Global regulatory norms after the crisis: The case of China and Basel standards

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Abstract

Are emerging great powers also regulatory revisionists? This question has become especially pertinent due to two main consequences of the global financial crisis since 2007: first, the decreased legitimacy of the existing global regulatory order, and second, the entry of major emerging countries into the key global standard-setting organizations. The Basel Committee on Banking Supervision, perhaps the most important of these organizations, is confronted with a vast new reform agenda and a greatly expanded membership. The prospects for global regulatory cooperation thus depend considerably on the attitudes of the most important newcomers, the most pivotal of these being China. So far, however, China’s position on banking regulatory reform has been cautiously supportive of a regulatory regime that retains a strongly western orientation. I argue that this position – in marked contrast to China’s attitude towards the dollar-based international monetary system – is a product of two main factors: it does not have negative international distributive consequences, and it serves the purposes of domestic economic reformers.


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The future of global financial regulatory cooperation is today very open and uncertain. The continuing global financial crisis since 2007 has substantially weakened the perceived effectiveness and legitimacy of western financial regulatory standards – notably those agreed and disseminated by the Basel Committee on Banking Supervision (BCBS) – and there has been only limited concrete progress to date on their reform. At the same time, the crisis has brought major emerging countries, hitherto on the sidelines of global standard setting, into the core global institutions responsible for coordinating global approaches to financial regulation. On the face of it, this combination would seem to be a recipe for regime collapse.

There is no consensus in the international political economy literature on whether such collapse is inevitable. To oversimplify, there are three longstanding traditions in this literature that speak to this question: realist, neoliberal, and constructivist. The realist position is that international regimes are always established by dominant great powers for their own benefit rather than those of others, so that as the relative power of other states increases, challenger states typically seek to modify regimes in their favour – rising conflict and regime collapse are thus likely (Gilpin 1981). The neoliberal view is more optimistic, encapsulated by Keohane’s (1984) argument that international regimes have public goods qualities that may permit them to withstand large shifts in the balance of international economic power (they can provide net benefits to all countries by reducing
transactions costs, facilitating policy transparency and deterring cheating). Finally, a constructivist position was elaborated by Ruggie (1982), who argued that changes in the distribution of international power can be less important than the creation and maintenance of a domestic and international consensus on underlying regime norms.

In this paper I investigate China’s attitudes towards Basel norms and rules and its position on financial regulatory reform. I argue that these attitudes are more supportive of the regime than the realist view would lead us to expect, but not for the reasons that the neoliberal view provides. The Basel regime is strongly perceived in much of the developing world to have been written by westerners for western financial institutions, but it can still provide substantial perceived net benefits for emerging countries such as China. This is not because it reassures Chinese banks and regulators that others are not cheating, but rather precisely because it permits most countries to be very selective in how they apply international rules to their banks. Implementation is often very difficult for outsiders to assess, enforcement mechanisms have been lacking, and substantial cheating by many countries has not been a major obstacle to their adoption and implementation elsewhere. For reformers, international regimes such as Basel can provide them with leverage in the domestic struggle over economic reform, a factor that “structural” realism and neoliberalism ignore. This also points to the still limited domestic consensus within China on key Basel norms, ongoing contestation among domestic interests and political actors, and the willingness of key policymakers to use

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1 Later, more regime-specific accounts in this rationalist tradition accorded a greater role to the net benefits that could be achieved by important domestic actors (industry groups, politicians, and regulatory agencies), but were more agnostic on the question of whether international regimes would survive large shifts in the balance of international power and influence (Oatley and Nabors 1998; Kapstein 1994; Singer 2007).

2 What I have termed elsewhere “mock compliance”: see Walter (2008).
norms strategically as part of an ongoing and very gradual process of domestic convergence. In fact, as we shall see, there is a low degree of Chinese adherence to one of the three main norms that I identify, and a cautious if supportive attitude to the rest. This also points to a middle ground between interest-based and constructivist accounts of international regimes and their associated norms and standards. It also suggests that achieving a new and broader international consensus on reforms to the Basel regime will be time-consuming and difficult.

The rest of this paper is structured as follows. The next section outlines the development of the Basel regime since the early 1970s and identifies its main norms and associated standards. Section 2 summarizes China’s evolving relationship with the Basel regime, which has become increasingly close since the mid-1990s. Section 3 focuses on how we can explain this evolving relationship.

1 The Basel regime

The dilemmas posed by the emergence of cross-border capital flows and global financial firms since the 1960s are emblematic of the difficulties posed in a hybrid global order that had been predicated on national financial regulation and supervision. Financial globalization has been associated with periodic crises of growing frequency and with important cross-border dimensions, prompting efforts to coordinate regulatory approaches. The major developed countries dominated these efforts. They possessed the largest and deepest financial systems and were also the primary beneficiaries of financial

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3 For a similar argument, see Hurd (2007).
4 Regulation is the process of rule-setting, whereas supervision refers to the process whereby agencies monitor actor compliance with behavioural rules and norms. Throughout, I often use ‘regulation’ as shorthand for both.
integration. The G7 countries were the most important participants, though the slightly larger G10 grouping that established the Basel Committee on Banking Supervision (BCBS) in 1974 was the primary forum for coordination efforts. From that time, the BCBS provided the primary forum in which regulators from the major countries met to agree principles and standards for banking regulation and supervision. Its country composition reflected the heavy European bias of the G10, a bias that was later reinforced when Luxembourg and Spain were added to the group.

Along with many other public and private international bodies, the BCBS elaborated a growing body of voluntary international standards concerning supposed best practice principles for financial regulation and supervision. Although this international standard-setting process has for some time been fairly technocratic and hidden from public view, it has become increasingly central to global economic governance. After the recent global financial crisis, the reform of Basel standards rose to the very top of the global economic governance agenda.

The activities of the BCBS can be seen as motivated by an attempt by national authorities in the most financially developed countries to deal with the regulatory and supervisory consequences of the globalization of the banking sector. An early objective was to ensure that offshore branches of member country banks operating in the Euromarkets did not escape adequate supervision, leading to the Basel “Concordat” of 1975 (Davies and Green 2008: 35).

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5 The G10 countries were in fact eleven: Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States.
The main work of the BCBS, however, has been negotiating and agreeing voluntary standards on minimum bank capital rules. Over time, the increase in global banking activity raised concerns that large national variations in bank capital requirements were producing two significant problems: competitive inequalities in global capital markets, and the potential for a regulatory ‘race to the bottom’ in which financial business gravitated towards the least stringently regulated jurisdiction. The particular problem for US and some European banks and regulators in the 1980s was Japan’s relatively lowly capitalized banks, which were less affected than their western counterparts by the Latin American debt crisis in the 1980s. The US Congress was concerned to increase the capital of money centre banks who were highly exposed to Latin American governments, not least to demonstrate that large IMF loans to these governments did not amount to an indirect bailout of Wall Street by American taxpayers (Singer 2007: ch.4). US regulators and banks were reluctant to accept significantly higher minimum capital requirements unless similar requirements were also adopted by regulators in competitor jurisdictions, including Japan (Kapstein 1994; Oatley and Nabors 1998; Reinicke 1995; Tarullo 2008: ch.3). To resolve this political dilemma, the senior US money centre bank regulator, the Federal Reserve (Fed), first negotiated a new bilateral capital standard with the Bank of England. These two authorities then effectively threatened to deny non-compliant banks from other jurisdictions access to the key financial centres of New York and London, encouraging their Japanese and other BCBS

6 In general terms, regulatory “capital” is the minimum amount of “risk capital” that banks must hold to conduct business – often, as we shall see, this is defined as shareholders’ equity (or “quasi-equity” capital).
counterparts to agree a modified version of the US-UK deal. This became known as the Basel Capital Adequacy Accord, or “Basel I”.

