Abstract

As a G-20 member, China is engaged in financial regulatory reform since the end of the global financial crisis. A core piece of this reform is the new banking regulatory standard that is issued by the Basel Committee on Banking Supervision. Chinese regulators have recently published prudential rules to implement Basel III standards domestically. A comparison between Basel III and domestic regulation shows that rather than merely compliant, China’s banking regulation is stricter than the global standards and will be implemented ahead of the internationally agreed timetable. Why is China voluntarily subjecting itself to tougher regulatory standards than the rest of the world? The paper finds four answers to this question. Adjustment costs for banks are relatively low, strict regulatory standards are helpful tools for macroeconomic management, and both Chinese banks and regulators are seeking international reputation for their respective purposes. This peculiar alignment of interests among different stakeholders provides an explanation for China’s uncommon position and informs the debate about the country’s integration into international institutions.

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China’s rise in recent years has triggered a lively debate on the impact of its emergence as a major power in the international system. Largely ostracized in the first post-war decades until the West changed course in the 1970s, the People’s Republic is a newcomer to the liberal world order. As China’s clout in the political, economic, and military realm continues to grow at a fast pace, the conditions of its integration into this global order are of extraordinary concern for scholars and policymakers around the world. The current debate in international relations situates the country in a spectrum that ranges from China as a challenger of the international system to a status-quo power that adheres to global rules of conduct. Scholars thus ignore the possibility of China as an over-compliant champion of the liberal world order. Yet this is exactly the position that the rising power is taking in the realm of global financial regulation.

The outbreak of the global financial crisis triggered the rise of Beijing as a major stakeholder in the G-20 and international bodies of financial regulation. In the wake of the crisis, the G-20 mandated a thorough overhaul of financial regulatory standards, including the Basel Accord on Banking Supervision. As a low-income country with a largely underdeveloped financial market, China’s adherence to global best practices was neither feasible nor expected before the global financial crisis. Yet this situation is changing fast. Currently Beijing is establishing a system of prudential banking regulation that is stricter than the international standards, and it is implementing it faster than anybody else. This phenomenon is called gold-plating, a somewhat derogatory term in the world of financial regulation. Why is China, an emerging market economy with a per-capita income much below the OECD average with a largely underdeveloped financial system, voluntarily subjecting itself to tougher financial standards than the rest of the world?

This paper shows that an unusual alignment of domestic interests in the quest for global reputation drives this phenomenon. The troubled institutional history of China’s financial system motivates all relevant stakeholders, both regulators and the regulated, to seek external validation of soundness and credibility, albeit for different reasons. Furthermore, although over-compliance with global financial standards is a costly signal for any country, it is much less so for China in the wake of the global financial crisis.

The remainder of this article starts with a review of current scholarship regarding the emergence of China and its position in the liberal world order. Further, it examines the key debate on the international political economy of financial regulation. An introduction of the Basel Accords on banking regulation is followed by a brief history of China’s development in this issue area. The paper then presents four explanations for the country’s drive to over-comply with Basel III regulatory
standards. First, it shows that after ten years of domestic banking reform and the global financial crisis, adjustment costs for China’s banks are relatively low. Second, macroeconomic policymakers need tight capital standards to reign in credit expansion and prevent the economy from over-heating. Third, because China’s banks lack a track record as well-governed corporations in the marketplace, they need to rely on international standards as the reputational basis for future regional and global expansion. Finally, promotion of and adherence to strict financial standards can be an instrument for Chinese regulators to attain status and prestige both in international regulatory bodies and at home. This peculiar alignment of interest among major stakeholders in the state and the financial sector helps explain why China is gold-plating in the realm of banking regulation.

The emergence of China as a major power has sparked a vivid debate among scholars of international relations. Identifying a key strain in the growing body of scholarship on the issue, John Ikenberry asks “Will China overthrow the existing order or become a part of it?” (Ikenberry 2008). Liberal scholars point out that over the past four decades, China has deliberately entered institutions that were established by the West, reassured others, and protected its own interest by relying on the rules and institutions of the Western liberal system. In the eyes of Ikenberry and others, this trajectory indicates that China’s rise takes place within, rather than outside the Western order.

In addition to the liberal argument for China’s peaceful rise, constructivist IR scholars make a case for a harmonious integration of this emerging power into the international system. For example, Johnston (2008) applies insight from social psychology to analyze China’s socialization into international institutions. The author argues that as a “novice” in international regimes, the People’s Republic is subject to processes of mimicking, social influence, and persuasion. Johnston analyzes China’s integration into several security regimes and concludes that Chinese policymakers have been socialized into international institutions.

Both the liberal and constructivist-oriented IR scholarship described above regard China as a country that is willing to adjust to global norms and standards. It challenges the realist argument that rising powers tend to upset the status quo (Mearsheimer 2001). Thus, the spectrum of the debate ranges from China as a challenger to the international system to a conforming player within. However, few scholars to date have contemplated the option of a rising power that exceeds and over-complies with the norms and standards of the established global order. Yet new evidence in the realm of financial regulation suggests that China is evolving from laggard to primus on a global scale.
Financial markets have been the spearhead of globalization since the 1970s, and liberalization of financial markets, along with business innovation and technological change has led to the prominence of transnational networks in the global economy (Castells 2000). The operation of these networks is framed by rules and regulations that are set by governments.

But the rule-making process does not share the transnational qualities of the networks themselves. Rather, regulators in the dominant centers of the world economy engage in regulatory innovation as first movers. Governments in the rest of the world are then faced with the option of whether or not to adjust to the hegemonic standard. Simmons (2001) explains that this choice is conditioned by the existence of market incentives to emulate the standard. At the same time, if the externalities of non-adherence by other jurisdictions are significant, the dominant center has an incentive to promote global harmonization by exercising political pressure via international organizations. Simmons uses the Basel Committee on Banking Supervision (BCBS) and bank capital adequacy rules as an example of regulation where the center has a strong interest to promote global standards because lax standards in other jurisdictions imply a considerable risk for the stability of its domestic banking system. At the same time, adherence to strict prudential regulation and compliance with stringent capital requirements are considered quality indicators of financial firms, generating market incentives for emulation in other jurisdictions. Simmons concludes that bank capital adequacy rules are thus an example of market-driven harmonization that is supported by institutional assistance (via the Basel Committee and IMF) rather than political pressure.

