management and related functional departments and staff, to confirm that the Board and senior management perform their responsibilities according to supervisory requirements and the bank's internal policies.</p>

	<p>EC2: <i>The Guidelines (Article 16)</i> requires banks to use appropriate methods to measure different types of market risks in the banking book and trading book, consistent with the nature, size and complexity of their businesses. Banks are expected to measure risk on the basis of reasonable assumptions and parameters. The Guidelines (Article 23) require banks to have a limit structure and review and update it periodically.</p> <p>During on-site examinations, supervisors review banks' written documents on the measurement and management of IRRBB. Supervisors hold discussions with board members, senior management, internal management at various levels, and staff at operational level, to confirm that the policies and procedures on IRRBB, including those on limit management, are communicated and implemented in a consistent manner across the institution.</p> <p>In practice, as China's interest rate is not yet fully liberalized, the interest rate risk management approaches and measures adopted by the medium and small-sized banks, and by some larger banks are not very sophisticated. Some large banks use more developed approaches for managing IRRBB. Most major banks appear to be using versions of gap analysis of impacts on income (and economic value for some banks) from various scenarios. Some major banks and foreign banks have models to incorporate behavioral assumptions on customer behavior while others base risk measurement and monitoring on contractual gap analysis. The treatment of basis risk and non-linear aspects of IRRBB appears to vary, with some not taking this into account. Some include non-parallel shifts of the yield curve, others do not. Use of models (such as VAR) to measure IRRBB overall is very infrequent. For small and medium-size unlisted banks IRRBB risk measurement and monitoring can be rudimentary. Listed banks' public reporting of the impact of parallel movements in interest rates is based on different assumptions across banks, making comparisons difficult.</p> <p>Supervisory process is based on onsite reviews as noted above. Banks report to CBRC semi-annually on the impact of an instantaneous 200bps parallel shift in interest rates. CBRC expects the result on income for a year to be less than 4 percent of capital.</p> <p>EC3: <i>CBRC Guidelines on Interest Rate Risk Management in the Banking Book (Article 24)</i> sets out requirements on the implementation of stress testing and how to use the results. <i>The CBRC Guidelines on Stress Testing by Commercial Banks</i> provides specific guidance and requirements on the scope and implementation of stress tests.</p> <p>CBRC advised that it plans to attach more importance to stress testing in its supervisory activities. This will include having banks better incorporate the results of stress tests into their daily operation and CBRC enhancing its own capabilities to assess banks' adequacy of stress testing, reasonableness of scenarios, and appropriateness of the use of results.</p>
Assessment	Largely Compliant
Comments	<p>Given the current and likely future environment of more liberalization, this is an area that deserves more attention by banks and supervisors. As techniques used for interest rate risk management in the banking book are becoming more complex, accompanied with more internal models adopted for the Basel II implementation, supervisors will need to place more emphasis on IRRBB. Banks (even those not moving to Basel II) should be encouraged in a step-by-step way to enhance their sophistication of measurement of this risk, including developing more behavioral assumptions, more forward looking cash flow analysis, impact of non-parallel interest rate shifts and more explicit stress/scenario testing.</p> <p>For smaller and mid-size banks, additional attention will be needed, including more sophisticated outlier analysis by supervisors.</p>
Principle 17.	<p>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</p>

	independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.
Description	<p>Relevant banking laws, regulations, and other prudential rules and guidelines require banks to have implemented sound corporate governance, effective internal controls, and independent compliance and internal audit functions. Banks are required to have sound internal control systems that are in line with their size and risk profile and sound internal audit systems that are independent of other functions and have independent reporting lines.</p> <p>EC1: Guidelines pertaining to internal controls specify the roles and responsibilities of the Board of Directors and senior management. The Board is responsible for approving the overall internal control policies and procedures, approving risk appetite and organizational structure, and ensuring compliance with relevant laws and regulations. Senior management is responsible for formulating the policies, establishing procedures to identify, measure, monitor, and control risks and ensuring the effective execution of the internal control systems. Board members are ultimately responsible for the level of risk taken by the bank.</p> <p>EC2: The CBRC evaluates the adequacy of banks' internal controls during its supervisory process, including onsite examinations. When evaluating the adequacy of a bank's internal control, the supervisory focus is placed on the following areas:</p> <ul style="list-style-type: none"> • Organizational structure and segregation of duties • Adequacy and comprehensiveness of policies and procedures • Implementation of the policies and procedures • Oversight by Board and senior management and whether they give appropriate and timely attention to identified deficiencies and follow up on the progress of corrective actions <p>Discussion with audit firm personnel indicated that banks generally have heightened their awareness of the importance of internal controls, as evidenced by the fact that the number of internal control deficiencies noted during their audits has steadily declined over the last few years. Improvements in internal controls are mainly due to enhanced corporate governance, more guidance from bank regulators, improved technology, and more experienced people.</p> <p>Assessors also met with a few Chinese banks to discuss their internal control process and noted that they have good awareness of the importance of a sound internal control system. Examination reports reviewed by assessors noted internal control deficiencies identified by CBRC examiners and this also is an indication of the strong supervisory focus of internal control in the examination process.</p> <p>In June 2008, MoF, CBRC, CIRC, CSRC, and the NAO jointly issued <i>the Basic Standard for Enterprise Internal Control</i> (some referred to as "C-SOX") for implementation in 2011. Under this standard, publicly listed companies (including banks) have to perform an assessment of the adequacy of their internal control systems and external auditors have to attest to their assertions. Based on discussions with bank management and accounting firm personnel, publicly listed banks have been working on developing and refining their internal control structure to meet the requirements. One bank indicated that its efforts include centralizing the internal control function, reorganizing its risk management and internal control committee, comparing its internal control policies and procedures against the standard's requirements, and developing an internal control rectification system as required by the standard. With the postponement of the implementation date until July 1, 2011, this bank indicated that it will have sufficient time to upgrade its internal control function to be fully compliant with the new standard. Though this requirement will present challenges, publicly listed banks likely will be prompted to continue improve their internal control environment.</p> <p>EC3: The Board of Directors and senior management are required to assume responsibility for the sound control environment of the bank. In addition, fit and proper tests and other</p>

	<p>supervisory guidelines require that the Board and senior management must possess the necessary expertise and experience to understand the underlying risks in banks' daily operations. To evaluate the Board and senior management's understanding of risks, the CBRC focuses on the competency of the Board and senior management, the functioning of the MIS and its capability of evaluating and reporting various types of risks, the effectiveness of the reporting system and whether it can ensure the Board and senior management be adequately informed on a timely basis.</p> <p>EC4: The <i>Banking Supervision Law</i> (Article 37) empowers the CBRC to require the bank to replace board members and/or senior management if the bank is found to be operating in an unsafe and unsound manner and fails to take timely corrective actions. Article 48 also empowers the CBRC to temporarily or permanently disqualify board members or senior managers from the banking industry.</p> <p>EC5: The prudential guidelines on corporate governance, internal controls and specific risk management areas set out explicit requirements on expertise, qualifications and resources of banks' back office and control functions relative to the front office. CBRC evaluates the competence of control personnel and the adequacy of resources through reviewing banks' policies and procedures and target review of high risk areas such as trading activities to determine whether effective control mechanisms are in place.</p> <p>EC6: The <i>CBRC Guidelines on Compliance and Compliance Functions in Commercial Banks</i> require banks to have in place an independent, permanent and effective compliance function with effective oversight of the board. During its supervisory process, the CBRC also ensures that the compliance function receives adequate resources that commensurate with the bank's risk profile and complexity. In addition, the supervisors determine whether the internal audit function conducts independent assessment of the compliance function.</p> <p>EC7 and EC8: Supervisory rules and guidance require banks to establish an independent, permanent and effective internal audit function to ensure compliance with relevant policies and procedures and their effectiveness.</p> <p>The CBRC also evaluates the independence and effectiveness of banks' internal audit function through its ongoing supervisory process. The assessment includes reviewing the adequacy of audit scope and plan, independence and reporting lines of the internal audit department, adequacy of resources, timeliness of corrective measures taken by management, and management's monitoring of outsourced functions.</p> <p>Based on meetings with a number of Chinese banks, they establish independent internal audit function that reports directly to the Audit Committee of the Board of Directors. In some instances, the head of Internal Audit reports administratively to the President/CEO of the bank. Banks also indicated that the CBRC requires them to have an internal audit staff that comprises at least 1 percent of total employees.</p> <p>AC1: Chinese banks adopt a bicameral structure with a Supervisory Board and a Management Board.</p> <p>AC2: The <i>CBRC Guidelines on Internal Audit</i> requires the Board to set up an Audit Committee, and internal audit department should directly report to the Board and Audit Committee.</p> <p>AC3: Chinese banks adopt a bicameral structure with a Supervisory Board and a Management Board.</p> <p>AC4: Under the <i>Notice on Reporting Mechanism of Major Emergencies Associated with Senior Management of Banking Institutions</i>, banks must report the following situations to the CBRC</p>
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	within three working days: (1) vacancy of senior management caused by defection, death, or actions by judicial or disciplinary authorities; (2) suspicious leave of senior management for more than three working days without the bank's approval; and (3) the vacancy of senior management due to resignation, dismissal, illness or training for more than a month.
Assessment	Compliant
Comments	None
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.
Description	<p>EC1: The duties, responsibilities and legal ability with regard to the supervision of bank's internal controls and enforcement of laws and regulations regarding criminal activities in and by banks are shared between the PBC and the CBRC.</p> <p>The <i>Anti Money Laundering Law of the People's Republic of China</i> (AML Law) which came into force on January 1, 2007 defines money laundering broadly to cover the proceeds from crime including those crimes related to terrorism, smuggling, embezzlement, bribery and fraud. The Law lays out the duties, responsibilities and authorities of the Competent Authority under the Act but does not name the Competent Authority. The AML Law also makes it incumbent upon <u>all relevant agencies</u> under the State Council to carry out their activities with regard to AML supervision within their own jurisdictions.</p> <p>The <i>Provisions on AML through Financial Institutions</i> passed under the AML Law, which also came into effect on the same day as the Law, names the PBC as the administrative department to 'supervise and administer' the AML work of the financial institutions and the sector supervisors (CBRC, CIRC, and CSRC) to exercise the duties of AML supervision and administration according to their respective functions. The provisions also authorize the PBC to perform the following functions:</p> <p>formulate policy jointly with the sector regulators; supervise and inspect the AML obligations of the financial institutions; investigate suspicious transactions and share information with overseas counterparts. These provisions require financial institutions to establish sound internal control systems of AML in accordance with the Law.</p> <p>The AML Law provides the framework for the division of responsibilities between the PBC as the administrative authority and the other financial regulators (Article 9), requiring the latter to participate in the drafting of the AML related rules and regulations and to lay out the rules for AML internal control requirements for their supervised entities. Finally, the CBRC as the financial regulatory authority is required to review the internal control systems for AML during the approval process for establishing the bank/branch in terms of Article 14 of the Law.</p> <p>In addition to the specific requirements to AML related internal controls in the related laws, CBRC has also laid out requirements for bank internal controls systems in the <i>Guidelines on the Internal Control of Commercial Banks</i> (see CP 17).</p> <p>Discussions that assessors had, indicated that some staff of the relevant agencies had differing perceptions or lack of clarity on the division of responsibilities in this regard.</p> <p>EC2: Supervisory expectations with regard to the existence of policies and processes to guard against financial abuse are contained in both the AML guidance issued by the PBC and the Guidelines on Internal Controls issued by the CBRC. CBRC guidelines include regular reporting of frauds to the regulator. There is an extensive supervisory program related to verification of internal controls at banks. STR reporting requirements to PBC are also in place and PBC does on-site examinations of banks related to AML issues. In discussions, PBC staff mentioned that they were generally satisfied with banks' performance regarding AML. Financial frauds in banks, on the other hand, are mainly the responsibility of the CBRC and</p>

