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China moves to reduce NPL risk and adopt its own version of Basel III

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China's financial regulatory authorities continue to take action to limit the risk of defaults on bank loans, particularly real estate loans. Meanwhile, China has decided to adopt international bank regulatory standards, unveiling its own version of Basel III in April.

Recent measures to reduce NPL risk

While the Chinese economy has maintained a high growth rate by virtue of RMB4trn of economic stimulus dating back to late 2008, it is also awash in liquidity stemming from monetary accommodation. Chinese M2 grew 27.7% in 2009 and 19.7% in 2010. As of end-March 2011, Chinese M2 had ballooned to RMB75.8trn (approximately US$11.5trn), exceeding US M2 (approximately $9.0trn as of the same date). Meanwhile, outstanding bank loans increased RMB9.6trn in 2009 and RMB8.0trn in 2010. Against such a backdrop, China's financial regulatory authorities have repeatedly warned about risks posed by banks' real estate loans and loans to local governments' "finance platforms[1]." In response, Chinese authorities have recently unveiled a series of measures to ensure banks' operational soundness, some of which are described below.

First, doubts about the quality of loans to local governments' finance platforms emerged as early as 2009. In June 2010, the State Council announced tighter regulatory controls on finance platforms[2]. Finance platform companies that raised funding exclusively for public projects and repaid their obligations mainly with government funding were prohibited from borrowing any further funds. Local governments were instructed to clarify responsibility for these finance platforms' debts, make arrangements to repay the debts, and appropriately wind down the finance platform companies. Finance platforms that raised funding for public projects with stable operating revenues and repay their debts mainly with their own earnings and finance platforms that raised funding for nonpublic projects were to be recapitalized in accord with the Company Law and converted to commercial enterprises with improved corporate governance.

Exhibit. China's new regulatory standards for domestic banks (effective January 1, 2012)

Tightening of Regulatory Controls on CARs	Improvement of Regulatory Controls on Liquidity Risk
Increases capital classifications from two (Tier 1 & Tier 2) to three (core Tier 1 (common equity, etc.), other Tier 1, & Tier 2).	Establishes liquidity-risk management metrics (e.g., liquidity coverage ratio (LCR), net stable funding ratio (NSFR), liquidity ratio, loan-deposit ratio, debt dependence). Of these, the LCR and NSFR must be at least 100%.
Optimizes risk asset calculation methodology and expands scope of risks to be backstopped by capital. Imposes an explicit capital charge for operational risk. Increases risk weights for trading and securitization operations and complex financial instruments (e.g., OTC derivatives).	Transitional period: banks must achieve compliance with the LCR standard by 2013-end and the NSFR standard by 2016-end.
Prescribes minimum core-Tier 1, Tier 1 & Tier 2 CARs of 5%, 6%, and 8%, respectively.	**Tightening of Regulatory Controls on Loan Loss Reserves**
Prescribes a minimum capital conservation buffer of 2.5% and countercyclical buffer of 0–2.5%.	Banks must maintain a minimum loan-loss reserve ratio (ratio of loan-loss reserves to loans outstanding) of 2.5% and minimum NPL coverage ratio (ratio of loan loss reserves to NPLs) of 150%.
Imposes a capital surcharge of 1% (provisional) on systemically important banks (SIBs).	Regulatory requirements imposed on loan loss reserves are to be adjusted dynamically and differentially based on China's economic development stage, quality of banks' loans, and differences in earnings power.
Based on the above, minimum CAR under normal conditions will be 11.5% for SIBs and 10.5% for other banks.	
Leverage ratio: ratio of Tier 1 capital to assets (on-B/S + off-B/S) must be at least 4%.	Transitional period: until 2013-end for SIBs; until 2016-end for non-SIBs with strong earnings power and small loan-loss reserve deficiencies; until 2018-end for other banks.
Transitional period: SIBs must achieve compliance by 2013-end, other banks by 2016-end.	

Source: NRI, based on CBRC documents

This regulatory clampdown on finance platforms is still ongoing. In April 2011, the China Banking Regulatory Commission (CBRC) issued a notice to banks regarding reducing risk and rectifying illegally collateralized loans by modifying the terms of existing loans to finance platforms, provisioning of reserves against losses on nonperforming loans (NPLs), and penalties for loans illegally secured by public assets such as schools or hospitals.

Second, the authorities have tightened regulations on real estate loans channeled through trust companies. Commercial banks entrust customer funds to trust companies, which invest the funds as a trustee. With the regulatory authorities tightening restrictions on bank lending in 2010, some of these entrusted funds were used to fund loans for real estate projects, circumventing restrictions on banks' real estate loans[3].