The central component of this accord was that all internationally active banks headquartered in Basel Committee countries should hold capital to the value of at least eight percent of their “risk-weighted” assets by the end of 1992. There were two basic objectives: “to strengthen the soundness and stability of the international banking system” and “to have a high degree of consistency in its application to banks in different countries with a view to diminishing an existing source of competitive inequality among international banks” (BCBS 1988: 1). Regulators were unable to offer a clear rationale for an eight percent minimum capital adequacy ratio (CAR), but according to some experienced practitioners it “was judged to be the kind of level that would allow well-run banks to stay out of trouble most of the time” (Davies and Green 2008: 38). Continuing uncertainties about appropriate levels of bank capital meant that regulators in the major financial centres usually encouraged banks to hold capital above the Basel minima (McDonaugh 1998a).

The two main norms of the Basel framework were thus: first, minimum capital requirements for internationally active banks to ensure reasonable system stability and second, common implementation of these minima across the major economies to ensure

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7 Defining capital was highly contentious but eventually achieved by a political compromise between those (e.g. Germany) who preferred a narrow equity-based definition and those (e.g. Japan) who wished to include other non-equity instruments. To satisfy the former, it was agreed that “Tier 1” (essentially equity) capital had to be at least 4% of total risk-weighted assets. Basel I also used a very blunt approach to risk determination by assigning risk weights ranging from 0% to 100% to broad categories of assets (e.g. the debt of OECD governments attracted a 0% risk weighting, credit lines with a maturity of more than one year 50%, and all corporate loans 100% irrespective of the condition of the borrower). Off-balance sheet commitments were also included.
approximate competitive equality. These norms were agreed explicitly only by BCBS regulatory representatives and the associated capital standards were intended to apply mainly to their own internationally active banks. But as the G10 countries represented a very large proportion of all international financial activity and then comprised the world’s three major international financial centres (New York, London and Tokyo), Basel standards became, by default, global standards and spread rapidly in the 1990s. Banks wishing to establish branches in the major global financial centres were effectively barred from doing so if their home countries were not reasonably Basel-compliant; the more costly alternative for banks from non-compliant countries was to establish separately capitalized local subsidiaries. Network effects increased the incentives of both governments and domestic banks to adopt Basel standards: that is, the more jurisdictions that adopted them, the greater the reputational costs for non-convergent actors. 8 Many countries, notably in the EU, also applied the capital rules to all their banks, not just internationally active ones. Inevitably, given the increasingly global reach of Basel standards, some non-member countries felt that the Committee’s narrow membership raised concerns about its representativeness and legitimacy. The BCBS deflected such arguments by pointing out that its membership encompassed the bulk of global financial activity and that Basel standards were voluntary; implementation even for members was on a “best efforts” basis.

Paradoxically, as Basel I spread globally, support for it among banks and regulators in the most advanced financial centres waned considerably. The Basel Committee had always intended that the accord would be periodically updated to reflect

8 Substantive behavioural convergence was another matter, however (Walter 2006b, 2008).
changes underway in the banking system (McDonough 1998a), but it underestimated the practical difficulties of achieving this. The major global banks felt that Basel I was increasingly inappropriate and constraining given the rapid expansion of trading in financial assets, of securitization, ⁹ and the development of new sophisticated internal risk management models. Basel risk weights were very crude and produced regulatory capital requirements that diverged substantially from these banks’ own judgements about the desirable level of “economic capital”, or the amount of capital they would set aside for each asset depending on their estimates of its riskiness. Regulators in the major international financial centres, particularly in New York and London, largely accepted this critique and argued that sophisticated banks should be permitted greater scope to manage their own risks. Officials at the US Federal Reserve in particular openly argued that financial innovation had made Basel CARs increasingly less meaningful (Tarullo 2008: 88). Crude risk weighting, by opening up a large gap between regulatory and economic capital, also encouraged banks to engage in regulatory arbitrage by issuing new financial products aimed at minimizing required capital. ¹⁰ Alan Greenspan, US Fed Chairman since 1987, argued as early as 1994 that the old approach to financial regulation, exemplified in Basel I, needed to give way to a new approach in which financial institutions would be largely “self-regulated”, a view he says most Fed officials

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⁹ Securitization refers to the process of pooling assets (such as mortgages or corporate loans) and issuing new securities – which can be sold and traded – backed by the cashflows that accrue to the pool.

¹⁰ The best examples were the rapid development of the collateralized debt obligation (CDO) and credit default swaps (CDS) markets from the late 1990s. These allowed banks to remove capital-costly loans from their balance sheets and to insure those that remained on-balance sheet (with the agreement of regulators in advanced countries, such insurance also reduced capital requirements). See McDonough (1998a and 1998b) and Tett (2009).
shared. By self-regulation, Greenspan meant greater reliance on both internal bank controls and external monitoring by third party creditors facilitated by greater transparency about internal risk management processes (Greenspan 2007: 489-92).

The first victory of this major bank and regulator coalition was the Market Risk Amendment (MRA) to Basel I in 1996. Trade organizations such as the American Bankers Association (ABA) and the Institute of International Finance (IIF) lobbied strongly in the mid-1990s for regulators to permit the use of quantitative “value-at-risk” (VaR) models to calculate “market risks” and hence capital requirements on their trading books (where banks held assets for short to medium term trading purposes rather than holding the assets to maturity). The Fed, led by Greenspan and other senior officials, promoted the argument for VaR within the BCBS despite the initial skepticism of other BCBS members (Tarullo 2008: 63ff). Residual skepticism was, however, sufficiently strong for the BCBS to apply a “multiplication factor” of three times the bank’s estimated VaR for purposes of capital calculation.

For the major banks and regulators, the MRA was insufficient to rectify the fundamental shortcomings of Basel I because it left the system of capital calculation for credit (i.e. default) risks untouched. Major banks and regulators who favoured a move towards market-based regulation thought that the principle behind the MRA should be extended to credit risks as well. In June 1998, Federal Reserve Bank of New York (FRBNY) President William McDonough took over as chair of the BCBS in June 1998, 

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12 VaR models calculate the probabilistic risk of loss on a given portfolio of assets in a particular trading period. “Market” risk on trading portfolios stemmed from movements in the prices of these assets.
so the Fed was in a stronger position to get its way.\textsuperscript{13} The following month the BCBS agreed to launch a major review of the Basel capital accord. McDonaugh’s view was that “the development of credit risk modeling [ought] to be the catalyst for a complete rethinking of the theory and practice of credit risk management” (McDonaugh 1998a). A revised Basel framework specifically should:

\begin{quote}
…include an approach to quantitative capital requirements that offers the possibility of translating our expectations for all types of financial institutions across countries; integrating the quantitative capital requirements with a set of qualitative expectations for banks in managing their risk and evaluating their capital needs; and relying as much as possible on market discipline, with emphasis on transparency and disclosure” (McDonaugh 1998b).
\end{quote}

The Basel Committee recognized that heavy reliance on internal risk management models was only appropriate for the most sophisticated banks. For the less sophisticated, the Committee proposed a revised “standardized approach” to capital calculation that would use the third party credit ratings for borrowers provided by credit ratings agencies to determine appropriate credit risk weightings for most assets. It also proposed a new capital charge for “operational” risk (the risk of loss from failures in processes, people or systems) to apply to all banks, as well as enhanced market discipline via greater bank transparency (BCBS 1999). In addition, it suggested tentatively that “for some sophisticated banks…an internal ratings-based [IRB] approach could form the basis for setting capital charges” (BCBS 1999: 5). Some international banks and the IIF criticized this initial proposal as insufficiently radical, but Greenspan and McDonough emphasized

\textsuperscript{13} The FRBNY is the primary regulator of the major US money centre banks based in New York.
that they needed to work with the BCBS to develop these proposals further. By mid-2000, advocates of a generalized move to an IRB approach seemed to have gained the upper hand in the Committee (Tarullo 2008: 99, 103-4). However, a second consultative proposal of January 2001 satisfied few constituencies in the private or the public sector, propelling the Committee into a complicated, iterative process of gathering public comments, conducting impact assessment exercises, discussions with banks, and internal re-negotiations and calibrations.