they report that these have been declining in recent years following the intense supervisory focus on these abuses. However, reports from CBRC, and the NAO indicate that fraud prevention remains a challenge at some banks and with some types of lending. CBRC's annual report indicates that some banks have not put in place sufficiently robust control mechanisms and more work is required.

EC3: Commercial banks are required to report to the China AML and Analyzing Center of the PBC both large and suspicious transactions under the AML Law (Article 4) and the Rules on Large-Value and Doubtful Transaction Reporting (LVTR). In 2009 alone, more than 40 million reports were filed. The CBRC does not have access to this data base and Article 6 of the Rules prohibits financial institutions from sharing this information with any entity. PBC staff informed the assessors that this information could not be shared due to confidentiality issues. However, they maintained that they would share information regarding cases they believed to be relevant for CBRC with them if there were no ongoing investigations. PBC inspection reports are also not routinely shared with CBRC though they stated that they would provide information to CBRC if they believed it to be material. Similarly, the investigation of a STR could be transferred to CBRC if it pertained to their area of responsibility. There have not been any joint inspections by the CBRC and PBC.

CBRC has in turn laid out its requirements that banks report frauds and crimes to it periodically (*Notice on Establishing the Statistical Information System of Frauds and Crimes*) also requires banks to report major events that may have an impact on banks' safety, soundness and reputation including those of robbery, theft, frauds, kidnapping of senior official, loss of confidential information. Timelines and procedures for reporting such events are laid out in the CBRC guidance on *Major Emergencies Reporting Policies*.

EC4: The requirements for customer identification are laid out in Chapter III of the AML law and reiterated in the Article 9 of the AML Provisions. Detailed guidance has been issued by PBC jointly with the regulatory agencies in the form of the *Rules for Financial Institutions on Customer Identification and Record Keeping (CDD Rules)*, which are comprehensive and cover the prescriptions laid out in the criteria. Banks are also suggested to understand the person who controls the customer and the actual beneficiary of the transaction, though there is no corresponding legal ability of the PBC or CBRC to take measures to verify this.

In addition to the Customer Due Diligence (CDD) Rules, the CBRC has also issued its own guidance on compliance with Know Your Customer (KYC) principles as part of its guidance on operational risk management in banks. Both PBC and CBRC verify compliance with CDD/KYC stipulations as part of their on-site examinations, with PBC focusing more on AML aspects in its inspections. PBC, CBRC, and banks assessors met indicated that more work was needed in practices related to identification of beneficial ownership. Some banks were enhancing their programs in this regard and were relying more on post-account-opening transaction monitoring to detect issues, rather than on comprehensive assessment of beneficial ownership in advance.

EC5: The requirements for banks to vet their correspondents from the perspective of effectiveness of AML/CFT measures is laid out in the CDD Rules (Article 6) while the CBRC Guidance on Internal Controls broadens this to include compliance with prudential practices and regulations in general. Both PBC and CBRC staff that the assessors met with stated that compliance with these requirements was looked at in the course of periodic on-site visits for AML and KYC/KYB compliance.

EC6: Every bank is required to either establish or designate a specific unit to be responsible for AML compliance in the organization. As of date, there were over 370,000 staff designated (of which 23,000 had full time responsibility) for AML issues in the Chinese banking system. In turn, the PBC has an extensive program of supervision of AML operations in the financial institutions and employs 600 personnel for this task. The supervisory program covers both on

	<p>and off-site supervision in legal entities as well as branches. In 2009 PBC conducted 2,298 AML related inspections and issued 190 penalties/sanctions. The off-site program requires that in addition to the transactions reports under the LVTR, banks also submit details of their KYC/CDD and internal control policies as well as notify whenever there are material changes in these policies, procedures or organizations.</p> <p>EC7: Both PBC and CBRC has adequate powers to take action against banks for non-compliance with rules and regulations regarding AML and other criminal activities. The AML Law (Chapter VI), AML Rule and the CDD Rules lay out in detail the violations punishable under the law as well as the penalties and sanctions that would apply either on the responsible individual or financial institution. The Banking Supervision Law and Commercial Bank Law and the Punishment Regulations lay out the penalties and sanctions applicable for violations of prudential rules and guidance, which would cover involvement in fraud and other criminal activities. Assessors were made aware of the willingness of authorities to impose penalties.</p> <p>EC8: The CBRC requirements and practices for internal audit of risk management are commented upon in CP 17. Supervisors have access to all reports issued by both internal and external auditors.</p> <p>CBRC guidance on <i>Compliance Risk Management of Commercial Banks</i> requires banks to establish compliance departments, appoint a compliance officer, and formulate internal guidance including a code of conduct. Separately, <i>Code of Conduct for Banking Industry Practitioners</i> provides a guiding framework for such codes. For AML purposes, PBC has laid out requirements for designating a compliance officer through their Notice 391. Besides this, banks have also established Task Forces on AML and fraud which are chaired by senior managers and which are responsible for laying out related policies and procedures. Banks report providing training programs in KYC/CDD on an ongoing basis to their staff.</p> <p>EC9, 10: Both CBRC and the PBC examine the policies and processes in place for reporting of abuse of financial services in the course of their supervision over AML and prevention of other financial abuses. The AML Law, (Articles 6 and 7) specifically provides that the reporter of such abuses (whether employee or other) and the reported abuse would be kept confidential. Article 16 of the law extends the privilege of confidentiality and protection under law to any financial institution reporting large or doubtful transactions. The <i>Rules on Assistance in Financial Frauds Investigation</i> encourages banks to provide incentives to those who assist in preventing or identifying frauds.</p> <p>EC11, 12: The high level framework for policy coordination among the relevant agencies in the financial sector and the PBC as the Financial Intelligence Unit (FIU) is the AML Joint Ministerial Conference which is headed by the PBC Governor and which has as its members the various regulatory agencies and other concerned Ministries. For the financial sector agencies, there is an AML Cooperation Mechanism between PBC, CBRC, CIRC, CSRC, and SAFE which coordinates AML responsibilities. The PBC, as the AML supervisor, shares information with the Ministry of Public Security through monthly meetings.</p> <p>For AML purposes, the PBC as the FIU and designated authority under the AML Law, is able to share information with overseas authorities and has entered into a few MOUs with some overseas FIUs. The China Anti-Money Laundering Monitoring and Analysis Center (CAMLMAC), under authority delegated by the PBC, has in turn also entered into information exchange arrangements with a few countries.</p> <p>AC 1: The CBRC has set up a special department for Fraud Investigation and has hired some specialists for dealing with financial crimes and the Ministry of Public Security has also seconded some officers to the CBRC for this purpose.</p>
Assessment	Largely Compliant
Comments	PBC and CBRC share responsibilities for oversight of banks in this area with PBC taking the

