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Banking Supervision and Its Regulations  
— Comparative Study between U.S. and  
China

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# **Banking Supervision and Its Regulations—Comparative Study between U.S. and China**

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## **I. INTRODUCTION**

The health of the economy and the effectiveness of monetary policy depend on a sound financial system. A smoothly functioning banking supervision regime is one of the cornerstones of any financial system. Only a stable financial system, which is one of the key aims of state regulation and oversight, can optimally fulfill its macroeconomic function of efficient and low-cost transformation and provision of financial resources. A global financial meltdown will affect the livelihoods of almost everyone in an increasingly inter-connected world. The primary goals of supervision and regulations include protecting depositors' funds, maintaining a stable monetary system, promoting an efficient and competitive banking system and protecting consumer rights related to banking relationships and transactions.

Banking supervision basically entails the rules that have to be complied with when

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setting up banks and carrying out banking business. The liberalization of the financial markets has created new business opportunities for banks which can significantly increase their risk. To enable banking supervisors to prevent bank insolvencies, new risks require new methods of banking supervision. It is thus not surprising that the liberalization of the financial markets over the past two decades has led to a tighter regime of prudential supervision. More specifically, examiners supervise the activities of bank holding companies and financial holding companies, their non-bank subsidiaries, and state-chartered member banks. Examiners also monitor the financial condition of these institutions and review for compliance with federal laws and regulations.

## **II. THE DEVELOPMENT TENDENCY OF INTERNATIONAL COMMERCIAL BANKS' SUPERVISION AND ITS IMPLICATIONS FOR CHINA**

In view of the steady increase of international banking activities, the appropriate regulation and supervision of multinational banks become more and more relevant. Financial regulators have long been aware of the problems surrounding the supervision of multinational banks, and considerable efforts have been invested in developing a sound regulatory framework. Most countries have adopted the BIS<sup>2</sup> guidelines for international banking supervision, so that basic supervisory

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<sup>2</sup> The BIS is an international organization which fosters cooperation among central banks and other agencies in pursuit of monetary and financial stability. Its banking services are provided exclusively to central banks and international organizations.

responsibilities are divided between the relevant home-and host country authorities. Together with the “Core Principle’s for Effective Banking Supervision” that were established following the BCCI<sup>3</sup> crisis, they are now followed by many countries. Moreover, bilateral Memoranda of Understanding specify how information exchange between these authorities is organized.

In recent years, a number of emerging market countries, particularly in Asia<sup>4</sup>, have become important participants in the international financial markets. The exposure of investors and banks in industrial countries to emerging market countries has increased substantially, as portfolio investment flows and bank lending to the emerging markets have grown and the latter’s financial sectors have expanded, relative to the financial sectors of industrial countries. Even developing countries are not yet major players in the financial markets would benefit from being included in multilateral arrangements—a sound financial system can make an important contribution to economic performance. G-10<sup>5</sup> has responded to the momentous changes in financial markets in the 1980s and 1990s by strengthening supervision and regulation of the international banking system through several multilateral arrangements. These arrangements have generally been successful in reducing risks to the system and averting potential problems.

In the past few decades, as one financial crisis falls, another rises, spurring the evolution of banking business areas and the development of banking supervision

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<sup>3</sup> BCCI, the Bank of Credit and Commerce International, was a major international bank founded in Pakistan in 1972. At its peak, it operated in 78 countries, had over 40 branches, and claimed assets of \$25 billion. It is the fourth largest bank in history.

<sup>4</sup> Singapore and Hong Kong have become, respectively, the fourth and fifth largest foreign exchange trading centers in the world.

