Basel Committee
on Banking Supervision

Regulatory Consistency Assessment Programme (RCAP)

Assessment of Basel III regulations – China

September 2013

BANK FOR INTERNATIONAL SETTLEMENTS

Note that this report refers to the RCAP grades prior to October 2025. The grade 'materially non-compliant (MNC)', ie one notch above the lowest grade, has since been renamed to 'partially non-compliant (PNC)' for greater clarity

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Contents

Glossary

ABCP	Asset-backed commercial paper
AFS	Available for sale
AMA	Advanced Measurement Approaches (for operational risk)
AT1	Additional Tier 1 Capital
BCBS	Basel Committee on Banking Supervision
BCP	Basel Core Principles for Effective Banking Supervision
BIA	Basic Indicator Approach (for operational risk)
BIS	Bank for International Settlements
CAR	Capital adequacy ratio
CBRC	China Banking Regulatory Commission
CCP	Central counterparty
CCR	Counterparty credit risk
CEM	Current Exposure Method (for counterparty credit risk)
CCF	Credit Conversion Factor
CET1	Common Equity Tier 1 Capital
CNY	Chinese yuan renminbi
CRM	Comprehensive Risk Measure (for correlation trading)
CRM	Credit risk mitigation (for credit risk)
D-SIB	Domestic Systemically Important Bank
DTA	Deferred tax asset
ECAI	External credit assessment institution
EL	Expected loss
FAQ	Frequently asked question
G-SIB	Global Systemically Important Bank
IAA	Internal Assessment Approach (for securitisations)
IRB	Internal Ratings-based Approach (for credit risk)
IMA	Internal Models Approach (for market risk)
IMM	Internal Models Method (for counterparty credit risk)
IRC	Incremental Risk Charge (for market risk)
LF	Liquidity facility
LGD	Loss-given-default
NPL	Non-performing loan
PBoC	People's Bank of China
PD	Probability of default
PONV	Point of non-viability
PSE	Public sector entity
PRC	People's Republic of China
RCAP	Regulatory Consistency Assessment Programme
RWA	Risk-weighted assets
SA	Standardised Approach (for credit risk)
SIG	Supervision and Implementation Group
SL	Specialised lending
SM	Standardised method (for counterparty credit risk)
SME	Small and medium-sized Enterprises
TSA	The Standardised Approach (for operational risk)
UCITS	Undertakings for collective investments in transferable securities
UL	Unexpected loss
VaR	Value-at-risk
WMP	Wealth management product

Preface

The Basel Committee on Banking Supervision (Basel Committee) sets a high priority on the implementation of the regulatory standards underpinning the Basel III framework. The benefits of the agreed global reforms can only accrue if these standards are made part of the regulatory framework and put to work. In 2011, the Basel Committee therefore established the Regulatory Consistency Assessment Programme (RCAP) to monitor and assess its members' implementation of Basel III standards. The RCAP assessments aim to ensure that each jurisdiction adopts Basel III standards in a manner consistent with the Basel III framework's letter and spirit. The intention is that prudential requirements based on a sound and transparent set of regulations will help strengthen the international banking system, improve market confidence in regulatory ratios, and ensure a level playing field.

This report presents the findings of the Basel Committee's RCAP Assessment Team on the domestic adoption of Basel III risk-based capital standards in China and their consistency with Basel Committee requirements.[1] The team was led by Mr Luigi Federico Signorini of the Bank of Italy and comprised six technical experts. The assessment was carried out in 2013 using information available as of 19 July 2013. The principal counterpart for the assessment was the China Banking and Regulatory Commission (CBRC), which adopted Basel III risk-based capital regulations in June 2012 (the *Capital Rules*) and brought them into force on 1 January 2013.

The assessment work consisted of three phases: (i) self-assessment by the CBRC; (ii) an on- and off-site assessment phase; and (iii) a post-assessment review phase. The assessment phase included a visit to Beijing during which the Assessment Team held discussions with the CBRC, the People's Bank of China (PBoC), various internationally active Chinese commercial banks, and two accounting firms. These discussions provided the Assessment Team with a comprehensive overview and a deeper understanding of the implementation of the Basel risk-based capital standards in China. The third phase provided the Assessment Team with technical feedback on its findings. The work of the Assessment Team and its interactions with the CBRC were coordinated by the Basel Committee Secretariat.

The scope of the assessment was limited to the consistency of domestic capital regulations in China with Basel III standards; issues relating to the functioning of the regulatory framework and the prudential outcomes were not part of the assessment exercise. Where domestic regulations and provisions were identified to be inconsistent with the Basel framework, those deviations were evaluated for their (potential) impact on the capital ratios and the international level playing field for banks. The Assessment Team did not make an evaluation of the capital levels of individual banks, the adequacy of loan classification practices, or the way banks currently calculate risk-weighted assets and regulatory capital ratios. As such, the assessment covers neither the soundness and stability of the financial banking sector in China nor CBRC's supervisory effectiveness.

The Assessment Team did note the evolving institutional and risk management framework in China, its macrofinancial setting, and the decade-long banking and prudential reforms in China. Since its establishment in 2003, the CBRC has pursued an agenda consisting of regulatory and supervisory reform, prudential strengthening and further aligning its capital regime with the Basel Committee standards. During the RCAP assessment process, the CBRC initiated further reforms to its capital regulations to rectify several RCAP assessment findings. In particular, the CBRC issued four new regulatory notices after

[1] It should be noted that China's compliance with other Basel III standards, namely the leverage ratio, the liquidity ratios and the framework for global systemically important banks (G-SIBs) will be assessed at a later date once those standards become effective as per the internationally agreed phase-in arrangements.

industry consultation to strengthen several aspects of its regulations. The CBRC expressed its intention to transfer the notices into the *Capital Rules*, as part of its biennial review of the Rules, in 2014–15.

The RCAP Assessment Team sincerely thanks CBRC Chairman Mr Shang Fulin, Vice Chairman Mr Wang Zhaoxing and the staff of the CBRC for the professional and efficient cooperation extended to the team throughout the assessment.

Executive summary

The CBRC issued the core elements of the Basel III capital standards in June 2012. Supplementary documents were published in October and November 2012, including additional requirements on capital instrument innovation, transitional arrangements, and capital adequacy ratio reporting. Based in part on the RCAP assessment process that began in January 2013, the CBRC issued a number of additional regulatory notices in July 2013 that further align the domestic regulations with Basel standards. The main changes related to the treatment of banks' exposures to central counterparties and the disclosure requirements for capital instruments. In addition, the CBRC issued a set of technical clarifications and requirements to complete important parts of the Chinese capital regulations and make them consistent with the international Basel III standards. Given their binding nature, the notices significantly contributed to the RCAP goal of consistent adoption of the Basel III standards.

While the CBRC addressed several assessment findings through issuance of regulatory notices, they decided not to rectify all identified deviations; specifically those relating to Pillar 1 rules for credit risk Standardised Approach (SA) and Pillar 3 rules for disclosure requirements were not addressed. While the outstanding deviations were assessed as currently immaterial, under certain circumstances they could become material. In particular, the Assessment Team considered that the finding for credit risk SA could materialise in the event of a downgrade of the credit rating of the Chinese sovereign.[2] For this reason, the Assessment Team judged the finding to be potentially material.

The CBRC indicated a willingness to revise the *Capital Rules* if there is a significant change in the rating assessment for China. In the judgement of the Assessment Team, however, the possibility of a downgrade and the potential effect on banks' capital ratios cannot be ignored. The credit risk SA component of the Chinese capital regulations was thus marked down to "Largely Compliant". The Pillar 3 component was also graded as "Largely Compliant", due in particular to the lack of full compliance with the Basel III standards concerning the disclosure of detailed information on credit risk and securitisations.

Overall, the Assessment Team determined the Chinese capital regulations to be closely aligned with the international Basel III standards. Based on the available data and information and notwithstanding the issues noted above, it assessed the capital regulatory regime to be "Compliant" overall.

[2] The Chinese sovereign is currently rated AA– by Standard and Poor's, Aa3 by Moody's and A+ by Fitch.

Response from the CBRC

As one of the largest emerging economies, China has strong commitment to global regulatory reform and standards for the purpose of building a sound and resilient financial system. In June 2012, the CBRC developed the *Capital Rules* benchmarking international norms to ensure a timely implementation of Basel III from 1 January 2013, the start date set by the Basel Committee. The *Capital Rules* reflect the authorities' continuous efforts for strengthening banking regulation and supervision. Compared with the Basel rules text, the *Capital Rules* have a wider scope of application and set higher requirements in selected areas in a more prudent way.

The CBRC is in full support of the RCAP put in place by the Basel Committee, which comes at an important time to foster a consistent adoption of Basel capital standards and a level playing field for internationally active banks. As can be seen from this assessment and previous ones, it is useful in many ways for the authorities to take the necessary steps to refine their domestic regulations in line with the Basel framework. In return, the Committee can also take advantage of the dialogue with national supervisors to collect opinions for future improvements to the Basel standards.

We welcome the detailed assessment of capital regulations in China and highly appreciate the professionalism of the Assessment Team, whose comments and recommendations have therefore been well received and carefully considered by the CBRC. By issuing additional regulatory documents, the CBRC has bridged a number of differences based on the self-assessment and findings by the Assessment Team. Although we are confident that in the foreseeable future the Chinese economy will remain in good shape, the CBRC will stay forward-looking and will continue to monitor the challenges for the banking sector and their implications.

The Basel III implementation is an evolving process that deserves ongoing commitment, hard work and coordinated efforts. So we look forward to further cooperation and collaboration with the Basel Committee.

1 Assessment context and main findings

1.1 Context

Status of implementation

In June 2012, the CBRC issued the State Council-approved *Capital Rules* adopting the risk-based Basel III capital framework.[3] In October and November 2012, supplementary documents were published, including the *Instructions on CAR reporting*, as well as additional regulatory documents regarding the transition to Basel standards and the choice of capital instruments (see Annex 4 and also further below).[4] The *Capital Rules* apply to all 511 commercial banks registered in the People's Republic of China (PRC), including small and medium-sized commercial banks that are not internationally active. The rules do not apply to so-called policy banks, which are non-deposit-taking, state-guaranteed investment entities.[5] The *Capital Rules* follow the implementation schedule stipulated by the Basel Committee for Basel III.

In July 2013, the CBRC issued further regulatory documents ("notices") on exposures to central counterparties (CCPs), disclosure requirements for capital instruments, requirements for internal ratings-based approach (IRB) implementation and technical clarifications.[6] The Assessment Team reviewed and discussed these notices with the CBRC during its on-site visit resulting in a number of amendments to align the capital requirements with Basel III standards.

Implementation context

Structure of the banking system and financial soundness

At the end of 2012, 511 commercial banks were registered in the PRC, with total bank assets (including off-balance sheet assets) amounting to CNY 129 trillion (approximately USD 20 trillion), circa 240% of GDP (see Annex 9 for an overview of selected key indicators of the Chinese banking sector). The financial system is dominated by the five largest commercial banks, which hold about 60% of total banking assets. One Chinese commercial bank – Bank of China – is classified as a global systemically important bank (G-

[3] The *Capital Rules* are available at: www.cbrc.gov.cn/chinese/home/docDOC_ReadView/79B4B184117B47A59CB9C47D0C199341.html. For the assessment, the Assessment Team relied on English translations by the CBRC of the domestic regulations and regulatory documents. In a few specific instances, eg for market risk and Pillar 3, the team assessed the appropriateness of the English translation of the Chinese rules through comparison with the original text in Chinese. For those sections, the translation was generally found to be appropriate.

[4] The documents are available at: www.cbrc.gov.cn/chinese/home/docDOC_ReadView/E7D4FBF66EE946BA86E647A5E9E58829.html, and www.cbrc.gov.cn/chinese/home/docDOC_ReadView/8C4ABFEFEB734B6E8830348DB997DB19.html. The Instruction on CAR Reporting (Yin Jian Fa, No. 53, 2012) was issued to banks and also published in the Handbook of the CBRC Off-site Supervisory Report 2013, China Financial Publishing House.

[5] According to the State Council papers no 20, 22 and 25, three "policy banks" were established in 1994, comprising the Export-Import Bank of China, the Agricultural Development Bank of China, and the China Development Bank. Policy banks were established with the special purpose of executing national industrial policies and financial policies, and thus supporting the nation's economic development. These institutions do not take deposits. According to the Rules on Fiscal Management of National Policy Banks (issued by Ministry of Finance, no 491, 1997), the Ministry of Finance holds the full amount of registered capital of these institutions, examines and approves their business plans, and subsidises any loss incurred (Article 32). Further, these institutions are regulated by the CBRC to undertake business in a prudent manner. The ways in which funds are raised and used are also approved by the PBoC. The institutions are rated as equivalent to the sovereign according to the three largest global rating agencies. Given the nature and economic function of these institutions, the Assessment Team considered them out of scope for the assessment of the Basel standards.

[6] The notices were issued on 19 July 2013, and are available at www.cbrc.gov.cn/english/index.html (English translation).

SIB). The CBRC is in the process of developing a framework for domestic systemically important banks (D-SIBs).

Under the new Basel III standards, the weighted average total capital ratio of Chinese banks stood at 13% in 2012 while the Tier 1 ratio and the CET1 ratio were both 10%.[7] The ratio of non-performing loans (NPLs) of commercial banks over total loans amounted to 0.95% at the end of 2012. The average provisioning ratio (the ratio of loan loss provisions to total loans) for commercial banks was 2.82% (the CBRC requires all banks to meet a minimum provisioning ratio of 2.5% by 2016); and the provisioning coverage ratio (ratio of loan loss provisions to NPLs) was 296%.

While the Chinese banking system is growing rapidly, the core of its banking business remains traditional, concentrated on credit products and services. This is reflected in a high proportion of loans relative to total assets and a relatively high share of RWA for credit risk as percentage of total RWA. Bank credit has increased from CNY 16 trillion in 2003 to CNY 67 trillion in 2012, equivalent to more than 120% of GDP.[8] Overseas assets and assets denominated in foreign currency are relatively small as the focus of Chinese banking, thus far, is primarily domestic.

The CBRC has been cautious in allowing banks to engage in complex financial activities. Some examples include correlation trading (which has not been permitted so far), and a closely monitored opening into securitisation products and complex OTC derivatives.[9] Reflective of this is the relatively small proportion of trading in financial activities, with an average market risk RWA of less than 1% of total RWA. The securitisation markets are small and at a pilot stage. At the end of 2012, the volume of outstanding asset-backed securities was less than CNY 20 billion.

In recent years, a market for wealth management products (WMPs) has developed. These products offer retail customers an alternative to traditional bank deposits and have seen strong growth, in part due to the existing caps on bank deposit rates. Banks offer WMPs directly but also indirectly through trust companies. In spring 2013, the CBRC issued new regulations for banks with regard to the prudential treatment of WMPs. The Assessment Team discussed the nature and structure of WMPs and the possible economic similarity to securitisations. According to the CBRC, there is no tranching of credit risk and banks do not provide liquidity facilities to WMPs and therefore WMPs are not classified as securitisations. The CBRC applies the standard credit risk rules if the WMPs are held on a bank's balance sheet. As a result, WMPs were not considered by the team when assessing the CBRC's implementation of the securitisation framework.

Basel standards

With the introduction of new capital requirements effective on 1 January 2013, all banks in China are on the Standardised Approach for credit risk and market risk and the basic indicator approach for

[7] Weighted by total assets.

[8] The CBRC's *Annual Report 2012* (Appendix 7-4).

[9] The CBRC is authorised by statutory power to conduct bank product approvals through the *Law of the People's Republic of China on Banking Regulation and Supervision*. In this context, the CBRC is authorised to develop regulations and regulatory documents for market entry purposes. The market entry for product approval is conducted on a firm-specific basis. An example of such regulation is the *Interim Measures for the Management of Derivatives Transactions of Financial Institutions* (Decree of the CBRC, no 1, 2004), which contains the approval requirements for banks to conduct derivatives transaction business. Another example is the market entry of wealth management products (WMPs). According to the *Interim Measures for Individual Wealth Management Products* (Decree of the CBRC, no 2, 2005), banks must meet specific qualitative requirements for conducting wealth management business. For each principal-guaranteed WMP, the bank is required to apply for prior approval; for each WMP of other types, the bank is required to report to the CBRC 10 working days prior to initiation of these products and the CBRC has veto power to reject the report within this period.

operational risk. Thus far, the CBRC has not approved the use of internal model-based approaches for measuring risk-weighted assets (IRB, AMA, IMA). However, at the time of the assessment, the CBRC was reviewing the application of a number of Chinese banks (see table below).

Status of approval of advanced Basel approaches

Number of banks, end-March 2013 — Table 1

	Advanced approach approved by CBRC	Application submitted and under review by CBRC	Pre-application phase (bank is in process of developing models for CBRC approval)
Credit risk (IRB)	0	6, for FIRB	4
Market risk (IMA)	0	6, only for general risk, SA remains for specific risk	4
Operational risk (AMA)	0	0	0

Source: CBRC.

Certain more sophisticated approaches of the Basel framework have not been made available by the CBRC, including the internal model method (IMM) and standardised method (SM) for counterparty credit risk, the comprehensive risk measure (CRM) for correlation trading risks, the intermediate approaches for options and commodity risks in the trading book, and the internal models based approaches for equity exposures in the IRB framework. Other approaches have in some cases been simplified (see also Annex 11 and Annex 12).

Regulatory system and mode of supervision

Since 2003, the CBRC has been responsible for banking regulation and supervision in China. The CBRC derives its legal authority to formulate and amend rules and guidelines from the *Law of the People's Republic of China on Banking Regulation and Supervision*. Article 21 of this Law 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 in accordance with applicable laws and administrative regulations.

The CBRC regulates its own rule-making process through the *CBRC Rule-making Provisions*, which state that the regulatory and supervisory rules formulated by the CBRC should be reviewed on a regular basis to ensure relevance and effectiveness. Article 79 of the *CBRC Rule-making Provisions* states that the CBRC should examine and evaluate the implementation and performance outcome of the banking laws and regulations, as well as assess the quality, effectiveness and implementation results of prudential rules and guidelines issued by the CBRC. Article 66 states that explanatory notes are as legally binding as the rules themselves. According to the *CBRC Measures on Regulatory Documentation*, the CBRC has the discretion to determine the most effective form by which to impose revised or new regulatory requirements.

Structure of prudential regulations

The relevant hierarchy of prudential regulations in China consists of the following four levels:

(i) Laws enacted by the National People's Congress;

(ii) Ordinances enacted by the State Council;

(iii) Regulations issued by the CBRC; and

(iv) Regulatory documents issued by the CBRC.

As per the above, the CBRC has the power to issue instruments in the latter two categories: (i) "Regulations", which are the prudential regulations with the highest legal force and are used for implementation of key elements of the prudential framework, and (ii) "Regulatory documents", which have a legal status subordinate to Regulations.

Within these two categories, the CBRC has issued an array of regulatory instruments to set out its prudential requirements. The CBRC uses a variety of names and titles. For example, Regulations can be termed "Decrees", "Provisions", "Measures" or "Rules". An example is the *Capital Rules* which are coded as Decree of the CBRC no 1, 2012.[10] Regulatory documents are coded with "Yin Jian Fa" (银监发), "Yin Jian Tong" (银监通), "Yin Jian Ban Fa" (银监办发), and "Yin Jian Ban Tong" (银监办通).[11] All documents, irrespective of their classification, are legally binding (see below). An example of a regulatory document is the *Notice of the CBRC on Transition Arrangements for the Implementation of the Capital Rules for Commercial Banks*, which is coded Yin Jian Fa, no 57, 2012.

During the assessment period, the CBRC issued four new regulatory documents:[12]

(i) *Notice on Measurement Rules of Capital Requirements for Bank Exposures to Central Counterparties* (CCPs);

(ii) *Notice on Enhancing Disclosure Requirements for Composition of Capital*;

(iii) *Notice on Regulatory Policies for Implementing IRB of Commercial Banks*; and

(iv) *Notice on Policy Clarification of Capital Rules*. This notice includes clarifications and requirements and is written in the form of questions and answers.

The notices issued by the CBRC significantly enhance the consistency of the domestic rules with the minimum Basel standards. The issuance of these notices therefore had a positive impact on the final outcome of the assessment.

Enforceability and bindingness of prudential regulations

To determine the uniform application and enforcement of various prudential documents issued by the CBRC, the Assessment Team used seven criteria:[13]

(1) The regulatory instruments are part of a well-defined, clear and transparent legal hierarchy and regulatory framework;

(2) They are public and freely available;

(3) They are viewed as binding by banks as well as by the supervisors;

(4) They would generally be legally upheld if challenged;

(5) They are supported by precedence of enforceability;

[10] An overview of Regulations and Regulatory documents issued by CBRC in 2012 is listed in the Annex of the CBRC's *Annual Report 2012*.

[11] In English, "Yin Jian" means "Banking Regulatory"; "Fa" means "Documents issued"; "Tong" means "Circulars issued"; "Ban Fa" means "Documents issued through the General Office of the CBRC"; and "Ban Tong" means "Circulars issued through the General Office of the CBRC".

[12] The notices were issued on 19 July 2013 by the CBRC, and are part of the *Notice on issuing regulatory documents on capital regulation for Commercial Banks* (Yin Jian Fa, no 33, 2013). The notices are available at www.cbrc.gov.cn/english/index.html (English translation).

[13] As a general principle, RCAP assessments only take into consideration "binding" regulatory documents that implement the Basel standards. This is to ensure that standards are laid down in a robust manner and that a legal basis exists for supervisors and third parties to ensure compliance with the minimum requirements.

(6) They are properly communicated and the consequences of failure to comply are properly understood and carry a similar practical effect as for the primary law or regulation; and

(7) The instrument is expressed in clear language that complies with the Basel provision in substance and spirit.

Based on the assessment of these seven criteria, the Assessment Team concluded that the regulatory documents issued by the CBRC meet the criteria and hence are eligible for the RCAP assessment (see also Annex 7).

Areas where the CBRC rules are stricter than the Basel requirements

In a number of areas, the Chinese regulations go beyond the minimum Basel standards (see Annex 11 for a listing of such requirements).[14] For example, the CBRC applies a CET1 ratio requirement including capital conservation buffer of 7.5%, instead of 7% (the Basel minimum of 4.5% plus the capital conservation buffer of 2.5%) as required by Basel III. In addition, the CBRC applies the minimum capital requirements to all commercial banks in mainland China, including small and non-internationally active banks. The Assessment Team has noted these areas of super-equivalence, but has not taken them into account in determining the assessment gradings.[15]

1.2 Scope of the assessment

Scope

As mentioned above, the RCAP assessment focused on the completeness and consistency of the existing local regulatory requirements with the Basel risk-based capital standards, complemented by information on the timeliness of Basel standards adoption. The assessment did not evaluate the adequacy of capital or resilience of the banking system in China, or the CBRC's supervisory effectiveness.

The assessment focused on two dimensions:

A comparison of domestic regulations with the capital standards under the Basel framework to ascertain if all the required provisions have been adopted (*completeness* of the regulation); and

Whether there are any differences in substance between the domestic regulations and the Basel III capital standards and their significance (*consistency* of the regulation).

In carrying out the above, the RCAP Assessment Team considered all binding documents that effectively implement the Basel framework in China as of 19 July 2013, the cut-off date for the assessment (Annex 4).[16]

[14] The last assessment of the CBRC's compliance with *Basel Core Principles for Effective Banking Supervision* was carried out during 2010 as part of the IMF-World Bank FSAP and published in 2012. It was found then that deviations from the Basel I regime tended to be conservative, requiring more capital or acting to increase the quality of capital that qualifies under the rules. The capital regime assessed was based on the 1988 Basel Accord and the 1996 market risk amendment (Basel I). The Basel II regime was not formally assessed, as it was not in place at the time of the FSAP assessment.

[15] It should be noted that the assessment solely focuses on regulatory deviations that could potentially weaken the banking system or that would potentially provide domestic banks with an unfair advantage over international peers. While the report duly mentions areas where local rules set more stringent requirements than the minimum Basel standards, in accordance with agreed RCAP assessment policy these areas receive no recognition in the assessment, nor are they considered for the grading in this report.

[16] For the broader context of the assessment, the report has drawn on other Basel work streams (QIS/CMG reports), and the published versions of financial stability assessments and Chinese compliance with the Basel Core Principles.

Any identified deviations were assessed for their materiality (current and potential) by using both quantitative and qualitative information. For potential materiality, in addition to the available data, the assessment used expert judgement on whether the domestic regulations met the Basel standards in substance and spirit.