Drezner (2007) takes this theory one step further by distinguishing between the rewards and adjustment costs of policy coordination among jurisdictions. Cross-border economic integration increases the rewards for coordination but the adjustment costs that governments and corporations incur remain unchanged. For small (and open) economies, the benefits of policy coordination are significant, generally greater than the adjustment costs. For sizeable economies in contrast, adjustment costs are considerable whereas the benefits of adjusting to a global standard are relatively small. This is because trans-border transactions represent a smaller share of the overall economic activity. As a consequence, market size determines the state incentive to engage in global harmonization of regulatory standards. In addition, big states can rely on their go-it-alone power and resort to economic coercion, threatening market closure if other states refuse to adhere to their domestic standards. In other words, market size is the source of power in the world of regulatory policy coordination. This is the logic behind Drezner’s (2007) theory of regulatory outcomes.
Historical institutionalists have developed an alternative framework for understanding the politics of global regulation. They argue that market size is a necessary but not sufficient condition for bargaining leverage on the international stage. The crucial element that holds explanatory power is the historical evolution of domestic regulatory institutions. Farrell and Newman (2010) emphasize two mechanisms at the core of historical institutionalism: policy feedback and relative sequencing.

Policy feedback refers to the propensity of institutional reform to create client groups that then have a strong incentive to lobby for its maintenance in the future. The authors note: “Those interest groups that have succeeded in embedding themselves within the relevant institutional frameworks will unsurprisingly use their advantageous position to pursue regulatory policies that favor them (and potentially disfavor other groups).” (Farrell and Newman 2010, 620). The domestic beneficiaries of any given institutional setting thus influence state preferences at the international level.

Relative sequencing is another mechanism that conditions the importance of market size. The development of any domestic regulatory system is a long and path-dependent process. Considerable differences exist among jurisdictions in terms of degree of development and regulatory capacity. For example, newly emerging economies have only recently started to build a sophisticated financial regulatory institutional framework and often lack the capacity to assess policy alternatives to adopting the dominant standards. Ceteris paribus, this situation puts developed countries at an advantage.

Historical institutionalists thus call into question any theory that seeks to establish a direct relationship between market size and power in the realm of global regulatory politics. In a reply to these charges, Drezner (2010) suggests to use China’s integration into the world of global financial regulation as an empirical test for his and the historical institutionalist approach. Drezner’s great power theory emphasizes the considerable size of China’s domestic market. In his eyes, the country has already become a big power whose economic interests diverge clearly from that of the developed core countries. As a consequence, the likely outcomes of current global regulatory reform are either rival standards, where the great powers each promote their own regulatory settings, or sham standards, which are promoted by international institutions but lack enforcement (Drezner 2007). Historical institutionalists on the other hand would point out that institutional development in China lags behind that of the core countries. Given the insufficient regulatory capacity of the Chinese authorities, this approach would predict that Beijing adheres to the regulatory standards of the dominant center.

None of the above approaches however contemplates the possibility that China exceed global regulatory standards. The purpose of this paper is to fill this void by analyzing China’s stance in the field of prudential banking regulation, specifically Basel III standards, and its underlying reasons.
The Basel Accords

Facing serious disturbances in the international currency and banking markets, the leaders of ten developed economies (the so-called G-10) decided to meet in the quaint Swiss town of Basel in 1974. They agreed to establish a committee in order to institutionalize transnational cooperation in the field of banking supervision. The Committee consists of representatives of member state central banks and regulatory authorities. It has been established without a formal treaty and does not publish regulation that is legally binding. It can thus be regarded as one of the first government networks (Slaughter 2004). Over the last four decades, membership has grown to 27 countries and jurisdictions. In addition, many non-member jurisdictions follow the recommendations of the BCBS. After initial work on a common understanding regarding the responsibilities of host and home jurisdictions of multinational banks, the Basel Committee started negotiating a common set of prudential standards and principles that would increase the quality of banking supervision across borders.

The first Basel Accord of 1988 established a set of standards designed to reduce default risk and increase the resilience of banks. Basel I defined two categories (tiers) of bank capital in terms of its capacity to absorb unexpected losses and assigned different risk weights to bank assets. The centerpiece of the Basel Accord is the so-called capital adequacy ratio, requiring banks to hold capital equal to 8% of total risk-weighted assets, with higher-quality Tier 1 capital accounting for at least 4% (BCBS 1988). Due to rapid financial innovation, the Basel I Accord was soon criticized as outdated, and negotiations started in the 1990s to formulate an updated set of prudential banking standards (Davies and Green 2008). Released in 2004, Basel II improved the measurement of credit risk and included measures to capture operational risk, but it lowered the capital adequacy ratio to 6% and was soon criticized for providing banks with too much leeway in modeling the risk of their operations (Porter 2010; Singer 2010; Young 2012). Not all jurisdictions had taken steps towards implementation when the global financial crisis hit in 2008. Banks were at the center of the financial turmoil and no matter whether banks adhered to Basel II standards or not, few had capital and liquidity buffers big enough to weather the crisis without substantial state support. One year later, the G-20 mandated the BCBS to build on the lessons learned from the crisis to establish a new set of regulatory standards. At the same time, membership of the Basel Committee expanded to include all G-20 member states.

In December 2010 the Committee finalized the new Basel III standards with an implementation schedule from 2013 until end-2018. The new regulatory framework is substantially more comprehensive than its predecessor. It expands risk coverage to instruments and markets that were particularly
problematic during the crisis, such as trading book exposures and securitized assets, thus increasing the scope of assets that capital requirements must meet. At the same time, Basel III rules entail a stricter definition of Tier 1 capital. This is a lesson learned from the financial crisis where banks failed to liquefy what counted as Tier 1 capital in order to absorb unexpected losses (BIS 2012).