<sup>5</sup> The Group of Ten, the policymaking body for the ten industrial countries with the largest economies.

frame in domestic, regional and international level.<sup>6</sup> The Asian crises, Russian crisis, Turkey crisis, Argentine crisis and Brazil crisis along with their spread to the world are typical examples.<sup>7</sup> Even though U.S. and Japanese supervisory agencies adopted different measures to maintain soundness and safety of their banking and financial system as well as single bank, the systemic turbulences and crises were still inevitable. It can be well illuminated by the crises of savings and loan institutions in U.S. occurred during late 1980s and early 1990s and 1998 Asian financial crises.<sup>8</sup>

With the incessant changes of external environment, the modes of the international commercial banking supervision went through four phases from Administrative order approach to Standard approach, Internal model-based approach<sup>9</sup> and then Pre-commitment approach<sup>10</sup>. Because of the increasing complexity of financial instruments and the speed of movement in financial markets, intrusive supervision has become less meaningful. Thus the U.S. federal banking agencies have adopted a risk-focused approach to banking supervision that emphasizes the adequacy of banks' internal risk management systems. Together with the traditional approaches of loan review and transaction monitoring, market-based supervision will best ensure the

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<sup>6</sup> See Carl-Johan Lindgern et al., *Bank soundness and Macroeconomic Policy* (1996).

<sup>7</sup> See Douglas Arner et al., *FINANCIAL CRISES IN THE 1990s* (2002). Joseph J. Norton, *The Modern Genre Of Infrastructural Law Reform: The Legal and Practical Realities—The Case of Banking Reform in Thailand*, 55 *SMU L. REV.* 235 (2002).

<sup>8</sup> See G.N. Olson, *BANKS IN DISTRESS: LESSONS FROM THE AMERICAN EXPERIENCE OF THE 1980s* (2000); Symposium, *The S & L Crisis: Death and Transfiguration*, *Annual Survey Issue on Financial Institutions and Regulations*, 39 *Fordham L. REV.* S1 (1991); L. William Seidman, *FULL FAITH AND CREDIT: THE GREAT S & L DEBACLE AND OTHER WASHINGTON SAGAS* (1993).

<sup>9</sup> The internal models methodology for measuring exposure to market risk is based on the following general conceptual framework. Price and position data arising from the bank's trading activities, together with certain measurement parameters, are entered into a computer model that generates a measure of the bank's market risk exposure, typically expressed in terms of value-at-risk. This measure represents an estimate of the likely maximum amount that could be lost on a bank's portfolio with a certain degree of statistical confidence.

<sup>10</sup> The pre-commitment approach to bank capital regulation is a radical departure from existing bank regulatory methods. First proposed in Kupiec and O' Brien (1995 c), the approach advocates letting banks choose their capital levels and fining them if losses exceed this level. The essence of the proposal is to use fines (or other penalties) to encourage risky banks to hold more capital than safer ones.

continued viability of the banking sector.

### **III. BANKING SUPERVISION IN U.S**

A fundamental goal of modern United States banking law is to prevent another Great Depression, with massive runs on banks, and heavy costs to society.<sup>11</sup> Bank regulation in the United States is highly fragmented compared to other G-10 countries where most countries have only one bank regulator. In the U.S., a bank's primary regulator could be the Federal Reserve Board, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, or any one of 50 state regulatory bodies, depending on the charter of the bank. And within the Federal Reserve Board, there are 12 districts with 12 different regulatory staffing groups.

It is also one of the most highly regulated banking environments in the world, however, many of the regulations are not safety and soundness related, but are instead focused on privacy, disclosure, fraud prevention, anti-money laundering, anti-terrorism, anti-usury lending, and promoting lending to lower-income segments. Even individual cities enact their own financial regulation laws.

#### **Significant Legislation**

Over the years, legislation has changed what banks can or cannot do. For example, the Gramm-Leach-Bliley Act of 1999 abolished the core provisions of the Banking Act of 1933, also known as the Glass-Steagall Act, which restricted banks from

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<sup>11</sup> See page 136, Banking and Financial Institutions Law, William A. Lovett

selling insurance and securities. As the impact of the law takes hold, consumers will be able to purchase a variety of services, such as car insurance or a checking account, and trade stocks, all at one place. The Federal Reserve has been given responsibility for regulating these multiple-service providers. Legislation also regulates both the international activities of U.S. banks in foreign locations and the activities of foreign banks in U.S. locations. For example, the International Banking Act of 1978 provided equal powers for foreign banks operating in the United States to promote equal competition between them and U.S. banks. In addition, the International Lending Supervision Act of 1983 requires the Federal Reserve and other U.S. banking agencies to consult with bank regulators in other countries to adopt consistent supervisory policies to facilitate international banking. The Federal Reserve is responsible for regulating branches of foreign banks operating in the United States.