	<p>lead in AML related work and CBRC in financial frauds and other abuse of financial services. There is no regular sharing of AML inspection related reports nor does CBRC have access to the STRs but both agencies state that they share information with each other when material, although there is no established protocol in this regard. The supervisor (CBRC) could benefit from more regular sharing of information with the PBC with regard to their examination findings and material doubtful transaction reports. Given the shared responsibilities which may often overlap, it is desirable for the two agencies to enhance and elaborate their information sharing arrangements and document their respective responsibilities in a formal protocol or MOU.</p> <p>The FATF published a report on the findings of their AML/CFT assessment undertaken in late 2006. Some of the deficiencies identified in the report have been addressed in rules/guidance issued after the FATF assessment. A few of the findings continue to be relevant as of this assessment for banks and it would be important for the authorities to continue work on addressing these. Among these are: (i) there are no legal obligations for banks to identify and verify beneficial ownership. While the CDD Rules have attempted to rectify this in part by requiring banks to take ‘reasonable measures’ in this regard, they acknowledge the absence of a legal obligation hampers effectiveness. Further progress is also needed in implementation; (ii) there were no requirements to ascertain the status of third parties; and (iii) while there are no shell banks in China, there were no specific legal requirements that prohibit connections with shell banks; or that correspondents do not permit their accounts to be used by shell banks.</p>
Principle 19.	<p>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.</p>
Description	<p>EC1: The <i>Banking Supervision Law</i> vests the CBRC with broad authority to regulate and supervise banks on both a solo and consolidated basis to ensure the safety and soundness of the banking system. The CBRC carries out its supervisory efforts through onsite examinations and offsite surveillance and monitoring, with the objective of developing a thorough understanding of the risk profile of the supervised banks. Typically, various onsite examinations are conducted every year and may be conducted on a full scope or targeted basis. A full-scope examination addresses all key areas of a bank’s operations, including corporate governance, risk management, asset quality, capital adequacy, management capability and compliance with laws and regulations. The CBRC also can conduct target examinations at its discretion and cover one or more specific areas of review. Examples include IT risk, market risk and performance of new business or products. In addition, the CBRC maintains the ongoing supervision of banks through offsite surveillance, which includes analyzing financial trends and using results of the early warning system known as the Risk Early Warning Analysis Supporting System (REASS).</p> <p>EC2: The CBRC uses its supervisory information system to monitor and assess the developments and trends of the banking sector using aggregate banking data, focusing on asset quality, lending concentrations, and other key indicators. In addition, it closely monitors the impact of macroeconomic and market developments on the banking system. For this purpose, it engages close communications with relevant government agencies responsible for macroeconomic and policy making, including the NDRC. To address systemic risks, the CBRC participates in the cooperation and coordination with other financial supervisory agencies (such as CIRC and CSRC) to obtain sufficient understanding of the development in the nonbank financial institutions.</p> <p>EC3: The CBRC monitors and assesses banks’ business operations and risk profile through onsite and offsite supervisory efforts. During each supervisory cycle, the CBRC supervisors assess the risk profile of each bank and determine the supervisory strategies for the year (see further discussions of a supervisory process in CP 20).</p>

	<p>The CBRC uses the CAMELS+ rating system (C – capital; A – asset quality; M – management; E – earnings, L – liquidity; S – sensitivity to market risk; + - other factors) to assign supervisory ratings to domestic banks, based on a scale of 1-6, with “1” being the strongest and “6” being the weakest. For the CAMELS+ rating system, the methodology is defined in the <i>CBRC Guidelines on Supervisory Ratings of Commercial Banks</i>. Each component’s rating is determined by a set of quantitative indicators (60 percent) and qualitative indicators (40 percent). For example, the quantitative indicators for Capital are Tier 1 capital ratio and total capital ratio, while the qualitative factors include capital management capability and asset quality’s impact on capital. Each component is assigned a weighting (i.e., 20 percent for capital, 20 percent for asset quality, 25 percent for management, 10 percent for earnings, 15 percent for liquidity, and 10 percent for sensitivity to market risk) and the composite rating is then determined accordingly. Overall, the criteria cover 22 quantitative indicators, 33 qualitative indicators and 109 sub-criteria. Assessors reviewed samples of examination reports which documented the use of these quantitative and qualitative factors in assigning the CAMELS+ ratings.</p> <p>For foreign banks operating in China, the ROCA (R-Risk Management; O-Operations; C-Compliance; A-Asset Quality) rating system is assigned to a foreign bank’s branches in China, while the SOSA (Strength of Support Assessment) ranking system is used to assess the consolidated financial strength of a foreign banking organization to provide support to its operations in China.</p> <p>EC4: The CBRC ensures banks’ compliance with laws, regulations, and other supervisory requirements through rulemaking, onsite examinations, and offsite surveillance. Through rulemaking, it requires banks to have a compliance function. During onsite examinations, the CBRC ensures banks have the policies and procedures for compliance with relevant laws and regulations and reviews the effectiveness of the compliance function. The offsite surveillance function identifies banks that do not meet regulatory requirements and limits such as CAR, liquidity ratio, and large exposure limits.</p> <p>EC5: Both the <i>Banking Supervision Law</i> and the <i>Commercial Banking Law</i> specify changes in bank activities or structure that require CBRC’s approval. In addition, the CBRC requires banks to notify it of any events that may lead to substantive changes in banks’ activities, structure, and overall condition. Examples include issuing a set of requirements for the reporting of emergency events that may affect banks’ operations and risk profile.</p> <p>EC6: The CBRC maintains a supervisory information system for its ongoing supervision of banks and it facilitates the processing, analyzing, and monitoring of prudential information. The systems include early warning supporting system, large exposures system, and banks’ board of directors and senior MIS. The data and information generated from these databases are then used for follow-up supervisory actions.</p> <p>AC1: Through ongoing risk monitoring and assessment, the CBRC supervisors focus on signs of deterioration or the emerging risks in both individual banks and the banking system and take supervisory steps accordingly. As mentioned in CP20, the supervisors use the Risk Matrix to evaluate each bank’s inherent risk level and trend (increasing, stable, or decreasing) and early warning system to promptly identify emerging risks. These results serve as important references for supervisors to develop or refine their supervisory strategies.</p>
Assessment	Compliant
Comments	As discussed above, the CAMELS+ rating system is driven by a rather formulaic and quantitative approach with percentage weighting assigned to each rating component (e.g., capital has a 20 percent weighting), despite the fact that qualitative factors are also considered. Since examining a bank and assigning individual and composite ratings require a great deal of judgment, this formula based approach does not promote examiner judgment.
Principle 20.	Supervisory techniques. An effective banking supervisory system should consist of on-site and off-site supervision and regular contacts with bank management.