In addition to a wider definition of assets and a more stringent one of capital, Basel III raises the minimum standards for capital as a percentage of risk-weighted assets. The minimum capital requirement (Tier 1 and 2) increases from 6% under the previous standards to 10.5%. Banks must hold Tier 1 capital (mostly common equity and retained earnings) equal to 8.5% of risk weighted assets. The absolute minimum common equity share of Tier 1 capital is 4.5%. An additional conservation buffer of 2.5% bars banks from extending discretionary distributions such as bonuses and dividends until the common equity core capital reaches a level of 7%, up from 2% under Basel II. The new agreement further establishes a countercyclical buffer of up to 2.5% that domestic regulators can apply at discretion in response to excessive credit expansion and the building up of systemic risk in their jurisdiction. Finally, banks with large, highly interconnected, and complex operations (global systemically important financial institutions, G-SIFI) face an additional surcharge. In total, Banks are required to hold common equity equivalent to between 7 and 12% of risk-weighted assets, with a total (Tier 1 and 2) capital adequacy ratio from 10.5% to 15.5% (BCBS 2011; BIS 2012).

[Table 1 here]

The risk-based capital measures mentioned above are complemented by a new leverage ratio. Excessive leverage on and off-balance sheet was a major feature of this and previous financial crises (Engelen et al. 2011). Therefore, Basel III includes a leverage ratio that requires banks to hold Tier 1 capital equivalent to 3% of total unweighted assets. Finally, in order to curb liquidity risk, new minimum liquidity requirements are introduced under Basel III.

These new banking standards are a cornerstone of global financial regulatory reform, designed to reduce the likelihood that banks would wreak havoc on each other and the entire economy as they did during the global financial crisis of 2007-9.

**China and Basel III**

China was largely isolated from the global economy until the late 1970s. The Chinese economy has benefitted from integration into trade networks since the beginning of reform and opening policy in 1978, but the development of the financial system has lagged behind. After three decades of Maoist planned economy and a decade of Cultural Revolution, the flow of capital was almost completely under
the direct control of the central government, and banks merely served as accounting institutions. In October 1979, one year after embarking on the path of economic reform, Deng Xiaoping declared that “we must turn the banks into real banks” (Qiao, Su, and Zhang 2010, 73). Following the bank diversification program that was approved by the 3rd Plenum of the 11th Party Congress, major banks like the Agricultural Bank of China and Bank of China were re-established, separated from the central bank, or newly created.

At the time when the first Basel Accord was released, China’s financial system barely counted on a few “real banks”, and the central bank was merely four years old. A commercial banking law was not in place until 1995. It is thus not surprising that domestic regulatory authorities did not engage in regulation in line with Basel until the mid-2000s. One of the first acts of the China Banking Regulatory Commission (CBRC), created in 2003, was to publish the Regulation Governing Capital Adequacy of Commercial Banks that implemented Basel I standards domestically, in effect since March 2004 (OECD 2010).

In the same year, the Basel Committee finalized Basel II standards that were, as explained above, more lenient with respect to capital requirements but more sophisticated regarding internal risk measurements. Consequently, the CBRC decided to make the new requirements binding only for large banks with substantial operations in foreign jurisdictions (including Hong Kong). Even for the selected banks, implementation of Basel II standards was not an urgent priority (Rana 2012). A CBRC statement from 2007 reads: “Obviously, it is a gradual and long-term course to meet all the standards; therefore, banks must, based on their own situation, make an overall plan and gradually meet the Basel II standards in a phased, well sequenced manner.” (CBRC 2007). China joined the Basel Committee in 2009 along with all other emerging countries of the G-20, but even in May 2012, China was among the six G-20 members that had not implemented Basel II (FSB 2012a).

This is changing fast with the new Basel standards. China is evolving from laggard to primus inter pares in financial regulation. China’s new banking standards will not only be stricter than Basel III, they will be implemented ahead of the internationally agreed schedule.

In October 2009, the CBRC published a notification “On improving the commercial bank capital replenishment mechanism”, preparing banks for recapitalization in line with expected higher capital requirements. In June 2011, half a year after Basel III standards were published, the CBRC released the “Commercial Bank Leverage Ratio Management Method”. After circulating consultation papers in April 2012, the CBRC followed up with the “Capital Rules for Commercial Banks”, approved by the State Council in June 2012. This centerpiece of bank capital regulation is complemented by three guidance
notices on the specifics of implementation that were released in October and November of the same year. These documents, published ahead of the FSB-mandated deadline of end-2012, contain all rules that are currently required for the domestic implementation of Basel III standards (State Council Development Research Center 2013b).

A striking feature of China’s implementation of Basel III is that domestic rules are stricter than the international standards in several categories. The following three gold-plated rules stand out. Basel III raised the common equity capital ratio from 2% to 4.5%, but China’s minimum ratio is set at a 5% level. Second, Chinese authorities require a leverage ratio that is one percentage point higher than the international standard. The third difference concerns loan loss provisions. China’s regulators do not impose a fixed provisions rate and coverage rate on banks. However, they promote a model of dynamic provisions regulation with the goal of loan loss provisions equal to 2.5% of total loans, and a 150% coverage rate of these loans. In contrast, Basel III refrains from setting any specific standard in this area. Instead, the Basel Committee merely states that it is “[…] addressing incentives to stronger provisioning in the regulatory capital framework.” (BCBS 2011, 6).

The BCBS visited China in 2013 to undertake a consistency assessment as part of its new peer review program. The Committee gave Chinese regulators the best possible overall grade of “compliant” and duly noted a total of 17 points where China is gold-plating Basel III standards (BCBS 2013b). This list is incomplete because it fails to incorporate the above-mentioned leverage ratio and provisioning rules. Even though the peer reviewers pointed out that the areas where domestic regulation exceeds international standards were not taken into account as mitigants for compliance assessment, China’s efforts are likely to have generated certain respect in the international regulatory community.