As indicated earlier, the CBRC has not made available certain more sophisticated approaches. As these approaches are not explicitly mandated by the Basel-standards, the Assessment Team implicitly considered them as "not applicable" for the assessment (see also Annex 12).

Bank coverage

For the assessment of materiality of identified deviations, the CBRC provided data from domestic banks on a best efforts basis.[17] The coverage of banks generally consisted of 12 banks, including all internationally active banks (with branches and/or subsidiaries abroad) as well as non-internationally active banks that are systemically relevant from a domestic point of view. The 12 banks cover approximately 80% of domestic banking assets. For some findings, data on the largest six banks, which cover approximately 63% of domestic banking assets, were provided.

The CBRC also provided the team with additional background information regarding financial market developments and market trends, for example regarding the development of derivatives markets and data on asset-backed securitisation.

1.3 Assessment grading and methodology

As per the RCAP methodology approved by the Basel Committee, the outcome of the assessment was summarised using a four-grade scale, both at the level of each of the 15 key components of the Basel capital framework and overall assessment of compliance by a jurisdiction: compliant, largely compliant, materially non-compliant and non-compliant.[18] A regulatory framework is considered:

Compliant with the Basel framework if all minimum provisions of the international framework have been satisfied and if no material differences have been identified that would give rise to prudential concerns or provide a competitive advantage to internationally active banks;

Largely compliant with the Basel framework if only minor provisions of the international framework have not been satisfied and if only differences that have a limited impact on financial stability or the international level playing field have been identified;

Materially non-compliant with the Basel framework if key provisions of the Basel framework have not been satisfied or if differences that could materially impact financial stability or the international level playing field have been identified; and

Non-compliant with the Basel framework if the regulation has not been adopted or if differences that could severely impact financial stability or the international level playing field have been identified.

[17] Data of the following banks were collected (alphabetically): Agricultural Bank of China, Bank of China, Bank of Communications, China Construction Bank, Industrial & Commercial Bank of China, China CITIC Bank, China Everbright Bank, China Merchants Bank, China Minsheng Banking Corporation, Industrial Bank, Ping An Bank, Shanghai Pudong Development Bank.

[18] This four-grade scale is consistent with the approach used for assessing countries' compliance with the Basel Committee's *Core principles for effective banking supervision*. The actual definition of the four grades has been adjusted to take into account the different nature of the two exercises. In addition, components of Basel III that are not relevant to an individual jurisdiction may be assessed as not applicable (N/A).

The materiality of the deviations was assessed in terms of their current or, where applicable, the potential future impact on capital ratios. For this, the team considered the impact on the capital ratios of banks and did not extend the analysis to the wider Chinese economy or systemic risk. Wherever relevant and feasible, the Assessment Team, together with the CBRC, attempted to quantify the impact, both in terms of current materiality and potential future materiality based on data collected from Chinese banks in the sample.[19]

The non-quantifiable gaps were discussed with the CBRC and outcomes were guided by expert judgement. It was also taken into account that, as a general principle, the burden of proof lies with the assessed jurisdiction to show that a finding is not material or not potentially material.

Further information on the materiality assessment is given in Section 2 and Annex 10.

1.4 Main findings

Overall

The *Capital Rules* in China generally were found to be consistent with the core elements of the Basel minimum standards (see Table 2 below). The latest set of the CBRC "notices" have significantly improved the capital framework in a large number of aspects and positively influenced the final assessment outcome (see Annex 6).

With regard to credit risk (Standardised Approach) the team notes that the treatment is currently stricter than the Basel standard as the CBRC applies a higher fixed risk weight for claims on domestic banks. However, in the event of a downgrade of the Chinese sovereign credit rating, the current treatment would become less strict, assigning certain exposures towards domestic banks (and public sector entities treated as banks) a lower risk weight than under the Basel standards. The Assessment Team judges the impact as being potentially material and therefore assessed the component as "Largely Compliant". However, given that the deviation would materialise only in the event of a downgrade, the team considered the overall grading of "Compliant" as justified.[20]

With regard to Pillar 3, the findings were considered important for this component, but of lower material relevance for the overall assessment of the capital framework in China.

Summary assessment grading — Table 2

Key components of the Basel capital framework	Grade
Overall grade:	C
Scope of application	C
Transitional arrangements	C
Pillar 1: Minimum capital requirements	
Definition of capital	C

[19] Due consideration was given to the number of banks having the relevant exposure, the size of exposures impacted, the range of impact and possibility of any rise in the relative proportion of the impacted exposures in the balance sheets of banks in the foreseeable future.

[20] The overall grading is supported by a scenario analysis that measures the potential size of the discrepancy between the capital ratio reported under the *Capital Rules* and the capital ratio under Basel III rules in the event of a downgrade of the Chinese sovereign. The scenario analysis uses a statistical approach based on the historical probability of a downgrade of the sovereign. The expected discrepancy for the six largest Chinese banks would be limited. More details are provided in the main findings and detailed findings sections.

Credit Risk: Standardised Approach	LC
Credit risk: Internal Ratings-Based approach	C
Credit risk: securitisation framework	C
Counterparty credit risk rules	C
Market risk: standardised measurement method	C
Market risk: internal models approach	C
Operational risk: Basic Indicator Approach and Standardised Approach	C
Operational risk: Advanced Measurement Approaches	C
Capital buffers (conservation and countercyclical)	C
G-SIB additional loss absorbency requirements	NA
Pillar 2: Supervisory Review Process	
Legal and regulatory framework for the Supervisory Review Process and for taking supervisory actions	C
Pillar 3: Market Discipline	
Disclosure requirements	LC

Compliance assessment scale (see section 1.3 for more information on the definition of the grades): C (compliant), LC (largely compliant), MNC (materially non-compliant) and NC (non-compliant). (N/A) To be assessed after the Committee concludes the final Basel standards.

As the assessment progressed, the CBRC used the RCAP process to rectify approximately 90 of the identified issues through amendments to the Chinese rules (Annex 6). These amendments addressed deviations in various areas of the capital framework, including capital, credit risk, market risk, operational risk and Pillar 3. The assessment team considers the amendments that were published on 19 July 2013 via regulatory notices as rectifications of the gaps. The CBRC expressed its intention to transfer the notices into the *Capital Rules*, as part of its biennial review of the Rules, in 2014-15.

As part of the RCAP, discussions were held with senior representatives of select Chinese banks. The objective was to get their perspectives on the implementation of the Basel capital standards in China. The views exchanged were constructive and the overall industry view was positive about the CBRC's regulations, and its approach to regulation and supervision, and Basel III implementation. Main findings by component

Scope of application and transitional arrangements

The CBRC applies prudential requirements at the highest level of regulatory consolidation: the banking group level. According to local rules, the establishment of bank holding companies is not permitted and commercial banks usually are part of large diversified financial groups that are not included within the Basel scope of application. These groups are also not subject to direct CBRC supervision. The Basel standards do not set clear criteria as to how to assess the appropriateness of the scope of application of prudential regulations. Practices seem to differ across member jurisdictions and the Assessment Team therefore felt that this could not be assessed. The Assessment Team did note that the CBRC applies a set of rules that aim to limit possible risks that could fall outside the perimeter of prudential supervision. These include monitoring and limiting exposures to connected parties (including shareholders),[21] controlling dividend payments, and requiring that any shareholder willing to hold a 5% or higher share

[21] The *Measures for Connected Transactions between the Commercial Banks and their Insiders or Shareholders* (Decree of the CBRC, no 3, 2004) can be found at www.cbrc.gov.cn/chinese/home/docView/311.html.

of the capital of a commercial bank must be previously approved by the CBRC (financial strength/capacity being one of the aspects assessed in this approval process). No deviations of substance were identified with regards transitional arrangements specified under the Basel minimum standards.

Definition of capital

The CBRC applies a minimum CET1 capital ratio of 5.0%, which is higher than the Basel minimum standard of 4.5%. Regarding minority interests, due to the higher minimum capital requirements, a correspondingly higher share of minority interest in subsidiaries is counted towards group capital. The effect is a lower excess capital (with respect to the minimum), compared to the excess capital calculated under the Basel standards. At the same time, as an effect of the higher minimum capital requirements, the capital ratios tend to be slightly higher, due to the higher amount of minority interests that is recognised as capital. This particular "side effect" of more stringent capital requirements is not explicitly covered by Basel rules. Data collected by the CBRC show that the impact is low (virtually nil for most banks, and less than 5 basis points for the most affected bank). The team judges that the higher minimum requirement and the corresponding lower amount of excess capital are more significant, and therefore considers the CBRC's definition of capital as compliant.

Credit Risk: Standardised Approach

The *Capital Rules* specify that exposures to the domestic sovereign, banks, and public sector entities are assigned fixed risk weights and do not employ the Basel risk-weighting options that are linked to external credit assessments. Currently, the *Capital Rules* apply higher risk weights than prescribed by Basel (eg 25% for claims on domestic banks instead of the 20% prescribed by Basel); however, this could change in the event of a rating downgrade of the Chinese sovereign (the Basel risk weight for claims on domestic banks and domestic PSEs would, in that case, go up to 50%).[22] Calculations by the CBRC indicate that, in the event of a downgrade, the weighted average capital ratio of the six largest, internationally active banks would be approximately 15 basis points higher than a capital ratio based on Basel III standards as an effect of the unchanged risk weights on bank exposures. In addition, the team estimates that, in such an event, another 3–4 basis point overstatement could result from the unchanged risk weight for claims on PSEs. Weighting the impact by the probability of a downgrade, however, would produce an expected impact that is considerably lower. The Assessment Team estimates that, for the most affected large bank, taking into account the frequency of similar events in the past, the expected impact on the capital ratio of a downgrade in a three-year time horizon would lie in the range of 3–6 basis points for the exposures to banks; for exposures to PSEs the expected impact should lie in a range of 1–2 basis points.[23] The effect is driven by the exposures to other domestic banks that have a maturity of greater than three months, because such exposures would not benefit if China were to exercise its national discretion and apply Basel paragraph 54. Considering that the deviation is currently not material

[22] The exposures that would be affected by a downgrade of the Chinese sovereign are (i) claims on the domestic sovereign not denominated and funded in domestic currency, (ii) claims on banks with a maturity longer than three months, (iii) claims on banks with a maturity shorter than three months not denominated and funded in the domestic currency, and (iv) claims on domestic PSEs that are not treated as claims on the sovereign or are not denominated and refunded in domestic currency. According to data provided by the CBRC, 99.6% of the claims on the China sovereign are denominated and funded in the domestic currency. The weighted average share of claims on other domestic banks with a maturity longer than three months is approximately 4.7% of total assets. The weighted average share of claims on domestic PSEs is approximately 0.9% of total bank assets.

[23] The historical probabilities are taken from the sovereign migration matrix of Standard and Poor's. The estimated range results from assumptions about the degree of co-movement between different agencies' rating actions.

but could materialise in the event of a downgrade, the Assessment Team judges the finding as potentially material and has listed it for a follow-up assessment (see Annex 8).

Further, the *Capital Rules* differ in their treatment of loans past due for more than 90 days as they do not require a higher risk weighting (150%) for the unsecured portion of the loan when provisions are less than a certain percentage of the outstanding amount.[24] Based on data provided by the CBRC for the largest six banks in the sample, the average of loans past due 90 days or more as a percentage of total assets is currently 0.30%. In addition, over 88% of loans past due 90 days or more have specific provisions ranging between 50% and 100% with the average specific provision per loan ranging between 60% and 70% for each of the six banks. Overall, due to the level of specific provisions held against past due exposures, as well as the low level of past-due loans as a percentage of total assets, the team judged this finding as not material.

In addition, the *Capital Rules* allow loans to domestic PSEs and banks that are past due 90 days or more to be assigned to a risk weight category lower than permitted under the Basel III framework.[25] However, according to data provided by the CBRC, none of the largest six sample banks had domestic bank loans that were past due 90 days or more and only one bank had PSE loans that were past due. In this instance, specific provisions of 97.5% were held against these loans. Given that this bank's total past-due loans to total assets ratio was in line with the aggregate 0.30% ratio, this deviation was also considered not material. The team noted that the deviation would unlikely become material within the assessment horizon given the currently low level of bank exposures to domestic PSEs (0.90%), and the required high specific provisions. While there could be an issue with exposures to banks (8.4% of total assets), this would be offset by the existing lack of any past due bank exposures reported by the six largest banks.

Finally, a number of deviations have been detected with regard to eligible collateral. In particular, the treatment of debt securities issued by foreign banks and PSEs is different from that of those issued by domestic ones. For example, the eligibility criteria for debt securities issued by foreign banks and PSEs include the rating of the sovereign of incorporation, but do not consider the actual creditworthiness of foreign banks and PSEs (via a direct credit assessment of the debt securities). Given the limited use by banks of that specific kind of collateral, the finding is not considered material at present, but could potentially become so in the future.

Credit risk: Internal Ratings-Based approach

The general structure and most of the detailed requirements for the Internal Ratings-based Approach (IRB) are in substance consistent with the Basel standards. Some approaches, however, have not been implemented or have been implemented in a simplified or more generalised manner without all of the details. For example, certain approaches have not been made available for particular types of exposures that are currently non-existent or have only a small share in the portfolios of Chinese commercial banks. For the same reason, other approaches have been simplified or generalised. However, none of these

[24] This is related to the different provisioning rules implemented, for prudential purposes, by the CBRC. According to these rules, banks must maintain the higher of (i) a ratio of total loan loss provisions to total loans of at least 2.5% and (ii) a ratio of total loan loss provisions to non-performing loans (NPLs) higher than 150%. Essentially, this top-down provisioning requirement is a forward-looking dynamic regulatory approach, which enhances the loss absorbency of individual banks and of the banking sector as a whole. The effect is that loans past due 90 days or more (which typically is consistent with the definition of NPLs) will be more than fully provisioned against on an aggregate basis. The CBRC does specify in its regulatory requirements that loans that are classified "substandard", "doubtful" and "loss" – all of which are typically 90 days or more past due – must have specific provisions of 20%, 50%, and 100%, respectively.

[25] Basel allows a 50% risk weight if specific provisions are at least 50%.

adjustments result in less restrictive requirements compared to the Basel standards (for a detailed assessment see Annex 11).

In certain cases, the implementation results in a more rigorous treatment and higher capital requirements. For example, Chinese banks are not permitted to apply the top-down approach for purchased receivables or the double default framework for hedged exposures. Another example is a more rigorous treatment of equity exposures by not allowing internal model-based approaches (for a more detailed overview of more rigorous treatments, see Annex 11). As specified earlier, these super-equivalent provisions are not taken into consideration for the assessment outcome.

Credit risk: securitisation framework

The discrepancies found between the Basel securitisation framework and the *Capital Rules* generally arise from the lack of corresponding provisions in the *Capital Rules* related to liquidity facilities and asset-backed commercial paper programmes (ABCP). This is largely due to the fact that such programmes and their related exposures do not currently exist in China and, thus, at present are immaterial. Since the CBRC must approve any new securitisation activity, it can monitor new developments in the market and the Commission has indicated that it would take the appropriate regulatory action to implement the necessary requirements to address banks' exposures to such programmes. The team considered the deviations as not material.

Counterparty credit risk rules

Of the three approaches for Counterparty Credit Risk (CCR) available in the Basel framework, only the simplest one (Current Exposure Method) has been adopted in the *Capital Rules*: its implementation is aligned with the Basel text, except for the collateral received by a bank as margin, whose exposure-reducing effect is not recognised. This is more conservative than Basel. While this might represent a disincentive towards the use of collateral, in bilateral discussions with the Assessment Team, Chinese commercial banks generally indicated that collateral is used under standard ISDA agreements that set out margining requirements between counterparts. Hence, the team judged the counterparty credit risk rules as consistent with the Basel standards.

Regarding the requirements for exposures to central counterparties, the rules are found consistent with the Basel standards.

Market risk: standardised measurement method

The *Capital Rules* do not contain all of the available standardised approaches of the Basel market risk framework. According to the CBRC, this reflects the small scale and the straightforward nature of Chinese banks' trading activities. For example, the more sophisticated risk measurement methods for options risk and commodity risk have not been implemented. The Basel standards, however, explicitly require supervisors to apply the rule that the more a bank is engaged in options trading or commodities trading, the more sophisticated its risk measurement methods need to be. Hence, at present those Chinese banks that would like to expand their trading activities, particularly in more complex activities such as writing options, would not be required by regulation to use more sophisticated intermediate approaches.

Data show that trading activities currently represent an insignificant share of banks' business: at the end of 2012, the percentage of written options was only 0.09% of total assets and the percentage of commodity options was 0.24% of total assets. Furthermore, data for the last five years suggest that trading activity in commodities and written options has not increased rapidly. In fact, bank exposures to written options have shown a downward trend. The CBRC also provided data showing that trading assets are a very small portion of total assets (this is also reflected in market risk being less than 1% of total RWA).

Consequently, the CBRC's expectation is that trading activity will not increase dramatically in the foreseeable future and that, even if it did, it would be limited to an expansion of activity involving simple products. This view has been confirmed in bilateral discussions with Chinese commercial banks and independent audit firms. The Assessment Team therefore concludes that the findings are not material.

In a number of areas of the market risk framework, the *Capital Rules* are super-equivalent in comparison to the Basel approaches (see Annex 11).

Market risk: internal models approach

The *Capital Rules* are generally consistent with the Basel standards for the internal models approach (IMA) for market risk. Worthy of note is that the comprehensive risk measurement approach for correlation trading activities has not been implemented, as the CBRC does not allow banks to engage in correlation trading.

Operational risk: Basic Indicator Approach, Standardised Approach and Advanced Measurement Approaches

There are currently no banks in China that use the Advanced Measurement Approaches (AMA); while some of the larger banks have been working towards this goal for the last few years, no bank has yet entered the pre-application phase (see Table 1). The Assessment Team identified no deviations of substance from international standards.

Capital buffers (conservation and countercyclical)

The countercyclical capital buffer is treated as part of the Chinese macroprudential framework. A formal framework is under development and, together with the PBoC, the CBRC is currently in the process of developing the operational modalities to be finalised before January 2016, the deadline set by the Basel Committee.

Pillar 2: Supervisory Review Process

From a legal perspective, the CBRC derives its authority to apply the Pillar 2 standards primarily from the *Law of the People's Republic of China on Banking Regulation and Supervision*. The CBRC has the powers and the autonomy to take supervisory action against the banks it regulates and thus meets the preconditions for effective Pillar 2 supervision set out by the Basel framework.

Pillar 2 requires supervisors to assess deviations from the reference definition of default. Such deviations are explicitly allowed under the Pillar 1 IRB approach for practical reasons but could result in insufficient minimum capital requirements and, therefore, could need to be addressed by Pillar 2 measures, including by means of additional capital requirements. This assessment requirement for Pillar 2 purposes is not explicitly implemented. Although the ongoing approval process for the IRB approach of banks should ensure that supervisors make this assessment, the missing explicit implementation could nevertheless become relevant after approval of the IRB approach and could result in insufficiently identified cases where additional capital or other corrective actions under Pillar 2 would be required. While the team assessed this finding as potentially material, it considered the overall implementation of Pillar 2 as substantially consistent with the Basel standard.

Disclosure requirements

While most of the core Pillar 3 requirements have been implemented, they are incomplete in certain areas. The missing requirements include detailed disclosure of relevant data about credit quality and securitisation. In particular, regarding credit quality, a breakdown of impaired loans and loan loss allowances by industry is not explicitly required by domestic regulation, although some evidence of such a breakdown has been found in banks' annual reports. Nevertheless, taking into account the importance of credit risk on the balance sheet of Chinese banks, the assessment is that the deviations are potentially material.

For securitisation, the disclosure requirements have been somewhat simplified, based on the current limited development of the market. However, although prior approval on a product-specific basis can help to prevent banks from assuming a more proactive attitude with respect to the securitisation business, implementing the Basel requirements on disclosure in their entirety would be more prudent, as it would guarantee that market participants receive adequate information in the eventuality of a rapid evolution of banks' engagement in the securitisation market.

2 Detailed assessment findings

The component-by-component details of the assessment of China's compliance with the risk-based capital standards of the Basel framework are detailed in this part of the report. The focus is on the identified deviations and their materiality.

2.1 Scope of application

Section grade	Compliant
Summary	The CBRC applies prudential requirements at the highest level of regulatory consolidation: the banking group level. According to local rules, the establishment of bank holding companies is not permitted and commercial banks usually are part of large diversified financial groups that are not included within the Basel scope of application. A minor deviation was identified in what relates to the treatment of equity investments in commercial entities. However, the deviation was deemed not material.
Basel paragraph no	Basel II – Paragraphs 20–23
Reference in domestic regulation	The *Capital Rules*, Articles 2, 6 and 169 The *Implementation Measures for Banking Licensing*, Article 12
Findings	The Chinese framework is applied to commercial banks on a consolidated basis. The rules are not applied to policy banks since they are government-owned institutions that do not take deposits from the public. Given the nature and economic function of these institutions, the Assessment Team considered them out of scope for the assessment of the Basel standards. The *Capital Rules* do not explicitly require that consolidation should include any holding company that is the parent entity within a banking group. According to local rules, the establishment of bank holding companies is not permitted and commercial banks usually are part of large diversified financial groups that are not included within the Basel scope of application. These groups are also not subject to direct CBRC supervision. The Basel standards do not set clear criteria as to how to assess the appropriateness of the scope of application of prudential regulations. Practices seem to differ across member jurisdictions and the Assessment Team therefore felt that this could not be assessed. The Assessment Team did note that the CBRC applies a set of rules that aim to limit possible risks that could fall outside the perimeter of prudential supervision. These include monitoring and limiting exposures to connected parties (including shareholders),[26] controlling dividend payments, and requiring that any shareholder willing to hold a 5% or higher share of the capital of a commercial bank must be previously approved by CBRC (financial strength/capacity being one of the aspects assessed in this approval process).
Materiality	Not material
Basel paragraph no	Basel II – Paragraphs 35–36
Reference in domestic regulation	The *Capital Rules*, Article 68
Findings	As a general rule, Chinese regulation requires that all banks' equity investments in commercial entities be risk-weighted at 1250% (while Basel only recommends that investments above a certain materiality level should be risk-weighted at 1250%). There is an exception for "equity investments in commercial entities passively held by the bank within the legally prescribed disposal period" and "equity investments in commercial entities made by the bank due to policy reasons and with the special approval of the State Council" that can be risk-weighted at 400%. The identified gap is that Chinese regulation does not incorporate the materiality thresholds prescribed by Basel rules (15% of the

[26] The *Measures for Connected Transactions between the Commercial Banks and their Insiders or Shareholders* (Decree of the CBRC, no 3, 2004) can be found at www.cbrc.gov.cn/chinese/home/docView/311.html.

	bank's capital for individual significant investments in commercial entities and 60% of the bank's capital for the aggregate of such investments) beyond which the 1250% risk weight should always be applied. However, Chinese authorities demonstrated that there are currently no investments in commercial entities that exceed those materiality levels and that existing investments in commercial entities eligible for the 400% risk weight mainly represent legacy positions that are gradually being phased out. These positions were created through debt-equity swaps during the financial restructuring of state-owned enterprises in the early 2000s. It should be noted that, for equity investments in commercial entities that are below the threshold, the Basel rules prescribe a risk weight of 100% and that *on average* the CBRC's *Capital Rule* is therefore significantly more conservative.
Materiality	Not material

2.2 Transitional arrangements

Section grade	Compliant
Summary	No deviations have been identified. The team notes that the CBRC applies the Basel II Standardised Approach as a floor for banks using the IRB approach or AMA.
Basel paragraph no	Basel II – Paragraph 46–49
Reference in the domestic regulation	The *Capital Rules*, Articles 164, 171 and Annex 14-3
Findings	The CBRC applies a capital floor based on the Basel II Standardised Approach. The reason is that the CBRC has never implemented Basel I, but moved directly to Basel II/III. The team judges this in line with the spirit of the Basel standards, pending the Basel Committee's decision on capital floors. Basel paragraph 49 indicates that supervisors should have the flexibility to develop appropriate bank-by-bank floors that are consistent with the Basel principles and subject to full disclosure of the nature of the floors adopted. Such floors may be based on the approach the bank was using before adoption of the IRB approach and/or AMA, which in the case of Chinese commercial banks is the Basel II Standardised Approach.
Materiality	Not material

2.3 Pillar 1: Minimum capital requirements

2.3.1 Definition of capital

Section grade	Compliant
Summary	Chinese rules are broadly in compliance with Basel III recommendations.
Basel paragraph no	Basel III – Paragraph 62
Reference in domestic regulation	The *Capital Rules* – Articles 38 and 39
Findings	Chinese regulation requires a minimum CET1 ratio of 7.5% compared to 7.0% under Basel standards. This higher ratio leads to a slightly higher recognition of minority interest than in the Basel standards, producing slightly higher capital ratios. Data show that the impact is less than 5 basis points for the most affected bank. Aside from its low materiality, the team judges the more stringent capital requirement to be of higher importance than the impact of minority interest on capital ratios.
Materiality	Not material
Basel paragraph no	Basel III – Paragraph 65
Reference in domestic regulation	The *Capital Rules* – Articles 38 and 41 The *Implementation Measures for Bank Licensing* - Articles 65, 66, 82 and 93 Laws of the PRC on Commercial Banks – Article 43
Findings	Chinese rules do not explicitly prohibit the inclusion in Common Equity Tier 1 of capital issued to third parties out of a special purpose vehicle (SPV). However, the issuance of capital instruments via SPV lacks sufficient legal basis in China. Also, regulation prevents

	any issuance of new regulatory capital instruments without previous approval from CBRC, which allows the CBRC effective control over the issuance of capital instruments.[27]
Materiality	Not material

2.3.2 Capital buffers (conservation and countercyclical)

Section grade	Compliant
Summary	No deviations from Basel requirements were identified.