Description	<p>Typically, the supervisory process conducted by the CBRC consists of seven stages:</p> <ol style="list-style-type: none"> 1) Preparing a supervisory plan. At the beginning of a supervisory cycle, the Chief Supervisor determines the supervisory strategies based on previous examination findings, supervisory ratings, and risk assessments. 2) Collecting information. Information collected includes supervisory returns, internal and external audit reports, onsite examination reports, and other press and publicly available reports. Based on the information, the Chief Supervisor prepares an updated Institutional Overview. 3) Performing ongoing analysis. Chief supervisor uses various methods to analyze the bank's financial condition and risk profile. 4) Performing risk assessment. The supervisor analyzes the types, severity, and trends of risks faced by the bank. The Risk Matrix lists seven inherent risk categories (credit, market, liquidity, operational, legal, reputational, and strategic), identifies the risk level (high, medium, or low), risk trend (increasing, stable, or decreasing), and risk management strength (strong, acceptable, or weak). 5) Planning onsite examinations. Based on the results of the risk assessment, the Chief Supervisor prepares an examination plan which includes information on examination resources and duration of the examination. Typically, the supervisory cycle is 12 months for supervised banks. However, the Chief Supervisor follows the principle of "the higher the risk, the higher the frequency of examination." 6) Assigning supervisory rating. Chief supervisors are responsible for assigning supervisory rating by using the CAMELS+ rating methodology, based on the findings obtained from OSS and on-site examinations, at least annually during a supervisory cycle. In case material deficiencies are identified during the supervisory cycle (for example, at the end of on-site examinations) in a bank or a banking group, rating results will be adjusted on a timely basis. 7) Conducting follow-up supervision. Upon the conclusion of the risk assessments, examination reports, and supervisory rating reports, the Chief Supervisor prepares the annual Supervisory Report and the Letter of Supervisory Opinions for the bank which only includes the composite rating. <p>Assessors reviewed a sample of reports discussed above such as risk assessments and supervisory plan, together with other reports including targeted review reports (e.g., review of board oversight and governance, internal control, and real estate lending), as well as minutes of exit meeting and tripartite meeting. These supervisory reports were considered thorough and captured key supervisory focus and major examination findings. While a risk assessment by type of risk and quality of a bank's risk mitigants is an input into supervisory planning, this link appeared weak in the examples reviewed by assessors. As the CAMELS+ rating is often backward looking in practice, its use in determining supervisory frequency should be reconsidered.</p> <p>EC1: Banking supervision is carried out through a combination of onsite examinations and offsite surveillance efforts. The onsite and offsite processes are articulated in the <i>CBRC Offsite Surveillance Manual</i> and the <i>CBRC Onsite Examination Manual</i>. In addition, the CBRC maintains regular communications with supervised banks' Board of Directors and senior management. The CBRC maintains onsite and offsite staff at the head office and local branches. For larger banks, the CBRC designated a Chief Supervisor who is responsible for the overall supervision of a particular bank, including defining the scope of the examinations and providing guidance to onsite examination teams. According to CBRC policy, an annual assessment must be conducted to determine the adequacy of the supervisory plan, the quality and effectiveness of onsite examinations and offsite surveillance reports in an attempt to identify areas for improvements.</p> <p>EC2: Both the onsite and offsite guidance developed by the CBRC have established a process for planning and conducting onsite examinations and offsite surveillance, and provide guidance</p>
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	<p>on each stage of the onsite and offsite process. In addition, the CBRC has established a coordination and information sharing mechanism between onsite and offsite supervisory functions. For example, the priorities and scope of an onsite examination is based on the feedback the Chief Supervisor receives from the offsite surveillance results.</p> <p>EC3: The CBRC considers onsite examinations as an important supervisory tool as it provides examiners the opportunity to evaluate management capability and the bank's risk management systems and internal controls. The frequency and scope of onsite examinations depend on the risk profile, size and complexity of the bank. An examination generally covers an assessment of capital adequacy, risk management practices, liquidity, earnings, asset quality review, and following up on weaknesses identified during the previous examination or during the offsite surveillance process. At the end of the examination, examiners discuss with bank management regarding the major findings and conclusions before issuing an examination report and, if applicable, supervisory actions.</p> <p>During discussions with the CBRC, assessors noted that the agency has used many resources to perform branch examinations. Much of the focus of branch examinations is compliance based. As referenced in CPI, the CBRC is facing some resource challenges. As banks' risk management systems are more centralized, the CBRC could consider cutting back on branch examinations to free up resources for other supervisory priorities.</p> <p>EC4: The offsite surveillance process includes reviewing prudential returns and other public information to analyze the financial condition of a bank on an ongoing basis. The early warning system also serves as a tool to identify any significant deteriorating trend exhibited by banks. This offsite process helps develop the priorities and scope of onsite examinations and also keep continuous monitoring and evaluation of progress in correcting deficiencies identified during onsite examinations.</p> <p>EC5: The CBRC has extensive communications with all levels of bank management through formal meetings, onsite visitation, and exit meetings during the conclusion of an examination. At the last stage of each supervisory cycle, the supervisors hold separate meetings with the bank's board of directors, supervisory board and senior management to discuss the significant issues identified during the current cycle, and require the bank to take corrective actions if necessary. The respective supervisory departments hold workshops with senior management of major banks every quarter to discuss the latest developments of their respective risk profile.</p> <p>Offsite supervisors also engage in discussions with bank management when they seek to follow up on certain emerging problems or trends. For larger banks, the Chief Supervisors have more frequent contacts with management due to the nature of ongoing supervision and monitoring of the supervised banks.</p> <p>EC6: The evaluation of the quality of management and the adequacy of board oversight is an essential part of the onsite examination process. The "M" component of the CAMELS+ ratings system reflects the board's oversight and management's capability (and it carries the highest 25 percent weight for determining the composite rating). While assessing the risk management and internal control functions of the banks, supervisors also consider the capabilities of their board members and senior management. The CBRC also has performed target reviews of board and management performance and the governance structure of banks. Assessors have reviewed a target examination report on governance structure and management performance; the report discusses the deficiencies identified in the evaluation and the corrective steps that the bank should undertake.</p> <p>EC7: The CBRC evaluates the internal audit function as part of the examination process. The evaluation focuses on the independence of the function, the adequacy of the staffing and expertise, the frequency and the scope of the coverage, and the adequacy of the audit plan. Depending on the outcome of the evaluation, the examiner determines whether and to what</p>
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	<p>extent it will reply on the work of the internal audit function.</p> <p>EC8: The CBRC communicates findings on its onsite and offsite supervision through both written reports and discussion with management. Written reports include <i>Letters of Supervisory Opinions</i> at the conclusion of each supervisory cycle that details the overall condition of the bank, the composite supervisory rating, and the corrective actions that are warranted. In addition, the CBRC meets with management through prudential meetings and during onsite visits. Typically, examiners meet with bank management at the conclusion of the examinations to report major findings.</p> <p>AC1: The CBRC has established a communication mechanism to communicate supervisory findings with bank management and, if necessary, supervisors will meet with board members individually if there are significant supervisory findings warranting their immediate attention.</p>
Assessment	Compliant
Comments	<p>As referenced in EC3, the CBRC has dedicated many resources to branch examinations. At a time the agency is facing resource challenges, it is advisable for the CBRC to consider reducing the extent of branch examinations as many banks are now centralizing their risk management systems. The CBRC could then shift these resources to focus on other supervisory priorities.</p> <p>While banking supervisors at the CBRC share examination findings with bank management and other emerging supervisory concerns with bank management on an ongoing basis, the Letter of Supervisory Opinions only discloses the composite rating of the bank. It is recommended that the individual component rating be disclosed to the bank to increase the bank's awareness of its relative strengths or weaknesses in each area.</p>
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.
Description	<p>EC1: A major part of the offsite surveillance process in China is the collection, review and analysis of the prudential returns submitted by banks. Article 33 of <i>the Banking Supervision Law</i> provides CBRC the authority to require banks to submit prudential returns on financial information as well as audited financial statements prepared by CPAs. Article 61 of <i>the Commercial Bank Law</i> provides that commercial banks shall submit balance sheets, income statements and other statistical reports to the CBRC and PBC.</p> <p>Requirements for regulatory reports appear extensive. Among other things, the report schedules include on- and off-balance-sheet assets and liabilities, profit and loss, capital adequacy, liquidity, large exposures, asset concentrations, loan loss provisioning, related party transactions, interest rate risk and market risk. On asset quality, banks are required to submit data on NPLs (defined as loans classified as sub-standard, doubtful, and loss) and loans that are on past-due status. Furthermore, nonperforming and past due loans by geographical regions and industries also have to be reported. Information on top ten largest borrowers and depositors is also required. The CBRC revises the schedules periodically based on supervisory needs and changes in accounting standards.</p> <p>EC2 and EC3: By statute, banks are required to submit their prudential reports based on <i>the Accounting Standards for Business Enterprises</i> issued by the MoF in 2006. As referenced in CP22, the standards have substantially converged with the IFRS. As for the valuation rules, the requirements are also in line with the relevant accounting principles, which call for banks to adopt prudent valuation methods and use current values as necessary.</p> <p>EC4 and EC5: The CBRC requires different returns to be submitted on a monthly, quarterly, semi-annual or annual basis. Most schedules are required to be submitted quarterly. However, the schedules such as assets and liabilities, loan classification, provisioning, and liquidity are required to be submitted each month. The frequency of the returns is primarily based on the importance and urgency of information. Although most schedules are submitted quarterly, the</p>

	<p>CBRC can require more frequent submissions for parts or all of the schedules, if the bank is considered to have a higher risk exposure.</p> <p>In order to ensure the comparability of the data submitted by different banks, the CBRC has formulated uniform requirements for the submission frequencies. All the monthly, quarterly, semi-annual and annual statements are based on the Gregorian calendar. To maintain data quality, the CBRC employs a set of data quality control methods, including verifying different reporting items, reviewing unusual data changes, performing on-site examinations of data quality, and engaging in effective communications with external auditors. In addition, the stock data and flow data are verified with each other in many schedules, such as the verification between the flow data in loan quality migration template and its relevant stock data. If the fiscal year of a foreign bank in China is different, the CBRC will require that foreign bank in China to make the adjustments accordingly.</p> <p>EC6: The CBRC has broad authority to obtain information from supervised banks, including quantitative information such as prudential returns and qualitative information such as banks' internal management reports. Furthermore, the CBRC has the power to directly obtain information from bank customers and other borrowers if it has reasons to believe that these individuals and entities have violated any banking law. In addition, Article 5 of the <i>Guidelines on Banks' Consolidated Supervision</i> empowers the CBRC to collect information of a bank's controlling shareholders.</p> <p>EC7: The CBRC has the authority to review all the records of the bank that are considered necessary in connection with carrying out its supervisory responsibilities. Articles 33 and 34 of the Banking Supervision Law give the CBRC the power to have full access to banks' documents during onsite examinations and to request additional information for offsite monitoring purposes. Furthermore, the CBRC has access to banks' board, management, and staff to discuss supervisory matters.</p> <p>EC8: Banks in China are required to comply with all the regulatory reporting requirements and other additional reporting or disclosure requests. A failure to comply with these requirements could lead to monetary penalties and other enforcement actions. The <i>Banking Supervision Law</i> (Article 46–48) specifies the corrective actions that banks must take and prescribes different levels of supervisory actions. For example, if a violation is regarded as material or the bank fails to take corrective measures promptly, the CBRC can suspend the bank's activities or revoke its banking license.</p> <p>EC9: The CBRC reviews and verifies the accuracy and integrity of regulatory reports through onsite examinations. In addition, the CBRC uses extensive offsite automated programs to perform validity checks of data. Once validity edits exceptions are identified, banks will be contacted and they must provide explanations for the deviations or correct any errors as appropriate on a timely basis.</p> <p>EC10 and EC11: The CBRC generally does not engage external experts to perform supervisory tasks, although it may do so in certain cases. Under such circumstance, the CBRC signs agreements with external experts and specifies their roles and responsibilities of their engagements. For example, a CBRC branch has engaged external auditors to participate in some onsite examinations. Under the <i>Internal Procedures of Commissioning External Auditing Institutions</i>, the CBRC also provides specific requirements on the supervision of these external experts and requires that they report significant findings to the CBRC as soon as they are identified.</p>
Assessment	Compliant
Comments	None
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.
Description	<p>EC1 and EC2: Information provided by banks to their supervisors must be accurate. As such, banks must have adequate financial record-keeping systems. To ensure information accuracy and reliability, the CBRC has guidance in place to require banks to maintain a sound internal control and financial reporting systems and regularly reviews the effectiveness of these systems during onsite examinations. <i>The Accounting Law</i> (Article 4) and the <i>Commercial Banking Law</i> (Article 55) provide that the bank's Board of Directors and senior management are responsible for the adequacy and accuracy of financial records and information. The CBRC requires banks with total assets exceeding RMB 1 billion to have their financial statements audited by qualified external audit firms. Publicly listed banks also are encouraged to disclose their self-assessment of the adequacy of internal controls that is reviewed by their external auditors. The MoF has the power to review and approve the qualification of external auditors and perform periodic onsite review of the quality of audit. The CSRC and the MoF are jointly responsible for approving the qualifications of accounting firms serving as the external auditors for publicly listed banks.</p> <p>EC3: The CBRC requires banks to comply with all the applicable laws and accounting standards in preparing their financial statements. Accordingly, banks are required to follow accepted accounting principles which cannot be changed at banks' discretion. During its ongoing supervisory process, the CBRC also ensures that banks have set aside appropriate provisions which are properly presented and deducted from profits.</p> <p>EC4 and EC5: External auditors must opine on whether the bank's financial statements, taken as a whole, are presented fairly in accordance with relevant accounting principles and standards. In conducting the external audit, the external auditors are also required to follow accepted auditing standards. The auditing standards issued by the MoF provide detailed audit requirements in such areas as the off-balance-sheet items, NPLs, loan loss allowances, trading activities and adequacy of internal control. The CBRC can exercise its supervisory discretion to establish and extend the scope of external audits of individual banks, if warranted.</p> <p>EC6: <i>The CPA Law</i> provides that if an accounting firm fails to comply with auditing standards, the MoF has the power to issue a warning or suspend the accounting firm from performing audit services. The MoF and the CSRC have the supervisory authority over the accounting firms that provide audit services to publicly listed companies, including banks. They have the power to reject and rescind the licenses of the auditors. During the supervisory process, if the CBRC believes that the external auditors do not have the requisite expertise, independence or fail to follow professional standards, it can recommend banks to replace their external auditors. In addition, the CBRC can inform the MoF relating to its concerns or recommend additional action steps for the MoF. The CBRC does not have the direct power to reject and rescind the appointment of an external auditor that is deemed to have inadequate expertise or independence.</p> <p>EC7: In 2006, the MoF issued a new set of accounting standards, consisting of one basic accounting standard and 38 specific accounting standards, which have substantially converged with IFRS. The only differences currently are in the areas of related party disclosures and reversal of impairment write-downs. Given the unique circumstances in China, the IASB decided to exempt from the disclosure requirements for transactions between a government-controlled reporting entity and that government or other entities controlled by that government in August 2009.</p> <p>To gauge whether the new accounting standard is in line with IFRS, the 12/31/09 financial statements of two major Chinese banks filed in China and Hong Kong were reviewed. Both banks list their shares on the Hong Kong Stock Exchange (called H Shares) and they are required to report their financial statements in accordance with Hong Kong Financial Reporting Standards (HKFRS) which follow IFRS. For both entities, the differences in the reported net income between the two statements filed in Hong Kong and China are very minor.</p>