In addition to stricter regulatory standards, China also commits to a tighter implementation schedule. Basel III is scheduled to be gradually phased in between the beginning of 2013 and end-2018. The Chinese schedule however stipulates full implementation two years earlier, by end-2016. Capital surcharges for global systemically important banks (G-SIB) will be gradually phased in between 2016 and 2018, but surcharges for Chinese G-SIB are in place since 2010. In the area of liquidity requirements, China had already established domestic rules when the Basel Committee was still embroiled in a prolonged process of negotiation with bank lobbyists. Beijing further beat the international standard setters by implementing the 4% leverage ratio in 2012 (PBOC Research Institute 2012d; BIS and BCBS 2013; BCBS 2013a).
The ambitious implementation schedule in China contrasts with the reality of Basel III implementation in the rest of the world. According to an FSB report from October 2012, only 8 out of the 27 Basel Committee member jurisdictions issued the final set of Basel III-related regulations. The remaining jurisdictions missed the globally agreed deadline of January 1st 2013 to start phasing in the new regulatory standards (FSB 2012b).

In sum, China is establishing a system of prudential banking regulation that is stricter than the international standards, and it is implementing it faster than anybody else. Why is China, an emerging market economy with a per-capita income much below the OECD average and a largely underdeveloped financial system, voluntarily subjecting itself to tougher financial standards than the rest of the world?

The remainder of this paper presents four answers to this question. It shows that an unusual alignment of interest between regulators and the regulated in an overall favorable economic environment drives China’s efforts to exceed global banking standards.

1. Relatively low adjustment costs for banks

Adherence to stricter capital adequacy requirements implies costs for banks, and in the case of Basel III, these costs might be considerable. First, in order to comply with the new Basel standards and given depressed equity markets, many banks have to deleverage, that is sell off assets and reduce their loan portfolios. This process also extends to the trading book and off-balance sheet securitized assets that were a major source of income for Western banks before the global financial crisis. The world’s number one bank lobby organization, the Institute of International Finance (IIF), even produced a study showing the implementation of Basel III would strangulate credit expansion, thus slowing down global GDP growth by more than three percentage points (IIF 2011). While this is likely to be an overestimate, the current deleveraging, changes in asset book composition, and new restrictions on trading activities that are a consequence of global regulatory reform challenge the profitability of Western banks. China’s banks in contrast have a different balance sheet composition and income structure, which greatly reduces their adjustment costs.

Since its re-emergence in the 1980s, China’s financial system withstood two crises. The reform process that took place in the period between these two crises helps explain why China’s banks today are in a different position than their Western competitors. The Asian Financial Crisis of 1997 exposed the weaknesses of the domestic banking system. Banks had engaged in what Central Bank Governor Zhou Xiaochuan (2007) refers to as “policy lending” and “relationship lending”, disregarding prudential assessment in order to please influential party officials or to comply with investment policies from the
The structure and timing of domestic banking reform left China’s big banks flush with capital as the global financial crisis approached (Qiao, Su, and Zhang 2010; Ba 2010).

The 2007-9 financial crisis was mixed news for China’s financial system. On the one hand, domestic financial institutions had little exposure to Western financial markets and none of them had to be bailed out by the government. Furthermore, domestic derivatives markets are still very small in terms of transactions and tightly regulated. Capital account restrictions further protected the domestic financial system from contagion. On the other hand, banks engaged in massive credit expansion under China’s RMB 4 trillion (S$586 bn) stimulus program, a move that observers qualified as a return to policy lending (Goodstadt 2011; Shih 2008). Even though the official NPL ratio has fallen to around 1%, doubts about loan performance are widespread. Concerned with the impact of the global financial crisis, the CBRC urged banks to further increase their capital adequacy ratio.

According to the IMF’s Financial System Stability Assessment, for China’s biggest 17 banks the Tier 1 capital as percentage of risk-weighted assets has increased from 6% in 2007 to 9.6% in 2010, with an equity-to-asset ratio of 6% that exceeds both Basel and gold-plated Chinese leverage ratio standards.
Furthermore, loan-loss provisions have jumped from 118% of non-performing loans in 2008 to 218% in 2010 (IMF 2011). Whereas Western banks have pressured regulators to grant them a transition phase until the end of 2018, China’s major banks have already met all Basel III capital requirements by September 2012 (OECD 2013).

In addition to state-sponsored recapitalization and market-driven equity capital flows, China’s big banks benefit from their position in the domestic market that guarantees a substantial net interest gap profit. Since the early 2000s, Chinese authorities have established a system of financial repression that involves fixing the rates at which banks lend and take deposits. The upper limit of deposit rates and lower limit of loan rates provides domestic banks with an interest spread between 2.5 and 3.5 percentage points until 2009 and 2-2.5 since then whereas banks in the rest of the world must deal with a much less comfortable margin of around 1.45 on average. In 2011 alone, the 16 Chinese banks that are currently listed on stock exchanges received a net interest gap profit of $186bn, that is 80% of their total profit. China’s banking system has thrived in this environment of fast economic growth and guaranteed profit margins, with total banking assets growing at an annual rate of 17-20% since 2004 (Qiao, Su, and Zhang 2010; PBOC Research Institute 2012a; BIS 2012).

The Banker Magazine revealed in its June 2013 report that ICBC now is the world’s biggest bank in terms of Tier 1 capital, the first Chinese bank to reach this position in history. Furthermore, with double-digit net profit growth rates, China’s big four banks ranked among the top 15 in profit as early as 2009. Now they occupy the first four places in the ranking (The Banker 2013).

[Table 3 here]

Having weathered the global financial crisis largely unscathed and backed by a domestic financial arrangement that ensures substantial profits in an overall environment of rapid economic expansion, Chinese banks are in an excellent position to incur the adjustment costs of adherence to Basel III standards, much more than their competitors around the world.