Six years after the process of revision was launched, the BCBS announced agreement on a revised capital framework, commonly called Basel II. It provided a menu of three different approaches to capital calculation in “Pillar 1” of the agreement (BCBS 2004: Part 2). The first option in Pillar 1 was the Advanced IRB approach (“A-IRB”), which made substantial use of banks’ own internal models for the calculation of credit and operational risks. The second option was a simpler “foundational” (F-IRB) approach, which envisaged greater input from supervisors on credit loss exposures. The third, most basic option was a “standardized” approach closer to Basel I but which encouraged the use of external credit risk ratings to assign risk weights for credits to governments, firms and other banks. Pillar 2 of the new accord provided supervisors with the tools and responsibility to review banks’ overall risk management processes and strategy and to levy additional discretionary capital charges on banks deemed to have sub-optimal internal risk management frameworks. Pillar 3 aimed to promote market discipline as a complement to internal risk management and supervisory review via a set of disclosure requirements intended to allow market participants better to assess a bank’s risk profile against its capital.
The shift from Basel I to Basel II thus reflected, albeit imperfectly, an emergent third norm of greater reliance on market self-regulation that had begun to take hold in the early 1990s. This third norm was promoted vigorously by key actors in the US Fed, with support from regulators in the UK and much encouragement from large complex financial institutions themselves. It was strongly associated with the growing faith in the self-stabilizing nature of deregulated financial markets, something that Greenspan, during this period the world’s most influential central banker and bank supervisor, had long accepted. It also reflected the view that a greater reliance on market mechanisms could promote efficiency and stability simultaneously – indeed, that there was no substantive trade-off between these two objectives. It should be noted that the primary emphasis of Basel II was to encourage more sophistication in risk assessment and management; the definition and level of required capital in Basel I was retained, demonstrating considerable inertia in this key component of the framework.

The growing strength of this new norm was reflected in the Basel Committee’s preference for the A-IRB approach to capital calculation. The two other options were intended to apply to less sophisticated banks and, by implication, to most developing countries. Those regulators favouring greater reliance on market-based regulation had argued that Basel II should provide incentives for banks and regulators to move towards the IRB approach over time. This accorded with the demand by some major banks that they should be permitted to hold less capital if their internal models demonstrated that this was both efficient and safe. More cautious regulators felt that overreliance on banks’ internal models might be dangerous. A built-in incentive for banks and regulators to migrate towards an IRB approach was also inconsistent with the norm of establishing a
level competitive playing field. In developed countries, including notably in the US and Germany, smaller banks argued that this would give an unfair advantage to larger competitors.

For developing countries generally, there was a concern that if Basel II favoured advanced country banks it would inhibit their overall financial and economic development (Powell 2004). Even the “basic” standardized approach was evidently developed for G10, not developing country banks, and would involve major implementation costs and the additional capital charge for operating risk at a time when many developing countries were still in the process of adopting Basel I. Its emphasis on the use of external ratings also seemed to ignore the widespread criticisms of the performance of ratings agencies in recent emerging market crises, as well as the small number of developing country banks and firms with credit ratings. Finally, many countries feared that Basel II would raise the capital cost of international bank lending to emerging markets.

The final outcome reflected a balance between these competing arguments, though Basel II reflected the growing importance of the third norm of market self-regulation.14 Pillar 1 retained the minimum eight percent CAR of Basel I and the basic definition of eligible capital, implying a floor to capital relief for sophisticated banks (BCBS 2006: 12). Even the A-IRB approach compromised on a pure IRB model by requiring banks to use their internal models to calculate inputs to the Basel Committee’s own regulatory model (Herring 2007: 415-416). However, Pillar 2 permitted supervisors

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14 Basel II also turned out to be a great deal more complex and prescriptive than its main proponents had initially hoped. One indication of this is that while Basel I (as updated through 1998) was only 25 pages long, Basel II reached 239 pages by June 2004 and 333 pages in its more comprehensive version of June 2006; it continues to grow.
on a discretionary basis to provide some capital relief to the most sophisticated banks. It explicitly aimed “to encourage banks to develop and use better risk management techniques in monitoring and managing their risks” (BCBS 2004: 158). Pillar 3’s promotion of market discipline was intended to incentivize banks to improve internal risk management processes and to migrate towards the IRB approach over time. The potential that Basel II would favour more sophisticated banks therefore remained. This substantially politicized both the negotiation and the implementation process in the US, but, as we will see, much less so in China.

It was also unclear whether Basel II could achieve similar levels of global adoption to Basel I. The new agreement was greeted without enthusiasm in much of the developing world; many developing countries were still in the process of implementing Basel I and saw the new approach as inappropriate to their circumstances. The BCBS had made some efforts to increase the perceived input legitimacy of the revised agreement by publishing its initial proposals and asking for comments from interested parties from all countries. The Core Principles Liaison Group (now the International Liaison Group or ILG) was also established to improve consultation with non-members, though it included only a few emerging market countries. Even within this group, the extent of real consultation was narrow and focused heavily upon implementation issues.\footnote{These countries consisted of Argentina, Brazil, Hungary, India, Indonesia, Korea, Malaysia, Poland, and Singapore. The expanded ILG consisted of representatives from France, Germany, Italy, Japan, the Netherlands, Spain, the United Kingdom and the United States, 16 non-Basel Committee members (Argentina, Australia, Brazil, Chile, China, the Czech Republic, Hong Kong, India, Korea, Mexico, Poland, Russia, Saudi Arabia, Singapore, South Africa, and the West African Monetary Union), the European Commission, the International Monetary Fund, the World Bank, the Financial Stability Institute, the Association of Supervisors of Banks of the Americas, and the Islamic Financial Services Board.}
On the eve of the 2008 global financial crisis, the core norms of the Basel framework were thus threefold. The first norm was that financial stability should be promoted in an increasingly integrated world economy through international agreement on supervisory responsibility and core prudential standards. The second norm was that prudential standards should be harmonized where possible to ensure that regulation was not a major source of competitive inequality. The third norm was that financial stability could be best promoted by increased reliance on market-based regulation, both within firms and in the financial marketplace more generally.

There have always been tensions and tradeoffs between these norms. Basel I in reality paid more attention to achieving rough competitive equality than to promoting financial stability (FSA 2009: 55). Basel II reflected a desire to tilt the regulatory framework in favour of relatively sophisticated international banks without significantly changing the total amount of required capital in the banking system. The third norm was the last to emerge, achieving growing prominence in the Basel framework from the mid-1990s, though it was always more contested than the first two norms. After the global financial crisis of 2008, which revealed serious failures of risk management in some of the world’s most sophisticated banks, it became widely seen as incompatible with the stability norm. The most famous expression of these new doubts was provided by Alan Greenspan in his testimony to Congress in October 2008, when he said that recent events had revealed “a flaw” in his philosophy: “Those of us who have looked to the self-interest of lending institutions to protect shareholders’ equity, myself included, are in a
state of shocked disbelief.” Adair Turner, Chairman of the UK’s Financial Services Authority (FSA), also testified in early 2009 to a Parliamentary committee that “before the current crisis prompted a deep rethink of regulation, FSA staff had not considered whether banks’ business models were sufficiently robust because the watchdog had left that to industry and did not consider that its job”. 17

This rethink prompted a re-examination of the Basel framework. There is now a broad consensus that both Basel I and II permitted excessive levels of financial leverage18 and left banks seriously under-capitalized, unable to withstand the kind of systemic loss of confidence that occurred in late 2008. 19 The retention of the Basel I capital definitions in Basel II reflected considerable complacency amongst regulators and banks as the latter engaged in extensive regulatory arbitrage (sometimes openly abetted by regulators themselves), as leverage in the sector increased, and as the securitization trend accelerated. The risks that became concentrated in banks’ trading books were poorly accounted for by VaR models and capital requirements were especially thin in this area. The framework’s focus on capitalization also placed insufficient emphasis on bank liquidity and leverage (FSA 2009). These were indictments of Basel I as much as Basel II; indeed, Basel II was not fully implemented in many countries before the crisis and so

18 Financial leverage is generally defined as the extent to which an entity borrows to purchase assets, though in the financial sector it is often defined as an entity’s total liabilities (or total assets) as a proportion of shareholders’ equity (or the reverse of this ratio).
cannot easily be blamed for it. But the crisis also cast considerable doubt on the basic rationale and approach behind the MRA and Basel II because it revealed that market participants, not just regulators, were unable to determine appropriate levels of capitalization, liquidity and leverage over the cycle. The framework’s growing reliance on market assessments of financial risk even amplified the credit cycle, since market actors demonstrate a systematic tendency to underestimate risk during periods of financial stability (Brunnermeier et al. 2009). This meant that an element of destabilizing “pro-cyclicality” was built into MRA and Basel II-style capital requirements.