In October 2009 the World Bank issued the *World Bank Report on the ROSC–Accounting and Auditing*. The report commended China’s effort in implementing a revised accounting standard that has substantially converged with IFRS. The report also issued a number of policy recommendations. In particular, the report cited that the audit quality of the smaller to mid-sized accounting firms needs improvement. The assessors met with MoF officials responsible for auditing and accounting and they agreed with the conclusions of the ROSC report. Enhancing audit quality is important for the banking sector as banks need to obtain reliable financial information from different types of borrowers. Discussions with major accounting firm personnel also confirmed that as they have experienced frequent cases of requiring “prior period adjustments” after taking over audits of companies from smaller accounting firms. Furthermore, the report recommended that the MoF increases its resource in performing the audit quality review of accounting firms. In 2008, the MoF audit quality review only covered 10 percent of the accounting firms. A regional accounting firm interviewed by assessors indicated that the MoF inspected the firm about five year ago. Increasing the oversight of the accounting profession is another important step to improve the credibility and reliability of the published financial statements.

With the adoption of the new accounting standards as of January 1, 2007, the CBRC has required the phase-in implementation of the standards by the banks before yearend 2009. Subsequently, the CBRC also conducted an evaluation of the Chinese banks’ implementation of the accounting standards and concluded that most banks have successfully adhered to the new standards.

EC8 and EC9: The CBRC requires periodic public disclosure by banks that adequately reflect their financial condition and reviews banks’ governance and internal control structure during the ongoing supervisory process to ensure the reliability of the disclosed information. The information required to be disclosed includes qualitative and quantitative information on a bank’s financial performance, financial position, risk management strategies and practices, risk exposures and corporate governance. Based on discussions with audit firm personnel, Chinese banks’ disclosure standards have been improving and they gradually have provided more meaningful discussions of their risk management practices.

The CBRC also considers the size and complexity of a bank’s operations in setting the disclosure requirements. For banks with total assets below RMB 1 billion or total deposits below RMB 500 million, they could seek the approval from the CBRC for temporary exemption from disclosure as long as they provide adequate justifications and submit a future disclosure plan.

EC10: While the CSRC and the Stock Exchanges have the primary responsibilities for reviewing public companies (including banks) compliance with the relevant disclosure standards and for taking appropriate enforcement actions, the CBRC also assesses banks’ compliance with information disclosure requirements during its ongoing supervisory process. The *Banking Supervision Law* also provides that banks must comply with reporting and information disclosure requirements and that non-compliance will be subject to various enforcement actions depending on the severity of violations.

EC11: *The Banking Supervision Law* requires the CBRC to compile and publish aggregate statistical data and reports on the banking sector. Such information includes aggregate data on banking industry assets, liabilities, equities, profits, loan classification and asset quality. The CBRC publishes this information on its official website or through the media. Based on a review of the CBRC 2009 annual report, aggregate banking system data pertaining to the categories mentioned above are presented in the Appendix section of the annual report.

AC1: *The Rules on Banks’ Information Disclosure* (Article 17) requires banks to hold tripartite meetings with external auditors and the supervisors prior to the issuance of the audit reports. In addition to the tripartite meetings, the CBRC regularly meets with external auditors to discuss

	<p>issues such as major audit findings, adequacy of provisions, and compliance with laws and regulations. As stated above in CP 9, during the external audit of a bank, if the amount of loan loss provisions calculated using relevant accounting principles is less than the regulatory minima (i.e., the regulatory benchmark rule and the minimum loan loss coverage rule), the external auditors and the banking supervisors will engage in further discussions. Auditors that assessors met described these meetings as frank and open.</p> <p>AC2: <i>The China Standard on Auditing No. 1613: The Relationship between Banking Supervisors and External Auditors</i> stipulates that external auditors should report significant issues that require immediate supervisory attention or actions to the banking supervisors (Article 27). In addition, if the external auditor is engaged by the banking supervisor to perform certain specialized tasks, the auditor is required to issue reports to the CBRC that include a discussion of matters of material significance (Article 29).</p> <p>AC3: <i>The China Standard on Quality Control of Firms No. 5101- Business Quality Control</i> (Article 19) stipulates that accounting firms must rotate the audit engagement partner, concurring partner and senior manager of the audit team of public companies every five years. In addition, the <i>Guidelines on Professional Ethics of Chinese CPAs</i> stipulate similar requirements.</p> <p>AC4: The CBRC requires banks to have policies and procedures for information reporting and disclosure. In addition, the CBRC requires banks' Board of Directors and senior management to formulate and implement disclosure policies.</p> <p>AC5: The CBRC has the authority to access external audit reports and related workpapers to address any significant supervisory concerns.</p>
Assessment	Largely Compliant
Comments	<p>The authorities should consider introducing more stringent auditor independence requirement to enhance the credibility of the auditing profession. Currently, audit independence rule is still developing in China and major accounting firms in China follow their global firm-wide independence standards as a guideline. Many countries strictly prohibit the same external audit firm from performing a number of defined non-audit services to ensure that the external auditor is independent in fact and in appearance.</p> <p>The authorities should continue to implement the policy recommendations identified in the October 2009 <i>World Bank Report on the ROSC–Accounting and Auditing</i>. In particular, the report cited that the audit quality of the smaller to mid-sized accounting firms needs improvement. Furthermore, the report recommended that the MoF increases the oversight of the accounting profession which is another important step to improve the credibility of the published financial statements.</p> <p>As indicated in EC6, the CBRC does not have the direct power to reject or rescind the appointment of an external auditor who is deemed unfit to perform a reliable and independent audit and therefore is not in compliance with this Essential Criteria. It is recommended that the CBRC should be given the direct power to reject or rescind the appointment of external auditors who have inadequate expertise or independence, or who don't follow professional standards.</p> <p>The financial crisis has shown the importance of obtaining financial data on banks on a timely basis. Transparency of the banking system should be further enhanced if the CBRC publishes the aggregate banking data in a more frequent basis (such as quarterly) and includes more financial ratios such as net interest margin. Furthermore, while the CBRC did disclose other ratios such as ROA and loans-to-deposits ratios in the text of its annual report, these ratios should be displayed more prominently together with other key ratios in one designated section to provide a snapshot of the overall financial condition of the banking industry. CBRC should ensure that capital adequacy numbers are reported publicly by banks on a current basis,</p>