2. Macroeconomic Considerations

High capital and liquidity requirements are prudential instruments designed to enhance the resilience of the banking system, but these measures also affect macroeconomic variables, in particular credit and money supply. In its Basel III impact assessment, the BCBS recognizes that higher capital standards raise the price of loans, thus affecting credit supply and overall output expansion (BCBS 2010). In China however, Basel III is not an obstacle to growth but another convenient instrument in the hands of macroeconomic policymakers.
Although it might be tempting to regard China’s development success as the consequence of a singular export-led growth model, in reality policymakers have constantly changed and adjusted macroeconomic management in a trial-and-error fashion (Wu and Ma 2013). Until the late 1990s, China’s foreign exchange reserves were low, the current account was relatively balanced and it can be argued that the value of the renminbi was close to market equilibrium. It was only after the Asian Financial Crisis that policymakers adopted a macroeconomic management model that combined export promotion with foreign exchange reserve accumulation as a self-insurance policy against external shocks (State Council Development Research Center 2013e; Lardy 2013; Chin 2010).

China’s current account surplus rose from 1.3% of GDP in 2001 to over 10% in 2007, and its capital account also registered a constant surplus throughout the 2000s. The consequence of this inflow of capital, according to the Balassa-Samuelson effect, is either nominal currency appreciation or inflation, both of which are highly undesirable for the authorities. Because China adopted a fixed exchange rate from 1998 to 2004 and let the renminbi appreciate only slowly before and after the global financial crisis, fighting inflation by controlling money supply growth has become a formidable task for financial authorities.

The People’s Bank of China (PBOC) has adopted two methods to sterilize capital inflows. First, it issued bonds (4tr RMB outstanding in 2010) that domestic commercial banks would be obliged to buy in significant quantities. Second, it has raised the portion of deposits that commercial banks must retain at the central bank. The required reserve ratio (RRR) rose from 6% in September 2003 to 15% by end-2008 (China Finance 40 2013; Lardy 2013). This contrasts with a constant and low or even non-existent RRR in most Western countries do date.

China’s foreign exchange sterilization program made an important contribution to money supply and inflation control. But the stimulus program in the wake of the global financial crisis brought new challenges for macroeconomic management. In 2009, the total amount of outstanding RMB loans expanded by 33% and bank assets jumped from 197% of GDP to 229% (IMF 2011; State Council Development Research Center 2013c; PBOC Research Institute 2013a). Fearing an overheating of the economy, the authorities used all available instruments to curb further credit growth. The central bank raised the RRR 6 times since 2010 up to an all-time high of 21.5% for major Chinese banks in June 2011. This measure significantly reduced the available capital that banks can transform into loans. Limiting bank loans in turn has a significant direct effect on money supply in a country where banks comprise over 80% of the financial system. This shows that Chinese authorities use prudential regulatory tools not
merely to enhance the stability of the financial system but also for purposes of macroeconomic management (PBOC Research Institute 2012a; M. Zhang 2012).

An additional way to regulate credit expansion with prudential instruments is the loan-to-deposit ratio. China’s regulators have enforced an explicit loan-to-deposit ratio cap of 75% until 2003. Regulatory intervention has become unnecessary since then as the growth rate of deposit was constantly higher than that of loans, reducing the loan-to-deposit ratio to an average of 67% between 2005 and 2011 (J. Huang 2013). This rule however complements the RRR as a prudential instrument that, together with nominal credit quotas and interest rate management forms the central bank’s “three magic weapons” (三大法宝 san da fabao) in monetary policy (PBOC Research Institute 2013b).

Using instruments such as the loan-to-deposit and reserve requirement ratios, authorities can regulate the relationship between the assets and liabilities side of a bank’s balance sheet. Basel III standards represent a complementary instrument that regulates its assets in relation to equity. All three measures can be employed to adjust credit expansion and thus money supply growth in the economy.

It is also noteworthy that Chinese authorities are facing criticism from the IMF for using nominal credit growth targets rather than market-based measures. As a partial alternative to interest rate liberalization, especially one with international legitimacy, Basel III standards help the central bank restrain credit expansion and fight inflationary pressures. Because stringent Basel standards have monetary and prudential regulatory functions that are mutually reinforcing, they are welcome by Chinese macroeconomic policymakers.

Stringent prudential regulation and financial repression does not come without unintended side effects, however. In an environment where depositors lack profitable investment opportunities and where small and medium businesses face severe credit constraints, the shadow banking system is burgeoning. Chinese households use wealth management products (WMP) increasingly as deposit substitutes, and corporate savings enter the financial market through a variety of trust products and other, even less transparent instruments. Data from the PBOC shows that shadow banking accounts for 30% of the RMB 17.3tn in credit issued in 2013, up from 23% in the previous year (Mitchell 2014). This massive credit expansion outside of regulatory control poses a challenge for both the central bank’s monetary policy and its financial stability objectives, as even top-level policymakers have recently admitted publicly (J. Zhang 2014; “Local Bond Payment Bill Doubles in Year Since China NPC” 2014). It does not however affect compliance with Basel III because the perimeter of Basel regulations is restricted to the formal banking sector. Chinese scholars and policymakers have made an effort to show why the Chinese shadow banking system is different from the West (Chinese Academy of Social Sciences
Nevertheless, the growth of the shadow banking sector shows that even gold-plated Basel III regulations are of limited effectiveness in ensuring monetary and financial stability.

3. Reputation for Banks

Simmons (2001) points out that banking regulation entails high market incentives for emulation. This is because capital adequacy rules provide market participants with information about the soundness of a financial institution. Investors and shareholders reward companies that comply (or over-comply) with regulatory standards and investment analysts and rating agencies provide better risk assessments for them. Risk is factored into the price of capital in financial markets, and therefore financial institutions that adhere to prudential standards enjoy access to cheaper capital. This is crucial for banks, whose business model fundamentally relies on the price difference between the capital they receive and lend (Brummer 2010).

China’s banks have grown fast in the comfortable domestic environment described above, but have rarely ventured abroad. All big four banks have branches in the main trade and financial centers around the world, but branches in these locations currently offer a very limited range of financial services, with the exception of Hong Kong.

However, the demand for cross-border financial services will rise as the Chinese economy continues to transform. Salaries in China have been rising since 2004, elevating production costs for companies, in particular in the coastal regions. In the near future, especially in those global market sectors that are dominated by price competition, Chinese firms will be forced to either to lose market share or to outsource operations to lower-wage countries, preferably in South East Asia. China’s banks have a prime opportunity to accompany the overseas expansion of domestic companies as financial services provider, but they need to establish an adequate cross-border network of branches and subsidiaries first (Zhou 2012; Ba 2010).