Although the crisis therefore placed the third norm of market self-regulation in considerable doubt, it reinforced the priority of the first norm that financial stability should be pursued through international regulatory harmonization. In London in April 2009, G20 leaders agreed:

- to establish the much greater consistency and systematic cooperation between countries, and the framework of internationally agreed high standards, that a global financial system requires. Strengthened regulation and supervision must promote propriety, integrity and transparency; guard against risk across the financial system; dampen rather than amplify the financial and economic cycle; reduce reliance on inappropriately risky sources of financing; and discourage excessive risk-taking.  

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20 As discussed below, Basel II had not been implemented in the US and China; in the EU, it was implemented for most banks from the beginning of 2008.
In this new climate, lingering support for the view that the Basel framework should provide capital relief to the most sophisticated banks (which are often also the largest and most global) had evaporated – on the contrary, many proposals would require the largest and most complex banks to hold more capital than average so as to reduce the risk to taxpayers. As the balance shifted back to the first norm, however, concerns in the banking sector and among governments about the need for approximate competitive equality re-emerged.

Both of these developments ensured that although the legitimacy of the Basel framework was in some doubt by late 2008, the BCBS itself proved indispensable. Under pressure from G20 leaders, the Basel Committee initiated a “comprehensive strategy” aiming to rectify the serious weaknesses in the Basel framework. This included considerably higher capital requirements for credit and market risks, a reversal of the pro-cyclical bias of the framework, higher quality capital (meaning more common shareholders’ equity rather than “hybrid” capital), and the generalized introduction of simple prudential leverage and liquidity ratios as backstops to a complex risk-weighted capital framework. The BCBS envisaged that these more stringent requirements would be agreed by the end of 2010 and phased in gradually so as not to hamper economic recovery, but achieving general implementation by the end of 2012. In London in April

22 How much higher remained a matter of debate as of mid-2010, but the BCBS had already agreed in mid-2009 to impose substantially higher capital requirements on riskier activities such as trading and securitization exposures (BCBS 2009a, 2009b).

2009, the G20 also placed the Financial Stability Board (FSB)\textsuperscript{24} in a more prominent position of coordinating and monitoring progress in regulatory standard setting.

But in spite of this broad agreement on the necessary direction of reform, many crucial and controversial details remained to be negotiated. So does another consequence of the crisis, the increased economic and political diversity within the BCBS itself. In June 2009, all remaining G20 countries were given full BCBS membership.\textsuperscript{25} This meant that for the first time countries with very different levels of financial development and regulatory/supervisory capacity would be negotiating the details of the new proposals. The very different post-crisis economic trajectories of the major developed and developing countries adds to the difficulty of achieving consensus, as concerns about the competitive and macroeconomic impacts of the new proposals are multiple and widespread. Even among the most advanced countries, there were signs of growing unilateralism in financial reform, which threatened to undermine the G20 commitment to coordinate new financial regulation: new bonus taxes in the UK and France, proposals from the US administration for a bank financial levy that would penalize large, risky banks, and a ban on banks engaging in proprietary trading, and a ban on the short selling of bank shares by Germany.\textsuperscript{26} In short, even though the two core norms of the Basel

\textsuperscript{24} The Financial Stability Forum was established by G7 finance ministers and central bank governors in 1999. In April 2009 it was renamed the FSB after an agreement at the G20 London summit.

\textsuperscript{25} The BCBS initially agreed in March 2009 to expand its membership to a handful of mainly large emerging market countries (Australia, Brazil, China, India, Korea, Mexico and Russia). This limited expansion soon proved politically unsustainable and only three months later it announced that it would open membership to all other countries in the G20 (this added Argentina, Indonesia, Saudi Arabia, South Africa and Turkey. See BCBS, “Basel Committee broadens its membership”, 10 June 2009, http://www.bis.org/press/p090610.htm, accessed October 15, 2009).

\textsuperscript{26} “Big banks in call for greater coordination”, \textit{FT.com}, 26 January 2010.
framework remain intact, the details of global banking regulatory standards are likely to remain in flux for some time to come.

2 China and the Basel framework

For most of the reform period, the Basel framework was largely irrelevant for China, with its state-controlled and domestically-oriented banking system. China’s level of financial development – although relatively high compared to many countries at similar levels of economic development – remains much lower than that of the G7 countries. Its financial system is also relatively bank-dominated and substantially less open than many other major developing countries, with the large state-owned banks playing a central role (McKinsey Global Institute 2009: 27-9; Barth et al. 2007). These banks are also primarily domestically-oriented, in sharp contrast to the more sophisticated and increasingly internationalized G10 banks on which the Basel framework has been heavily focused.

From the mid-1990s, however, the Chinese leadership began to see the Basel framework as a useful set of benchmarks for reforming the highly inefficient and mostly insolvent domestic banking sector. In contrast to the US, competitiveness issues were not initially an important motivator for China’s growing convergence with the Basel framework. Instead, Basel became a useful source of political leverage for reformers wishing to clean up and modernize China’s banking system, since they faced powerful vested interests that resisted financial sector reform.

China signaled that it would follow the broad trend among developing countries to adopt the Basel framework in its acceptance of the minimum eight percent CAR in
article 39 of the law of the People's Bank of China (PBOC) of 1995 (Brehm and Macht 2004: 322). This was relatively late by the standards of some other East Asian countries, but the delay was unsurprising given the relatively underdeveloped state of China’s banking system and regulatory infrastructure. Nevertheless, by this stage the costs of adoption of the Basel framework for the government and for Chinese banks were limited. The voluntary nature of the Basel framework permitted substantial autonomy in the process of implementation. China’s financial system was dominated by large, state-owned banks and most of the focus of reform – and on the implementation of the Basel framework in particular – was on these large banks rather than on the thousands of smaller rural and city banks. At this stage, no Chinese banks had significant international operations – in this sense, the Chinese government, like those of many developing countries, went beyond the Basel framework, which applied only to internationally active banks. The Basel framework also permitted the Chinese government to maintain control over its banking system and to continue to prevent significant foreign competition for Chinese banks. For the banks themselves, adoption was acceptable because the enforcement of the new rules and of related loan accounting and other standards was weak (Brehm and Macht 2004, Brehm 2008).  

The central bank was also the main regulator until 2003, and its approach reflected the relatively low priority placed by the government on prudential regulation in the high growth era. Over time, rapid growth

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27 This was also consistent with another trend in developing Asian countries (Walter 2008).
28 For an analysis of the damaging relationship between factional politics and the tendency of the Chinese system to create large amounts of bad loans, see Shih (2008). On the eve of the Asian financial crisis in mid-1997, the level of nonperforming loans in the Chinese banking sector was among the highest in Asia despite China’s exceptional growth performance. The political elite had required the banking system to bear much of the burden of the restructuring of state-owned enterprises (SOEs). The banks were relieved of existing NPLs in the mid-1990s and had capital
allowed the government to recapitalize the major banks to push them above the minimum Basel capital ratios – though it took until the end of 2008 for almost all Chinese banks to meet this minimum standard.