	whether they are listed entities or not. As a result, market participants could see how individual banks compare to their peer groups.
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.
Description	<p>EC1: In the course of the supervisory process, the CBRC communicates continuously with the bank management, and on occasion with the bank Boards, on the deficiencies brought out by the on-site, off-site or other examinations (external audits and AML inspections) and expects that the issues be resolved satisfactorily. A supervisory letter is issued at the end of the supervisory cycle to communicate major concerns as well. The rectification of these deficiencies is followed up periodically and also taken in to account in determining the scope of ensuing on-site examinations.</p> <p>EC2: The supervisory role in bank intervention and resolution is laid out in both the <i>Commercial Bank Law</i> and <i>Banking Supervision Law</i>. The <i>Commercial Bank Law</i> provides for CBRC to determine and organize the implementation of the taking-over of a troubled bank (Article 64–68); voluntary dissolution due to division or merger (Article 69) and liquidation (Article 70–72). The <i>Banking Supervision Law</i> empowers the CBRC to take-over or facilitate the restructuring of a distressed bank in the event that the interests of the depositors and other customers is jeopardized (Article 38) and to close an institution in case serious violations of laws and regulations or unsafe and unsound practices have endangered the financial order and public interest.</p> <p>Assessors discussed practical experience with CBRC staff. The preferred resolution approach is to arrange a take-over of a troubled bank by a healthy bank. If that approach is unachievable, a restructuring or reorganization is attempted and only if that does not work, to have the institution file for bankruptcy. In recent years there have been few cases of restructuring and reorganization and only once case of closure of a bank.</p> <p>EC3, 4, 6: CBRC has a range of supervisory tools available to deal with non-compliance with laws, regulations and rules; to counter unsafe and unsound practices and to act in the interests of depositors and public interest. The <i>Banking Supervision Law</i> (Articles 37 to 42) provides for a wide range of actions to be taken within a prescribed period if a bank fails to correct deficiencies, or if safety and soundness of the institution or interests of depositors is threatened. These include the ability to suspend part of the business, withhold approval for new products and services; restrict payment of dividend; restrict asset transfers; order controlling shareholders to transfer their shares; replace directors and senior managers or withhold their powers and withhold approval of new branches. Article 40 provides for further ability to take action against directors and senior managers including requesting that responsible persons be detained at the order and not be permitted to leave the country and to request the judicial authority to prevent them from transferring their properties or creating lien on them. In addition, the CBRC keenly follows up on the end use of disbursed funds and in what may be a rare authority provided to supervisors, if CBRC determine in the course of its inspection that banking institutions and/or individuals within these institutions may have violated laws and regulations, they can investigate them by interviewing other individuals and institutions (e.g., bank customers, borrowers and counterparts) and asking for related documents (Article 42).</p> <p><i>The Commercial Bank Law (Chapters 7 and 8) also provides specific provisions on penalties, including takeover and closure, which are to be applied to banks in keeping with the gravity of the situation. In general, the law authorizes the CBRC to direct banks to take corrective action, confiscate any illegal gains that may have accrued from the violation and to impose monetary penalties. These cover situations such as establishing branches without approval, misusing their licenses, varying the interest rates in violation of regulations, engaging in any unauthorized activity; granting loans to related parties without an arms length basis; obstructing inspections, providing false or misleading information or data; violating large exposure rules etc. The PBC also has similar powers in respect of the inspections that it may carry out or data that it may call</i></p>

	<p>for.</p> <p>An earlier umbrella regulation, the <i>Regulations Governing the Punishment against Illegal Financial Activities (1999)</i> provides the framework for sanctioning illegal financial activities, maintaining financial order and preventing or mitigating financial risks. The administrative bodies for the purposes of this act are the CBRC, PBC, and SAFE, and these regulations provide more details of the relevant punishments that could be taken against any violations.</p> <p>In practice, there is sufficient evidence to show that the CBRC uses the powers available to impose necessary sanctions and require corrective action from banks. In the year 2009 alone, the CBRC imposed RMB 11.5 million in penalties, issued over 4,000 sanctions or corrective actions (significant number of which pertained to suspension or restrictions of activities) and revoked the qualifications of 86 senior managers.</p> <p>EC5: CBRC has the power to take measures if a bank's capital adequacy falls below the prescribed minimum (currently 11.5 percent for the five large banks and 10 percent for others). The <i>Banking Supervision Law (Article 37)</i> requires the CBRC to take remedial measures within a prescribed period if a bank fails to meet prudential rules and for the bank to take appropriate corrective action and to report to the CBRC. If the bank fails to correct the deficiencies within the given period, the CBRC has the authority to take further enforcement actions. In terms of the <i>Commercial Bank Law (Article 75)</i> if a bank fails to meet the regulatory capital adequacy requirements, the CBRC has the power to require it to take corrective actions and impose a fine within the range of RMB 200,000 and RMB 500,000; if the case is serious or the correction is not made within the required timeframe, the CBRC has the power to close its business for rectification or revoke its license.</p> <p>CBRC expects supervisors to intervene at an early stage in case the capital ration falls below the minimum. <i>The CBRC Rules on Capital Adequacy of Banks</i> require banks to report the CAR quarterly on a solo basis and half-yearly on a consolidated basis. In case any material events affect the CAR, banks are required to report to the supervisor. Supervisors also review the CAR through on and off-site examinations and reviews.</p> <p>Under these Rules, CBRC categorizes banks as “adequately capitalized,” “undercapitalized” and “significantly undercapitalized.”</p> <ul style="list-style-type: none"> • For an adequately capitalized bank (Total CAR not less than 8 percent and Tier I not less than 4 percent), the CBRC has the authority to intervene to prevent bank capital from falling below the minimum levels. • For an undercapitalized bank (CAR less than 8 percent and Tier I less than 4 percent) , the CBRC is required to issue a supervisory letter including actions to be taken and the timeframe, submit and implement an acceptable capital restoration plan, reduce risk assets, restrict asset growth and restrict or suspend dividend or other forms of payment to shareholders. • For a significantly undercapitalized bank (CAR less than 4 percent or Tier I less than 2 percent) , the CBRC has the authority to take further actions such as ordering the banks to replace the board member or the senior management, taking over or closing the bank. <p>In practice, the CAR is a key indicator monitored by the CBRC and is also one of the key factors that the CBRC takes into account in reviewing and approving the bank's new business and branch or subsidiary applications. In the past, banks which have fallen in the under-capitalized category have been asked to stop dividend payments and been denied expansion of branches.</p> <p>AC 1: The framework for guarding against the supervisor unduly delaying corrective action has the following components. First, supervisory accountability is imposed by Article 12 of the <i>Banking Supervision Law</i> under which the CBRC has set up an extensive supervisory</p>
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	<p>accountability system to review and monitor the effectiveness of its employees. The Staff Compliance Department of the CBRC monitors and inspects the activities of both the CBRC head office and its local offices to ensure efficiency and effectiveness of supervisory actions. Second, the CBRC has put in place monitoring systems (described in CP 19–20) which aim to provide early indications of banking problems. Third, there is a framework which seeks to link supervisory actions albeit broadly to falling capitalizations.</p> <p>AC 2: Banking groups in China are typically bank-led and the CBRC has explicit authority to restrict the activities of banks as part of its portfolio of remedial actions. It also has MOUs in place with other domestic supervisory agencies for nonbanks which can be used to coordinate supervisory actions. In the case of locally incorporated foreign banks, these can be owned only by foreign banks in the first place, and the CBRC seeks to exchange information with the overseas supervisors through formal and informal agreements to remain alert to the condition of the parent. However, in case of bank groups led by non-financial groups, the ability of CBRC to ring fence the bank from the actions of the parent groups is not clearly established in law. CBRC is confident that it can act under existing authority to enforce this.</p> <p>AC 3: CBRC has entered in to MOUs with the sector supervisors to share information through joint meetings and reports and has also another MOU with the CIRC to take joint coordinated action in case of insurance firms held by banks and vice versa. Through these mechanisms, it keeps them informed of remedial actions taken. One joint examination of wealth management products has also been conducted under this MOU.</p>
Assessment	Compliant
Comments	<p>CBRC has recently introduced capital buffer expectation for banks which are announced as a counter-cyclical measure but it is unclear whether this is a temporary measure or permanent and the manner in which it would be varied with the business cycle. It is also not clear how their intervention schedule for less than well capitalized banks will change to accommodate this requirement. International experience suggests that it is important for supervisors to intervene well before the capital ratio is breached and hence CBRC should revisit their capital guideline and intervention schedule to (a) incorporate the buffer expectations (b) require intervention before the current minimum is breached.</p>
Principle 24.	<p>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.</p>
Description	<p>EC1/2: <i>The Banking Supervision Law</i> provides the CBRC with broad authority to regulate and supervise banks on a consolidated basis (see Article 25).</p> <p>Banks that maintain banking and/or non-banking subsidiaries are referred to as banking groups, of which the CBRC acts as the consolidated supervisor.</p> <p><i>The Banking Supervision Law</i> expressly provides the CBRC with the authority to regulate and supervise the financial entities that are established outside China with the CBRC's approval, as well as the cross-border activities of banks and other financial institutions licensed by the CBRC (see Article 2).</p> <p>The CBRC applies its statutory rule-making authority by issuing <i>the Guidelines on Consolidated Banking Supervision</i> (hereinafter referred to as <i>the Guidelines</i>), which provides a comprehensive framework for consolidated supervision of banking groups, including the scope, elements and methods of consolidated supervision, requirements for consolidated supervision of cross-border activities, and guidance on banking groups' own management activities on a consolidated basis.</p> <p>Key prudential measures such as capital adequacy rules, large exposure limits and limits re liquidity and funding structure apply on a consolidated basis in a banking group. They also apply on a consolidated basis to cross-pillar groups.</p>