In order to successfully compete in the financial sector abroad, Chinese banks need to rely on reputation. Their subsidiaries overseas need to attract deposits and secure cheap wholesale financing in capital markets, both of which require investor confidence. But how can Chinese banks build this reputation? The historical track record is not an option, for two reasons. First, even though some Chinese banks were established as long as 100 years ago, they ceased operating as companies under the planned economy of the People’s Republic. Only after Deng’s call for turning them back “into real banks” did China’s banks resume operations, and even then financial intermediation was subject to heavy state
intervention until the commercial bank law of 1995 was passed. In other words, most Chinese banks have less than 30 years of a track record.

Second, to further complicate things, this track record is everything but confidence-inspiring. Due to low-quality corporate governance, backwards risk management and widespread relationship and policy lending, the banks reached the point of technical bankruptcy in 1998 and again in 2003. Both times, banks had to be bailed out and undergo restructuring under the supervision of state authorities. The latest recapitalization of a bank using foreign exchange reserves occurred as recently as 2008 (IMF 2011). Foreign observers who believed that banks had gained some autonomy from the state were disappointed by the massive loan expansion under the 2009 stimulus package (Goodstadt 2011).

Adherence to purely domestic regulatory standards would not inspire investor confidence either. Domestic prudential supervision lacks credibility because the state has a double role as a regulator of the banks on the one side, and as the majority shareholder on the other. The IMF (2011, 19) also highlights this point, stating that “The heavy involvement by the state in many aspects of the financial system reduces market discipline, weakens corporate governance, and is likely to create soft budget constraints.”.

Under these circumstances, Basel III serves as a highly valuable external source of reputation. The new banking standards are developed by the Basel Committee and apply to banks in all major jurisdictions around the world. The Basel Committee engages in regular review exercises both with regulatory agencies and the banks themselves in order to ensure the quality of standards implementation, thus improving the transparency and credibility of China’s banks. Chinese observers are well aware that Basel standards help domestic banks enter overseas markets (Ifeng Finance 2011).

China’s biggest lender, ICBC, may be most suited to illustrate this phenomenon. The bank made first steps overseas by acquiring minority stakes in Standard Bank (South Africa) in 2007, ACL Bank (Thailand) in 2009, and by buying the broker-dealer operations of Fortis Securities in the United States one year later. More recently, ICBC purchased majority shares of banks in Canada in 2010 and Argentina in 2012 and converted them into its first foreign subsidiaries. The bank is now considering acquisitions in the Middle East as it seeks to triple overseas earnings between 2013 and 2016 (Martin 2014).

A bid to take over the US branches of the Hong Kong-based Bank of East Asia in 2011 however was blocked by the Federal Reserve on the basis of prudential regulatory concerns (Thomas and Guerrera 2011). A Chinese regulator explains: “When the Chinese banks would want to open a branch in the States, for quite a long time the US regulators didn’t agree, saying that you have a poor regulation. [...] We negotiate with the Federal Reserve to push them open to Chinese banks.”
Basel III functions as an international seal of banking quality that Chinese banks can use to overcome resistance by foreign regulators. Furthermore, banks that are able to fulfill or even exceed Basel requirements can count on favorable treatment in international capital markets. Therefore, the adjustment costs of adherence to Basel III are outweighed by the benefits these standards confer to China’s major banks as they pursue outward expansion in the future.

4. Reputation for Regulators

International reputation is a valuable asset not just for banks as they expand overseas. Regulators, too, seek reputation in the international financial community, albeit for different reasons. In a contribution to the debate on China’s evolving relationship with international organizations, Pearson (1999) identifies leverage as a mechanism by which the latter exert influence on Chinese policymakers. Leverage is at work when domestic political figures refer to arguments and practices promoted by international organizations in order to change domestic rules.

There is evidence that this leverage mechanism is at work in China’s financial regulatory world, but the reputational dynamics surrounding Basel III go far beyond. Leverage in this sector can be thought of as a two-step process. First, rather than merely employing the ideas and rules of international standard-setting bodies, Chinese authorities are gold-plating them in order to gain recognition and respect with their peers abroad. It is only as a second step that policymakers then use this international reputation to enhance their position vis-à-vis bureaucratic competitors and the leadership in the domestic realm.

Regarding the first step, leading policy figures emphasize that in order to protect its domestic interests, must have a voice in the international financial market and the supervisory bodies that regulate it (Yi 2009; Zhou 2012; State Council Development Research Center 2013e).

Policymakers in Beijing conceive of the international financial environment as a three-tiered system in terms of influence. Core countries can rely on their economic power and status as emitter of an international reserve currency to influence monetary and exchange rate policy of other countries. Non-core countries have a lesser degree of influence but nevertheless are important stakeholders in the international system, in contrast to the third group, peripheral countries. In the wake of the global financial crisis, China and other emerging market economies are regarded as moving from the periphery to the non-core group of countries, thus thoroughly influencing the long-term evolution of the international financial system (State Council Development Research Center 2013d).
Since the G-20 was elevated to the prime forum of global economic governance, China has called for and achieved governance reform in the IMF and the World Bank in order to give greater voice for itself and other emerging economies (Wade 2011). The politics of influence in government networks however are more complicated than those of the big international financial institutions. In principle, all members of standard-setting bodies such as the BCBS are on equal standing, and decisions are made by consensus. In the absence of formal voting shares, voice is bestowed upon member countries according to their market size and legitimacy. The precondition for legitimacy in turn is compliance with the financial standards promoted by the government network itself. Because China’s share of global financial markets is still negligible (Hong Kong is a separate member of the standard-setting bodies), legitimacy through compliance and, in fact, over-compliance is the only way for attaining voice in these government networks.