From standpoint of risk prevention, the CBRC has issued notices regarding such bank-trust cooperative ventures. First, in August 2010, the CBRC issued a notice (1) limiting loans and other funding instruments' share of bank-trust co-managed assets to a maximum of 30%, (2) mandating that commercial banks move on to their balance sheets in 2010–11 any off-balance-sheet assets of their bank-trust cooperative ventures, and (3) requiring loan-loss reserves equivalent to a minimum of 150% of NPLs[4]. In 2011, the CBRC issued another notice (1) instructing banks, as a general rule, to move their bank-trust cooperative ventures' off-balance-sheet assets on to their balance sheets at a rate of 25% per quarter, (2) requiring banks to hold a supplemental capital cushion equivalent to 10.5% of their bank-trust cooperative ventures' trust loans yet to be moved on balance sheet, and (3) prohibiting trust companies from paying dividends if their loan loss reserves are below 150% of their bank-trust cooperative ventures' nonperforming trust loans or less than 2.5% of cooperative ventures' total trust loans outstanding[5]. In parallel with these notices, the CBRC also issued a warning about the risk of trust companies' own real estate trust businesses in November 2010[6].

China to adopt its own version of Basel III

In addition to the above regulatory measures in response to risks that have already manifested, it is noteworthy that China, which had been preparing to adopt the Basel II and III regulatory regimes, has decided to proactively adopt its own version of Basel III.

Following last December's release of the text of Basel III, the CBRC issued Guiding Opinions on the Implementation of New Regulatory Standards in China's Banking Industry (the "Guiding Opinions") on April 27, 2011. The Guiding Opinions set standards for Chinese domestic banks with respect to their capital adequacy ratios (CAR), leverage ratios, liquidity, loan-loss reserves, and other such matters in light of domestic circumstances (see Exhibit). The standards are to be phased in over a transitional period beginning January 1, 2012.

China's core-Tier 1 (common equity, etc.) ratio is 50 basis points higher than Basel III's corresponding ratio, reflecting that Chinese banks already meet a core-Tier 1 standard of 4.5%. Additionally, the CBRC had been phasing in new regulatory controls, including CAR regulations, since 2010 in response to developed countries' post-crisis financial regulatory reforms. Concepts of dynamic adjustment (e.g., dynamic provisioning) and differentiation (e.g., target-setting that varies as a function of individual banks' risks) that were incorporated into these new regulatory controls were carried over to the new regulatory standards also.

According to the Guiding Opinions, international bank regulatory standards will apply even in China from 2012, when China's newly announced regulatory standards will take effect.

This is of great significance in terms of China's plans to internationalize the renminbi and further liberalize its capital account. As China proceeds with capital account liberalization, exchange rate (i.e., RMB/USD rate) volatility will inevitably increase. Meanwhile, China will likely liberalize interest rates in parallel with capital account liberalization, as Japan did in the 1980s. Looking ahead, Chinese banks, which currently earn stable net interest margins of around 300 basis points, will be exposed to exchange rate and interest rate volatility and have more difficulty making money.

China's new regulatory standards should enhance Chinese banks' international competitiveness by increasing their risk resilience and prompting them to evolve beyond business models predominantly predicated on unrestrained quantitative expansion.

Note

1) Finance platforms are independent corporations established by local governments to finance public investment projects. Bank loans to finance platforms increased sharply in response to economic stimulus policies.

2) As of end-November 2010, outstanding bank loans to finance platforms totaled RMB9.09trn, of which RMB1.77trn is reportedly at risk of default (Securities Daily, April 19, 2011).

3) Bank-trust cooperative ventures assets' totaled RMB1.53trn as of end-March 2011. Trust companies' real estate loans made in 2010 totaled RMB286.4bn (flow basis).

4) CBRC Notice on Regulating Relevant Matters Concerning the Wealth Management Cooperation between Banks and Trust Companies (August 12, 2010).

5) CBRC Notice on Further Regulating the Wealth Management Cooperation between Banks and Trust Companies (January 13, 2011). Additionally, the Chinese media reported that the People's Bank of China (PBoC) also imposed a requirement that trust companies deposit reserves equivalent to 150% of their new self-funded loans in special (non-interest-bearing) accounts at the PBoC (Shanghai Financial News, April 8, 2011).

6) CBRC Notice on Risk Alert for Property-Related Trust Businesses.

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