	<p>The CBRC exercises consolidated supervision of the global activities of banking groups during the processes of licensing and ongoing supervision, and by making arrangements for cross-border and cross-sector supervisory cooperation. During the process, the CBRC monitors and assesses all significant aspects of banking groups' operations and applies prudential requirements to ensure their safety and soundness.</p> <p>As the consolidated supervisor of banking groups, the CBRC keeps itself informed of the overall structure of each banking group and maintains adequate understanding of each group's activities, both domestic and cross-border.</p> <p>There is no legislation in place re financial holding companies. Nor is there any decision as to whether that would be desirable and, if so, how they would be regulated and supervised on a consolidated basis, and by what authority.</p> <p>In discussion with assessors CBRC staff showed themselves to be knowledgeable about banking groups under their supervision. However, the law and guidelines do not prohibit ownership structures for banks that may complicate CBRCs ability to conduct comprehensive consolidated supervision. In particular, banks may be owned by corporate groups. Any banking entities that are part of such a group within China, or any of the listed permissible activities for banks in China would have to be located within the bank in China or within subsidiaries of that bank approved by the CBRC. Overseas branches and subsidiaries of those banks in China would be included in the consolidation. So these entities would also be subject to consolidated supervision.</p> <p>However, there is nothing to prohibit such a corporate group from also owning a bank outside China that would not be part of the banking group subject to CBRC consolidated supervision. As the foreign bank would not need CBRC approval, there would be no opportunity to use approval power to force a corporate structure that permitted consolidated supervision. Such corporate structures with affiliated banks not supervised on a consolidated basis have occasionally existed in the recent past, but none exist currently. These arrangements have been material to the corporate groups involved but have not been material to the overall banking system. And CBRC has acted to get additional information from the foreign supervisor to assist in its supervision of the overall entity.</p> <p>As a technical matter, since bank ownership rules do not require approval by <u>beneficial</u> owners, it is technically possible for one beneficial owner to own bank affiliates that would not be subject to combined consolidated regulation and supervision. This matter of legal impediments to assessing beneficial ownership is covered in CP 4. Nor do the rules deal with indirect changes in control in corporate chains above the bank.</p> <p>CBRC noted it did on-site consolidated examinations of several banks in 2009, including sending staff to overseas branches and subsidiaries.</p> <p>China is experimenting with bank- insurance and bank- fund management firm cross ownership. Several pilot projects exist. These pilots operate on the basis of the insurance or fund management firm being a subsidiary of the bank. CBRC imposes strict firewalls between the bank and the insurance or fund management subsidiary—no extension of credit, no common senior management, separate risk management. However the parent bank is required to establish policies, rules, duties and procedures for the consolidated management of the insurance subsidiary. It is also required to bring the subsidiary into the centralized information management system to monitor and manage the risk exposures of the subsidiary in a centralized way (<i>See Rules on Pilot Equity Investments in Insurance Companies Article 14 and 15</i>).</p> <p>Under the regulatory principles and the MOU between CBRC, CSRC and CIRC each is responsible for supervision of their own entities. Discussions with CBRC staff indicate that if a matter directly concerns the operations of both the bank and the insurance firm, such as</p>
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	insurance product sales through the bank branches, there is the possibility of joint CBRC/CSRC examinations. However for other risk control matters within the fund management or insurance subsidiary of a bank, CBRC leaves these to the other regulator. They then share information, as necessary. As noted in CP6, the investment in the subsidiary (accounting value) would be deducted for bank regulatory capital rules. Large exposure rules for such a mixed group apply on the consolidated entity.
Assessment	Largely Compliant
Comments	CBRC is well able to conduct consolidated regulation and supervision and does so capably in the vast majority of cases. Legislation needs to be amended to give them the power to conduct such supervision in all cases or to give them the power in complex ownership structures to require that all banking entities be consolidated within the structure. That would reduce the need for CBRC to rely on informal/indirect approaches in such cases which may not be completely effective. The arrangement for cross-ownership pilots leaves CBRC exposed to not adequately understanding the inherent risk and risk mitigants of the fund management or insurance subsidiary. By not being able to examine the subsidiary risk management system directly, yet the parent bank having overall risk management responsibility; it may be difficult for CBRC to satisfy itself of the quality of that control in practice. CBRC having authority to examine should be revisited.
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.
Description	<p>EC 1, 2: As of end 2009, there were over 250 foreign banks from 46 countries operating in China as subsidiaries/branches/representative offices, though they accounted for less than 2 percent of total banking system assets. Nine Chinese banks had 48 branches in around 20 countries and 3 banks had 18 subsidiaries in 12 countries. In addition, Chinese banks have also taken minority equity stakes in many overseas banks. Thus, the cross-border profile of the Chinese banking system has changed significantly in the past decade and their global footprint is growing. Accordingly, CBRC has paid a lot of attention to home-host cooperation and information sharing in recent years. The Banking Supervision Law (Article 7, 11) authorizes CBRC to establish supervisory cooperation arrangements with supervisors in other countries and regions for the purpose of supervision of cross-border banking and to share information after making relevant arrangements for the preservation of confidentiality with home and host supervisors. The scope of cooperation and information sharing is usually listed out in MOU, and as of the assessment date, CBRC had entered into 36 MOUs with overseas supervisors covering roles as both home and host supervisor. In cases where MOUs have not been established, information sharing arrangements may be ad-hoc or based on an exchange of letters. The existence of formal arrangements is notified to the public through an announcement on the CBRC website.</p> <p>EC3, 4: As a home supervisor, CBRC has the legal authority to share information with overseas hosts while preserving confidentiality and has entered into several MOUs for this purpose. CBRC internal manuals, which were made available to the assessors, lay out the procedures to be followed and the information to be shared on a regular basis. It has also established a supervisory college for its largest bank and is in the process of launching a second college. As a home supervisor, it conducts regular on-site inspections of the overseas operations of domestic banks and discusses the findings of these with the host supervisors.</p> <p>Similarly, as a host supervisor, it has the legal authority to share information and has developed internal procedures and processes to guide this. In practice, it does this on request from the overseas supervisors. Major inspection findings are not shared routinely but driven by request made under such arrangements. Home supervisors are permitted to undertake inspection visits though the scope may be reduced due to the fact that access to customer accounts is not routinely permitted on grounds of confidentiality restrictions. CBRC also maintains regular bilateral contacts through regular visits to overseas supervisors and has been actively developing contacts through enhanced presence in multilateral meetings and forums.</p>

	<p>EC 5: Overall, foreign banks are subject to the same prudential requirements such as CAR, liquidity ratios, large exposure limits, loan loss provisioning and reporting requirements as domestic banks. There are a few areas where there is additional reporting or other requirements placed on foreign banks on the basis of addressing the higher risks, e.g., legal risk, associated with cross border presence. Thus foreign banks are required to meet net positive domestic asset requirements, i.e., the balance of the domestic assets in local and foreign currencies of a foreign bank branch shall not be less than the balance of its domestic liabilities in local and foreign currencies. Similarly, they are required to report the cross-border flows of large amount of funds and cross-border transfer of assets. At the same time, foreign banks have also been given more time than domestic banks to phase in some regulatory requirements, for example those pertaining to the Loans to Deposit ratio, Large Exposure limits and internal audit staffing requirements. Overall, the foreign bank representatives that the assessors met expressed their satisfaction at the level playing field with regard to the application of prudential regulation.</p> <p>EC6: Before issuing a license to a foreign bank, the CBRC is required by the <i>Foreign Bank Regulations</i> to confirm that the applicant is effectively supervised by the home supervisor; and that has obtained approval (or a statement of no objection) from its home supervisor. In practice, CBRC calls for the written consent of the home supervisor and their opinion on the application. In order to make a determination of effective consolidated supervision, it examines the legal framework, obtains information on regulatory practices particularly as relating to the ability and experience of the home supervisor in consolidated supervision, takes a view on the willingness and ability of the home authority to cooperate and share information. CBRC staff reported that applications from overseas jurisdictions have been turned down for not meeting this test. CBRC has also undertaken an internal evaluation of all home supervisors and updates its assessments periodically. It uses the licensing process to trigger a cooperation agreement and post-licensing, and maintains regular contact with the home supervisor through bilateral visits.</p> <p>EC7: As a home supervisor, the CBRC routinely conducts examinations of overseas offices and subsidiaries of Chinese banks with frequency based on size, complexity and materiality of operations. As a host supervisor, it will permit overseas supervisors to make on-site visits to local operations though access to customer accounts may be restricted though access to customer accounts may be restricted in keeping with confidentiality concerns. KYC is the responsibility of the PBC though CBRC also looks at KYC/CDD aspects in its examinations.</p> <p>EC8: There are no shell banks and booking offices in China.</p> <p>AC 1: While the need for a shared communication strategy has not so far been felt or needed, there are no legal constraints for such an exercise in future.</p>
Assessment	Compliant
Comments	As China becomes an increasingly important destination for foreign banks and as Chinese banks increase their global footprint, home-host information and cooperation related issues take on more importance. CBRC has made significant strides in this regard.