2.3.3 Credit risk: Standardised Approach

Section grade	Largely compliant
Summary	The *Capital Rules* generally are drafted at a higher level than the Basel framework. In certain instances, the *Rules* attempt to simplify Basel, a tendency that has led to several deviations with respect to risk weighting and eligible collateral. The *Capital Rules* specify that exposures to the domestic sovereign, banks, and public sector entities are assigned fixed risk weights and do not employ the Basel risk-weighting options that are linked to external credit assessments. At present, this does not lead to lower weights than prescribed by Basel rules, given current ratings; however, it could lead to lower risk weights in the event of a rating downgrade of China. The effect is therefore judged potentially material with respect to exposures to domestic banks that have a maturity of greater than three months. In addition, the team estimates that in such event another 3–4 basis point overstatement could result from the lower risk weight for claims on PSEs. Weighting the impact by the historical probability of a downgrade, however, would produce an expected impact that is considerably lower. The Assessment Team estimates that for the most affected large bank, taking into account the statistical frequency of similar events in the past, the expected impact on the capital ratio of a downgrade in a three-year time horizon would lie in the range of 3–6 basis points for the exposures to banks; for exposures to PSEs the expected impact should lie in a range of 1–2 basis points.[28] The Assessment Team notes that the CBRC expressed willingness to revise the relevant rules if there is a relevant downgrade in the rating assessment of China. Further, the *Capital Rules* differ in their treatment of loans past due for more than 90 days as they do not require a higher risk weighting (150%) for the unsecured portion of the loan when provisions are less than a certain percentage of the outstanding amount. This is related to the different provisioning rules implemented, for prudential purposes, by the CBRC. According to such rules, banks must maintain the higher of (i) a ratio of total loan loss provisions to total loans of at least 2.5% and (ii) a ratio of total loan loss provisions to non-performing loans (NPLs) of more than 150%. Essentially, this top-down provisioning requirement is a forward-looking dynamic regulatory approach that enhances the loss absorbency of individual banks and of the banking sector as a whole. The effect is that loans past due 90 days or more (which typically is consistent with the definition of NPLs) will be more than fully provisioned against on an aggregate basis. CBRC does specify in its regulatory requirements that loans that are classified “substandard”, “doubtful” and “loss” – all of which are typically 90 days or more past due – must have specific provisions of 20%, 50%, and 100%, respectively. Based on data provided by the CBRC for the largest six banks in the sample, the average of loans past due 90 days or more as a percentage of total assets is currently 0.30%. In addition, over 88% of loans past due 90 days or more have specific provisions ranging between 50% and 100% with the average specific provision per loan ranging between 60% and 70% for each of the six banks. In addition, it is possible that loans to domestic PSEs and banks that are past due 90 days or more could be assigned to a risk weight category lower than what is permitted under

27 The *Implementation Measures for Bank Licensing* (Decree of the CBRC, no 7, 2006) can be found at www.cbrc.gov.cn/chinese/home/docDOC_ReadView/20070117617288DF6523FEC1FFAD69638E6F3400.

28 The historical probabilities are taken from the Standard and Poor’s sovereign migration matrix. The estimated range results from assumptions about the degree of co-movement between different agencies’ rating actions.

	the Basel framework (that is, the 50% risk weight with national discretion if specific provisions are at least 50%). However, according to data provided by the CBRC, none of the largest six sample banks had domestic bank loans that were past due 90 days or more and only one bank had PSE loans that were past due. In this instance, specific provisions of 97.5% were held against these loans. Given that this bank's total past-due loans to total assets ratio was in line with the aggregate 0.30% ratio, this deviation is currently not material. Finally, a number of deviations have been detected in the range of eligible collateral with respect to Basel standards (paragraph 145). In particular, the treatment of debt securities issued by foreign banks and PSEs is different from that of those issued by domestic ones. Given the limited use of that specific kind of collateral, the finding is not currently considered material, but could potentially become so in the future.
Basel paragraph no	Basel II – Paragraph 53
Reference in domestic regulation	The CBRC *Capital Rules*, Article 57, assign a 0% risk weight to a commercial bank's claims on the Chinese central government and the People's Bank of China.
Findings	Basel paragraph 53 requires that claims on sovereigns be risk-weighted based on the external credit assessment of the sovereigns. China has three assessments: AA– (S&P); Aa3 (Moody's); and A+ (Fitch). Currently, according to Basel II, paragraph 98, banks' exposures to China would be assigned to the 0% risk weight. However, if China were downgraded by either Moody's or S&P, then the appropriate risk weight under Basel for exposures to China would increase from 0% to 20%. The possibility of a credit rating downgrade and a corresponding increase in the risk weight for claims on China is not incorporated into the CBRC's *Capital Rules*. Alternatively, Basel paragraph 54 allows, at national discretion, a lower risk weight to be applied to banks' exposures to their sovereign if denominated in the domestic currency and funded in that currency. The CBRC has indicated that it is not necessary to apply the preferential treatment allowed under paragraph 54 given the current external credit rating. Further, the CBRC indicated that, if China's external credit rating were downgraded, this would not be material as only 4.8% of banks' exposures (as a percentage of total assets) are to China. In addition, if China were downgraded, then the CBRC could use the national discretion permitted under Basel paragraph 54 to apply a lower risk weight to banks' exposures to their sovereign of incorporation since 99.6% of sample banks' claims on China are denominated and funded in CNY. In addition, the CBRC indicated a willingness to issue a regulatory document (and revise the *Capital Rules*) if there is a significant change in the rating or when the Basel Committee revises the Standardised Approach to reduce the reliance on external credit ratings.
Materiality	Currently not material given the present scale of Chinese banks' exposure to their sovereign, the fact that virtually all of such exposures are denominated and funded in the local currency, and China's current external rating. In addition, the team considers this deviation with respect to banks' exposures that are not denominated and funded in the domestic currency is unlikely to grow to the point where it could become material. In order for this to occur, banks' total exposures to China would have to increase significantly and the share of these exposures that are not denominated and funded in the domestic currency would have to grow even more dramatically.
Basel paragraph no	Basel II - Paragraph 57
Reference in domestic regulation	The CBRC *Capital Rules*, Article 58, assign a 20% risk weight to a commercial bank's claims on domestic public sector entities (PSEs).
Findings	Under Basel paragraph 57, claims on domestic PSEs are to be risk-weighted, at national discretion, in accordance with option 1 or option 2 for claims on banks. The CBRC has indicated that it has chosen option 1 for risk-weighting claims on domestic PSEs. Option 1 assigns a risk weight to such exposures based on the credit assessment of the sovereign. In the case of China, which has an external credit assessment equivalent to AA–, the sovereign rating would warrant a 20% risk weight for exposures to domestic PSEs. However, if China were downgraded by one of the other rating agencies, then the appropriate risk weight under Basel for banks' exposures to domestic PSEs would increase to 50%. The possibility of a rating downgrade and an increase in the risk weight for claims on domestic PSEs is not incorporated into the CBRC's *Capital Rules*. Currently, Chinese banks' exposures to domestic PSEs as a percentage of total assets are 0.90%.
Materiality	Currently not material given the low exposure level to domestic PSEs and China's current external rating. However, it could become material in the future. For this to occur, banks'

	exposure to domestic PSEs (as a percentage of total assets) must increase to approximately 3%, which is about three times the current exposure level.
Basel paragraph no	Basel II - Paragraph 60-63
Reference in domestic regulation	The CBRC *Capital Rules*, Article 61, assigns a risk weight of 25% to banks' claims on other domestic banks, which in the current situation is super-equivalent to Basel, and a 20% risk weight to claims that have an original maturity of three months or less.
Findings	Under Basel paragraph 63, claims on domestic banks are to be risk-weighted, at national discretion, in accordance with either option 1 or option 2. The CBRC has stated in responses that it has adopted option 1 and does not consider the preferential treatment permitted under Basel paragraph 54. Option 1 for risk-weighting claims on domestic banks assigns a risk weight to such exposures based on the credit assessment of the sovereign of incorporation. As stated, this would be the equivalent of an AA– assessment in the case of China. However, as mentioned above, if China were downgraded by one of the other rating agencies, then the appropriate risk weight under Basel for exposures to domestic banks would increase to 50%. The possibility of a rating downgrade and an increase in the risk weight for claims on domestic banks is not incorporated into the CBRC's *Capital Rules*. Also, the reduced 20% risk-weighting for short-term claims on domestic banks with an original maturity of three months or less is inappropriately applied as the CBRC is using option 1 for risk-weighting claims on banks and not option 2 under which this exception is permitted. In addition, since the CBRC is not utilising the national discretion permitted under Basel paragraph 54, then they are not able to invoke paragraph 64, which states that when the national supervisor has chosen to apply the preferential treatment for claims on the sovereign as described in paragraph 54, it can also assign, under both options 1 and 2, a risk weight that is one category less favourable than that assigned to claims on the sovereign, subject to a floor of 20%, to claims on banks of an original maturity of three months or less denominated and funded in the domestic currency. The team took into consideration that Basel allows a national discretion to assign a risk weight to short-term claims on banks one category less favourable than that assigned to claims on the sovereign, subject to a floor of 20% (Basel paragraphs 54 and 64). Thus, if China were downgraded, then under paragraphs 54 and 64, such short-term exposures to domestic banks could continue to be assigned to the 20% risk weight. The weighted average total holdings of (1) claims and (2) short-term claims on domestic banks as a percentage of total assets are 8.43% and 3.66%, respectively. The exposure to claims on banks being assigned to the 25% risk weight is relatively small (eg claims on banks with a maturity of greater than 3 months is 4.7%), but is not immaterial, and it could grow further in the future. When the potential growth is coupled with a possible downgrade of China the impact could be significant. If China were downgraded to a rating equivalent of single A+, then such exposures would, under Basel, be assigned a 50% risk weight. The CBRC has calculated that this would have a negative weighted average impact on the total capital ratios of the six largest banks in the sample of approximately 15.3 basis points. In addition, the weighted average increase in risk-weighted assets for these institutions would be 1.29%.
Materiality	Currently immaterial given China's current external rating. However, this deviation is potentially material given the current level of banks' exposures to other domestic banks as a percentage of total assets.
Basel paragraph no	Basel II - Paragraph 75
Reference in domestic regulation	There is no corresponding requirement in CBRC's *Capital Rules*.
Findings	Basel paragraph 75 requires that the unsecured portion of any loan (other than a qualifying residential mortgage loan) that is past due for more than 90 days, net of specific provisions (including partial write-offs), will be risk-weighted as follows: 150% risk weight when specific provisions are less than 20% of the outstanding amount of the loan; 100% risk weight when specific provisions are no less than 20% of the outstanding amount of the loan; 100% risk weight when specific provisions are no less than 50% of the outstanding amount of the loan, but with supervisory discretion to reduce the risk weight to 50%. The CBRC indicated in its response that there is no need to assign a higher risk weight to loans past due 90 days or more because of their stringent provisioning policy that requires 150% provisioning against non-performing loans, which are generally defined as loans 90 days or more past due. The CBRC's loan provision approach is also not consistent with the

	Basel requirements because past-due loans could be assigned to a risk weight lower than 50% (which is permitted by Basel paragraph 75 in certain circumstances). In response to questions from the Assessment Team, the CBRC clarified that there are two provisioning systems in China: (1) a bottom-up provisioning system that is based on Chinese GAAP that is consistent with IFRS with respect to which loans are provisioned on an individual or collective impairments and (2) a top-down provisioning system that is based on CBRC regulatory rules, which require commercial banks to adequately set aside loan loss provisions. According the CBRC's *Provisioning Rules*, banks must have an adequate amount of aggregate provisions to satisfy (i) the 2.5% total loan loss provision to loan ratio and (ii) a ratio of total loan loss provisions to non-performing loans (NPLs) of 150% (provisioning coverage ratio) in order to enhance the loss absorbency of individual banks and the banking sector as a whole. Essentially, the top-down provisioning requirements are a forward-looking dynamic regulatory approach, which creates a countercyclical provision buffer. The CBRC pointed out that the average NPL ratio for all commercial banks was approximately 1% at end of 2012 and that the 2.5% provision/loan ratio requirement currently is more binding than the 150% provision/NPL ratio. As a result, Chinese banks have an average aggregate provision coverage ratio of nearly 300%. The extra 200% of provisioning serves as an additional buffer during an economic downturn. Regarding the definition of NPLs, the CBRC clarified that a key consideration is the number of days that a loan is past due and that loan loss provisioning is against the book value of the past-due loans. According to Article 11 of the *Guidance for the Risk-Based Loan Categorization*, "a loan is overdue (including any extension period) for a certain period of time", then will be categorised at least as substandard and be defined as a NPL. In addition, re-ageing is not permitted. When loans are restructured and are considered new loans, Article 12 of the *Guidance for Risk-Based Loan Categorization* requires the loan to be classified as substandard and considered an NPL for the following six months. The aforementioned top-down provisioning requirements operate in tandem with the bottom-up provisioning treatment and the provisioning practices of the commercial banks are audited by external auditors. The effect of this treatment is that loans past due 90 days or more will be more than adequately provisioned against on an aggregate basis. CBRC regulatory requirements specify that loans that are classified substandard, doubtful and loss – all of which are typically 90 days or more past due – must have specific provisions of 20%, 50%, and 100%, respectively. Based on data provided by the CBRC for the largest six banks in the sample, the average of loans past due 90 days or more as a percentage of total assets is currently 0.31%. In addition, over 88% of loans past due 90 days or more have specific provisions ranging between 50% and 100% with the average specific provision ratio per loan ranging between 60% and 70% for each of the six banks. Such levels of specific provisions would not only meet the Basel requirements to allow banks to continue to risk-weight loans at 100% when they become past due, but also would meet the requirement that permits national discretion to assign loans to the 50% risk weight. The impact on the total capital ratio of not applying the 150% for those loans for which specific provisions are less than 20% is an average 0.28 basis points. Also, under the CBRC's provisioning treatment, it is possible that loans to domestic PSEs and domestic banks that are past due 90 days or more could be assigned to a risk weight category lower than permitted under the Basel framework (that is, the 50% risk weight with national discretion if specific provisions are at least 50%). It is possible that this deviation may be relevant. However, according to CBRC data, none of the largest six sample banks has domestic bank loans that were past due 90 days or more and only one bank had PSE loans that were past due against which specific provisions of 97.5% were held. Given that this bank's total past-due loans to total assets ratio was in line with the average 0.31% ratio, this deviation currently is immaterial.
Materiality	Not material
Basel paragraph no	Basel II - Paragraphs 103–106
Reference in domestic regulation	*Capital Rules*, Article 61
Findings	There is no capital treatment specified for short-term claims under the standardised credit framework (Basel paragraphs 103–106), except for short-term claims (original maturity of three months or less) on domestic banks (Article 61 of the *Capital Rules*). This finding is not material because short-term exposures that are externally rated would not receive the benefit of a lower risk weight. Instead they would be assigned to the risk weight category

	appropriate to the counterparty, which can often lead to assignment of the exposure to a higher risk weight (eg 100% for corporate exposures).
Materiality	Not material
Basel paragraph no	Basel II - Paragraph 145
Reference in domestic regulation	*Capital Rules*, Annex 2-4.1
Findings	Basel II lists the collateral instruments that are eligible for recognition in the simple approach, which include equities, UCITS etc. The *Capital Rules* do not consider these instruments eligible, and only allow a limited number of high-quality debt securities. Annex 2 of the *Capital Rules*, while being a simpler version of the eligible collateral table in Basel paragraph 145, permits collateral that is not specified in Basel paragraph 145. For instance, debt securities issued by domestic PSEs and foreign PSEs (with sovereigns rated A– or above for foreign ones) are eligible collateral, while in paragraph 145 debt securities issued by PSEs treated as sovereigns are considered eligible, provided they are rated at least BB– and irrespective of the nationality of the issuer, and those issued by PSEs are eligible if rated at least BBB–, irrespective of the nationality of the issuer and of the sovereign rating of the jurisdiction where they are incorporated. Also, in Annex 2 of the *Capital Rules*, debt securities issued by multilateral development banks, the BIS, and the IMF are considered eligible collateral irrespective of their rating, while Basel paragraph 145 requires the aforementioned securities to be rated at least BBB– (Annex 2 does list all the MDBs that currently meet the Basel criteria - see Basel footnote 24 to paragraph 59). According to information provided by the CBRC, the weighted average amount of assets collateralised by debt issued by MDBs, the BIS, and the IMF as a percentage of total assets is equal to zero. In addition, in order for debt securities of foreign commercial banks and PSEs to be considered eligible collateral, the *Capital Rules* prescribe that the sovereign of incorporation of these entities needs to be rated at least A–. Under the Basel requirements, instead, these entities would have to be directly rated at least BBB–. Thus, the actual creditworthiness of foreign banks and PSEs (via a direct credit assessment) is not considered when determining whether their debt securities are eligible collateral. The CBRC provided information that showed that the weighted average of assets collateralised by debt securities of domestic and foreign PSEs as a percentage of total assets is 0.13%. The percentages of total assets collateralised by debt of (i) domestic banks and (ii) foreign banks are 0.84% and 0.09%, respectively.
Materiality	The implementation of collateral eligibility deviates in a number of ways from Basel; in particular, there is a difference in the treatment of foreign banks and PSEs vs domestic ones, with only the debt securities issued by the former subject to a rating threshold and that threshold based on the sovereign rating of the country of incorporation (instead of the direct credit rating of the same issuers). In light of the currently limited use of this type of collateral by banks in China, the finding is considered not material at present, though potentially material in the future.
Basel paragraph no	Basel II - Paragraphs 182–187
Reference in domestic regulation	No corresponding provision
Findings	Basel paragraphs 182–187 set forth the simple approach for recognising collateral. Specifically, Basel paragraph 182 stipulates that the risk weight on the collateralised portion will be subject to a floor of 20% unless the conditions in paragraphs 183–185 are met, such as an OTC derivative transaction subject to daily mark to market, collateralised by cash, and there is no currency mismatch, which should receive a 0% risk weight. The CBRC's *Capital Rules* do not specify the 20% floor requirement or the specified Basel exceptions to the floor. According to data provided by the CBRC, exposures that are collateralised and assigned to a risk weight below 20% are equal to 0.69% of total assets of the sample banks and the weighted average impact on the total capital ratio of not implementing the 20% risk weight floor requirement is 2.25 basis points. However, in Annex 8-2.1.4 of the *Capital Rules*, which corresponds to Basel paragraph 186 (calculation of the counterparty credit risk charge for OTC derivatives), the formula used by CBRC does not take into consideration CA (the volatility adjusted collateral amount under the comprehensive approach). As a result the exposure amount of an OTC derivative should be higher than if CA were considered. CBRC has indicated in responses that the OTC derivatives market is still in the early stages

	of development, which is supported by information in the report entitled, "Financial Market Performance in 2012" that shows small volumes of forward transactions (CNY 16.6 billion or about USD 2.7 million) and interest rate swaps (CNY 2.9 trillion or approximately USD 475 million).
Materiality	Not material
Basel paragraph no	Basel II - Paragraphs 193 and 197
Reference in domestic regulation	*Capital Rules*, Annex 2 and Annex 6 The Guaranty Law of the People's Republic of China
Findings	The first sentence of Annex 6-4.3 of the *Capital Rules* states that only credit default swaps and total rate of return swaps (TROR swaps) that provide credit protection equivalent to guarantees will be eligible for recognition, which corresponds to Basel paragraph 193. However, unlike Basel, the *Capital Rules* do not preclude the recognition of credit protection provided by TROR swaps where a bank records the net payments received as net income, but does not record offsetting deterioration in the value of the hedged asset (either through reductions in fair value or by an addition to reserves). As a result, Basel could be viewed as more conservative than Annex 6-4.3. The CBRC stated that the exception has not been specified. However, they collected information from the 12 sample banks that show that there are no TROR swaps in China. In addition, according to data provided by the CBRC, only 0.83% (as a percentage of total assets) of all standardised assets/exposures is guaranteed.
Materiality	Not material

2.3.4 Credit risk: Internal Ratings-Based Approach

Section grade	Compliant
Summary	The general structure and most of the detailed requirements for the Internal Ratings-Based approach (IRB) are in substance consistent with the Basel standards. Some approaches, however, have not been implemented or have been implemented in a simplified manner without implementing all of the details. For example, certain approaches have not been made available for particular types of exposure that are currently non-existent in China or have currently only a small share in the portfolios of Chinese commercial banks. Although for the same reason other approaches have been simplified or more generalised, this has been always tailored in a way that does not result in less restrictive requirements compared to the Basel standards. For a detailed assessment of these adjustments, see Annex 11. In certain cases, the implementation even results in a more rigorous treatment and higher capital requirements. For example, Chinese banks are not allowed to use the double default framework for hedged exposures. Another example is a more rigorous treatment of equity exposures by not allowing models-based approaches. Also, the top-down treatment for purchased receivables has not been made available; instead, to be treated as IRB exposures, purchased receivables must be assigned to the corporate asset class and be assessed and rated individually as other corporate exposures, and their dilution risk must be immaterial; alternatively, they have to be treated according to the Standardised Approach, provided their share in the overall portfolio remains within the generally allowed limits for partial use. As specified earlier, these super-equivalent provisions are not taken into consideration for the assessment outcome. For financial collateral issued by certain domestic issuers (including the Ministry of Finance, the People's Bank of China and Chinese policy banks, domestic PSEs and commercial banks), that is recognised as eligible under the Foundation approach according to Annex 6-6.1.1 points (d) to (g) of the *Capital Rules* without applying the rating requirements according to paragraph 145 (c) Basel II, see the assessment of the respective findings for financial collateral recognised in the Standardised Approach according to Annex 2-4.1.4 to 4.1.7 of the *Capital Rules* (Basel II, paragraph 145). This conforms with paragraph 289 of Basel II, which refers to eligibility under the Standardised Approach.

