Another major event which could potentially have a strong impact on Chinese banks and their environment is the new capital accord (Basel II). This is mainly due to the fact that Basel II and the whole risk management framework are at a stark contrast to the current Chinese banking reality.

Ba Shusong¹ (Ba S., 2005b) sees challenges for China with Basel II, ranging from capital and risk management to data and disclosure, as well as organisational structures, incentive compatibility (between banks and regulators), market-oriented supervision and the fostering of financial innovation.

It is necessary to differentiate among three ways in which the impact will be felt: first, the new capital rules will influence bank’s activity when they have to comply with the new standards; secondly, relationships between Chinese banks and other international banks through which they have inter-bank business will also be affected; and finally, the adoption of the new rules will impact on Chinese regulators (Marshall et al., 2005b).

At the level of the bank’s operating environment, a number of challenges appear. The authorities (especially local authorities) will certainly have different incentives from those of the regulators in implementing these reforms. Since social stability is a priority, it is questionable how far reforms can go. It is by no means certain that Basel II will represent a final departure from the usual use of administrative controls rather than laws and regulations. In addition, Basel II could guarantee the end of local authorities’ influence in choosing the banks’ local management. Finally, the recently established CBRC still lacks the human and financial resources as well as sufficient knowledge and experience in bank supervision to fully enforce all the new capital adequacy standards.
The CBRC has clearly stated that it will first concentrate on implementing Basel I requirements and will thus not require Chinese banks to comply with the new Basel II rules for now. “结合国情，积极参照” is the motto (i.e. “according to the national situation, participate actively”, CBRC, 2006a). But because other banks will implement Basel II standards from 2007 onwards and the costs of implementation are expected to be higher in China, CBRC has demanded that Chinese banks slowly edge towards the new rules and start preparing (Ba S., 2005a). Regulators and banks will need to work together in order to spur financial innovation, increase information and transparency, and finally create an effective supervision in credit risk management, where banks have the right incentives to comply with (Ba S., 2005a). If credit risk measurement is set to remain based on Basel I for the time being, pillar 2 on supervisory review and pillar 3 on market discipline (see Annex) will be implemented more quickly in China. The CBRC has received the BIS approval for proceeding in this way.

16.1 Rationale and incentives behind the current implementation schedule

In view of the above mentioned challenges, it is important to review the choices that are available to Chinese regulators and which approach would take into account the current conditions in China. What are their incentives in implementing Basel II and what are the choices?

Because Basel II has no legal force, Chinese regulators can choose whether to implement the standards of the accord. They must decide whether it makes sense and is possible to implement the standards in China. Their decision will also depend on the banks’ external and internal environments.

Liu Mingkang, the Chairman of CBRC, was quoted as saying that Basel II represents “extremely crucial and formidable novel reform practices” (The Asian Banker, 2004b). In his letter to Jaime Caruana (CBRC, 2003), Liu recognises the importance of the new accord and shows his full support for the new developments (CBRC had always closely followed the latest developments and integrated them into new regulations). The position of CBRC is clear: a better risk and capital management in banks would promote economic growth and the stability of the financial system. But Basel II is “both an opportunity and a challenge for the Chinese banking industry” (CBRC, 2003). Thus, in view of the current situation of the banking industry in China, Liu proposes not to officially implement the new accord in full for at least a