F. Recommended Action Plan and Authorities' Response

Recommended action plan

Table 3. China: Recommended Action Plan to Improve Compliance with the Basel Core Principles

Reference Principle	Recommended Action
1.1 Responsibilities and Objectives	Ensure upcoming revised 12 th five year plan developed by the State Council for the financial sector emphasizes importance of safety and soundness including early intervention by the regulator to get potential problems resolved and the contribution safe and sound banks make to achieving economic and social goals. Make improving banks' risk management as a way of supporting economic and social goals a priority over the next five years—not just in leading banks but in all banks. Consider amending CBRC objectives to emphasize early intervention. Reduce focus on NPLs and increase focus on more forward-looking monitoring and measurement of risk. CBRC leadership to continue to emphasize the importance of prudential goals in implementation of national economic policies.
1.2 Independence, Accountability and Transparency	Give CBRC authority for staffing and budgeting within broadly-set targets. Consider moving to model where industry fees directly fund CBRC to enhance independence. Develop a State Council supported plan to upgrade CBRC staff expertise including more budget flexibility and allowing CBRC more flexibility in remuneration to better attract and retain specialist resources. Address potential independence issues.
CP 4 Transfer of Significant Ownership	The law should clearly require evaluations of ultimate beneficial owners and shareholders exercising indirect control in all cases of acquisition and transfers of significant ownership in banks.
CP 6 Capital Adequacy	Reconsider the few areas where capital rules are less conservative than Basel I. Consider ways to draw out implementation of Basel II to ensure success, such as a longer parallel run period. Secure more specialist resources on an ongoing basis to effectively supervise Basel II banks. Enhance disclosure of capital position of banks.

Reference Principle	Recommended Action
CP 7 Comprehensive Risk Management	Persevere in current direction to improve bank compliance with CBRC guidance. Ensure adequate focus on risk management capabilities of the banks, not just the Basel II banks. Encourage banks to have more risk-related measures in their annual board-approved strategy setting. Perform cross-bank targeted review of risk management practices with focus on enterprise-wide approach, benchmark banks and provide feedback on areas for improvement. Encourage use of more enterprise wide scenario stresses such as how a slowdown would affect all risk areas. Encourage more relating of capital banks hold to their risks. Consider targeted review of this across major banks, benchmark, and provide feedback. Consider more detailed guidance on relating capital to risk for non-Basel II banks.
CP 8 Credit Risk	Further develop more forward looking assessment of credit risk in CBRC risk rating system. Encourage banks to use more of their own risk metrics in setting their annual credit risk strategies. Make sure all major banks have implemented CBRC credit risk guidance.
CP 9 Problem Assets	Establish a less burdensome mechanism to facilitate the loan write-off process.
CP 10, 11 Large Exposures and Related Party Lending	Bring common ownership of enterprises by local governments into the definition and discipline of large exposures and related party transactions.
CP 12 Country and Transfer Risk	Ensure implementation of country and transfer risk management guidance (issued in June 2010) in all major banks. Have banks submit an action plan to deal with deficiencies by year-end 2010. Perform a supervisory review of policies and practice for these banks within the next 18 months.
CP 13 Market Risk	Develop and implement an effective strategy to increase specialist resources in this area. Repeat the 2006 cross-system review of market risk management at regular intervals as a means of assessing progress, benchmarking and pushing for continuous improvement. Review appropriateness of threshold for exemption from market risk capital determination.
CP 14 Liquidity Risk	Put additional supervisory focus on this area as a means of reinforcing implementation of the guidance issued in 2009. Signal to banks at senior levels the desire for more sophisticated liquidity risk management. Put high priority on performing an assessment of all major banks against the new guidance.
CP 15 Operational Risk	Ensure all major banks have a plan to develop at least RCSA and KRI across their businesses. Enhance expertise of CBRC resources to permit cross-system review of major banks progress against 2007 guidance. Priority is less than for liquidity and IRRBB. Guard against pressure for premature moves to AMA.

Reference Principle	Recommended Action
CP 18 Abuse of Financial Services	Improve coordination and information sharing between CBRC and PBC through more regular and frequent information including those arising from AML inspection findings; and large and doubtful transaction reports. Develop an information sharing protocol between CBRC and PBC. Continue progress on dealing with fraudulent transactions in and by banks. Make it legally binding on banks to identify beneficial customers.
CP 22 Accounting and Disclosure	Develop an auditor independence requirement to enhance the credibility of the auditing profession. Prioritize implementation of policy recommendations identified in the October 2009 <i>World Bank ROSC Report on Accounting and Auditing</i> focusing on improving the audit quality of the smaller to mid-sized accounting firms and stronger oversight of the accounting profession. Empower CBRC to reject or rescind the appointment of an external auditor who is deemed unfit to perform a reliable and independent audit by them. Enhance the transparency of the banking system by publishing aggregate banking data, key financial ratios, and peer group averages quarterly. The frequency of audit oversight inspections should be increased.
CP 24 Consolidated Supervision	Amend legislation to give CBRC authority to force banks in all cases to be held in corporate structures that permit consolidated supervision. Use new authority re beneficial ownership and indirect control (CP 4) to ensure corporate structures permit consolidated supervision. Give CBRC authority to examine fund management and insurance affiliates of banks if concerns re risk and risk management capabilities exist.

Authorities' response to the assessment

46. The Chinese authorities welcome and support the BCP assessment as an opportunity for reflection and improvement for banking regulation and supervision according to international standards. The assessment team has undertaken excellent work, demonstrating high quality professionalism, dedication and the ability to cut through complex issues in a constrained timeframe. The authorities appreciate the opportunity to provide the following comments on the assessment.

47. The CBRC, with strong support from the Chinese government, has actively pursued its statutory mandate for safety and soundness of the banking sector through promulgating a prudential framework benchmarked to international standards and continuously improving supervisory effectiveness. This effort is facilitated by substantial enhancement in corporate governance and risk management in the Chinese banking industry through three decades of reform and opening up. These achievements and progress have been largely recognized in the

assessment report. The assessment demonstrates that the banking supervision in China is broadly in compliance with the BCP.

48. There are a number of issues in the assessment for which the authorities would like to provide further clarification. The assessment identifies the potential ability for the State Council to override CBRC rules as a potential threat to CBRC's operational independence. The CBRC does not see this as an independence concern that would compromise its effectiveness. According to the Law on Banking Regulation and Supervision, the CBRC shall, in accordance with applicable laws and administrative regulations, formulate and promulgate supervisory rules and guidelines for banking institutions. And according to the Legislation Law, only under the circumstances of violating laws and regulations, or existence of inconsistencies between rules issued by different ministries or commissions, the State Council may alter or annul "inappropriate" rules issued by the ministries or commissions. Therefore, the CBRC can perform its rule-making authority independently unless its rules and guidelines contravene relevant laws or administrative regulations. Such an arrangement serves as a check and balance on the CBRC and other government agencies to exercise authority in accordance with law. This also helps maintaining the integrity and consistency of the legal framework in China. In practice, the State Council has never altered or annulled the rules and guidelines issued by the CBRC.

49. The assessment also indicates that the CBRC's current budgeting and headcount arrangements could lead to potential independence issues and hamper supervisory effectiveness. Since its establishment, the CBRC has received unrelenting support from the State Council and relevant ministries in undertaking banking regulation and supervision. The CBRC has upgraded the efficiency and quality of its staff through continuous recruiting, training and development efforts, while the efficiency of supervision has also been enhanced through effective application of IT. However, the CBRC acknowledges that, like many banking supervisory agencies around the world, it faces challenges in attracting, developing and retaining supervisory talent in an increasingly competitive and complex industry environment. By working closely with relevant government agencies, the CBRC aims to further increase supervisory resources where appropriate, upgrade staff skills and retain high-quality front-line supervisors, in order to fulfill its mandate for safety and soundness in a fast changing industry environment.

50. The CPs revised in 2006 place a greater emphasis on risk management, and the methodology requires assessors to consider the practices of banks as well as supervisory agencies. The CBRC, since its establishment, has made great efforts to improve its risk-based supervision capacity, while requiring banks to enhance their corporate governance and risk management capabilities. To this date, the main business of Chinese banks is still traditional deposit-taking and commercial and retail lending. It is only in recent years that a few banks have been allowed to enter into non-bank financial businesses on a trial basis and these operations remain very small. As a result, China's banking sector is much simpler than those of developed markets, where the risk environment is much more challenging due to greater complexity and interconnectedness. The assessment acknowledges that the CBRC has played a major role in the significant and impressive progress that banks have made in improving their risk management, while identifying a number of areas for further improvement. The authorities' view differs from the assessment in the degree to which banks' risk management

is commensurate with the current risk environment they operate in. However, the authorities concur that continued improvements in banks' risk management are needed, as financial reform deepens and liberalization creates greater interconnectedness and complexities in the Chinese financial system. For example, looking ahead, comprehensive enterprise-wide risk management that takes account of interactions among risks and effectively relates capital to risks will need to be further strengthened at the Chinese banks. Meanwhile, the CBRC will also continue to enhance its capability in evaluating banks' risk profiles and risk management processes together with the increase in size and complexity of the Chinese banking sector.

51. The assessment has proven to be valuable and rewarding in generating insights and suggestions that will contribute towards the improvement of banking supervision in China. The CBRC appreciates the recommendations made in the assessment, and will take actions on those that are considered appropriate and applicable. Some of them are already being implemented and others taken into account in the CBRC's medium- and long-term plans to improve supervisory effectiveness. The CBRC will also continue to push forward the reform and opening-up of the Chinese banking sector, which has proven a key driver in enhancing the safety and soundness of Chinese banks. In the meantime, the CBRC will continue to actively engage in the activities of the FSB and the BCBS to develop and reform international banking supervisory standards, so as to contribute towards the enhancement of the resilience of the global banking system.