2.3.5 Securitisation framework

Section grade	Compliant
Summary	The deviations found between the Basel Securitisation Framework and the *Capital Rules*

	generally arise from the lack of corresponding provisions in the *Capital Rules* related to liquidity facilities and asset-backed commercial paper programmes (ABCP). This is largely due to the fact that such programmes and their related exposures do not currently exist in China and, thus, are currently immaterial. The Assessment Team notes that the CBRC must approve any new securitisation activity and is thus able to monitor new developments in the market and take the appropriate regulatory action to implement the necessary requirements to address banks' exposures to such programmes. The Assessment Team therefore considers the missing provisions in this component as not material.
Basel paragraph no	Basel II - Paragraphs 565(g)(i)–(g)(iii)
Reference in domestic regulation	No corresponding provision
Findings	There is no provision directly corresponding to the new Basel paragraphs 565(g)(i)–(g)(iii) arising due to Basel 2.5. During the market turmoil, several banks that provided liquidity facilities (LFs) to asset-backed commercial paper (ABCP) programmes chose to purchase commercial paper issued by the ABCP conduit instead of having the conduit draw on its LF. The LF provider then risk-weighted the ABCP based on the paper's external rating. As a result, the LF provider benefited from the external rating on the commercial paper when assigning a risk weight to that paper, even though the rating was due in large part to the bank's own support of the conduit in the form of the LF. The Basel Committee has added language to the Basel II framework so that a bank cannot recognise ratings – either in the SA or in the IRB Approach – that are based on guarantees or similar support provided by the bank itself. In other words, the Committee concluded that banks should not be allowed to recognise external ratings when those ratings are based on support provided by the same bank. For example, if a securitisation exposure is rated AAA, and that rating is based on a guarantee provided by a bank, the bank should not benefit from a lower risk weight on the securitisation exposure when the bank holds that AAA-rated exposure. The CBRC indicated that, in China, banks do not have ABCP programmes or liquidity facilities (LFs) to such programmes. The authorities indicated that they are following Basel's ongoing work to reform the securitisation framework and plan to conduct a comprehensive review of their framework in the future. However, the impact could be material if the ABCP market develops and there are no established requirements. The CBRC's self-assessment indicated that the securitisation market is still developing and that the total amount of accumulated issuance is less than CNY 90 billion (or approximately USD 14.8 billion). As of year-end 2012, the outstanding principal balance of ABS and MBS was about CNY 20 billion (or nearly USD 2.4 billion), representing less than 0.02% of the total assets of commercial banks. The Assessment Team notes that the CBRC has the authority to monitor and approve new developments in the market.
Materiality	Not material
Basel paragraph no	Basel II - Paragraphs 574 and 575
Reference in domestic regulation	No corresponding provision
Findings	Basel paragraphs 574 and 575 deal with the treatment of exposures in second loss position or better in ABCP programmes and establishes an exemption from deduction for those unrated securitisation exposures, including a liquidity facility, provided by sponsoring banks to ABCP programmes that meet certain requirements. Where these conditions are satisfied, the risk weight is the greater of (i) 100% or (ii) the highest risk weight assigned to any of the underlying individual exposures covered by the facility. The CBRC indicated that there is no matching to Basel paragraphs 574 and 575 due to the fact that, in China, banks do not have liquidity facilities to ABCP programmes, nor are there any ABCP programmes. See findings for Basel paragraphs 565(g)(i)–(g)(iii) above. The Assessment Team notes that the CBRC has the authority to monitor and approve new developments in the market.
Materiality	Not material
Basel paragraph no	Basel II - Paragraphs 579 and 581
Reference in domestic regulation	No corresponding provisions

Findings	Basel paragraph 579, as revised by Basel 2.5, states that a bank may apply a 50% credit conversion factor (CCF) to the eligible liquidity facility regardless of the maturity of the facility. However, if an external rating of the facility itself is used for risk-weighting the facility, then a 100% CCF must be applied. Basel paragraph 581 sets forth the treatment of overlapping exposures that provide duplicative coverage to the underlying exposures, such as liquidity facilities and credit enhancements to ABCP programmes. The CBRC's *Capital Rules* have not yet updated paragraph 579 to conform to Basel and continue to distinguish between short- and long-term commitments to reflect the lower risk of being exposed to a draw by the counterparty over a shorter period of time. Again, the CBRC has indicated that Chinese banks do not provide LFs to ABCP programmes since there are no such programmes in China. Hence, there is no corresponding provision for paragraph 581. The Assessment Team notes that the CBRC has the authority to monitor and approve new developments in the market.
Materiality	Not material
Basel paragraph no	Basel II - Paragraph 609 and paragraphs 619 and 620
Reference in domestic regulation	No corresponding provision
Findings	Basel paragraph 609 establishes the hierarchy of securitisation approaches. However, in the CBRC's *Capital Rules* there is no provision for the Internal Assessment Approach (IAA), which is only available to exposures (eg liquidity facilities and credit enhancements) that banks (including third-party banks) extend to ABCP programmes. In addition, in order to utilise the IAA, such exposures must satisfy the conditions of Basel paragraphs 619 and 620. There are no corresponding provisions addressing paragraphs 609, 619, and 620 (IAA-related terms) because, as the CBRC has indicated, there are no ABCP programmes in China. The Assessment Team notes that the CBRC has the authority to monitor and approve new developments in the market.
Materiality	Not material.
Basel paragraph no	Basel II – Paragraph 613(c)
Reference in domestic regulation	No corresponding provision
Findings	Basel paragraph 613(c) discusses when a liquidity facility supporting an ABCP programme would be considered the most senior position within the programme for purposes of determining the appropriate capital requirement. There is no corresponding requirement in the *Capital Rules* due to the fact that there are no ABCP programs in China. The Assessment Team notes that the CBRC has the authority to monitor and approve new developments in the market.
Materiality	Not material
Basel paragraph no	Basel II – Paragraph 639
Reference in domestic regulation	No corresponding provision
Findings	Basel 2.5 revised paragraph 639 to require that the CCF for eligible liquidity facilities under the IRB approach the CCF be 100%. The *Capital Rules* have not yet updated this item from Basel II. The CBRC stated that, in China, there are no ABCP programmes or liquidity facilities to such programmes. The Assessment Team notes that the CBRC has the authority to monitor and approve new developments in the market.
Materiality	Not material
Basel paragraph no	Basel II – Paragraph 640
Reference in domestic regulation	No corresponding provision

Findings	There is no corresponding reference to Basel paragraph 640 regarding overlapping exposures, probably due to the lack of an ABCP market. The Assessment Team notes that the CBRC has the authority to monitor and approve new developments in the market.
Materiality	Not material

2.3.6 Counterparty credit risk rules

Section grade	Compliant
Summary	No deviations were identified by the RCAP Assessment Team

2.3.7 Market risk: The Standardised Measurement Method

Section grade	Compliant
Summary	Most of the issues raised during assessment were closed because of recently issued regulatory notices. However, in some areas, the *Capital Rules* do not cover the more sophisticated methods to measure market risk. Basel 2.5 was only partly introduced because correlation trading is not permitted in China. The CBRC is authorised to conduct bank product approvals and can therefore prevent banks from trading certain financial products. The Assessment Team therefore considers the findings not material, assuming that the CBRC will take the appropriate regulatory action if such products were to be allowed.
Basel paragraph no	Basel II, paragraph 689(iv), 709(ii), 709(ii-1)
Reference in domestic regulation	*Interim Measures for the Management of derivatives transactions of financial institutions*, Article 5, 7, 9, 13
Findings	Basel 689(iv) is not reflected in the CBRC rules. The CBRC answered that commercial banks have not been allowed to engage in correlation trading transactions and this will not be allowed in the foreseeable future as correlation trading transactions are considered too complex and risky. The CBRC is authorised by statutory power to conduct bank product approval by the *Law of the People's Republic of China on Banking Regulation and Supervision*, and therefore has the power to prevent banks from entering the market for correlation trading. Article 18 stipulates that products and services offered by a banking institution within its business scope shall, in accordance with applicable regulations, be subject to prior approval or filing requirement. The CBRC shall, in accordance with applicable laws and administrative regulations, make public the products and services that are subject to prior approval or report for filing requirement. Pursuant to the above stipulations, the CBRC develops rules, administrative measures or guidelines for market entry purposes.
Materiality	Not material
Basel paragraph no	Basel II, paragraph 701(iv), 718(lvi), 718(lv), 718(lxiii)–718(lxix)
Reference in domestic regulation	-
Findings	According to Basel 701(iv), supervisory authorities will apply the rule that the more a bank is engaged in writing options, the more sophisticated its measurement method needs to be. However, in China the sophisticated measurement method is not permitted. Considering the simple nature of trading activity in China at present, CBRC currently considers the simplified approaches as appropriate for Chinese banks.
Materiality	Data provided by the CBRC suggest that bank exposures to written options are small. As of the end of 2012, the percentage of written options was only 0.09% of total assets. In addition, judging from past trends, trading in written options is unlikely to increase rapidly. Overall, this finding is considered immaterial.
Basel paragraph	Basel II, paragraph 712(iii), 718
Reference in domestic regulation	-
Findings	The total specific risk capital charge for nth-to-default credit derivatives is to be computed according to paragraph 718, and the total specific risk capital charge for securitisation

	exposures is to be computed according to paragraph 709(ii). However, this is not implemented in the CBRC rules. The Assessment Team notes that the CBRC has the authority to monitor and approve new developments in the market. The CBRC stated that in China banks are not allowed to engage in nth-to-default derivatives.
Materiality	Not material
Basel paragraph no	Basel II, paragraph 718(xlix) to 718(liii)
Reference in domestic regulation	-
Findings	In measuring commodity risk, the CBRC introduced only the simplified approach. The CBRC indicated that most of the commodity products in Chinese banks are spot products. The Assessment Team notes that the CBRC has the authority to monitor and approve new developments in the market.
Materiality	As for commodity trading, from 2007–09, there was only one large bank active in this business. From 2010, two large banks began trading commodities. The CBRC also stated that these large banks are applying for the internal models approach on market risk and have made preparations for measuring commodity risk in their internal models. Overall, this finding is considered immaterial.

2.3.8 Market risk: Internal Models Approach

Section grade	Compliant
Summary	The *Capital Rules* are largely in line with the Basel standards. Some of the issues raised during the assessment were rectified in the regulatory notices.
Basel paragraph no	Basel II, paragraph 718(xcv), 718(xcvi), 718(xcvii)
Reference in domestic regulation	-
Findings	Basel II, paragraph 718(xcv), 718(xcvi), 718(xcvii) are not implemented. Commercial banks have not been allowed to engage in the correlation trading transactions as stated above, so that requirements relating to correlation trading portfolio in Basel 2.5 are not applicable in China.
Materiality	Not material

2.3.9 Operational risk: Basic Indicator Approach and the Standardised Approach

Section grade	Compliant
Summary	There are some minor deviations from the Basel standard.
Basel paragraph no(s)	646, 647, 661
Reference in domestic regulation	The *Capital Rules* Articles 95, 150
Findings	Basel paragraph 646 says that banks are encouraged to move along the spectrum of available approaches as they develop more sophisticated operational risk measurement systems and practices. Basel paragraph 647 says that internationally active banks and banks with significant operational risk exposures are expected to use an approach that is more sophisticated than the Basic Indicator Approach (BIA). Basel paragraph 661 says that supervisors have the right to insist on a period of initial monitoring of a bank's TSA before it is used for regulatory capital purposes. The CBRC does not provide explicit encouragement in their domestic regulations for banks to move along the spectrum of approaches and all of the banks in China are currently BIA. The CBRC says that they expect major BIA banks to satisfy the qualitative criteria for the Standardised Approach (TSA) and some of the larger banks, including the top five banks, have applied for or are in the process of applying for the use of TSA. The domestic regulation does not explicitly implement Basel paragraph 661. The CBRC has not implemented the ASA (footnote 104 – Basel).
Materiality	Not material

Basel paragraph no(s)	652, 662
Reference in domestic regulation	The *Capital Rules* Articles 99 to 102 Annex 12-2.2 Table 2
Findings	Basel paragraph 652 says that the banks' activities are to be divided into the eight business lines of Annex 8, which, together with Basel paragraph 662, also details the principles for business line mapping. The CBRC allows activities to be mapped to the eight business lines of Annex 8 and an additional "Other businesses" category. The highest charge has been used for this "Other businesses" category, so there is no potential downward bias for the calculation of capital for TSA due to this. The need for review and adjustment for new or changing business activities (paragraph 662) and some of the principles for business line mapping, Annex 8 (b), (d), (h) and (i), have not been explicitly implemented in the domestic regulation. These include requirements that the mapping process must be subject to independent review that senior management is responsible for the mapping policy that processes must be in place to define the mapping of any new activities or products and that activities which cannot be readily mapped must be allocated to the business line it supports. The CBRC has instead placed reliance on more general high level requirements on governance and validation.
Materiality	Not material

2.3.10 Operational risk: Advanced Measurement Approaches

Section grade	Compliant
Summary	Some banks in China have started preparing for AMA, with improvements being made with respect to loss data collection, risk and control self-assessments (RCSA) and key risk indicators (KRI), and the development of models (currently only for internal use). While the CBRC is not encouraging banks to apply for the AMA, it is monitoring and assessing their progress. The CBRC believes that it will be a few years at least before the AMA is used by any of their banks. The initial deviations identified, in this assessment, have been addressed through the Notice on Policy Clarification of the *Capital Rules* (see Annex 6)

2.4 Pillar 2: Supervisory review process

Section grade	Compliant
Summary	The CBRC's legal authority to apply the Pillar 2 standards is derived primarily through the *Law of the People's Republic of China on Banking Regulation and Supervision*. Of the roughly 25,000 employees of the CBRC, approximately two thirds are involved in front line supervision. The CBRC has internal guidance concerning their supervisory process, including handbooks concerning the off-site and on-site assessments. There would seem to be more of a focus on capital, although risk management is becoming more important over time and, for example, the licensing process may include examinations on risk management. Commercial banks are required to complete and provide to the CBRC an annual assessment of the due diligence of board members. The CBRC was able to provide the Assessment Team with an example of supervisory actions it has taken; in Q1 2013, action was taken against a medium-sized bank which, due to its rapid expansion in interbank assets and a large stock of unqualified capital instruments, had become an outlier among its peers with respect to its CAR (Basel III) requirement. The CBRC required the bank to take corrective measures by reducing risk exposures within a specified period of time and the bank was restricted from expanding its balance sheet and branch network. The CBRC indicates that they would take further enforcement action if this deadline is not met. The team identified one potentially material deviation with regard to the requirement that supervisors should assess the impact of deviations from the reference definition of default, which are explicitly allowed under the Pillar 1 IRB approach provided that the bank makes adjustments that at least achieve broad compliance with the reference definition. This requirement is not implemented by the CBRC. Although currently the ongoing approval

	process for the IRB approach of banks should ensure that supervisors make this assessment, the missing implementation could become relevant after approval of the IRB approach and could result in insufficiently identified cases where additional capital or other corrective actions would be required. Whilst the team judged this finding as potentially material, it considered the overall implementation of Pillar 2 as substantially consistent with the Basel standards.
Basel paragraph no	755
Reference in domestic regulation	The *Capital Rules* Articles 73, 135–148, 161 Annex 13-2.3, 2.8, 2.9, 2.12, 2.14, 3.6 Annex 15-6,7,8,9 Annex 2-4 *Interim Measures on Commercial Banks' Implementation of Advanced Approaches to Capital Management*, Article 2
Findings	Basel paragraph 755 says that there is an important role for supervisory review of compliance with certain conditions and requirements set for standardised approaches and that there will be a particular need to ensure that use of various instruments that can reduce Pillar 1 capital requirements are utilised and understood as part of a sound, tested, and properly documented risk management process. This broad requirement has not been explicitly implemented in the domestic regulation. The CBRC points to specific requirements, regarding the supervisory review of standardised approaches, contained in their internal guidance on supervisory practices as reflecting the supervisory focus directed in this area; the materiality seems to be limited.
Materiality	Not material
Basel paragraph no	Basel II, paragraph 766
Reference in domestic regulation	Annex 13-2.5, Annex 14-2.1.6, -2.1.7 of the *Capital Rules*
Findings	Basel II, paragraph 766 requires supervisors to assess individual banks' application of the reference definition of default and its impact on capital requirements, and in particular focus on the impact of deviations from the reference definition according to Basel II, paragraph 456 (use of external data or historic internal data not fully consistent with the reference definition of default). For practical reasons, paragraph 456 of Basel II explicitly allows such deviations from the reference definitions under the Pillar 1 IRB approach. It solely requires adjustments that achieve broad compliance with the reference definition but does not require the achievement of full compliance with the reference definition of default. Although such deviations are explicitly allowed under Pillar 1, they could, however, result in insufficient minimum capital requirements and, therefore, could need to be addressed by Pillar 2 measures, including by additional capital requirements. The assessment by supervisors required by paragraph 766 Basel II serves to ensure that supervisors become aware of a relevant impact of such allowed deviations and then can take appropriate measures under Pillar 2. These particular requirements for supervisors have not been implemented. The specific assessment requirements for supervisors are implemented neither in the requirements for supervisory review of the ICAAP in Article 137-4 of the *Capital Rules* nor in the general empowerment for the CBRC in Annex 14-2.1.6 and 2.1.7 of the *Capital Rules* to require corrections for important parameters when reviewing and approving a bank's IRB approach. Although Annex 13-2.5 of the *Capital Rules* implements similar assessment requirements for banks as part of the internal capital adequacy assessment process (ICAAP) and although ICAAP is subject to supervisory review, this is no sufficient substitute for missing implementation of the specific assessment requirements for supervisors.
Materiality	Currently not material because no Chinese commercial bank has received permission for the IRB approach and during the initial approval of a rating system also deviations from the definition of default should be part of the assessment by supervisors. However, the Assessment Team considers it potentially material since neither the ongoing supervisory assessment of banks' validation nor the verification requirements for banks are sufficient as a replacement for the requirement that supervisors assess individual banks' application of the reference definition of default and its impact on capital requirements, and in particular the impact of deviations from the reference definition of default. Without implementing the specific assessment requirements for supervisors, supervisors could insufficiently

	identify cases where the impact of deviations from the reference definition of default on capital requirements would require additional capital requirements or other corrective actions would be required under Pillar 2.
Basel paragraph no	Supplemental Pillar 2 paragraph 16
Reference in domestic regulation	The *Capital Rules* Articles 105, 111–121 Annex 13-1
Findings	Supplemental Pillar 2 paragraph 16 says that, in order to determine the overall risk appetite, the board and senior management must first have an understanding of risk exposures on a firm-wide basis and that, to achieve this understanding, the appropriate members of senior management must bring together the perspectives of the key business and control functions. Basel paragraph 16 continues to say that, in order to develop an integrated firm-wide perspective on risk, senior management must overcome organisational silos between business lines and share information on market developments, risks and risk mitigation techniques. This requirement has not been explicitly implemented but the CBRC claims that requirements relating to the reporting of risk to the board and senior management would implicitly provide coverage of this.
Materiality	Not material
Basel paragraph no	Supplemental Pillar 2 paragraph 87
Reference in domestic regulation	The *Capital Rules* Articles 109, 161-167 Annex 15-12 Supervisory Guidance on Sound Remuneration of Commercial Banks, Articles 2, 16, 17, 19, 22-26 Supervisory Guidance on Performance Evaluation of Banking Institutions, Articles 5, 7.
Findings	Supplemental Pillar 2 paragraph 87 says that the board of directors must monitor and review the compensation system to ensure the system includes adequate controls and operates as intended. This requirement has not been explicitly implemented in the *Capital Rules*. The Supervisory Guidance on Sound Remuneration of Commercial Banks (Article 17) states however that the board of directors shall assume ultimate responsibility for monitoring the compensation system, delegating the review of the compensation system and policies to an independent compensation committee. The supervisory guidance is a binding regulatory document.
Materiality	Not material

2.5 Pillar 3: Market discipline

Section grade	Largely Compliant
Summary	Generally speaking, most of the Pillar 3 requirements have been implemented. Nevertheless, for certain areas, the disclosure requirements are incomplete. The missing information sometimes refers to material data (eg Table 4 on credit quality or Table 9 on securitisation).
Basel paragraph no	812
Reference in domestic regulation	*Capital Rules* Article 158
Findings	Under current Basel standards (see paragraphs 211, 387 and 537 for IRB approach) the supervisory approval for use of internal model is subject to compliance with disclosure requirements. The CBRC's *Interim Measures on Commercial Banks' Implementation of Advanced Approaches to Capital Management* contains rules which condition the approval of the advanced approach to, inter alia, the information disclosures (article 24 and 26); however, these are restricted, in their application, to the five main commercial banks (individually identified by name) and to "other large commercial banks" (article 3).
Materiality	The rule which conditions the approval of the advanced approaches to the compliance with

	the disclosure requirements should apply to the generality of the banks; however, given the current state of the implementation of advanced approaches in China and the clear stance of the CBRC to expect only the largest commercial banks to apply for the advanced approaches, the finding is not material and unlikely to become material.
Basel paragraph no	Pillar 3 – Table 4
Reference in domestic regulation	*Capital Rules* - Annex 15, 6.2
Findings	The *Capital Rules* require banks to disclose the "total amount of non-performing loans" and the "balance of loan loss provisions", but do not require the breakdown by industry or counterparty type of impaired loans, the specific and general allowances, charges for specific allowances and charge-offs during the period (as per Table 4 (f) of the Basel II text).
Materiality	Detailed information on banks' impaired loans, loan loss allowances, and charge-offs broken down at least by industry and/or counterparty type, is relevant for the assessment of the quality of credit portfolios. Although some evidence of the requested breakdown has been found in banks' annual reports, the team considers that regulation should explicitly incorporate this specific requirement, so as to ensure that banks continue to consistently disclose the required information. The finding is hence considered as potentially material.
Basel paragraph no	Pillar 3 – Table 9
Reference in domestic regulation	*Capital Rules* - Annex 15, 9.1 and 9.2
Findings	The *Capital Rules* require banks to provide certain information on securitisation exposures, but miss the provisions of Table 9 that require the disclosure of: • the nature of other risks inherent in securitised assets, risk management processes, use of CRM (Table 9 (a); • the types of SPEs, entities managed or advised (Table 9 (b)); • some accounting information (Table 9 (c), points 3, 4, 6 ,7); • the explanation of changes of quantitative information in last period (Table 9 (f)); • the breakdown and the disclosure on: type of securitised exposures (Table 9 (g)); • the breakdown of securitisation in reporting period by exposure type (Table 9 (j)); • exposures intended to be securitised (Table 9 (i)); • exposures deducted (Table 9, (l)).
Materiality	While the securitisation market is still in its infancy in China (as the data provided clearly show), it is also expected to resume and possibly expand, in line with the progressive opening of the Chinese financial system. As banks are not prevented by the law or by the rules to assume active roles (as originators, servicers, investors, providers of credit enhancement), it is important that the disclosure provided by them on their securitisation exposures is as complete as required by the international standards, in order to ensure that market participants can effectively assess their involvement in the business and the risks that they are assuming; the finding is hence considered not material in the present but potentially material in the future.
Basel paragraph no	Pillar 3 – Table 13
Reference in domestic regulation	*Capital Rules* – Article 167.3
Findings	The Chinese regulations do not include the provisions in Table 13 that require disclosure of: • information on accounting and fair value for equity exposures in the banking book (Table 13 (b)); • cumulative realised gains/losses arising from sales and liquidations in the reporting period (Table 13 (d)). The former is partially compensated (for listed banks) by a regulation issued by the Chinese Securities Regulatory Commission CSRC no 100, 2007), which requires disclosure of the equity investments of listed companies (article 38); the latter is implemented differently, by requiring banks to disclose relevant information on equity investments and the related loss/profit (Article 167.3 of the *Capital Rules*).
Materiality	The information required is substantially aligned with the Basel standards, with minor deviations in terms of scope of application (only listed banks for the equity investments) or

	granularity (loss/profit on equity investments instead of the prescribed cumulative realised gains/losses arising from sales and liquidations in the reporting period). Considering also the limitations imposed by the regulation on banks' equity investment, the finding is not material and unlikely to become material.
Basel paragraph no	Pillar 3 disclosure requirements for remuneration – Paragraph 11
Reference in domestic regulation	*Capital Rules* - Annex 15.12.1, 15.12.2
Findings	The *Capital Rules* implement only the main requirement (and not the related sub-items) for the quantitative information requested about employees' exposure to implicit and explicit adjustments of deferred remuneration and retained remuneration (letter (k) of the table on remuneration): • Total amount of outstanding deferred remuneration and retained remuneration exposed to ex post explicit and/or implicit adjustments; • Total amount of reductions during the financial year due to ex post explicit adjustments; • Total amount of reductions during the financial year due to ex post implicit adjustments.
Materiality	Absent any specific information on the existence and nature of implicit and/or explicit adjustments of deferred/retained remuneration in the Chinese context, the finding is considered potentially material.

Annexes

Annex 1: RCAP Assessment Team and Review Team

Team Leader:

Mr Luigi Federico Signorini	Bank of Italy

Team Members:

Mr Pier Bierbach	BaFin
Mr Tom Boemio	Federal Reserve Board
Mr Pierpaolo Grippa	Bank of Italy
Ms Chyng-Lan Liang	Prudential Regulation Authority, Bank of England
Ms Beatriz Simas Silva	Central Bank of Brazil
Ms Jiyoung Yang	Financial Supervisory Service

Supporting Members:

Mr Maarten Hendrikx	Basel Committee Secretariat
Mr Bruno Mastroianni	Bank of Italy

Review Team Members:[29]

Mr Bobby Bean	SIG member, Federal Deposit Insurance Corporation
Mr Karl Cordewener	SIG member, Basel Committee Secretariat
Mr Olivier Prato	SIG member, Autorité de contrôle prudentiel et de resolution, Bank of France
Mr Göran Lind	Sveriges Riksbank

[29] The Review Team is separate from the RCAP Assessment Team, and provides an additional level of quality assurance for the report's findings and conclusions. The RCAP Assessment Team has also benefitted from feedback from the RCAP Peer Review Board, and worked closely with Mr Udaibir Das, Head of Basel III Implementation at the Basel Committee Secretariat.