The initially limited approach to the implementation of Basel standards began to change in the late 1990s as the restoration of the solvency of China’s major banks became a key leadership priority. Zhu Rongji, who became Premier in March 1998, launched a series of financial reforms that indicated a stronger intention to adopt and implement Basel standards. The first phase of reform focused on the recapitalization of the major state-owned commercial banks (SOCBs) and the disposal of their high levels of nonperforming loans (NPLs). The second phase, from 2003, focused on the reorganization of these banks, the adoption of modern management practices, new governance structures, and foreign share listings (Luo 2008). Recapitalization was premised on a greater willingness to enforce the minimum eight percent CAR for the major banks. New rules on loan classification similar to those being adopted elsewhere in Asia were also introduced in 1998, and new accounting and loan loss provisioning rules were introduced in 2001 and 2002 respectively (Angklomkiew et al. 2009: 73-4).

Wen Jiabao continued this reform path from 2003. The creation in 2003 of the China Banking Regulatory Commission (CBRC), which took over from the PBOC as China’s principal bank regulator, was intended to force China’s banking system onto a more commercial footing so as to ensure that it was no longer the Achilles heel of the

injections from the PBOC, but efforts to encourage them to move to a more commercial, profit-oriented footing largely failed.
economy.\textsuperscript{29} The law establishing the CBRC drew heavily on the Basel Core Principles for Effective Banking Supervision, of which the capital adequacy regime is one part, and from other rules prevailing in the advanced countries, especially the US. The composition of the CBRC’s International Advisory Council is also intended to send a strong signal of the regulatory authorities’ intentions to converge upon what at the time were essentially western standards of banking regulation and supervision.\textsuperscript{30}

Hong Kong, a relatively sophisticated financial centre with one of the most westernized approaches to financial regulation in the region, was an important source of regulatory innovation for the mainland during this phase. Andrew Sheng, the former Chairman of the Hong Kong Securities and Futures Commission, played an important role as convener of the CBRC’s International Advisory Board (now \textit{Council}) and later became the CBRC’s chief advisor. David Carse, former chief executive of the Hong Kong Monetary Authority, also became a member. For the major SOCBs themselves, Hong Kong listings were an important step in their internal reorganizations and gave them access to foreign capital and managerial expertise. At the same time, the mainland Chinese authorities retained the flexibility to implement Basel and other international standards at a more gradual pace than Hong Kong, including for the SOCBs.

\textsuperscript{29} The PBOC retains a substantial supervisory role so that the Chinese model in this respect occupies an intermediate position between the US and UK systems.

\textsuperscript{30} In 2007, members of this advisory body were: Jaime Caruana, Director, IMF Monetary and Capital Markets Department and former Chairman, BCBS; Gerald Corrigan, Managing Director, Goldman Sachs and former President, FRBNY; Andrew Crockett, President, JP Morgan International and former Manager, Bank for International Settlements; Howard Davies, former Chairman, Financial Services Authority (UK); Edward George, former Governor, Bank of England; Masamato Yashiro, former President, Shinsei Bank. By 2009, George had died and Caruana had left; new members included Roger Ferguson, former Vice Chairman of the US Federal Reserve Board and former Chairman of the Financial Stability Forum, and Tom de Swaan, a former Dutch regulator and former Chair of the Basel Committee.
Luo Ping, then in the International Department of the CBRC, stated bluntly in November 2003 that “[b]esides [their] low capital base and asset quality, banks in China also suffer from poor corporate governance and internal controls and a lack of adequate risk management skills” (Luo 2003: 4). Even according to official figures, banking system NPLs in 2003 were still 18 percent of total loans, albeit down from 30% in 2001 (unofficial estimates were often much higher). Over 2003-4, the CBRC signaled an ambitious timetable for full Basel I implementation by the beginning of 2007, introduced the same five-tier system of loan classification as had other Asian countries, and moved NPLs to state-owned asset management companies.\footnote{This loan accounting required banks to classify loans as Normal, Special Mention, Substandard, Doubtful, and Loss (in declining order of quality). See Walter (2008).} In 2004, new legislation slightly revised the main banking regulations, combining most of the capital requirements of Basel I with the supervisory review and disclosure aspects (pillars two and three) of Basel II.\footnote{See Liu Mingkang, “Setting A New Stage in China’s Banking Supervision and Regulation”, 11 March 2004; Brehm and Macht (2004: 316-317).} Chinese officials referred to this selective active approach to international convergence as “Basel 1.5”. Although this fell short of a clear intention to move to adopt Basel II, the US position was not entirely dissimilar at this time (Herring 2007).

Since 2004, some of the gaps in behavioural conformity with the Basel framework have been reduced. According to the CBRC (2008: 146), the proportion of banking system assets in banks compliant with Basel I was a mere 0.6% in 2003; by early 2008 the figure was just over 80% and by its end 99.9%. This indicates substantial progress towards convergence on Basel I, though it also indicates that convergence remains elusive for many smaller Chinese banks (Davies 2008; Luo 2008). Some argue that the IMF had tried but failed to convince the CBRC to follow through on a threat that
banks that could not meet Basel I minima by the end of 2006 would be closed, but it
would have been very difficult to do this in the absence of a bank resolution or deposit
insurance system. 33 Weaker banks are also often controlled by local authorities, some of
whom refused to inject the necessary capital. Nevertheless, on the eve of the 2008 global
financial crisis, the improvement at the major SOCBs, with the exception of Agricultural
Bank of China (ABC), was impressive (Table 1). 34

34 It is worth noting that the large SOCBs have also adopted the more advanced International
Financial Reporting Standards (IFRS) system of loan classification, provisioning and reporting as
part of their international listing strategy. This system is being extended to all other Chinese
banks and is now broadly in line with best practice elsewhere in Asia. International Accounting
Standard (IAS) 39 on loan loss accounting and provisioning was implemented for all listed banks
on 1 January 2007 and for all other banks in 2009; banks were also encouraged to raise the ratio
of provisions to NPLs to at least 150% by end-2009 (Angklomkliw et al 2009: 73-4).
Table 1: Major Chinese State-Owned Banks, Asset Quality Indicators, 2007.
Source: Fitch Ratings, "Chinese Banks -- Annual Review and Outlook," 30 January 2008, www.fitchratings.com. Note: Figures are for the first half of 2007 unless otherwise indicated. “Special Mention” loans are those that are in danger of deteriorating but are not currently classified as NPLs.

<table>
<thead>
<tr>
<th>Bank</th>
<th>Total assets (RMB mn)</th>
<th>NPLs as % of total loans</th>
<th>Special Mention loans as % of total loans</th>
<th>Loan loss reserves as % of NPLs</th>
<th>Tier 1 CARs (%)</th>
<th>CARs (%)</th>
<th>Long term deposit ratings (Fitch Ratings)</th>
<th>Individual ratings (Fitch Ratings)</th>
</tr>
</thead>
<tbody>
<tr>
<td>ICBC</td>
<td>8,301,167</td>
<td>3.3</td>
<td>7.0</td>
<td>81.3</td>
<td>11.8</td>
<td>13.7</td>
<td>A</td>
<td>D</td>
</tr>
<tr>
<td>ABC</td>
<td>5,343,943</td>
<td>23.4</td>
<td>5.1</td>
<td>103.9</td>
<td>11.3</td>
<td>13.4</td>
<td>A</td>
<td>D</td>
</tr>
<tr>
<td>BOC</td>
<td>5,833,891</td>
<td>3.6</td>
<td>6.5</td>
<td>90.7</td>
<td>9.4</td>
<td>11.3</td>
<td>A</td>
<td>D</td>
</tr>
<tr>
<td>CCB</td>
<td>6,117,791</td>
<td>3.0</td>
<td>7.3</td>
<td>85.3</td>
<td>10.1</td>
<td>14.2</td>
<td>A</td>
<td>D</td>
</tr>
<tr>
<td>BOCOM</td>
<td>2,135,880</td>
<td>2.1</td>
<td>5.8</td>
<td>191.0</td>
<td>8.1</td>
<td>A+</td>
<td>n.a.</td>
<td></td>
</tr>
<tr>
<td>CDB</td>
<td>2,314,267</td>
<td>0.7</td>
<td>0.22</td>
<td>34.2</td>
<td>A+</td>
<td>n.a.</td>
<td>A+</td>
<td>n.a.</td>
</tr>
<tr>
<td>EIBC</td>
<td>258,297</td>
<td>3.5</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>A+</td>
<td>n.a.</td>
</tr>
<tr>
<td>ADBC</td>
<td>932,562</td>
<td>7.7</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>A+</td>
<td>n.a.</td>
</tr>
</tbody>
</table>