Beijing’s intentions to engage in gold-plating Basel in order to become a respected stakeholder in the international regulatory community do not go unnoticed. A regulator from Hong Kong states:

“I have an observation that China is keen on innovating domestic standard up to international standard at a fast pace in order to catch up with the international development. [...] I think they have a case to be keen on implementing those international standards domestically to be treated more seriously than other developing jurisdictions in order to gain [a position for] the country as a major player in international forums.” (interview with regulator, HK, 17 Jun 2013)

As mentioned above, China’s banks suffer from a reputational deficit due to a short and non-stellar track record. The same can be said for China’s regulatory authorities. Especially in the realm of financial regulation, China is a latecomer in institutional development. A central bank in the modern sense of the word was not established until 1984, and a banking regulatory authority as a self-standing institution did not exist until 2003. Many analysts doubt that the establishment of the CBRC has changed the profound political embeddedness of the banking sector and of regulators themselves (He 2013; Brehm 2008; Pearson 2007; Heilmann 2005). Hence, adherence to a global standard was a costly but necessary signal to China’s peers in the regulatory community. When asked about the main motivation for the massive regulatory upgrade that gold-plating Basel III implies, a Chinese regulator responds: “It’s international. Well, you see the foreign regulators went kind of, ‘Okay, the Chinese regulators really made a lot of progress.’” (interview with regulator, BJ, 27 Jun 2013)

An analysis of finer granularity reveals that the initiative to raise regulatory standards is not carried out by a unitary Chinese state. To be sure, all major ministries and state agencies benefit from a more prominent position of China in the forums of global economic governance. The issue of domestic
financial transformation however divides reform advocates in the Central Bank and State Council-associated think tanks on the one side and conservative skeptics, mainly in the Ministries of Finance, Commerce, and the National Development and Reform Commission on the other (Gruin 2013).

The second element of the leverage mechanism mentioned above applies in this environment of bureaucratic politics. Given the tension between financial reform skeptics and advocates within the government, the banking regulator seized the opportunity to gain leverage from the international financial reform movement led by the G-20 in the wake of the global financial crisis. A Chinese regulator explains:

“When the former and the first CBRC chairman, before his retirement, he had promulgated a Chinese banks capital adequacy rule, which I think largely just introduced the Basel III. [...] I think that he has the ambitions that under his leadership the Chinese banks reached most higher standards so that will be his credit.” (interview with regulator, BJ, 27 Jun 2013)

The initiative by Liu Mingkang 刘明康, CBRC chairman until 2011, was certainly not uncontroversial. Insiders remember that it generated a major debate among policymakers in Beijing who were concerned about the costs of stringent regulation and its effect on credit availability in the real economy. The publication of Basel III rules by the Basel Committee in December 2010 strengthened Liu’s position domestically. Furthermore, due to strict interpretation and fast implementation of Basel III, the CBRC is receiving positive feedback from the IMF (2011), the Basel Committee (BIS and BCBS 2012) and other parts of the international regulatory establishment. This has positive consequences for the CBRC chairman and his agency, as a Chinese regulator points out:

“So, if the head of the regulator got appraised by the foreign regulators, he will get a credit and he can use the credit to bargain with the Chinese leaders, see what I mean?” (interview with regulator, BJ, 27 Jun 2013)

It is important to recognize though that the phenomenon described above does not extend to all areas of financial regulatory reform. The initiative by the G20 and the FSB (FSB 2011) to bring the shadow banking system under regulatory control for example has not been received by Beijing with enthusiasm. Chinese scholars and policymakers have made an effort to show why international efforts to strengthen regulation are not compatible with the domestic situation (Zeng 2013; State Council Development Research Center 2013a). A thorough examination of the sectoral differences in Chinese financial regulatory convergence to international standards is beyond the scope of this paper, but a preliminary analysis indicates that the costs adjustment would be high and the benefits of external legitimacy low. Even though the dramatic expansion of the shadow banking system in China interferes
with conventional macroeconomic policy (PBOC Research Institute 2012b), we are unlikely to see China
gold-plating the emerging international standards of shadow banking regulation.

Conclusion

China’s current behavior in the realm of banking regulation provides only one data point that is
insufficient to validate or disprove any theory of global regulatory politics, let alone of a country’s
integration into the overall global liberal regime. Nevertheless, the case of Basel III implementation in
China helps to assess the strengths and weaknesses of salient theories in the current literature.

As the above study shows, Drezner’s (2007) point about the importance of adjustment costs to
global regulation is well taken. The private sector in the West is very vocal about the cost of Basel III
implementation, and few governments have respected the time schedule for its implementation thus
far. Because of the timing and scope of domestic banking reform however, Chinese banks face much
lower adjustment costs. Their limited exposure to the global financial crisis and their comfortable
position in a fast-growth economic environment further help them meet the new prudential
requirements.

At the same time, the Chinese example shows how difficult it is to establish a direct causal link
between market size and the balance between adjustment costs and benefits. Drezner (2010) predicted
that China as a major power would lack the incentive to converge to international regulatory standards,
yet in the case of Basel III China is making more effort to comply and over-comply than any other
jurisdiction. Not only does the country face lower adjustment costs than other large and even small
economies, but Beijing also lacks a credible threat of market closure. Eight years after the phase-in of all
WTO commitments regarding liberalization of the financial sector, foreign companies still only control
around 2% of financial assets. China thus lacks the monopsony power that the United States could rely
on when pushing for global implementation of the original Basel standards (Oatley and Nabors 1998).

What historical institutionalists can take from the Chinese example is not only support for their
arguments, but also rich material for further theory development. Several of the reasons why
adjustment costs for Chinese banks are relatively low are clearly linked to the domestic institutional
arrangement. Established commercial banks in China today can count on a privileged source of income
and thrive in a protected environment that has been created by public authorities.

While the Chinese case provides rich empirical material for the historical-institutionalist process
of policy feedback, the concept of relative sequencing is harder to apply here. There is no doubt that
institutional development in financial regulation lags behind the OECD countries and even some
emerging market economies. However, China is not blindly following Basel standards but selectively
gold-plating them, and there is evidence that this has been the result of a long and contentious process
of policy deliberation in Beijing. The coordinated employment of macroeconomic and prudential
regulatory instruments to steer the economy can be regarded as quite innovative, attracting the
attention of other middle-income countries (Redrado et al. 2006).