Annex 2: Implementation of the capital standards under the Basel framework as of end July 2013

Overview of adoption of capital standards

Table 3

Basel III Regulation	Date of issuance by BCBS	Transposed in Chinese rule	Date of issuance in China	Status
Basel II				
Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework – Comprehensive Version	June 2006	The *Capital Rules*	June 2012	4
Basel 2.5				
Enhancements to the Basel Framework	July 2009	The *Capital Rules*	June 2012	4
Guidelines for computing capital for incremental risk in the trading book	July 2009	The *Capital Rules*	June 2012	4
Revisions to the Basel II market risk framework	July 2009	The *Capital Rules*	June 2012	4
Basel III				
Basel III: A global regulatory framework for more resilient banks and banking systems –revised version	June 2011 (Consolidated version)	The *Capital Rules*	June 2012	4
Pillar 3 disclosure requirements for remuneration	July 2011	The *Capital Rules* *Guidance on Sound Remuneration of Commercial Banks*	June 2012	4
Treatment of trade finance under the Basel capital framework	October 2011	The *Capital Rules*	June 2012	4
Composition of capital disclosure requirements	June 2012	*Notice on Enhancing Disclosure Requirements for Composition of Capital*	July 2013	4
Capital requirements for bank exposures to central counterparties	July 2012	*Notice on Measurement Rules of Capital Requirements for Bank Exposures to Central Counterparties*	July 2013	4
Regulatory treatment of valuation adjustments to derivative liabilities	July 2012	*Notice on Policy Clarification of the Capital Rules*	July 2013	4

Number and colour code: 1 = draft regulation not published; 2 = draft regulation published; 3 = final rule published; 4 = final rule in force. For rules which are due for implementation as on 30 June 2012, the following colour code is used: Green = implementation completed; Yellow = implementation in process; Red = no implementation.

Annex 3: List of capital standards under the Basel framework used for the assessment

(i) International Convergence of Capital Measurement and Capital Standards: A Revised Framework (Basel II), June 2006

(ii) Enhancements to the Basel II framework, July 2009

(iii) Guidelines for computing capital for incremental risk in the trading book, July 2009

(iv) "Basel Committee issues final elements of the reforms to raise the quality of regulatory capital" Basel Committee press release, 13 January 2011

(v) Revisions to the Basel II market risk framework: Updated as of 31 December 2010, February 2011

(vi) Basel III: A global regulatory framework for more resilient banks and banking systems, December 2010 (revised June 2011)

(vii) Pillar 3 disclosure requirements for remuneration, July 2011

(viii) Treatment of trade finance under the Basel capital framework, October 2011

(ix) Interpretive issues with respect to the revisions to the market risk framework, November 2011

(x) Basel III definition of capital – Frequently asked questions, December 2011

(xi) Composition of capital disclosure requirements: Rules text, June 2012

(xii) Capital requirements for bank exposures to central counterparties, July 2012

(xiii) Regulatory treatment of valuation adjustments to derivative liabilities: final rule issued by the Basel Committee, July 2012

(xiv) Basel III counterparty credit risk – Frequently asked questions, November 2011, July 2012, November 2012

Annex 4: Local regulations issued by the CBRC implementing Basel capital standards

Overview of issuance dates of important Chinese capital rules — Table 4

Type and Descriptions	Time of issuance
Capital Rules for Commercial Banks	7 June 2012
Notice of the CBRC on Transition Arrangements for the Implementation of the Capital Rules for Commercial Banks	30 November 2012
Supervisory Guidance on Capital Instruments Innovation for Commercial Banks	29 November 2012
Instructions on CAR Reporting for Commercial Banks	29 October 2012
Notice on Regulatory Policies for Implementing IRB of Commercial Banks	19 July 2013
Notice on Measurement Rules of Capital Requirements for Bank Exposures to Central Counterparties	19 July 2013
Notice on Enhancing Disclosure Requirements for Composition of Capital	19 July 2013
Notice on Policy Clarification of Capital Rules	19 July 2013

Hierarchy of Chinese laws and regulatory instruments — Table 5

Level of rules (in legal terms)	Type
Laws	Enacted by the National People's Congress;
Ordinances	Enacted by the State Council;
Regulations	Issued by the CBRC;
Regulatory documents	Issued by the CBRC.

Annex 5: Details of the RCAP assessment process

A. Off-site evaluation

(i) Completion of a self-assessment questionnaire by the CBRC

(ii) Evaluation of the self-assessment by the RCAP Assessment Team

(iii) Independent comparison and evaluation of the domestic regulations issued by the CBRC with corresponding Basel III standards issued by the BCBS

(iv) Identification of observations

(v) Refinement of the list of observations based on clarifications provided by the CBRC

(vi) Assessment of materiality of deviations for all quantifiable deviations based on data and non-quantifiable deviations based on expert judgement

(vii) Forwarding of the list of observations to the CBRC

B. On-site assessment

(viii) Discussion of individual observations with the CBRC

(ix) Meeting with the PBoC, selected Chinese banks and accounting firms

(x) Discussion with the CBRC and revision of findings to reflect additional information received

(xi) Assignment of component grades and overall grade

(xii) Submission of the detailed findings to the CBRC with grades

(xiii) Receipt of comments on the detailed findings from the CBRC

C. Review and finalisation of the RCAP report

(xiv) Review of comments by the RCAP Assessment Team, finalisation of the draft report and forwarding to the CBRC for comments

(xv) Review of the CBRC's comments by the RCAP Assessment Team

(xvi) Review of the draft report by the RCAP Review Team

(xvii) Review of the draft report by the Peer Review Board

(xviii) Reporting of findings to SIG by the team leader

Annex 6: List of deviations rectified by amendments to Chinese rules during the RCAP assessment

Basel Paragraph	Reference to CBRC document and paragraph	Brief description of initial assessment finding	Reference to the amendments made by the CBRC to the pertinent rule(s) through supplementary regulatory notices
		Scope of Application	
Basel II – Paragraph 16	*Notice on Policy Clarification* – Q37	Chinese rules did not explicitly mention that open equity stakes in hedge fund, private equity investments and real estate holdings should be classified in the banking book.	According to *Notice on Policy Clarification* – Q37 there is now an explicit obligation that the previously mentioned exposures be classified in the banking book.
Basel II – Paragraph 44	The *Capital Rules*, Articles 21, 88 and 96; *Supplementary Notice on Regulatory Policy for Implementing IRB of Commercial Banks* – Item III	Chinese rules did not establish the value of the scaling factor to be applied to the risk-weighted asset amounts for credit risk assessed under the IRB approach.	The 1.06 scaling factor prescribed by Basel II is implemented in the *Notice on Regulatory Policy for Implementing IRB of Commercial Banks* – Item III.
		Transitional arrangements	
Basel II – Paragraph 45-49 BCBS press release 13 July 2009	The *Capital Rules*, Articles 164, 171 and Annex 14-3 *Notice on Policy Clarification* – Q 35	The *Capital Rules* did not fully implement the transitional arrangements for implementation of Basel II. More specifically, the CBRC has adopted a regulatory discretion that eliminates the capital floor after three years following a bank's IRB approval. This is inconsistent with the Basel Committee's agreement in 2009 to continue to apply capital floors for an indeterminate period of time	This deviation has been rectified by *Notice on Policy Clarification* – Q35 to keep the capital floor in place beyond three years of the parallel run period for conservative purposes
		Definition of Capital	
Basel III – Paragraph 55	The *Capital Rules* – Article 30 and Annex 1-2 *Supervisory Guidance on Capital - Instruments Innovation for Commercial Banks* – Paragraphs 2.1, 2.2 and 2.3 *Notice on Policy*	Chinese regulation did not specify the necessary effects of the write-down of instruments qualified for inclusion in Additional Tier 1 capital and classified as liabilities for accounting purposes (criterion no 11 of Basel III, Paragraph 55).	The necessary effects of the write-down of instruments qualified for inclusion in Additional Tier 1 capital and classified as liabilities for accounting purposes are incorporated in *Notice on Policy Clarification* – Q6.

	Clarification – Q6		
Basel III – Paragraph 75	The *Capital Rules* – Article 32-9 *Notice on Policy Clarification* – Q1	Chinese regulation did not incorporate all the requirements of this paragraph as amended by the 25 July 2012 press release. According to Chinese authorities the impact of the derecognition of accounting valuation adjustments arising from the bank's own credit risk related to derivative liabilities would not be material.	Regulation was amended via *Notice on Policy Clarification* – Q1 in order to adjust regulation and require that "with regard to derivative liabilities, all accounting valuation adjustments arising from the bank's own credit risk should be derecognised. The offsetting between valuation adjustments arising from the bank's own credit risk and those arising from its counterparties' credit risk should also be derecognised".
Basel III – Paragraph 79	The *Capital Rules* – Articles 14 and 33 *Notice on Policy Clarification* – Q3	There was no explicit requirement in regulation to deduct reciprocal cross-holdings in the capital of non-banking financial institutions. Regulation merely stated that "a commercial bank shall apply a "corresponding deduction approach" to its investments in the capital of other bank(s) that have resulted in the reciprocal cross-holdings of capital between banks, or any other capital investments deemed by the CBRC to have artificially inflated the capital position".	*Notice on Policy Clarification* – Q3 amended existing regulation in order to clarify that such deductions should also be extended to reciprocal cross-holdings of capital between banks and non-banking financial institutions.
Minimum Requirements to Ensure Loss Absorbency at the Point of Non-Viability – Paragraph 5	The *Capital Rules* – Annex 1-3.7 *Supervisory Guidance on Capital Instruments Innovation of Commercial Banks* – 2.3 *Notice on Policy Clarification* – Q5	Chinese regulation did not incorporate the requirements that "the issuance of any new shares as a result of the trigger event must occur prior to any public sector injection of capital".	Regulation was amended by *Notice on Policy Clarification* – Q5 in order to ensure compliance with the Basel text.
Minimum Requirements to Ensure Loss Absorbency at the Point of Non-Viability – Paragraph 6	*Notice on Policy Clarification* – Q2	Chinese regulation did not explicitly incorporate the "group treatment" requirements of Paragraph 6. According to these requirements, the terms and conditions of all non-common Tier 1 and Tier 2 instruments issued by subsidiaries, in order to be included in the consolidated bank's capital, must contain clauses which make sure that the relevant jurisdiction in determining the trigger event is the jurisdiction in which the capital is being given recognition for regulatory purposes (ie the home supervisor) – in order to guarantee this, an additional trigger event must be specified.	*Notice on Policy Clarification* – Q2 amended existing regulation in order to ensure compliance with the Basel text.
Minimum Requirements to Ensure Loss Absorbency at the Point of Non-Viability – Paragraph 7	*Notice on Policy Clarification* – Q2	Chinese regulation did not incorporate the requirement that "any common stock paid as compensation to the holders of the instrument must be common stock of either the issuing bank or of the parent company".	*Notice on Policy Clarification* – Q2 amended existing regulation in order to ensure compliance with the Basel text.
Composition of Capital	*Notice on Composition of*	The composition of capital disclosure requirements had not yet been incorporated in Chinese regulation by the time this assessment was initiated.	Chinese authorities released the *Notice on Composition of Capital Disclosure* in order to meet Basel

Disclosure Requirements	*Capital Disclosures*		requirements.
Basel III – Paragraph 132	The *Capital Rules*, Articles 2, 153, 156 and 169; *Notice on Policy Clarification* – Q4	Chinese regulation only partially covered the definition of earnings set forth in Paragraph 132 (b).	Missing elements were incorporated in Chinese regulation via *Notice on Policy Clarification* – Q4.
		Credit risk: Standardised Approach	
Credit risk – The Standardised Approach, paragraphs 153 and 154	NA	Basel paragraph 153 states that "for transactions in which the bank lends non-eligible instruments such as non-investment grade corporate debt securities, the haircut to be applied on the exposure should be the same as the one for equity traded on a recognised exchange that is not part of a main index". Basel paragraph 154 states that supervisors may permit banks to calculate haircuts using their own internal estimates of market price volatility and foreign exchange volatility. Permission to do so will be conditional on the satisfaction of minimum qualitative and quantitative standards stated in paragraphs 156 to 165. Both requirements were missing.	*Notice on Policy Clarification* – Q12 *Notice on Policy Clarification* – Q10 addresses the Basel requirements to implement relevant qualitative and quantitative requirements for using own estimates of haircuts, as well as clarifies relevant regulatory requirements.
Credit risk – The Standardised Approach, paragraphs 155-165	NA	As indicated above, Basel paragraph 154 states that supervisors may permit banks to calculate haircuts using their own internal estimates of market price volatility and foreign exchange volatility. Permission to do so is conditional on the satisfaction of minimum qualitative and quantitative standards stated in paragraphs 156 to 165. The *Capital Rules* stated that a commercial bank which meets the requirements for using own-estimate haircuts shall guarantee the reasonability of the estimation process and submit its own estimates to the CBRC for approval. However, the *Capital Rules* did not explicitly specify the requirements.	*Notice on Policy Clarification* – Q10 implements the relevant qualitative and quantitative requirements for using own estimates of haircuts.
Credit risk – The Standardised Approach, paragraph 168	Annex 6-7.2 of the *Capital Rules*	Annex 6-7.2 of the *Capital Rules* did not specify the exact formula set forth in Basel paragraph 168, which is more generalised for different holding periods. In addition, the *Capital Rules* did not appear as flexible as the Basel requirements for scaling the haircuts up or down when there is a different holding period from the minimum haircut. (See the requirements laid out in the latter part of paragraphs 168 and 169). The Annex appeared to address the lack of the specific formula set forth in Basel paragraph 168 by adjusting HM (paragraph 168) in the text at a higher fixed level of 10 days. It appeared as if the example of the formula provided in Basel paragraph 169 was copied directly into Annex 6-7.2.	*Notice on Policy Clarification* – Q10 provides the exact formula from Basel paragraph 168 if banks do not use the standard haircuts.
Credit risk – The Standardised Approach, paragraph 173	Annex 6-3 of the *Capital Rules*	Basel paragraph 173 recognises the effects of bilateral netting agreements covering repo-style transactions on a counterparty-by-counterparty basis if the agreements are legally enforceable in each relevant jurisdiction upon the occurrence of an event of default and regardless of whether the counterparty is insolvent or bankrupt. In addition, specific requirements for netting agreements are set forth, such as providing the non-defaulting party the right to terminate and close-out in a timely manner all transactions under the agreement upon an event of default and allowing for the prompt liquidation or setoff of collateral upon the event	*Notice on Policy Clarification* – Q11 specifies the exact requirements of paragraph 173 for netting agreements covering repo style transactions.

		of default. Annex 6-3 of the *Capital Rules* outlined the requirements for eligible netting, but they were not exactly the same as those set forth in Basel paragraph 173.	
Credit risk – The Standardised Approach, paragraph 182	NA	Also, the "Regulatory Weighting Approach" of the CBRC's *Capital Rules* did not include the requirement (set forth in Basel paragraph 182) that collateral must be marked to market at least every 6 months.	*Notice on Policy Clarification* – Q8 addresses this requirement.
Credit risk – The Standardised Approach, paragraphs 189-190	Annex 6-4.1 and 4.2	While aspects of the specific requirements in Basel paragraphs 189 and 190 are set forth in the Guaranty Law or Annex 6-4.1 and 4.2 (such as the guarantee must be unconditional), they are set forth at a higher level and not all Basel requirements were specified. In addition, the requirements in Annex 6-4 as written applied only to IRB banks, not to standardised banks, although the CBRC responded that standardised institutions are able to utilise the provisions of Annex 6.	*Notice on Policy Clarification* – Q8 explicitly lays out the requirements of paragraphs 189 and 190.
Credit risk - The Standardised Approach, paragraph 197	NA	Basel paragraph 197 requires a deduction from capital of a bank purchasing credit protection when there are materiality thresholds on payments below which no payment is made in the event of loss are equivalent to retained first loss positions. In response to a query from the Assessment Team, the CBRC stated that the *Capital Rules* did not have this specification because there is no such contractual arrangement for Chinese banks. In addition, only a couple of the sample banks were engaged in credit default swaps and only to a limited extent.	*Notice on Policy Clarification* – Q13 addresses this requirement.
Credit risk – The Standardised Approach, paragraph 200		If there is a currency mismatch between the credit protection and the exposure being hedged, then the amount of the exposure protected must be reduced by a haircut, H_{FX}. This requirement was missing.	*Notice on Policy Clarification* – Q13 fully implements paragraph 200.
		Credit risk: IRB	
Basel II, paragraphs 227, 228, 249-251, 280, 283	Annex 7-4.2 of the *Capital Rules*	Basel II, paragraph 227, specifies criteria for identifying high-volatility commercial real estate (HVCRE) as one of the five subclasses of specialised lending (SL) within the corporate asset class. Supervisors are required by Basel II, paragraph 228, to publish their classifications as HVCRE in their jurisdiction and to ensure application of such classifications in other jurisdictions to HVCRE loans in that jurisdiction. For banks using the "supervisory slotting criteria approach" for HVCRE, Basel II, paragraph 280, requires a mapping to supervisory categories based on the same slotting criteria as those for the income producing real estate (IPRE) subclass whereas the associated risk weights are higher. As an alternative at national discretion, Basel II, paragraphs 250 and 251, allow using the approaches to other corporates exposures but by applying a separate risk-weight formula for HVCRE. The specific criteria for identifying HVCRE exposures were not implemented. Instead, Annex 7-4.2 of the *Capital Rules* defines an abstract criterion "that the future rents, sales revenue or land sales revenue related to the income-producing real estate loans is subject to significant volatility" which then allows the commercial banks or the CBRC to apply the risk weights applicable to HVCRE under the "supervisory slotting criteria approach" that are implemented in Annex 7-4.2 of the *Capital Rules*. The separate risk-weight function for HVCRE was not	Part V of *Notice on Regulatory Policies for Implementing IRB of Commercial Banks* *Notice on Policy Clarification* – Q31

		implemented. Implementation is necessary because banks are not prevented from using for HVCRE the approaches to other corporates exposures, ie this national discretion has been exercised. A requirement for CBRC to publish their classifications as HVCRE and to ensure application of such classification in other jurisdiction to HVCRE loans in that jurisdiction was not implemented.	
Basel II, paragraph 231, third bullet point	Annex 4-5.1, 4-5.6 and Article 64 of the *Capital Rules*	According to the third bullet point of Basel II, paragraph 231, the exposure threshold to be met for categorising loans extended to small businesses as retail exposures applies also to small business loans extended through or guaranteed by an individual. The exposure threshold for classifying small business loans extended through or guaranteed by an individual as retail exposures was not implemented. Although Annex 4-5.6 of the *Capital Rules* requires meeting the exposure threshold implemented in Article 64-2 of the *Capital Rules*, this requirement is only applicable to exposures to micro- and small corporates but not to loans extended through an individual, ie where the exposure is to a natural person. The requirements for retail classification of exposures to natural persons are implemented by Annex 4-5.1 of the *Capital Rules* which, however, does not apply an exposure threshold. Consequently, if the initial borrower is an individual, regardless of whether the loan is for personal consumption or production and business, it would have been classified as retail exposure without any exposure threshold.	*Notice on Policy Clarification* – Q32
Basel II, paragraph 234, points (a) and (d) to (f)	Annex 5.4 of the *Capital Rules*	Basel II, paragraph 234, determines criteria which all must be met for treating a subportfolio as qualifying revolving retail (QRRE). This includes, according to point a, that the exposures are uncommitted (both contractually and in practice). Other requirements include, according to points d to f, that banks demonstrate low volatility of loss rates and that supervisors review relative volatility of loss rates and exchange information across jurisdictions, that banks store data on loss rates by banks, and that the supervisor concurs that the treatment as QRRE with underlying risk characteristics of the subportfolio. The abovementioned specific criteria were not implemented. The list of criteria for QRRE according to Annex 5.4 of the *Capital Rules* does not contain these criteria.	*Notice on Policy Clarification* – Q15
Basel II, paragraph 235	Annex 4-6.2.1 of the *Capital Rules*	Basel II, paragraph 235, requires that an instrument is considered as an equity exposure if it meets all of the requirements specified therein. One of these requirements is being irredeemable in the sense that the return of invested funds can be achieved only by the sale of the investment or sale of the rights to the investment or by the liquidation of the issuer. This distinguishes such instruments from debt obligations for which return of the invested amount can be achieved by a payment which the lender is obliged to make. Annex 4-6.2.1 of the *Capital Rules*, although requiring that the exposure is "irredeemable" (according to CBRC this term is used in the Chinese text of Annex 4-6.2.1 of the *Capital Rules*), does not implement the definition of "irredeemable" according to Basel II, paragraph 235, but instead requires that "the major source of income by holding the financial instrument comes from future capital gain rather than income only related to the length of holding period". This, however, assumes for both cases a limited holding period and therefore does not cover instruments which are irredeemable in the sense of Basel II, paragraph 235, but are held with the sole intention of profits generated over time by dividends paid, ie without any intention of	*Notice on Policy Clarification* – Q15

		a future capital gain by selling the instrument in order to achieve the return of invested funds. Since such instruments are not available for sale, these instruments are typically assigned to the banking book to which the IRB approach applies.	
Basel II, paragraph 237		Paragraph 237 requires that distinction between equity holdings and debt holdings or securitisation exposures is made based on the economic substance which is intended to be conveyed by the structuring of the instrument. This requirement was not implemented.	*Notice on Policy Clarification* – Q17
Basel II, paragraphs 240-242, 362, 363, 364-365, 366-368, 491, 492-499	Annex 4-7.2 of the *Capital Rules*	For purchased receivables, Basel II, paragraphs 363 to 368, specify the foundation and advanced IRB treatment of credit risk, and paragraph 363 in particular requires applying the highest risk weight function in case the bank cannot separate exposures by type in a mixed pool of purchased receivables. Basel II, paragraphs 369 and 370, specify the determination of risk-weighted assets for dilution risk of purchased receivables where this has not been demonstrated to be immaterial for the purchasing bank. According to Basel II, paragraphs 240 and 241, eligibility for applying the top-down approach (for risk quantification as permitted within in the standards for retail exposures) to purchased retail or corporates receivables requires that the bank applies minimum operational requirements including those in Basel II, paragraphs 492–499 and paragraph 491 requires satisfying these minimum also for making use of the IRB treatments of dilution risk. Applying the top-down approach to purchased corporates receivables requires in addition that the conditions in Basel II, paragraph 242 or 243, are satisfied. The way of applying the top-down approach to purchased retail or corporates receivables is determined by Basel II, paragraphs 364 and 365; in particular the estimates for PD and LGD (or EL) are required to be calculated without regard to any assumption of recourse or guarantees from the seller or other parties. Basel II, paragraphs 371 to 373(i), specify the treatment of purchased price discounts for receivables and the recognition of credit risk mitigants for purchased receivables. Basel II, paragraph 362, requires in particular IRB capital charges dilution risk of purchased receivables. None of the abovementioned requirements for purchased receivables are implemented. Instead, Annex 4-7.2 of the *Capital Rules* solely requires purchased receivables to be categorised as retail or corporates exposures; it even allows purchased corporates receivables meeting the eligibility criteria in Basel I,I paragraph 242, to be treated as an independent category of exposures without, however, specifying which risk weight formula to apply.	*Notice on Policy Clarification* – Q16 The top-down treatment for purchased receivables has not been made available, instead all purchased receivables must either be assigned to the corporates exposure class and assessed as individual as other corporates exposures and must not have material dilution risk, or the bank must use the Standardised Approach within the generally allowed limits, otherwise it cannot become or remain an IRB bank.
Basel II, paragraph 249		Basel II, paragraph 249, requires banks to apply the supervisory slotting criteria approach' to SL assets where they do not meet the requirements for estimation of PD. This requirement was not implemented; instead Article 48 of the *Capital Rules* leaves the use of the slotting criteria approach to the discretion of the bank.	Part I of *Notice on Regulatory Policies for Implementing IRB of Commercial Banks*
Basel II, paragraphs 257, 258	Article 47 of the *Capital Rules*	Paragraphs 257 and 258 specify the requirements if supervisors allow a phased rollout of the IRB approach. Besides a specification of what includes the phased rollout, these requirements include in particular mandatory application to all exposures within an asset class (or subclass) within a business unit and specific requirements related to an implementation plan, in particular to ensure that no capital relief is granted for transactions designed to reduce the aggregate capital charge by selectively transferring credit risk to the Standardised or the IRB	Part I of *Notice on Regulatory Policies for Implementing IRB of Commercial Banks*