The perceived success of this banking sector reform programme and the growing strength of China's major banks led eventually to a more ambitious though still partial approach to convergence on Basel II. A senior CBRC official argued in April 2006 that:

As a major milestone for banking supervision, Basel II is the way forward for all supervisors globally. But the timing for adoption is to be determined by non-G10 countries in light of their own market conditions. Emerging markets
should capitalize on Basel II in jumping up the learning curve for better risk management.⁴⁵

China's approach to Basel II has been a bifurcated one. This contrasts with the formal approach, if less the reality, of Basel I implementation in China. The government proposed that major SOCBs with an international presence would be required to implement the IRB approach, with the A-IRB approach the preferred option, before the end of 2010, with other banks following on a voluntary basis. In February 2007, the CBRC issued “Guidance on the Implementation of the New Capital Accord by the China Banking Industry.” This set out the plan for implementation, though it referred to the need to do so “based on China's realities” (CBRC 2007: 70). The standardized approach would be available to banks that did not qualify for the IRB approach, but they would be required to draw up a plan to adopt the IRB approach within three years – i.e. no later than 2013 (CBRC 2007: 72). In the meantime, these banks would be required to implement China’s Basel 1.5, eventually moving onto Basel II some years later.

Implementing banks were required to submit their first quarterly compliance assessment reports to the CBRC by the end of 2008 and to provide plans to rectify areas of non-compliance. By 2008, seven major commercial banks had become the focus of regulatory efforts for Basel II implementation (CBRC 2008: 73). These banks were required to improve data and information systems and to train board members, senior management, and staff in business lines and risk management to ensure adequate implementation.

Although doubts remain about the ability of Chinese regulators fully to implement Basel II for the major SOCBs, similar doubts apply to many countries.

How, if at all, have China’s attitudes to the Basel regime changed in response to the crisis? The early response of the authorities was to insist that Basel II implementation in China remained on track and that the crisis revealed not so much weaknesses in Basel II but the US failure adequately to regulate mortgages, securitization, the shadow banking sector, and off-balance sheet financing vehicles generally (Luo 2008). Chinese officials also emphasized that Basel II could not be blamed for the crisis as the build-up of vulnerabilities predated its implementation.\(^{36}\) In October 2008, CBRC even brought forward the deadline for Basel II implementation by the IRB banks by one year.\(^{37}\) This timetable lagged a number of advanced countries (including Hong Kong and the EU) but was similar to that of the US.\(^{38}\) From September to December 2008, the CBRC maintained the pace of implementation of Basel II. On 23 September, it issued five supervisory guidance papers relating to the implementation of Pillar 1 of Basel II. On 11 December, it issued a further eight draft papers for public comment relating to all three pillars (the now standard practice of more advanced countries of issuing draft regulations for public comment is another that has been adopted in China).\(^{39}\)

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\(^{36}\) Author interviews, Beijing, October 2008.


\(^{38}\) The Chinese SOCBs listed on the Hong Kong Stock Exchange are already subject to local disclosure requirements. Hong Kong’s Monetary Authority required all local banks to comply with Basel II (with the A-IRB approach optional) from 1 January 2007, but it did not require the SOCBs to do so.

\(^{39}\) CBRC (2008: 131-133); “The CBRC seeks comments on eight Basel II related rule-making documents”, December 11, 2008,
As the global crisis worsened and the Basel regime became subject to increasing criticism in the advanced countries, China's position adapted. Some Chinese officials started to voice more direct criticism of the Basel regime.\textsuperscript{40} Behind the scenes, Vice-Premier Wang Qishan is said to have asked in mid-2008 whether he should continue to take his Wall Street teachers' lessons seriously now that their own authority and credibility was in question (Davies 2008). However, these criticisms largely echoed those made by government and regulatory officials in the major countries (e.g. FSA 2009; US Treasury 2009a). Thus, the crisis led Chinese officials to call into question the third Basel norm of market-based regulation, but they did not reject openly the other two norms or the Basel framework in general. The financial stability norm remains crucial for China and it accepts the G20 consensus that the Basel framework must be reformed along the lines laid out in the three summits since November 2008. China’s support for this reformist stance was confirmed when it accepted the offer of membership in the BCBS in March 2009. Since then, the authorities pushed ahead with Basel II implementation and with further regulatory adjustments in line with recommendations of the G20 and associated work in the FSB, of which China is now also a member (FSB 2009). For example, in October 2009, CBRC issued new guidelines on liquidity risk management and it directed Chinese banks to undertake quarterly stress tests to identify key risks and to improve risk management practices –again, following similar tests in the advanced countries.\textsuperscript{41} Along with all other FSB members, China has also agreed to engage in an

\textsuperscript{40} Author interviews, Beijing and London, September 2008 and February 2009.

ongoing process of peer review aimed at promoting the implementation of FSB standards, which include Basel standards (FSB 2009: 9). Although China is generally resistant to a review process that results in “naming and shaming” as some have proposed, along with the US it has accepted the need for the G20 to lead the implementation of modifications to the Basel framework.\footnote{Author interviews, London, February 2010.} As of March 2010, China’s published record of adoption of the FSB’s new principles on compensation in the banking sector compare with those of the more developed countries in the G20 and appear much better than that of other major emerging countries such as India, Argentina, Brazil, Mexico, Turkey and South Africa (FSB 2010: 32-33). All of this reflects growing self-confidence in China’s own financial reforms and in the strength of its financial sector.

Despite this evidence of growing commitment on the part of the authorities to the Basel framework, the Chinese approach has been one of adaptation of Basel standards to domestic circumstances and gradual implementation. There are also remaining questions concerning compliance and enforcement of the formal rules at the domestic level. Despite the impressive capital ratios, profitability and low NPLs of the major banks, international analysts generally rated their stand-alone financial strength as relatively poor.\footnote{See table 1. Fitch Ratings (2008) gave independent financial strength ratings of D for most major Chinese banks and E for ABC (A being the highest possible rating). The independent strength rating does not take into account the probability of state support for banks, which of course is close to 1 in China.} That is, the major banks still depend heavily on implicit state financial support, and remain under state control despite foreign listing and the related injection of foreign private capital,
with their boards still dominated by state and Party representatives.\textsuperscript{44} Bank heads are vice-governors within the government and in 2009 four out of five of those of the large SOCBs sat on the Party’s Central Committee. The Party thus remains the dominant player in senior managerial and board appointments, limiting the impact of CBRC oversight, strategic investor stakes, and market constraints. The CBRC itself, like the PBOC, is of course also subordinated to the State Council. As long as competition remains limited, state ownership and party control predominates, lending decisions remain politicized, and bank staff incentives are oriented towards political priorities rather than economic risk management (Brehm 2008; Dobson and Kashyap 2006).

There are also continuing doubts about the reporting of NPLs by SOCBs despite the evident improvement of recent years. Levels of reported fraud in the financial system remain high, although enforcement has improved.\textsuperscript{45} Until recently, officially reported figures almost certainly substantially underestimated the true levels of NPLs – even official regulators admitted this (Luo 2003: 3; Ernst and Young 2006; Fitch 2006). There are also doubts about the capacity of banks to provision effectively for distressed assets and to sustain high profits given their high dependence on corporate loan business, high taxes, and rising competition (Fitch Ratings 2008: 3-6). The extraordinary growth in bank

\textsuperscript{44} In addition to the SOCBs, there are listed joint stock banks which accounted for nearly 14% of total banking sector assets by the end of 2007, but these are mainly owned by local governments and SOEs Foreign banks controlled a mere 2.4% of total assets (CBRC 2007: 139).