This study also highlights the importance of reputation as a driving force. Without a doubt,
reputation is tacit and social mechanism that escapes quantification. Nevertheless, reputation is not
merely an auxiliary to socialization that is embedded in the logic of appropriateness that constructivist
scholars study. Rather, it is a tacit asset with clear economic benefits, at least in the world of financial
regulation. Recent scholarship has highlighted the economic implications of employing a stigmatized
policy instrument such as capital controls, and how its reputation is changing in the post-crisis world
(Chwieroth 2014; Grabel 2014). Regarding prudential banking standards, Simmons (2001) has made
clear that global harmonization is supported by market-driven incentives to emulate, and this study
further supports her argument. In China’s case, banks need reputation to expand abroad, and regulators
need reputation in order to enhance their negotiating position both internationally and domestically.

In the search for international reputation, the interests of banks and regulators are aligned. In
addition, prudential banking standards represent a useful instrument for macroeconomic management
and one that does not inflict high costs on the financial system. It is this peculiar convergence of
outward-oriented incentives and domestic conditions on both the state and industry side that helps
explain why China is in the process of gold-plating Basel III banking standards.

An important limitation of this study is that it cannot make inferences regarding the stability of
the Chinese financial system. The reason is not that China emulate its neighbors’ exercise in “mock
compliance” with global financial standards (A. Walter 2008). Enhanced peer review mechanisms under
the auspices of the G-20 and the IMF reduce the maneuvering space for domestic regulatory finagling.
Moreover, China’s accounting standards have substantially converged with International Financial
Reporting Standards (IFRS) and International Standards on Auditing since 2005, and all stock listed
companies have to meet international accounting and auditing requirements (IMF 2011). Rather, the
new global regulatory standards themselves may be of limited effectiveness. Believing that compliance
with or even gold-plating of Basel III protects China from the next financial crisis may be just as naïve as
thinking the same of Basel II in the United States in 2006. Even though the Chinese financial system has
withstood a series of stress test simulations as part of the 2011 Financial System Stability Assessment,
the country is facing massive challenges that range from reducing local government debt (Shih 2008), to
internal rebalancing after years of debt-fueled overinvestment (Pettis 2013). Basel III does not effectively address these vulnerabilities, and a conservative implementation of its standards might even have the perverse effect of contributing to the concentration of systemic risk outside of its regulatory perimeter, in the shadow banking sector (“The Credit Kulaks” 2013). The next steps of market-oriented reform and opening to global capital flows lead China’s policymakers into unchartered and risky territory where no Basel plate can guarantee protection, no matter how golden it is.

Further research might look beyond the realm of financial regulation to discover the conditions under which emerging powers such as China exceed global standards. Ren (2012) argues that China is taking conscious steps to signal a non-revisionist stance in the G-20 while pushing for reform within the existing order. Over-compliance with global standards might also endow rising powers with reputational benefits in areas other than trade and finance. China’s stellar contribution to peacekeeping troops under the aegis of the United Nations might be a case in point (C.-H. Huang 2011). A cross-sectoral integration of research is needed to develop a theoretically rooted and empirically sound understanding of China’s integration into the liberal world order.
References


Tables:

Table 1: Basel III capital requirements as percentage of risk-weighted assets

<table>
<thead>
<tr>
<th></th>
<th>Common Equity Tier 1</th>
<th>Tier 1 Capital</th>
<th>Total Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum</td>
<td>4.5</td>
<td>6</td>
<td>8</td>
</tr>
<tr>
<td>Conservation buffer</td>
<td>2.5</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Countercyclical buffer</td>
<td>0-2.5</td>
<td></td>
<td></td>
</tr>
<tr>
<td>G-SIFI surcharge</td>
<td>1-2.5</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>7-12</td>
<td>8.5-13.5</td>
<td>10.5-15.5</td>
</tr>
<tr>
<td>Basel II</td>
<td>2</td>
<td>4</td>
<td>6</td>
</tr>
<tr>
<td>Basel I</td>
<td>n/a</td>
<td>4</td>
<td>8</td>
</tr>
</tbody>
</table>

Source: Basel Committee on Banking Supervision

Table 2: Basel III standards and Chinese standards (selection)

<table>
<thead>
<tr>
<th>Regulatory Standard</th>
<th>Basel II</th>
<th>Basel III</th>
<th>China</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common Equity Tier 1 Ratio</td>
<td>2</td>
<td>4.5</td>
<td>5</td>
</tr>
<tr>
<td>Leverage Ratio</td>
<td>n/a</td>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>Provisions Rate</td>
<td>n/a</td>
<td>n/a</td>
<td>2.5%</td>
</tr>
<tr>
<td>Provisions Coverage Rate</td>
<td>n/a</td>
<td>n/a</td>
<td>150%</td>
</tr>
</tbody>
</table>

Source: People’s Bank of China Research Institute

Table 3: Top 10 World Banks 2013

<table>
<thead>
<tr>
<th>Bank</th>
<th>Tier 1 Capital (USD bn)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industrial and Commercial Bank of China</td>
<td>160.6</td>
</tr>
<tr>
<td>JP Morgan Chase &amp; Co</td>
<td>160.0</td>
</tr>
<tr>
<td>Bank of America</td>
<td>155.5</td>
</tr>
<tr>
<td>HSBC Holdings</td>
<td>151.0</td>
</tr>
<tr>
<td>China Construction Bank Corporation</td>
<td>137.6</td>
</tr>
<tr>
<td>Citigroup</td>
<td>136.5</td>
</tr>
<tr>
<td>Mitsubishi UFJ Financial Group</td>
<td>129.6</td>
</tr>
<tr>
<td>Wells Fargo &amp; Co</td>
<td>126.6</td>
</tr>
<tr>
<td>Bank of China</td>
<td>121.5</td>
</tr>
<tr>
<td>Agricultural Bank of China</td>
<td>111.5</td>
</tr>
</tbody>
</table>

Source: The Banker