		approach. The requirements for phased rollout of the IRB approach were not implemented. They need to be implemented because Article 47 of the *Capital Rules* allows a phased rollout by requiring coverage by IRB approach of solely 50% of total assets at the time of application and allowing three years for reaching 80% coverage.	
Basel II, paragraph 259	Article 47 of the *Capital Rules*	Basel II, paragraph 259, limits the exemption from the IRB approach (for instead applying the Standardised Approach) to some exposures in non-significant business units as well as asset classes that are immaterial in terms of size and perceived risk profile. The requirement to be immaterial in terms of size was not implemented. Immateriality was only required in terms of perceived risk profile, by way of a coverage ratio for risk-weighted assets according to Article 47 of the *Capital Rules*.	Part I of *Notice on Regulatory Policies for Implementing IRB of Commercial Banks*
Basel II, paragraphs 263, 45–49, BCBS press release 13 July 2009	Article 171, Annex 14-3.4 to 3.5 of the *Capital Rules*	Basel II, paragraph 263, requires banks adopting the IRB approach to calculate capital requirements also by using the 1988 Accord for the time period as specified in Basel II, paragraphs 45 to 49. The Basel Committee has agreed, based on paragraph 48, to keep in place the Basel I capital floors beyond the end of 2009. Basel II, paragraph 46, requires a capital floor calculation based on the 1988 Accord. The Basel I capital floor had not been implemented as required by Basel II, paragraphs 263 and 45–49, revised by the decision to keep the Basel I capital floor. Article 171 of the *Capital Rules* does not generally keep the floor in place but limited the application of the floor implemented in Annex 14 of the *Capital Rules* to the parallel run period determined by CBRC for a bank. The minimum parallel run period is determined as three years starting from the end of the year when the banks is approved to adopt the IRB approach. Determining a longer parallel run period was left to the discretion of CBRC. The way of implementation could have allowed CBRC to waive the Basel I floor for a bank at any time three years after the bank has adopted the IRB approach. This could have resulted in materially lower capital requirements than by applying the Basel I floor as required according to the agreement of the Basel Committee.	*Notice on Policy Clarification* – Q35 The CBRC has provided clarification that the capital floor in place will be kept in place beyond three years of the parallel run period commencing, by specifying for the rules text “the parallel run period shall last for at least three years” and “the CBRC can appropriately extend the parallel run period.”, that “appropriately” means that, “for conservative purposes, the CBRC will keep the capital floor in place beyond three years of the parallel run period commencing”.
Basel II, paragraph 266, Basel Committee newsletter, no 14, December 2009		Basel II, paragraph 266, requires during the transition period specified by paragraph 263 Basel II that LGDs for retail exposures secured by residential properties cannot be set below 10% for any subsegment of exposures to which the formula for residential mortgage exposures in Basel II, paragraph 328, is applied. The Basel Committee has agreed, based on Basel II, paragraph 266, to maintain the 10% LGD floor for claims secured by residential mortgages. This LGD floor was not implemented.	Part IV of *Notice on Regulatory Policies for Implementing IRB of Commercial Banks*
Basel II, paragraphs 289, 145–146	Annex 6-2.6.1.1 of the *Capital Rules*	Basel II, paragraph 289, allows recognition of financial collateral limited to that which is eligible under the Standardised approach. Point a of Basel II, paragraph 145, limits eligibility of cash as collateral to cash as well as certificates of deposit or comparable instruments issued by the lending bank) on deposit with the bank which is incurring the exposure. Cash on deposit held as collateral at a third-party bank in a non-custodial arrangement is not included in the list of eligible collateral instruments but may, according to Basel II, footnote 44 to paragraph 145,	*Notice on Policy Clarification* – Q14 and Q18

		point a, be recognised by applying the risk weight of the third-party bank, provided that certain requirements are met. Points c and d of Basel II, paragraph 145, limit eligibility of debt securities to those having a specified minimum rating by a recognised external credit assessment institution, except for those being issued by a bank and meeting certain requirements. The limitation under the foundation IRB approach to financial collateral which is eligible under the Standardised Approach according to Basel II/III was not implemented. Points a to c of Annex 6-6.1.1 of the *Capital Rules* do not limit recognition of cash or certificates of deposit to that on deposit with the lending bank, and do also not implement the treatment for cash on deposit in a non-custodian arrangement at a third-party bank. Point k of Annex 6-6.1.1 of the *Capital Rules* allowed recognition of life insurance policies or similar wealth management products as financial collateral, although this is not included in the list of eligible collateral in Basel II, paragraphs 145-146.	
Basel II, paragraphs 290, 154–165	Annex 6-2.5 of the *Capital Rules*	Basel II, paragraph 290, requires that recognition of eligible financial collateral follows the methodology outlined in Basel II, paragraphs 147 to 181(i). Paragraphs 154 to 165 allow supervisors to permit banks to calculate haircuts using their own estimates provided that the minimum quantitative and qualitative criteria in Basel II, paragraphs 165 to 165, are satisfied and that haircuts are calculated individually at least for equity and for debt securities not meeting a certain minimum rating. Except for the conditions in Basel II, paragraph 155, none of the other conditions for permitting the use of own estimates of haircuts were implemented, including none of the minimum quantitative or qualitative criteria. Annex 6-2.5 of the *Capital Rules* solely required banks to guarantee the reasonability of the estimation process and to submit its own estimates of haircuts to the CBRC for approval.	*Notice on Policy Clarification* – Q10
Basel II, paragraphs 293, 173		Basel II, paragraph 293, requires for recognition of the effects of master netting agreements that in particular the criteria provided in Basel II, paragraph 173, are satisfied. Paragraph 173 specifies requirements for recognition of bilateral master netting agreements covering repo-style transactions. These requirements were not implemented. Implementation is necessary because Annex 6-3.5 of the *Capital Rules* allows recognition of master netting agreements for repo-style transactions.	*Notice on Policy Clarification* – Q11
Basel II, paragraphes 302, 117-118, 189-190, 197; Basel III paragraph 120	Annex 6-1.2.1 and 4.2.3 of the *Capital Rules*	Basel II, paragraph 302 (as revised by Basel III, paragraph 120), requires that the approach to guarantees and credit derivatives under the foundation IRB approach closely follows the treatment specified in Basel II, paragraphs 189 to 201. Basel II, paragraph 189, determines operational requirements common to guarantees and credit derivatives, and paragraph 190 determines additional operational requirements for guarantees, including the legal certainty requirements in Basel II, paragraphs 117 and 118. With two exceptions, all of the other operational and legal certainty requirements were not implemented. Implementation was limited to the requirements that a guarantee must be irrevocable (Annex 6-4.2.3 of the *Capital Rules*) and must be legally enforceable (Annex 6-1.2.1 of the *Capital Rules*), without, however, specifying that legal enforceability is required in all	*Notice on Policy Clarification* – Q8

		relevant jurisdictions.	
Basel II, paragraphes 302, 304, 305, 197, 199; Basel III paragraph 120	Annex 6-4 of the *Capital Rules*	Basel II, paragraph 302 (as revised by Basel III, paragraph 120) requires that the approach to guarantees and credit derivatives under the foundation IRB approach closely follows the treatment specified in Basel II, paragraphs 189 to 201. Basel II, paragraph 197, requires that materiality thresholds below which no payment is made must be treated like retained first loss positions and be deducted in full from the capital of the bank purchasing the credit protection. Basel II, paragraphs 304 and 305, require for partial coverage by guarantees or credit derivatives that the exposure is split into a covered and an uncovered amount, that the uncovered portion is assigned the risk weight of the underlying obligor, and that the treatment of partial coverage follows paragraphs 198 to 200 where Basel II, paragraph 199, requires the application of the securitisation framework in case of tranched cover. None of these requirements for treating materiality thresholds and partial coverage, for the uncovered portion and for tranched cover were implemented. The *Capital Rules* do not contain a requirement to mandatorily apply the securitisation framework implemented in Annex 9 of the *Capital Rules* to cases of tranched cover. Annex 9-1.2 of the *Capital Rules* do not require the application of the securitisation framework to all cases of tranched cover but solely stipulates "securitisation exposures can include [...] tranched cover".	*Notice on Policy Clarification* – Q26
Basel II, paragraph 314	Article 79-2 of the *Capital Rules*	For applying a 0% CCF, Basel II, paragraph 314, requires banks to demonstrate active monitoring and ability to cancel the facility upon evidence of a deterioration in the credit quality of the borrower. This requirement was not implemented. Implementation is necessary because Article 79-2 of the *Capital Rules* allows applying a 0% conversion factor to loan commitments that can be unconditionally cancelled at any time.	*Notice on Policy Clarification* – Q19
Basel II, paragraph 323	Annex 5-6.6.3.3, Annex 6-7.2 of the *Capital Rules*	For transactions falling in the scope of Basel II, paragraph 321, subject to a master netting agreement, Basel II, paragraph 323, requires the application of a floor to the average maturity. This floor is equal to the highest minimum holding period set out in Basel II, paragraph 16,7 for the transaction types contained in the master netting agreement. Basel II, paragraph 321, applies in particular to derivatives, but also to margin lending and repo-style transactions. This floor was not implemented. No requirement was implemented that would apply the maturities specified in Annex 6-7.2, which implements Basel II, paragraph 167, as a floor to the average maturity. Implementation of the floor is necessary because Annex 5-6.6.3.3 of the *Capital Rules* allows using the average maturity, although limited to derivatives subject to a master netting agreement.	*Notice on Policy Clarification* – Q27
Basel II, paragraph 338	Article 79-4 of the *Capital Rules*	For foreign exchange and interest rate commitments in a retail portfolio, Basel II, paragraph 338, prohibits use of own assessments of credit equivalent amounts and instead requires that EAD is determined according to the Standardised Approach; where Basel II, paragraph 83, requires for commitments applying a 50% or 20% CCF, respectively, depending on maturity. This requirement was not implemented. Article 79-4 of the *Capital Rules* explicitly requires for off-balance sheet retail exposures that banks use their internally estimated conversion factors, without any exception for foreign exchange or interest rate commitments.	*Notice on Policy Clarification* – Q20

Basel II, paragraphs 375-377	Annex 7-5.1.1 to 7-5.1.5 and 7-5.2	Basel II, paragraph 375, specifies the calculation of EL amounts and of total EL amount. In particular, equity exposures under the PD/LGD approach and securitisation exposures are excluded from total EL amount. Basel II, paragraph 376, specifies the calculation of EL for exposures other than SL subject to the supervisory slotting criteria; it requires in particular that banks must use their best estimate of expected loss for exposures in default, except under the foundation approach. Paragraphs 375 and 376 were not implemented. This implementation is necessary except for the specific requirement to exclude equity exposures under the PD/LGD approach because this approach has not been implemented. Articles 31-2.(2) and 32-4.(2) of the *Capital Rules* specify the calculation of excess and shortfall of loan loss provisions without specifying how expected loss is to be calculated under the IRB approach. Although Annex 5-4.6.11 of the *Capital Rules* requires banks to calculate for each defaulted asset its best estimate of the expected loss on that asset based on current economic circumstances and facility status, it does, however, not require that this best estimate of expected loss is to be used in the EL-provisions comparison instead of EL defined as PD*LGD*EAD.	Part II of *Notice on Regulatory Policies for Implementing IRB of Commercial Banks*
Basel II, paragraphs 380–386	Articles 31-2.(2) and 32-4.(2) of the *Capital Rules*	Basel II, paragraph 384, restricts comparison with EL to provisions that are eligible; Basel II, paragraph 380, specifies eligible provisions as those assigned to exposures under the IRB approach but excluding specific provisions for equity and securitisation exposures. Basel II, paragraphs 381 to 383, prescribe the methods for determining the portion of general provisions that can be attributed to the IRB instead of the standardised treatment of provisions in case a bank is using the Standardised Approach for a portion of their credit risk exposures. Paragraph 385 requires supervisors to consider whether the EL fully reflects the conditions in the market before allowing to include an excess of provisions over EL into Tier 2 capital or to offset the EL amount on non-defaulted assets by excess specific provisions for defaulted assets. Basel II, paragraph 386, requires in particular deduction of EL amounts for equity exposures under the PD/LGD approach. None of these requirements were implemented; however implementation of deduction of EL amounts for equity exposures under the PD/LGD approach is not necessary because this approach has not been implemented. Articles 31-2.(2) and 32-4.(2) of the *Capital Rules* do not restrict the calculation of excess and shortfall to eligible provisions or portions of general provisions attributable to the IRB treatment. Even if the accounting rules applicable to a bank were limiting "loan loss provisions" to loans, this would not have been sufficient for ensuring that such loans are not classified as equity exposures under Basel II/III because the definition of equity exposures extends to certain debt obligations. Article 31-2.(2) of the *Capital Rules* permits inclusion of excess provisions into Tier 2 capital without making this subject to prior assessment by supervisors whether EL fully reflects market conditions.	Part II of *Notice on Regulatory Policies for Implementing IRB of Commercial Banks*
Basel II, paragraph 393	Article 140 of the *Capital Rules*	Paragraph 393 requires, for the duration of any non-compliance with minimum requirements for the IRB approach, that supervisors will consider the need for the bank to hold additional capital under Pillar 2 or take other appropriate supervisory action. This requirement for supervisors was not implemented. Article 140 of the *Capital Rules* solely allows but does not require the CBRC to require corrective actions when a bank fails to meet	Part I *of Notice on Regulatory Policies for Implementation of IRB*

		the minimum requirements.	
Basel II, paragraph 415(i); Basel III, paragraph 112		Paragraph 415(i), introduced by Basel III, paragraph 112, requires that PD estimates for borrowers that are highly leveraged or whose assets are predominantly traded assets must reflect the performance of the underlying assets based on periods of stressed volatilities. This requirement was not implemented.	*Notice on Policy Clarification* – Q21
Basel II, paragraph 423; Basel III, paragraph 101	Annex 5-6.3.3 of the *Capital Rules*	Basel II, paragraph 423, as amended by Basel III, paragraph 101, requires in particular that banks' policies for treatment of individual entities in a connected group include a process for identification of specific wrong-way risk (as defined in paragraph 58 of Annex 4 of Basel II) for each legal entity to which the bank is exposed. This requirement was not implemented. In particular Annex 5-6.3.3 of the *Capital Rules* does not require identification of specific wrong-way risk for each legal entity belonging to a connected group, but instead requires determination of cross-default of related borrowers depending on their financial interdependence and integration.	*Notice on Policy Clarification* – Q28
Basel II, paragraphs 429-431, 433	Annex 5-7.2.6.5 of the *Capital Rules*	Basel II, paragraphs 429–431 and 433, require for rating systems in particular to collect and store data on key borrower and facility characteristics that should be sufficiently detailed to enable retrospective reallocation of obligors and facilities to grades, and to collect and store data on the estimates and realisations for risk parameters (PD, LGD, EAD) estimated by the bank, on the components of loss/recovery for each defaulted exposure, and on LGD estimates before and after evaluating the effects of risk mitigants where LDGs are estimated by the bank. None of these particular data maintenance requirements were implemented. Although Annex 5-7.2.6.5 of the *Capital Rules* generally requires data needed to develop and improve the internal rating systems, it does not contain explicit collection and storage requirements related to data on the estimates and realisations of risk parameters (PD, LGD, EAD), on the estimates of LGDs before and after evaluating the effects of risk mitigants and on the components of loss/recovery for each defaulted exposure. Annex 5-7.2.6.5 of the *Capital Rules* also does not contain an explicit requirement that the data collected should be sufficiently detailed to enable retrospective reallocation of obligors and facilities to grades.	*Notice on Policy Clarification* – Q30
Basel II, paragraph 457		Basel II, paragraph 457, requires the rating of the borrower and estimate LGD for a previously defaulted exposure as for a non-defaulted facility if the bank considers that the exposure's status is such that no trigger of the reference definition any longer applies, and requires that a second default would be deemed to have occurred should the reference definition subsequently be triggered. This requirement was not implemented. Annex 5-6.3 of the *Capital Rules* specifies the PD estimation and requirements but does not contain this requirement.	*Notice on Policy Clarification* – Q21
Basel II, paragraph 459	Annex 5-6.3 of the *Capital Rules*	Basel II, paragraph 459, requires in particular that authorised overdrafts must be subject to a credit limit set by the bank and brought to the knowledge of the client. In addition, banks are required to have in place rigorous internal policies for assessing the creditworthiness of customers who are offered overdraft accounts. These requirements were implemented for credit card lines only but not for authorised overdrafts in general, The requirements in Article 50 of the *Supervisory Rules for Credit Card*	*Notice on Policy Clarification* – Q34

		Business in Commercial Banks（Decree of the CBRC, No 2, 2011) are limited to credit card issuance and credit card holders.	
Basel II, paragraphs 466, 473, 479		Basel II, paragraphs 466, 473 and 479, allow solely for retail exposures, that a bank need not give equal importance to historic data if it can convince its supervisor that more recent data are a better predictor of loss rates or drawdowns, respectively. Neither the restriction to retail exposures nor the restriction to the preference of more recent data (rather than the preference of less recent data) was implemented. Annex 5-6.2.7 of the *Capital Rules* allows generally that banks need not give historical data at different stages equal importance if empirical experience shows that the historical data at a certain stage may better reflect the impact of the economic cycle and is helpful to the accurate estimation of parameters. Although CBRC explained the intention of this provision by achieving more conservative risk parameter estimates, an explicit legal requirement was missing that clarifies that permission cannot be granted in cases where selectively preferring data for certain years within the required data history while less weighting or even not at all considering data for other years would result in less conservative requirements.	*Notice on Policy Clarification* – Q33
Basel II, paragraph 477	Annex 5-6.5 of the *Capital Rules*	Basel II, paragraph 477, requires banks using own EAD estimates in particular to be able to monitor outstanding balances on a daily basis. This requirement was not implemented. Annex 5-6.5 of the *Capital Rules* specifies the EAD estimation and requirements but does not contain this requirement.	Part IV of *Notice on Regulatory Policies for Implementing IRB of Commercial Banks*
Basel II, paragraphs 485–489	Annex 6-4.4, -4.5.2, -4.6 of the *Capital Rules*	Basel II, paragraphs 485 and 486, require, for exposures for which own LGD estimates are used, that the bank has clearly specified criteria for adjusting borrower grades or LGD estimates for assessing the effect of guarantees and credit derivatives, and specify the requirements for these criteria and the circumstances to be reflected. Basel II, paragraph 487, requires that banks take all relevant information into account in adjusting borrower grades or LGD estimates or allocating retail exposures to pools. Paragraphs 488 and 489 specify additional requirements for these criteria related to single-name credit derivatives. None of these requirements were implemented. Implementation is necessary because Annex 6-4.4 of the *Capital Rules* generally allows banks using the Advanced approach to adjust either PD or LGD, and Annex 6-4.5.2 of the *Capital Rules* allows even under the substitution approach to use some grade between the obligor's and the guarantor's grade. Moreover, while Annex 6-4.6 of the *Capital Rules* also allows the application of the substitution approach under the Advanced approach, it alternatively also allows an unadjusted PD combined with reflecting the guarantee in the LGD estimate, and it does not explicitly exclude adjustments to borrower grades beyond a substitution of PDs in the RWA calculation.	*Notice on Policy Clarification* – Q29
Basel II, paragraphs 507 and 508	Annex 6-1.25, -6.1.3 of the *Capital Rules*	Basel II, paragraph 507, specifies requirements for eligibility of commercial real estate (CRE) and of residential real estate (RRE) as collateral, in particular that repayment does not depend materially on the cash flows generated by the collateral but rather on the underlying capacity of the borrower to repay the debt from other sources, and that the collateral value does not depend on the performance of the obligor. Basel II, paragraph 508, explicitly excludes income-producing real estate that falls under the SL asset class from recognition as collateral for	*Notice on Policy Clarification* – Q22

		corporates exposures. None of this was implemented. Implementation is necessary because Annex 6-6.1.3 of the *Capital Rules* allows recognition of commercial and residential property as collateral under the IRB foundation approach and explicitly allows recognition of the right to use and dispose of the state-owned land, and the commercial and residential property built on such land, excluding industrial property, and of the land use right obtained by transfer and the land used for building commercial property or residential property. Although Annex 6-1.25 of the *Capital Rules* generally requires that credit risk mitigants should not have a positive correlation with obligor risk, it does, however, not implement the specific eligibility requirements for RRE/CRE collateral according to paragraphs 507 and 508 of Basel II.	
Basel II, paragraph 509	Annex 6-6.1.3 of the *Capital Rules*	Paragraph 509 requires, when determining the C*/C** threshold according to Basel II, paragraph 295, for junior liens, that C* and C** are calculated by taking into account the sum of the junior lien and all more senior liens. This requirement was not implemented. Annex 6-2.7 of the *Capital Rules* which implements Basel II, paragraph 295, did not implement this requirement. Implementation is necessary because Annex 6-6.1.3 of the *Capital Rules* does not explicitly exclude junior liens from recognition as collateral.	*Notice on Policy Clarification* – Q22 Recognition of RRE/CRE has been limited to first liens
Basel II, paragraph 510	Annex 6-2.2 of the *Capital Rules*	Basel II, paragraph 510, requires, for recognition of real estate collateral under the Foundation IRB approach in particular, that the bank monitors on an ongoing basis the extent of any permissible prior claims on the property and appropriately monitors the risk of environmental liability arising in respect of the collateral. These two requirements were not implemented. The requirements for being recognised as collateral in Annex 6-2.2 of the *Capital Rules* did not include these requirements.	*Notice on Policy Clarification* – Q22 Recognition of RRE/CRE has been limited to first liens
Basel II, paragraphs 513 to 515	Annex 6-1.3.1 , -2.2.2, -2.3.8.3 of the *Capital Rules*	Basel II, paragraph 512, requires, for recognition of receivables, that the legal mechanism by which collateral is given must be robust and ensures that the lender has clear rights over the proceeds from the collateral. Basel II, paragraph 513, requires that banks must take all steps necessary to fulfil local requirements in respect of the enforceability of security interest. Basel II, paragraph 514, requires in particular that banks undertake further legal review as necessary to ensure continuing enforceability. The first sentence of Basel II, paragraph 515 requires that documentation of collateral arrangements in particular includes a clear and robust procedure for the timely collection of collateral proceeds. The second sentence of paragraph 515 requires that banks' procedures ensure that any legal conditions required for declaring the default of the customer and timely collection of collateral are observed.. None of these specific requirements were implemented. Annex 6-2.2.2 of the *Capital Rules* requires ownership of the collateral, ie the receivables themselves; but does not require that the lender has clear rights on the proceeds from the collateral, as required by Basel II, paragraph 512. Implementation of Basel II, paragraph 514, in Annex 6-1.3.1 of the *Capital Rules* does not contain an explicit requirement for further reviews as necessary to ensure continuing enforceability. The first and third sentences of Annex 6-2.3.8.3 of the *Capital Rules* contain the risk management requirements in Basel II, paragraph 520, but do not require (contractual) documentation of collateral arrangements for ensuring legal certainty, as	*Notice on Policy Clarification* – Q24

		required by Basel II, paragraph 515. The second sentence of Annex 6-2.3.8.3 of the *Capital Rules* implements the third sentence of paragraph 515 but does not contain the requirements in the first and second sentence of paragraph 515.	
Basel II, paragraph 517	Annex 6-2.2 of the *Capital Rules*	Basel II, paragraph 517, requires, when recognising receivables as collateral, that the margin between the amount of the exposure and the value of the receivables reflects all appropriate factors, including the cost of collection, concentration within the receivables pool pledged by an individual borrower, and potential concentration risk within the bank's total exposures. This requirement was not implemented. The requirements for being recognised as collateral in Annex 6-2.2 of the *Capital Rules* do not include these requirements.	*Notice on Policy Clarification* – Q24
Basel II, paragraph 519	Annex 6-1.25, -6.1.2 of the *Capital Rules*	Basel II, paragraph 519, requires that receivables from affiliates of the borrower (including subsidiaries and employees) are not recognised as risk mitigants. This requirement was not implemented. The list of eligible collateral according to Annex 6-6.1.2 of the *Capital Rules* does not provide for such exclusion. Although Annex 6-1.25 of the *Capital Rules* generally requires that credit risk mitigants should not have a positive correlation with obligors risk, this solely implements the general requirement in Basel II, paragraph 124, but is, however, not sufficient for implementing the requirement that banks do not recognise receivables from affiliates of the borrower (including subsidiaries and employees) as collateral.	*Notice on Policy Clarification* – Q24
Basel II, paragraphs 521-522	Annex 6-6.1.4 of the *Capital Rules*	Basel II, paragraphs 521 and 522, specify the standards that must be met if supervisors allow for recognition of the credit risk-mitigating effect of other physical collateral under the IRB Foundation approach. Supervisors are in particular required to determine if liquid markets and well established, publicly available market prices are available for the collateral type to be recognised. In order to receive recognition for additional physical collateral, banks are in particular required to have priority over all other lenders to the realised proceeds of the collateral, and additionally a list is specified of detailed requirements for the loan agreement and for the bank's credit lending policies and practices for that particular type of collateral. This was not implemented. Implementation is necessary because other collateral recognised by CBRC is eligible under the Foundation IRB approach according to Annex 6-6.1.4 of the *Capital Rules*. The general requirements in Annex 6-1 and -2 of the *Capital Rules* neither contain the specific requirements according to Basel II, paragraphs 521 and 522, for assessment by supervisors, nor the specific requirements for banks for receiving permission to recognise other physical collateral.	*Notice on Policy Clarification* – Q23
Basel II, paragraphs 523-524		Basel II, paragraphs 523 and 524, specify the requirements for risk-weighting of leases that expose the bank to residual value risk, and the requirements for recognition of other leases as collateralised exposures. None of these requirements were implemented.	*Notice on Policy Clarification* – Q25
		Counterparty credit risk	
Basel II, Annex 4, paragraph 9	Not implemented	The Basel text specifies that the EAD for each counterparty has to be calculated as the sum of EADs for each netting set with that counterparty; this specification was missing in the *Capital Rules*.	*Notice on Policy Clarification* – Q59