\textsuperscript{45} The Chinese National Audit Office (CNAO) is responsible for auditing the major institutions of the central government, including the PBOC and SOCBs. Established by the State Council and responsible to the Premier’s office, it has undertaken a series of audits since 1999 that have exposed the continuing problem of illegal lending and substantial fraud in government generally and some of the major banks in particular (including China Development Bank and Agricultural Bank of China). Whether these are good estimates of the full extent of poor lending practices is unclear. For example, in the case of CDB, a development bank that lends for politically important projects, the CNAO found that CDB made RMB 9.1bn ($1.3bn) in illegal loans in 2007 (3.7% of new loans) and that RMB 24.6bn of its loans had been embezzled (10% of new loans). See “Illicit loan scandal threatens CDB plans,” \textit{FT.com}, August 29, 2008.
credit over 2008-9, driven by the government’s need to implement much of the economic stimulus package through the banking sector, has also increased the risk of new NPLs in the future.\textsuperscript{46} This risk has been recognized by the CBRC, which tightened supervisory oversight after the crisis and called on banks to increase their loan loss provisioning ratios (CBRC 2008: 9). It remains unclear whether these initiatives will be sufficient to prevent a sharp rebound in levels of NPLs in the Chinese banking system. Even so, given projections of extraordinary asset write-downs for developed western financial systems (on the order of $1,000 billion for US banks and $1,600 billion for European banks over 2007-10),\textsuperscript{47} it is doubtful that China’s financial system is distinctively dysfunctional.

In sum, the political economy of the adoption of Basel standards in China has been very different to that in the US and other advanced countries. Whereas the negotiation and especially the implementation process were openly politicized in the US, in China implementation has been remarkably calm and consistent. This reflects to a considerable degree the very different political systems in the two countries. In the US, most of the political battles must be fought prior to decisions about implementation because of the relatively robust legal and regulatory framework of enforcement. In China, government decisions to adopt Basel standards have not always signaled the end of the implementation game because enforcement has been much less effective.

3 Explaining Levels of Behavioural Consistency in China

I argue that the main reason for the Chinese government’s positive attitude towards the Basel framework is that the leadership continues to see advantages in

\textsuperscript{46} “China’s banks lend with communist zeal”, \textit{FT.com}, July 8, 2009.
\textsuperscript{47} IMF (2009:10) estimates as of October 2009.
continuing to import financial regulatory and managerial “technology” from the advanced countries. As a result, even after the recent crisis, China has so far resisted attempts to destabilize and discredit the regime. These motivations are also essentially pragmatic rather than ideological, which is broadly true of the Chinese leadership’s approach towards financial reform in general.48

There are three main factors that explain the Chinese leadership’s view that positive benefits can be obtained from a cautious acceptance of the Basel framework. First, although China’s SOCBs now rank among the world’s largest and most profitable, China’s banking sector remains relatively backward in comparison with the largest banks from advanced countries and their restructuring and reform is unfinished business. This gives banks and regulators a strong incentive to import regulatory and managerial technologies from abroad. The Basel framework has the considerable advantage that China can do this without compromising national control over the banking sector. Second, the regulatory agencies, the CBRC and the PBOC, have a strong bureaucratic interest in using global standard setting to leverage their limited autonomy in the domestic policy process. Third, the political system has permitted the government to limit the politicization of banking sector reform. In this respect, the relative robustness of Chinese banks during the recent crisis has helped considerably in ensuring that the government has not needed to engage in a further round of costly bailouts of banks.

The belief that China’s financial system can benefit from importing foreign managerial and regulatory technology provides the most important motivation (CBRC

48 Thus, for example, China continues to use capital controls despite an historically unprecedented current account surplus; it has amassed large foreign exchange reserves as a precaution against financial crisis; and it has permitted only a very gradual and limited entry of international banks into the domestic market.
2008: 48). In this regard, the Asian financial crises of 1997-8 were an important watershed, as they alerted China’s leadership to the economic and political dangers posed by an unreformed financial sector.\(^4^9\) Although it is likely that there was considerable disagreement within the Chinese leadership over the relevance and implications of the Asian crisis for China, it had two important effects. First, it strengthened the hand of Zhu and his allies by providing an additional reason for tackling financial reform more seriously. Second, crises in other Asian developing countries and Japan undermined any viable Asian alternative to Western standards in financial regulation. Discussion among policy elites before the Asian crisis about the possibility of China adopting aspects of the Korean regulatory framework ceased after 1997.\(^5^0\) This left the western approach, exemplified by that in the US, as the only credible benchmark for Chinese reformers. This view was not unreasonable given the resilience of the US economy and its financial system during the emerging market crises of the 1990s and the LTCM and the dot.com collapses.

This tactic of using international institutions to overcome domestic resistance to reform has often been deployed by the Chinese leadership (Bergsten et al. 2008: 13). Basel norms and standards and the unrivalled legitimacy claims of US (and to some extent UK) regulators provided a powerful weapon which Chinese reformers, as elsewhere in Asia, used to sideline opponents of reform (Walter 2008: 18-27). This tactic is thus primarily pragmatic rather than ideological. The voluntary status of Basel standards is also an important consideration, as it has permitted the Chinese leadership to pick and choose what it needed from western financial regulatory models, to adapt them


\(^5^0\) Author interviews, Beijing, September 2008.
to Chinese domestic circumstances, and to maintain a gradualist approach to reform. The contrast between China’s tolerant attitude towards Basel and its increasingly difficult relationship with the IMF macroeconomic surveillance regime is revealing in this regard. It is also noteworthy that IMF-intervened Indonesia, Korea, and Thailand saw dramatic increases in levels of foreign ownership of their domestic banking sector after 1997 (by 2006, majority foreign-owned banks controlled about one third of banking system assets in these countries), whereas for China, foreign ownership remains low (at less than three percent). 51

This implies that although the Chinese leadership largely accepted the first Basel norm concerning the need for international standards to promote financial stability, this was by no means true of other key economic interests and associated political actors, for whom the growing focus on financial stability was costly. In addition, the policy leadership has only partly adhered to the competitive equality norm. In fact, an explicit goal of Basel implementation in China is to improve the competitiveness of Chinese banks (CBRC 2007: 71; Luo 2008: 5). The competitiveness of the five major SOCBs has been of particular importance to the Chinese leadership, since they account for half of total banking sector assets (CBRC 2008: 33) and have absorbed enormous amounts of state aid in the past. “Financial repression” in the form of low deposit rates has benefitted the major banks that are flush with deposits at the expense of joint stock banks and depositors (Lardy 2008). Earlier non-compliance with Basel had the drawback for Chinese banks wishing to operate in more developed jurisdictions of requiring them to take the relatively costly route of establishing separately capitalized local subsidiaries

(rather than branches). Perhaps more importantly, given the still low degree of internationalization of Chinese banks, this limitation was also a visible signal of lower international status for Chinese banks.\textsuperscript{52} The CBRC’s annual report in 2008 noted both the milestone reached in October 2008, when China Merchants Bank became the first ever Chinese bank to open a New York branch, and the achievement of global top ten status for ICBC and BOC.\textsuperscript{53}

The second factor, that China’s key regulatory agencies have a strong interest in promoting the legitimacy of Basel norms and standards, is related to the first. The CBRC has strong incentives to portray Basel standards to its domestic audiences as technocratic, externally validated, best practice regulatory benchmarks. This stance has helped to maintain pressure on the banks to raise their capital, reduce their NPLs and improve their asset allocation skills. It has also helped the CBRC to carve out a greater (though still limited) degree of operational autonomy vis-à-vis local political authorities, the banks, and the large state-owned enterprises that remain dependent on them. The Chinese political leadership had an interest in supporting this bureaucratic quest for greater operational autonomy, since it distances the leadership from politically difficult decisions about individual banks.