Basel III, paragraph 99 (additional paragraph to be inserted after Annex 4, paragraph 9 of Basel II)	Not implemented	The Basel III text provides a definition of "outstanding EAD: (for the purpose of the default risk capital charge) which takes into account CVA losses already incurred by a bank; this definition was missing in the *Capital Rules*.	*Notice on Policy Clarification* – Q59
Basel II, paragraph 92(i)	Not implemented	Together with the add-on factors for the calculation of potential future credit exposure under the Current Exposure Method, the Basel text also provides some clarifications regarding specific situations: contracts with multiple exchanges of principal, residual maturity set equal to time until next reset date, treatment of other derivatives, no add-on for single-currency IRS. These clarifications were missing in the *Capital Rules*.	*Notice on Policy Clarification* – Q58
Basel II, Annex 4, paragraph 96(ii)	Not implemented	The paragraph of the Basel text detailing the conditions for the eligibility of netting agreements was not implemented. The lack of these criteria in the *Capital Rules* could potentially allow a bank to recognise netting of transactions when the legal characteristics of the underlying agreement do not ensure that netting can actually be enforced when needed (ie at close-out).	*Notice on Policy Clarification* – Q59
Basel II, Annex 4, paragraph 96(iii)	Not implemented	The Basel text specifies that contracts containing walkaway clauses are not eligible for netting under the CCR framework; this specification was missing in the *Capital Rules*.	*Notice on Policy Clarification* – Q59
Annex 4 (new section IX implemented in the paper entitled *Capital requirements for bank exposures to central counterparties (CCPs*), July 2012)		Basel paragraph 256 was amended by Basel III to preclude use of the IRB approach for exposures to CCPs. The CBRC's initial draft notice on capital requirements for exposures to CCPs did not address this requirement.	*Notice on capital requirements for exposures to CCPs* – paragraph 1.5.
		Market risk	
Basel II, paragraph 687(ii)	*Capital Rules*, Article 83-84. *Guidelines on Market Risk Management of Commercial Banks*, Appendix 10	Basel paragraph 687(ii) points out the minimum criteria that should be included in the trading policies and procedures to calculate regulatory capital. However, not all the criteria were reflected in the CBRC's rules. In particular, the *Guidelines on Market Risk Management of Commercial Banks* – Appendix on Banking Book and Trading Book – did not fully cover the minimum standards as laid down in the second through sixth bullets of Basel paragraph 687(ii). In particular the following components were missing: (1) The activities the bank considers to be trading and as constituting part of the trading book	*Notice on Policy Clarification* – Q36

		for regulatory capital purposes; (2) The extent to which an exposure can be marked to market daily by reference to an active, liquid two-way market; (3) For exposures that are marked to model, the extent to which the bank can: (i) identify the material risks of the exposure; (ii) hedge the material risks of the exposure and the extent to which hedging instruments would have an active, liquid two-way market; (iii) derive reliable estimates for the key assumptions and parameters used in the model.	
Basel II, paragraph 688	*Capital Rules*, Article 83-84. *Guidelines on Market Risk Management of Commercial Banks*, Appendix 10	Basel paragraph 688 points out the basic requirements for positions eligible to receive trading book capital treatment. However, not all the criteria were reflected in the CBRC's rules. In particular, the following criteria were missing: banks shall have clearly defined policies and procedures for the active management of the position, which must include: positions are managed on a trading desk; position limits are set and monitored for appropriateness; dealers have the autonomy to enter into/manage the position within agreed limits and according to the agreed strategy; positions are marked to market at least daily and when marking to model the parameters must be assessed on a daily basis; positions are reported to senior management as an integral part of the institution's risk management process; and positions are actively monitored with reference to market information sources (assessment should be made of the market liquidity or the ability to hedge positions or the portfolio risk profiles). This would include assessing the quality and availability of market inputs to the valuation process, level of market turnover, sizes of positions traded in the market etc.	*Notice on Policy Clarification* – Q36
Basel II, paragraph 689(iii)	*Capital Rules*, Article 83, Annex 8-1.2	Basel paragraph 689(iii) deals with the term trading-related repo style transactions in the banking book that can be included in the trading book for regulatory capital purposes only if the following conditions are met: (1) all such transactions are to be included in the trading book; (2) the trading-related repo style transactions must meet the requirements of Basel paragraphs 687 and 688 and both legs are in the form of either cash or securities that can be included in the trading book. These conditions were missing.	*Notice on Policy Clarification* –Q53
Basel II, paragraph 701(vi)	*Capital Rules*, Article 111, 116, 125, 144, 152 *Guidelines on Market Risk Management of Commercial Banks*, Article 23 Appendix (part 12)	Basel paragraph 701(vi) requires that all transactions including forward sales and purchases shall be included in the calculation of capital requirements. Banks are expected to manage market risk in their trading book on a continuous basis. Also regulators have to ensure that banks do not "window-dress" by showing significantly lower market risk positions on reporting dates. Banks also are expected to maintain strict risk management systems to ensure that intraday exposures are not excessive. This requirement was missing.	*Notice on Policy Clarification* – Q51

Basel II, paragraph 703	*Capital Rules*, Annex 6-7 and 6-3.5.3, Annex 8-2	Basel paragraph 703 states that for repo-style transactions, all instruments that are included in the trading book may be used as eligible collateral. Instruments that fall outside the banking book definition of eligible collateral shall be subject to a haircut at the level applicable to non-main index equities listed on recognised exchanges (as noted in paragraph 151) However, where banks are using the own-estimates approach to haircuts, they may also apply it in the trading book in accordance with paragraphs 154 and 155. Consequently, for instruments that count as eligible collateral in the trading book but not in the banking book, the haircuts must be calculated for each individual security. Where banks are using a VaR approach to measuring exposures for repo-style transactions, they also may apply this approach in the trading book in accordance with paragraphs 178 to 181(i) and Annex 4. These requirements were missing in the *Capital Rules*.	*Notice on Policy Clarification* – Q53
Basel II, paragraph 708(i)	*Capital Rules*, Article 86, 87	Basel paragraph 708(i) is very specific as regards to when and how partial models use can be allowed. Hence, supervisors should have a policy or rule in place that requires banks to implement IMA fully over time. The flexibility is granted on a transitional basis, with the only exceptions quoted at the end of paragraph 708(i). *Capital Rules*, Article 86 allowed banks to use an internal model with a coverage of only 50% and therefore did not fully implement Basel paragraph 708(i).	*Notice on Policy Clarification* – Q50 The CBRC clarifies that the coverage of 50% is just the minimum requirement for using the Internal Model Approach to market risk capital charge. Moreover, banks adopting the Internal Model Approach for any single risk category will be expected over time to include all their operations, subject to the exceptions mentioned below, and to move towards a comprehensive model (ie one which captures all market risk categories). Banks that adopt a model will not be permitted, save in exceptional circumstances, to revert to the Standardised Approach. Banks using comprehensive models to measure their market risk may still incur risks in positions that are not captured by their internal trading risk management models, for example, in remote locations, in minor currencies or in negligible business areas. Any such risks that are not included in a model should be separately measured by using the Standardised Approach.
Basel II, paragraph 709(iii)	*Instructions on CAR Reporting* G4C-Section 3-2	Basel paragraph 709(iii) requires that, in measuring the risk, offsetting will be restricted to matched positions in the identical issue (including positions in derivatives). Even if the issuer is the same, no offsetting will be permitted between different issues since differences in coupon rates, liquidity, call features etc mean that prices may diverge in the short run. These requirements were missing.	*Notice on Policy Clarification* – Q38
Basel II, paragraph 711(i)	*Capital Rules*, Annex 10, 1. 1. 2.3	Basel paragraph 711(i) sets forth eligibility criteria for allocating securities to the "qualifying" category for measuring specific risk capital charges. These include securities issued by public sector entities and multilateral development banks, plus other securities that are rated investment grade by at least two credit rating agencies specified by the national authority; or rated investment grade by one rating and not less than investment grade by any other rating	*Notice on Policy Clarification* – Q52 The CBRC clarifies that when the bonds issued by commercial banks of China have been rated by at least two qualified external rating agencies as investment grade, they can be included in the "qualifying" category.

		agency specified by the national authority (subject to supervisory oversight); or subject to supervisory approval, unrated, but deemed to be of comparable investment quality by the reporting bank, and the issuer has securities listed on recognised stock exchange. The *Capital Rules* (Annex 10, 1.1.2) did not explicitly set out the requirements regarding the minimum rating quality of the securities.	
Basel II, paragraph 718(xxxviii)	*Capital Rules*, Annex 10-3.1	Basel paragraph 718(xxxviii) sets forth minimum criteria for the exclusion of any exchange rate positions that a bank has deliberately taken in order to hedge partially or totally against the adverse effect of the exchange rate on its capital ratio. These positions may be excluded from the calculation of net open currency positions, subject to each of the following conditions being met: such positions need to be of a "structural", ie of a non-dealing, nature; the bank should satisfy the CBRC that the "structural" position excluded does no more than protect the bank's capital adequacy ratio; and any exclusion of the position needs to be applied consistently, with the treatment of the hedge remaining the same for the life of the assets or other items. These conditions were only partly reflected in the *Capital Rules*, Annex 10-3.1.	*Notice on Policy Clarification* – Q39 and Q40
Basel II, paragraph 718(xxxix)		Basel paragraph 718(xxxix) specifies that no capital charge need apply to positions related to items that are deducted from a bank's capital when calculating its capital base, such as investments in non-consolidated subsidiaries, nor to other long-term participations denominated in foreign currencies which are reported in the published accounts at historic cost. These may also be treated as structural positions. This specification was missing.	*Notice on Policy Clarification* – Q40
Basel II, paragraph 718(XLviii)		Basel paragraph 718(xlviii) sets forth requirements for models measuring commodity risk. In particular, the methodology should encompass: directional risk, to capture the exposure from changes in spot prices arising from net open positions; forward gap and interest rate risk, to capture the exposure to changes in forward prices arising from maturity mismatches; and basis risk, to capture the exposure to changes in the price relationships between two similar, but not identical, commodities. These requirements were missing.	*Notice on Policy Clarification* – Q42
Basel II, paragraph 718(Lviii)		Basel paragraph 718(xLviii), footnote 150 specifies that, for options with a residual maturity of more than six months, when evaluating how far the option is in the money, the strike price should be compared with the forward, not current, price. A bank unable to do this must take the in-the-money amount to be zero. This requirement was missing.	*Notice on Policy Clarification* – Q41
Basel II, paragraph 718(Lxxiv) and 718(XCix)	*Capital Rules*, Annex 11-1, 11-2.3, 2.5, 8.7 *Capital Rules*, Annex	According to Basel II, paragraph 718(Lxxiv), the extent to which banks meet the qualitative criteria may influence the level at which supervisory authorities will set the multiplication factor. In particular, the following factors should be considered: (i) quantitative factors, including back-testing results; (ii) qualitative factors, including the extent to which banks meet	*Notice on Policy Clarification* – Q45

	16-1.3.5, 16.1.3.8 *Supervisory Guidance on Fair Value of Financial Instruments of Commercial Banks*, Article 10	the qualitative criteria; and (iii) the assessment of the quality of the bank's risk management system These factors were missing.	
Basel II, paragraph 718(Lxxvi)		Basel II, paragraph 718(Lxxvi), sets forth quantitative standards with regard to internal market risk models for the calculation of the capital charge. A number of criteria were missing from the *Capital Rules*, including: (e) Banks must update their data sets no less frequently than once every month and reassess them whenever market prices are subject to material changes. This updating process must be flexible enough to allow for more frequent updates. The supervisory authority may also require a bank to calculate its value-at-risk using a shorter observation period if, in the supervisor's judgement, this is justified by a significant upsurge in price volatility. (g) Banks will have discretion to recognise empirical correlations within broad risk categories (eg interest rates, exchange rates, equity prices and commodity prices, including related options volatilities in each risk factor category). The supervisory authority may also recognise empirical correlations across broad risk factor categories, provided that the supervisory authority is satisfied that the bank's system for measuring correlations is sound and implemented with integrity. (h) Banks' models must accurately capture the unique risks associated with options within each of the broad risk categories. This includes capturing option risk, basis risk and correlation risk in relation to the above four categories of market risk. (l) The multiplication factors m_c and m_s will be set by individual supervisory authorities on the basis of their assessment of the quality of the bank's risk management system, subject to an absolute minimum of 3 for m_c and an absolute minimum of 3 for m_s. Banks will be required to add to these factors a "plus" directly related to the ex post performance of the model, thereby introducing a built-in positive incentive to maintain the predictive quality of the model. The plus will range from 0 to 1 based on the outcome of backtesting. The backtesting results applicable for calculating the plus are based on value-at-risk only and not stressed value-at-risk. If the backtesting results are satisfactory and the bank meets all of the qualitative standards set out in paragraph 718(Lxxiv) above, the plus factor could be zero. The Annex 10a of this Framework presents in detail the approach to be applied for backtesting and the plus factor. Supervisors will have national discretion to require banks to perform backtesting on either hypothetical (ie using changes in portfolio value that would occur were end-of-day positions to remain unchanged), or actual trading (ie excluding fees, commissions and net interest income) outcomes, or both.	*Notice on Policy Clarification* – Q43, Q44, Q45 and Q47
Basel II, paragraph 718(xci-1-), 718(xci-2-)		Basel II, paragraphs 718(xci-1-) and 718(xci-2-), set forth minimum standards with regard to backtesting of specific risk capital charges. Neither paragraph was fully implemented in the *Capital Rules*.	*Notice on Policy Clarification* – Q46

Basel II, paragraph 718(cviii)-718(cvix)		Basel II, paragraph 718(cviii) and 718(cvix), set forth minimum standards with regard to valuation adjustments. For example, banks must establish and maintain procedures for considering valuation adjustments/reserves, and are expected to use third-party valuations to consider whether valuation adjustments are necessary. The following adjustments are expected to be formally considered: unearned credit spreads, close-out costs, operational risks, early termination, investing and funding costs, and future administrative costs and, where appropriate, model risk. These paragraphs were not fully implemented.	*Notice on Policy Clarification* – Q48
Basel II, paragraph 718(cx), 718(cxi), 718(cxii)		Basel II, paragraphs 718(cx), 718(cxi), 718(cxii) contain minimum standards with regard to the valuation adjustment of less liquid positions for regulatory capital purposes. These standards include for example the requirement that banks must establish and maintain procedures for judging the necessity of and calculating an adjustment to the current valuation of less liquid positions for regulatory capital purposes. The adjustments may be in addition to any changes to the value of the position required for financial reporting purposes and should be designed to reflect the illiquidity of the position. Further, for complex products including, but not limited to, securitisation exposures, banks must explicitly assess the need for valuation adjustments to reflect two forms of model risk: the model risk associated with using a possibly incorrect valuation methodology; and the risk associated with using unobservable (and possibly incorrect) calibration parameters in the valuation model. Adjustment to the current valuation of less liquid positions for regulatory capital purposes must impact Tier 1 regulatory capital. These requirements and standards were missing.	*Notice on Policy Clarification* – Q49
Operational risk			
Operational risk paragraphs 647, 680–683	The *Capital Rules*, Articles 95, 150 Annex 14-1.3 Annex 14-2.1	Basel paragraph 647 says that a bank will be permitted to use the Basic Indicator or Standardised Approach for some parts of its operations and an AMA for others provided certain minimum criteria are met. Basel paragraph 680 says that all of the bank's operations that are covered by the AMA should meet the qualitative criteria for using an AMA, while those parts of its operations that are using one of the simpler approaches should meet the qualifying criteria for that approach. The partial use of AMA (paragraph 647) and the associated minimum criteria (paragraphs 680–683) were omitted from the *Capital Rules*.	*Notice on Policy Clarification* – Q55 Some requirements of Basel paragraph 680 have not been explicitly implemented but they may be seen as implicit.
Operational risk paragraphs 656, 657, 658	The *Capital Rules* Articles 103-104 Annex 12-3.1.1 Annex 14-1 Annex 14-2.2	Basel paragraph 656 says that a bank adopting the AMA may, with the approval of its host supervisors and the support of its home supervisor, use an allocation mechanism for the purpose of determining the regulatory capital requirement for internationally active banking subsidiaries that are not deemed to be significant relative to the overall banking group but are themselves subject to this Framework. Supervisory approval would be conditional on the bank demonstrating to the satisfaction of the relevant supervisors that the allocation mechanism for these subsidiaries is appropriate and can be supported empirically. Basel paragraph 657 says that any banking subsidiaries whose host supervisors determine that they must calculate stand-alone capital requirements may not incorporate group-wide diversification benefits in their AMA calculations.	*Notice on Policy Clarification* – Q55 Basel paragraph 658 has not been explicitly implemented but this was deemed to be immaterial.

		Basel paragraph 658 says that the appropriateness of the allocation methodology will be reviewed with consideration given to the stage of development of risk-sensitive allocation techniques and the extent to which it reflects the level of operational risk in the legal entities and across the banking group, and that supervisors expect that AMA banking groups will continue efforts to develop increasingly risk-sensitive operational risk allocation techniques The use of an allocation mechanism and the conditions for this use (paragraphs 656, 658) were omitted from the *Capital Rules*. The requirements of Basel paragraph 657 were also omitted from the *Capital Rules*.	
Operational risk paragraph 666	The *Capital Rules* Annex 12-3.1.2	Basel paragraph 666 says that it is necessary that auditors and supervisory authorities are in a position to have easy access, whenever they judge it necessary and under appropriate procedures, to the system's specifications and parameters. This requirement has not been explicitly implemented in the *Capital Rules*.	*Notice on Policy Clarification* – Q57
Operational risk paragraphs 671, 673	The *Capital Rules* Annex 12-3.2 Annex 12-4	Basel paragraph 671 says that a bank must have documented procedures for assessing the ongoing relevance of historical loss data. Basel paragraph 673 says that, to assist in supervisory validation, a bank must be able to map its historical internal loss data into the relevant level 1 supervisory categories defined in Annexes 8 and 9 and to provide these data to supervisors upon request. While the *Capital Rules* require documentation covering the processing and adjustment of internal loss data, there is no specific requirement to assess the ongoing relevance of historical loss data. The *Capital Rules* require a bank to be able to map its historical internal loss data into categories that do not exactly align to those defined in Annex 8; in particular, an "Other businesses" categorisation is allowed. Ability to provide these data to supervisors upon request has also not been explicitly implemented.	*Notice on Policy Clarification* – Q57
Operational risk paragraph 674	The *Capital Rules*, Annex 12-3.2.2	Basel paragraph 674 says that a bank must have a systematic process for determining the situations for which external data must be used and that the conditions and practices for external data use must be regularly reviewed, documented and subject to periodic independent review. The *Capital Rules* have not explicitly implemented the requirements above.	*Notice on Policy Clarification* – Q57
Operational risk paragraph 676	The *Capital Rules*, Annex 12-3.2.4 Annex 16-4.5.2	Basel paragraph 676 says that a bank's firm-wide risk assessment methodology must capture key business environment and internal control factors and sets out the standards for the use of these factors. The requirements concerning the use of these factors have been omitted from the *Capital Rules*.	*Notice on Policy Clarification* – Q56
Operational risk paragraphs 678-679	Not implemented	Basel paragraphs 678 and 679 concern a bank's ability to take advantage of the risk-mitigating impact of insurance and sets out the criteria that need to be complied with and the elements that need to be captured. The further conditions set out in these paragraphs, on the use and allowance for the risk mitigating impact of insurance, were omitted from the *Capital Rules*.	*Notice on Policy Clarification* – Q54

Pillar 3			
Basel II – Pillar 3 - Table 3(b)	*Capital Rules* – Annex 15 – 5.1	The requirement that capital requirements for credit risk are disclosed with a breakdown by portfolio was missing.	*Notice on Policy Clarification* – Q63
Basel II – Pillar 3 – Table 5(a)	Not implemented	The requirement to disclose the names of ECAIs and ECAs used was missing.	*Notice on Policy Clarification* – Q7
Basel II – Pillar 3 – Table 6(f)	*Capital Rules* – Annex 15 – 6.6	Under the Basel framework, IRB banks are required to disclose, as a minimum, information on estimates of losses against actual losses in each portfolio over a period sufficient to allow for a meaningful assessment of the performance of the internal rating processes for each portfolio. This requirement was missing in the CBRC's regulation.	*Notice on Policy Clarification* – Q63
Basel II – Pillar 3 - Table 8(b, c)	Not implemented	The requirement to disclose quantitative information on counterparty credit risk was missing.	*Notice on Policy Clarification* – Q62
Basel II – Pillar 3 - Table 11(e, f)	Not implemented	The requirement to disclose information on Stressed VaR and Incremental Risk Charge for banks authorised to adopt such approaches was missing.	*Notice on Policy Clarification* – Q64
Basel II – Pillar 3 – Table 12(b, c)	Not implemented	Information on the scope and coverage of the different approaches used in the case of partial use of AMA was missing. For AMA banks, a description of the use of insurance for the purpose of mitigating operational risk.	*Notice on Policy Clarification* – Q55 *Notice on Policy Clarification* – Q54

Annex 7 Assessment of bindingness of regulatory documents

The following table summarises the assessment of the seven criteria used by the Assessment Team to determine the eligibility of the CBRC's draft Regulatory documents. The team concluded the regulatory documents issued by the CBRC are eligible for the RCAP assessment.