This helps to explain why government officials saw little to gain from calling the legitimacy of the Basel framework into question after the 2008-9 crisis. Chinese banking remains fairly traditional in nature, mostly recycling domestic savings to firms as loans.

\textsuperscript{52} I thank Howard Davies for this point.
\textsuperscript{53} CBRC (2008: 49, 51). ICBC and BOC were ranked eighth and tenth respectively among all global banks by total Tier 1 capital by \textit{The Banker} magazine in July 2008 (they had both ranked in the top ten for the first time in 2007).
Securitization is relatively underdeveloped in China and derivatives markets are still small. Basel standards proved particularly inadequate in these areas, but these shortcomings are less costly for China. The Chinese authorities have also retained more traditional prudential controls alongside the more advanced Basel regulations they have been introducing, a decision which in retrospect looks sensible. For example, Chinese banks can only loan up to 75% of their deposit base and home buyers can only borrow up to 70% of the value of their property (60% in the case of second homes). As Liu Mingkang, CBRC Chairman, remarked at an IIF conference in Beijing in June 2009, “Basel II is problematic; traditional ratios are still useful; small is beautiful and old is beautiful as well.”\(^{54}\) Over time, this message of a need to return to simpler and more restrictive banking regulation has been advocated more robustly.\(^{55}\)

In actuality, the CBRC’s attempt to foster a culture of financial conservatism in China came under severe pressure from October 2008. The rapid expansion of bank lending as part of the government’s fiscal stimulus package not only placed banks’ capital ratios under pressure,\(^{56}\) but also signaled a return to government-directed lending (total loan growth more than doubled from 2008 to 2009). By late 2009 there were signs of growing alarm in the CBRC, PBOC and the leadership that the rapid growth of bank lending could produce a new wave of NPLs and economic overheating. The PBOC raised banks’ reserve requirements and reduced lending quotas, and the CBRC issued a series of warnings that banks needed both to restrain lending and ensure that adequate risk

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\(^{56}\) “China banks said to submit capital raising plans”, *Bloomberg.com*, 24 November 2009.
assessment procedures were in place. Worryingly for the authorities, these moves did little to reduce actual lending growth in early 2010.

The third factor that helps to explain the Chinese leadership’s willingness and ability to sustain a gradualist approach to Basel convergence is the relatively low levels of politicization of banking regulation in China. The very nature of international standards has permitted less politicization: they have allowed the retention of Chinese sovereignty and they had the important advantage that they were not urged upon China by the IMF or the US (in contrast to the controversial issues of RMB revaluation and financial liberalization above and beyond China's WTO commitments). The fact that the rest of Asia was moving in the same direction from the late 1990s provided additional domestic political cover. It is possible that the agreement of China to participate in an FSAP review of its financial regulatory framework and the G20 agreement to assign the FSB the responsibility of conducting peer reviews of member implementation of international standards will threaten this in the future, but so far this has not been the case. At present, China’s willingness to accept this monitoring indicates its growing self-confidence in this policy area and the relative lack of concern that China’s financial regulatory reforms give other major countries.

Perhaps the most important contributor to low levels of politicization is the domestic political system. Although the more vigorous adoption of Basel standards since the late 1990s has been costly for some banks and related borrowers, the nature of the Chinese political system means that such opposition is more likely to be played out as informal non-compliance rather than as open objections to the government’s policy. Such

57 “China raises bank reserve requirements”, FT.com, 12 January 2010.
opposition included powerful factional elements within the party-state apparatus that benefited from a system in which access to bank credit was determined by national and local political interests (Shih 2008). After the crisis of 2008-9, the decision not to emphasize the flaws of the Basel framework reflects the desire to maintain the pace of financial reform in the face of such opposition, which almost certainly intensified as economic growth fell.

This explanation of Chinese official attitudes towards the Basel framework emphasizes the primary importance of domestic economic and political objectives for the government and its regulatory agencies. But international factors were not irrelevant, including, as mentioned above, the role of the Asian crisis of the late 1990s. Furthermore, in marked contrast to some other controversial issues such as the RMB exchange rate and the global role of US dollar, the Basel regime has not been seen in Beijing as having negative consequences for China’s international position, especially that vis-à-vis the US. The concern of many developing countries that Basel II might constrain their ability to borrow abroad is not a drawback for China, whose government wishes to avoid any dependence on external borrowing. The pragmatic strategy of importing western-style financial regulatory standards is also consistent with China’s commitment to other international agreements, particularly the agreement under its negotiated WTO entry in 2001 to liberalize, though only very partially, its financial sector.

At the same time, the growing significance of international markets for China’s own major banks has provided additional incentives for Chinese convergence. Four of these are listed in Hong Kong and although their international presence is currently limited, this may well expand rapidly in the future. In the meantime, adherence to Basel
standards has made it easier for them to attract private investors and foreign managerial and risk management expertise. The SOCBs and some of the joint stock banks have in fact been very keen on the adoption of Basel II and IFRS, as well as raising their international profile by joining international banking organizations such as the IIF.  

These banks have also been able to improve their credit ratings and increase their attractiveness vis-à-vis domestic competitors. Although it is unclear how much Basel II implementation will affect the cost of funding, ratings agencies do claim to take Basel II adoption into account when rating banks. The major Chinese banks also have relatively low leverage and are highly liquid, so that new Basel standards in these areas are unlikely to affect negatively their international competitiveness.  

In the end, however, these international factors have been important for China but not as significant as domestic motivations in explaining rising levels of behavioural consistency with Basel norms and standards. The main motivation of the Chinese leadership has been to view the Basel framework on its own merits, primarily in terms of the pragmatic benefits it can bring to Chinese economic reform. But the relative absence of negative international distributional consequences for China has been an important background factor in facilitating this pragmatic approach.

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58 On the now significant Chinese bank membership of the IIF, see IIF (2009: 49).
60 The Chinese case is thus inconsistent with accounts that emphasize the importance of external pressures on developing countries to adopt international standards (e.g. Simmons 2001, and Soederberg, Menz and Cerny 2005).
4 Conclusion

The picture of growing levels of Chinese convergence on the Basel regime over time can obscure the difficult and contested nature of domestic implementation in China. The incompatibility between new bank regulations and the interests of key actors in the Chinese financial system, from local party officials to large banks and SOEs, initially produced major implementation failures. These have diminished in scale and scope over time but they persist, so that the Chinese leadership has continued to see value in using Basel norms and standards strategically in the battle over domestic economic reform. The 2008-9 crisis was a major blow to the credibility and legitimacy of the Basel framework and to the associated US approach to financial regulation. Only deft footwork on the part of the BCBS prevented it from being discredited altogether. In part because this reduced legitimacy threatened the Chinese leadership’s reform strategy, China has emerged as a new if partial defender of the Basel regime.

This support from the pivotal emerging country may prove to have been a decisive factor in the stabilization of the Basel regime after the recent global crisis, though may be too soon to tell whether Basel will survive in the longer term. So far, China’s cautious acceptance of Basel’s core norms and standards for its major banks provides little support for either the realist or neoliberal views of the relationship between international power and regime evolution. It is more consistent with domestic politics accounts of international policy coordination (e.g. Singer 2007), though such accounts have underemphasized the way in which international technocratic norms have been used strategically to promote domestic reform. The flexibility of the regime has also assisted its survival and evolution, since countries such as China have been able to cherry pick
from its provisions and even from among the regime’s core norms. Finally, despite common generalizations about the incompatibility between Basel standards and developing country interests, the Chinese leadership has not seen Basel as problematic for China in international distributive terms (in contrast to its position on matters such as the RMB exchange rate and the global role of the US dollar). On the contrary, China’s cautious strategic use of Basel norms and standards has permitted the leadership to achieve crucial domestic and international policy objectives.
Bibliography


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