Criterion	Assessment
(1) The regulatory instruments are part of a well defined, clear and transparent legal hierarchy and regulatory framework;	Chinese authorities have explained that in China, the hierarchy of law-making distinguishes between laws and ordinances issued by the People's Congress and State Council and those regulations and regulatory documents issued by the CBRC. The CBRC derives its rule-making power from Article 21 of the *Banking Regulation and Supervision Law* and is authorised to establish regulations and regulatory documents for the banking sector, including risk management, internal control, capital adequacy, asset quality, provisioning, risk concentration, interconnected transaction, liquidity etc. The prudential regulatory requirements are provided in both regulations and regulatory documents. According to I.1 and I.2 of the *Notice on Implementing the CBRC Rule-making Provisions*, the term "regulations" refers to the documents that are made pursuant to laws, ordinances and decisions and orders of the State Council, in accordance with statutory procedures, within the power of CBRC and coded as Decrees of the CBRC. These regulations have general binding force for the banking sector, and are used to govern the regulated financial institutions and their business activities. Titles of the regulations can vary from "rules" to "measures" and the like based on the content. The term "regulatory documents" refers to the CBRC documents with their legal status subordinated to regulations, and are issued to govern the regulated financial institutions and their business activities. The regulatory documents have general binding force for the banking sector, instead of being binding on individual regulated financial institutions. The regulatory documents generally carry a name in the format "Notice on XXX", "Notice on Implementing XXX", and "Notice of Guidelines on XXX".
(2) They are public and freely available;	Once regulatory documents are issued, the CBRC notifies the banks and posts them on the CBRC website.[30]
(3) They are viewed as binding by banks as well as by the supervisors;	In *CBRC Rule-making Provisions*, Article 66 provides that the CBRC's regulations and interpretations or explanatory notes of regulations are equal in legal force to regulations. Also, according to Article 37 and 46 of the *Banking Regulation and Supervision Law*, any bank that fails to meet prudential regulations and regulatory documents issued by the CBRC shall be subject to remedial measures or enforcement actions. In addition, the Assessment Team confirmed the bindingness of regulatory documents through its bilateral discussions with Chinese commercial banks and accounting firms.
(4) They would generally be legally upheld if challenged;	According to Article 62 of *Judiciary Interpretation of the Administrative Litigation Law*, the Court can refer to effective regulations as well as regulatory documents when making judgement in trial of administrative cases. As such, the regulations and regulatory documents are expected to be legally upheld if challenged in court.
(5) They are supported by precedent;	For example, the previous version of *Capital Rules* was first promulgated by the CBRC in 2004 as a "regulation", and were supported by a number of "regulatory documents" thereafter, serving as interpretation or supplements, such as the *Notice on Tier 2 Capital Instruments* or *Notices on CAR Calculation*. In 2006, an updated version of *Capital Rules* was re-issued to incorporate all additional requirements set forth in those notices. Starting from 2007, the CBRC issued the *Notice on Guiding Opinion for Implementing New Basel Accord*, the *Supplementary Notice on CAR Calculation under New Accounting Standards*, and a series of notices on supervisory guidelines covering Pillar 1, 2 and 3 of Basel II, which in

[30] For example, the *Capital Rules* (Decree of the CBRC, No.1, 2012), available at: www.cbrc.gov.cn/chinese/home/docDOC_ReadView/79B4B184117B47A59CB9C47D0C199341.html. See also the *Notice on Transition Arrangements for the Implementation of the Capital Rules for Commercial Banks* (Yin Jian Fa, No. 57, 2012, available at: www.cbrc.gov.cn/chinese/home/docDOC_ReadView/E7D4FBF66EE946BA86E647A5E9E58829.html.

	2012 were incorporated into the current *Capital Rules* in accordance with Basel III. In this evolving process, any bank that fails to meet the requirements in the notices shall incur corrective measures or enforcement actions, including but not limited to a supervisory letter requiring prompt correction to eliminate the loopholes.
(6) They are properly communicated and consequences of failure to comply are properly understood and carry a similar practical effect as for the primary law or regulation;	According to Article 37 and 46 of the *Banking Regulation and Supervision Law*, any banking institution that fails to meet prudential regulations and regulatory documents shall be subject to remedial measures or enforcement actions.
(7) The instrument is expressed in clear language that complies with the Basel provision in substance and spirit (eg phrased in terms of requirements, not just interpretation, guidance, or best practice).	Wording like "require, must, should, shall" is used in the notices. The Assessment Team assessed the regulatory documents in both the letter and spirit for compliance with the Basel standards.

Annex 8: List of issues for follow-up RCAP assessments

Due to the rapidly evolving nature of the Chinese financial system, the Assessment Team has adopted in its evaluations a relatively short assessment horizon (three years), specifically for the deviations that required an evaluation of potential materiality. Consequently, the Assessment Team suggests that China should consider a follow-up RCAP assessment – alongside the review of liquidity and the SIB standards that will start from 2015 – to evaluate progress and to identify any new issues that could impinge on the efficacy of capital regulations that are currently in place. In particular, the Assessment Team marked the following deviations as potentially material and considers them relevant for re-assessment in future RCAP assessments:

- Credit risk SA: different approach to risk weighting of claims on domestic banks and PSEs, eligibility criteria for collateral and the treatment of past-due loans in relation to the Chinese provisioning rules;
- Pillar 2: no requirement for supervisors to assess deviations from the reference definition of default; and,
- Pillar 3: missing requirements regarding detailed disclosure of relevant data about credit quality, securitisation and remuneration.

Annex 9: Key financial indicators of Chinese banking system

Overview of Chinese banking sector

Table 6

Size of banking sector (CNY billions)	
Total assets all banks operating in the jurisdiction[31]	129,103
Total assets of all locally incorporated internationally active banks	76,917
Total assets of locally incorporated banks to which capital standards under Basel framework are applied	128,816
Number of banks	
Number of banks operating in China	511
Number of internationally active banks	6
Number of banks required to implement Basel standards (according to domestic rules)	511
Number of Global Systemically Important Banks (G-SIBs)	1
Capital standards under the Basel framework	
Number of banks required to implement Basel equivalent standards	511
Use of advanced approaches by banks	See Table 1
Capital adequacy banking sector (CNY billions; percent)	
Total capital	5,447
Total Tier 1 capital	4,203
Total CET1 capital	4,202
Total risk-weighted assets	41,894
RWAs for credit risk (percent of total RWAs)	91.3%
RWAs for market risk (percent of total RWAs)	0.8%
RWAs for operational risk (percent of total RWAs)	7.9%
Total assets all banks operating in the jurisdiction[32]	129,103
Total off-balance sheet bank assets	11,127
Capital Adequacy Ratio (weighted average)	13.0%
Tier 1 Ratio (weighted average)	10.0%
CET1 Ratio (weighted average)	10.0%

Source: CBRC, data as of end-2012.

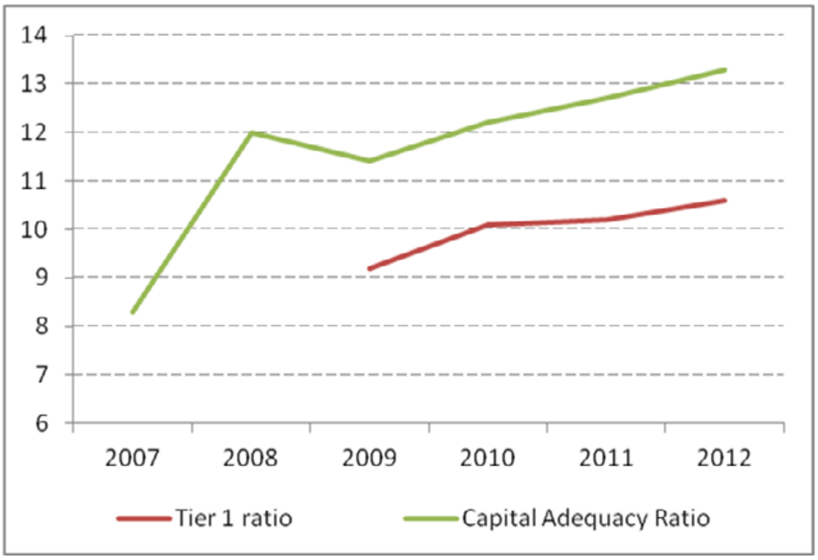
[31] Including off-balance sheet assets.

[32] Including off-balance sheet assets.

Evolution of capital ratios of Chinese commercial banks

Weighted average, in percent

Figure 1

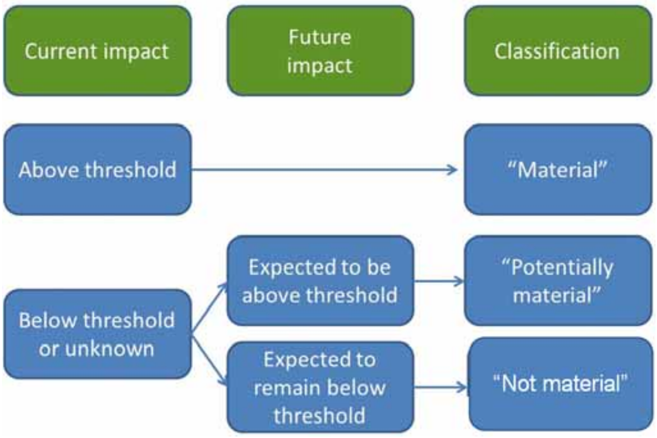


Source: CBRC.

Annex 10: Materiality assessment

The assessment of materiality distinguished between quantifiable and non-quantifiable gaps. For the China RCAP, an attempt was made to quantify the impact of all quantifiable gaps for each bank in the sample affected by the gap. In total, 20 gaps were assessed based on bank data and data available to the CBRC. In those cases where the computation of the impact was not straightforward, the computation erred on the conservative side. Where no data was available to quantify gaps, the review team relied on expert judgement. Following this approach, an attempt was made to determine whether gaps are “not material”, “material” or “potentially material”.

Classification of quantifiable gaps — Figure 2



Number of gaps by component — Table 7

Component	Non-material	Material	Potentially material
Scope of Application	2	0	0
Transitional Arrangements	1	0	0
Definition of Capital	2	0	0
CR: Standardised Approach	5	0	3
CR: IRB	0	0	0
Securitisation	7	0	0
Counterparty credit risk	0	0	0
MR: Standardised Approach	4	0	0
MR: IMA	1	0	0
OR: SA/BIA	2	0	0
OR: AMA	0	0	0
Pillar 2	3	0	1
Pillar 3	2	0	3

Note: materiality is defined based on quantitative benchmark thresholds (for the quantifiable gaps) and expert judgement (for the non-quantifiable gaps). See Section 2 with the detailed assessment findings for further information.

Annex 11: Areas where the CBRC's rules are modified or stricter than the Basel standards

In several places, the CBRC has adopted a stricter approach than the minimum standards prescribed by Basel or has simplified or generalised an approach in a way that does not necessarily result in stricter requirements under all circumstances but never results in less rigorous requirements than the Basel standards. The following list provides an overview of these areas, which was put together with the help of the CBRC. It should be noted that these areas have not been taken into account as mitigants for the overall assessment of compliance.

Scope of application

1. The scope of application of the *Capital Rules* is larger than required by the Basel standards: all commercial banks, including small banks and non-internationally active banks, are covered.

Transitional arrangements

2. There is no phase-in arrangement for the minimum capital ratio. Commercial banks should meet a minimum ratio of 5% CET1, 6% Tier 1 and 8% total capital as of 1 January 2013; meanwhile, the capital conservation buffer was introduced earlier, from 1 January 2013 rather than 1 January 2016 as required by Basel.

3. The *Capital Rules* do not allow transitional arrangements for the regulatory adjustments (deduction and prudential filters) besides minority interests.

Definition of Capital

4. The *Capital Rules* generally apply a risk weight of 1250% to equity investments in commercial entities, with the only exception of a 400% risk weight applied to "equity investments in commercial entities passively held by the bank within the legally prescribed disposal period" and "equity investments in commercial entities made by the bank due to policy reasons and with the special approval of the State Council". Under Basel rules (paragraph 36), equity investments in commercial entities receive instead a 100% risk weight, provided they do not exceed a materiality threshold (15% of the bank's capital for individual significant investments in commercial entities and 60% of the bank's capital for the aggregate of such investments).[33]

[33] In theory, the Chinese treatment of equity investments could prove less stringent than Basel if the investments which receive a 400% risk weight exceeded the materiality thresholds (in which case they would have to be deducted under Basel standards); however, this is unlikely to happen, given the figures at stake and the limited amount of equity investments by banks in China.

5. The minimum requirement for CET1 is 5% rather than 4.5% as required by Basel. The requirement for CET1 including the capital conservation buffer is 7.5% instead of 7% as required by Basel.

Credit risk rules

6. Under the Standardised Approach for credit risk, claims secured by residential property are risk-weighted at 50% rather than 35%, the minimum required by Basel. Further, the *Capital Rules* only allow a limited number of high-quality debt securities as eligible collateral, not recognising for example the equities and UCITS allowed by Basel.

7. With regard to the IRB approach, under Basel, claims on certain financial institutions would be assigned to the corporate exposures class (eg certain leasing firms), whereas the *Capital Rules* assign these exposures to the bank exposures class. The exposures therefore cannot benefit from the firm size adjustment for SMEs.

- *Basel paragraph:* Basel II, paragraphs 230, 65, 272, 273; Basel III, paragraph 102
- *Basel standard:* Beyond banks and domestic PSEs treated like banks under the Standardised Approach, inclusion in the bank assets class is limited by Basel II, paragraph 230, to those security firms outlined in Basel II, paragraph 65; where solely those security firms are included that are subject to supervisory and regulatory arrangements comparable to those under the Basel II/III framework and in particular subject to comparable capital requirements.
- *The CBRC's implementation*: This limitation has not been implemented. Annex 4-3 of the Capital Rules extends this asset class to all non-bank financial institutions that have been established with the approval and are subject to the supervision of the financial supervisory authority. This extends the range of this asset class broadly to all regulated financial institutions according to Basel II, paragraph 272, as revised by Basel III, paragraph 102.
- *Assessment:* The broader inclusion into the banks' asset class results in more rigorous capital requirements because this prevents exposures to regulated financial institutions that are SMEs and would be assigned to the corporates asset class under Basel II/III, from reduction of capital requirements by the firm-size adjustment for SMEs

8. Capital requirements for credit risk can be higher for banks that have purchased receivables in their portfolio. If a bank is not able to assess purchased receivables as individual as corporates exposures or if the dilution risk is material, the *Capital Rules* require banks to use the Standardised Approach (this is to avoid implementation of the particular IRB requirements for purchased receivables). When the bank has a material risk exposure to purchased receivables in the Standardised Approach, which exceeds the materiality threshold for partial use, or when size of these exposures is material, this could prevent a bank from becoming an IRB bank. The bank would face higher capital requirements when the capital requirements under the Standardised Approach are higher than under the IRB approach.

- *Basel paragraph:* Basel II, paragraphs 240–242, 362, 363, 364–365, 366–368, 491, 492–499
- *Basel standard:* For purchased receivables, Basel II, paragraphs 364–368 specify the foundation and advanced IRB treatment of credit risk, Basel II, paragraphs 369 and 370 specify the determination of risk-weighted assets for dilution risk of purchased receivables where this has not been demonstrated to be immaterial for the purchasing bank. Basel II, paragraphs 491–499 establish minimum requirements for any purchased receivable for which a bank makes use of the top-down treatment of default risk or the IRB treatments of dilution risk.

- *CBRC's implementation*: The top-down approach for credit risk of purchased receivables (for both retail and eligible corporates receivables) and the IRB treatment of material dilution risk have not been implemented (including related minimum requirements). Instead the Notice on Policy Clarification – Q14 on the treatment of purchased receivables as IRB exposures requires that such receivables must be assigned to the corporate asset class (even if they are purchased retail receivables) and that they be assessed and rated as individually as other corporate exposures, and their dilution risk must be immaterial; alternatively, they have to be treated according to the Standardised Approach, provided that their share in the overall portfolio remains within the generally allowed limits for partial use.
- *Assessment:* This method of implementation prevents banks from applying the IRB approach to purchased receivables where the bank has insufficient information to assess and rate purchased receivables as individually as other corporate exposures (caused by the typical constellation between the bank as the purchaser of the receivables, the seller of the receivables and the obligor to which the bank typically has no direct relationship where this is not a customer of the bank) or where dilution risk is material. Should the size or perceived risk profile of purchased receivables to which the bank would therefore be required to apply the Standardised Approach become material either in terms of size or perceived risk profile, this would exclude the bank generally from being allowed to use the IRB approach for any credit risk exposure according to Part I of the Notice on Regulatory Policies for Implementing IRB of Commercial Banks, which implements Basel II, paragraph 259. This can result in higher capital requirements for credit risk where the capital requirements for a bank under the IRB approach were lower than under the Standardised Approach to credit risk.

9. The Basel IRB approach applies an asset value correlation multiplier that increases the capital requirements for claims on regulated financial institutions whose total assets are greater than or equal to USD 100 billion. This threshold has not been implemented in the *Capital Rules*, and as a result the higher asset value correlation multiplier applies also to claims on smaller regulated financial institutions.

- *Basel paragraph:* Basel II, paragraph 272; Basel III, paragraph 102
- *Basel standard:* Basel II, paragraph 272, as revised by Basel III, paragraph 102, requires the asset value correlation multiplier to be applied only to exposures to those regulated financial institutions whose total assets are greater than or equal to USD 100 billion.
- *CBRC's implementation*: This restriction to larger regulated financial institutions has not been implemented. Annex 3-1.1.2 of the Capital Rules requires the increased correlation to be applied to all "financial institution exposures". According to the definition in Annex 4-3 of the Capital Rules, this covers broadly all regulated financial institutions according to Basel II, paragraph 272 as revised by Basel III, paragraph 102.
- *Assessment:* This method of implementation results in increased risk weights for exposures to smaller regulated financial institutions which do not exceed the threshold and would therefore not be subject to the asset value correlation multiplier according to Basel II, paragraph 272 as revised by Basel III, paragraph 102.

10. The *Capital Rules* do not offer the double default framework for IRB exposures. As a result, the capital requirements for positions eligible for the double default framework – eg exposures hedged by certain credit derivatives – would be higher than if the double default framework were applied.

- *Basel paragraph*: Basel II, paragraphs 284(i)-(ii), 307(i)-(ii)
- *Basel standard*: Basel II, paragraphs 284(i) to (ii), allow the double default framework to be applied to exposures that meet the conditions specified in Basel II, paragraphs 307(i)-(ii).
- *CBRC's implementation*: The double default framework has not been implemented.

- Assessment: Since this prevents a downward adjustment to the capital requirements by the multiplier dependent on the PD of the protection provider, omitting the implementation can result in higher capital requirements for exposures that would meet the eligibility requirements for the double default framework according to Basel II, paragraphs 307(i)-(ii), and for which banks would therefore be allowed under Basel II, paragraphs 284(i) to (ii), to apply the double default framework.

11. According to Basel, the EAD for unused committed credit lines (an off-balance sheet item) under the IRB Foundation approach is based on the lower of the value of the unused committed credit line and the value that reflects any possible constraining availability of the facility, provided that certain requirements are met (Basel paragraph 313). The *Capital Rules* do not recognise any possible constraining availability and the resulting EAD will therefore be equal or higher than under Basel.

- *Basel paragraph*: Basel II, paragraph 313
- *Basel standard*: Paragraph 313 allows the EAD for unused committed credit lines to be determined as the lower of the value of the unused committed credit line and the value that reflects any possible constraining availability of the facility, provided that certain requirements are met.
- *CBRC's implementation*: This recognition of possible constraining availability has not been implemented.
- A*ssessm*ent: The resulting EAD for unused committed credit lines for which possible constraining availability exists is therefore larger than required by Basel II, paragraph 313.

12. Under the IRB Foundation approach, Basel requires the lower of the applicable CCFs to be applied where a commitment is obtained on another off-balance sheet exposure (Basel paragraph 315). The application of the lower of the two CCFs has not been implemented in the *Capital Rules*, which can therefore result in a higher EAD measure.

- *Basel paragraph*: Basel II, paragraph 315
- *Basel standard:* Basel II, paragraph 315 requires the lower of the applicable CCFs to be applied where a commitment is obtained for another off-balance sheet exposure.
- *CBRC's implementation*: The application of the lower of the two CCFs has not been implemented.
- *Assessment*: Therefore, the CCF for that exposure to which the higher CCF is applicable is higher than required by Basel II, paragraph 315.

13. Under the simple risk weight method for equities, Basel requires a 300% risk weight to be applied for equity holdings that are publicly traded and a 400% risk weight to all other exposures. The *Capital Rules* do not offer the simple risk weight method separately for the IRB approach; instead, the implementation of the Standardised Approach is required to be applied to all equity exposures. The risk weights applied are either 400% or 1250%. This method of implementation effectively results in the mandatory application of the simple risk weight method to all equity exposures, whereby the risk weights for certain equity exposures are higher than required by Basel. All publicly traded equity holdings receive a risk weight of 400% instead of 300%. Equity exposures that are neither passive holdings of equity investments in commercial entities nor investments due to policy reasons and with approval of the State Council receive a risk weight of 1250% instead of 400%.

- *Basel paragraph*: Basel II, paragraph 344
- *Basel standard*: Basel II, paragraph 344 requires that a 300% risk weight be applied for equity holdings that are publicly traded and a 400% risk weight to all other exposures.

- *CBRC's implementation*: The simple risk weight method has not been implemented separately for the IRB approach; instead, the implementation of the Standardised Approach is required to be applied to all equity exposures (first paragraph of Annex 6 of the Capital Rules). The risk weights applied are either 400% or 1250% (Annex 2-1.10.2 to 1.10.4 of the Capital Rules).
- *Assessment:* This method of implementation effectively results in mandatory application of the simple risk weight method to all equity exposures, whereby the risk weights for certain equity exposures are higher than required by Basel II, paragraph 344. All publicly traded equity holdings receive a risk weight of 400% instead of 300%. Equity exposures that are neither passive holdings of equity investments in commercial entities nor investments due to policy reasons and with approval of the State Council receive a risk weight of 1250% instead of 400%.

14. Capital requirements are higher than required under Basel for those equity exposures for which a bank's PD/LGD or VaR estimates would indicate a risk level below that assumed by the simple risk weight method because neither the internal models method for equity exposures nor the PD/LGD approach for equity exposures has been made available as an alternative to the simple risk weight method.

- *Basel paragraph*: Basel II, paragraphs 346–355
- *Basel standard*: Basel II, paragraphs 346 to 355 allow banks, subject to permission by the supervisor, to determine capital requirements for equity exposures by applying either the VaR-based Internal models method or the PDG/LGD method.
- *CBRC's implementation*: These methods have not been implemented. Instead, the method of implementing capital requirements for equity exposures results effectively in requiring the mandatory application of the simple risk weight method to all equity exposures (see first paragraph of Annex 6, Annex 2-1.10.2 to 1.10.4 of the Capital Rules).
- *Assessment:* This results in higher capital requirements for equity exposures for which the capital requirements would be lower under either the Internal models method according to Basel II, paragraphs 346 to 349, or the PD/LGD approach according to Basel II, paragraphs 350 to 355, if the bank meets the conditions for the respective approach.

Market risk rules

15. Regarding the measurement of general market risk, Basel requires that "Separate maturity ladders should be used for each currency and capital charges should be calculated for each currency separately and then summed with no offsetting between positions of opposite sign. In the case of those currencies in which business is insignificant, separate maturity ladders for each currency are not required" (paragraph 718(ii)). However, the *Capital Rules* require separate maturity ladders to be used for each currency, even for those currencies in which business is insignificant.

16. Basel requires a 2% capital charge for the specific risk of OTC equity index futures and equity index options (paragraph 718(xxix)), whereas the *Capital Rules* apply an 8% capital charge.

Counterparty credit risk rules

17. Of the three approaches for Counterparty Credit Risk (CCR) available in the Basel framework, only the simplest one (Current Exposure Method) has been adopted in the *Capital Rules*, but disallowing collateral received by banks as margin to reduce the exposure.

Annex 12: List of approaches not allowed by the regulatory framework

The following list provides an overview of approaches that the CBRC has not made available to its banks through its regulatory framework. Where the Basel standards explicitly request certain approaches to be implemented under specific circumstances, the missing approaches have been taken into account in the assessment. However, where the Basel standards do not require jurisdictions to implement these approaches, they have been implicitly treated as "not applicable" for the assessment.

Internal ratings based approach

- Top-down approach for credit risk of purchased receivables and IRB treatment of material dilution risk (Basel II, paragraphs 240–242, 362, 363, 364–365, 366–368, 491, 492–499)
- Double default framework for hedged exposures (Basel II, paragraphs 284(i)-(ii), 307(i)-(ii))
- Recognition of possible constraining availability in EAD for unused committed credit lines under the Foundation approach (Basel II, paragraph 313)
- Within the simple risk weight, the method for equity exposures:
    - 300% risk weight for equity holdings that are publicly traded (Basel II, paragraph 343)
    - Off-setting of long positions by short cash positions and derivative instruments in the same individual stocks held in the banking book (Basel II, paragraph 345)
- Internal models method for equity exposures (Basel II, paragraphs 346–349)
- Internal modelling PD/LGD approach for equity exposures (Basel II, paragraphs 350–355)

Counterparty credit risk

- Internal Modelling Method
- Standardised Method
- Advanced approach for CVA

Market risk

- Intermediate approaches for option positions
- Maturity ladder approach for commodity risk
- Comprehensive Risk Measurement for correlation trading