### **The dual banking supervision system**

The *National Bank Act of 1863* created a system of banks throughout the United States that were chartered by the federal government. In 1865, an amendment to the act placed a tax on state bank notes, bringing all banks in the United States under federal supervision. However, a number of banks were exempt from the tax and continued under their state charters until the *Federal Reserve Act of 1913*<sup>12</sup>. This was known as the "dual banking system."

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<sup>12</sup> The Federal Reserve act is the act of Congress that created the Federal Reserve System, the central banking system of the United States, which was signed by President Woodrow Wilson on December 23, 1913. For some eighty years before that time the country had been operating without a central bank after the charter for the Second Bank of the United States was allowed to lapse in 1832, renewal legislation having been vetoed by President Andrew Jackson.

The Federal Reserve System, also the Federal Reserve, informally The Fed, is the central banking system of the United States. The Federal Reserve System is a quasi-governmental banking system composed of (1) a presidentially-appointed Board of Governors of the Federal Reserve System<sup>13</sup> in Washington, D.C.; (2) the Federal Open Market Committee; (3) twelve regional Federal Reserve Banks located in major cities throughout the nation; and (4) numerous private member banks<sup>14</sup>, which own varying amounts of stock in the regional Federal Reserve Banks<sup>15</sup>.

The Federal Reserve Act of 1913 established the present day Federal Reserve System and brought all banks in the United States under the authority of the federal government, creating the twelve regional Federal Reserve Banks which are supervised by the Federal Reserve Board. Notwithstanding the Glass-Steagall Act of 1932 and the Banking Acts of 1933 and 1935, which were attempting to reform various banking abuses, the Federal Reserve System has remained more or less unchanged through to the present day. The Glass-Steagall Act was repealed in 1999, whereas the Banking Act of 1933 simply strengthened the supervisory powers of federal authorities and created the Federal Deposit Insurance Corporation.

The Federal Reserve System supervises and regulates a wide range of financial institutions and activities. The Fed works in conjunction with other federal and state authorities to ensure that financial institutions safely manage their operations and

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<sup>13</sup> It is an independent federal government agency. The board is required to periodically report to the Senate. The Board of governors is responsible for the formulation of monetary policy. It also supervises and regulates the operations of the Federal Reserve Banks and US banking system in general.

<sup>14</sup> The member banks are privately owned corporations. The stocks of many of the member banks are publicly traded.

<sup>15</sup> The federal reserve banks are owned by private member banks. Each member bank owns nonnegotiable shares of stock in its regional Federal Reserve Bank.

provide fair and equitable services to consumers. Bank examiners also gather information on trends in the financial industry, which helps the Federal Reserve System meet its other responsibilities, including determining monetary policy.

Roger Ferguson Jr, a Governor of the Federal Reserve Board, once clearly made the case for the Federal Reserve maintaining a significant role in banking supervision. He argued that<sup>16</sup>,

*‘ In the last analysis, there simply is no substitute for understanding the links among supervision, regulation market behavior, risk taking, prudential standards, and- let us not lose sight-macro stability. The intelligence and know-how that come from our examination and regulatory responsibilities play an important, at times, critical-role in our monetary policy making. No less relevant, our economic stabilization responsibilities contribute to our supervisory policies. Observers and supervisors from single-purpose agencies often lose sight of how too rigorous or too lenient a supervisory stance-or a change in stance-can have serious and significant macro-economic implications, the consideration of which is likely to modify the supervisory policy. In short, I think the Fed’s monetary policy is better because of its supervisory responsibilities, and its supervision and regulation are better because of its stabilization responsibilities.’*

Since 1863, commercial banks in the United States have been able to choose to organize as national banks with a charter issued by the Office of the Comptroller of the Currency (OCC) or as state banks with a charter issued by a state government. The

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<sup>16</sup> FRB 1998 conference speech.

choice of charter determines which agency will supervise the bank: the primary supervisor of nationally chartered banks is the OCC, whereas state-chartered banks are supervised jointly by their state chartering authority and either the Federal Deposit Insurance Corporation (FDIC) or the Federal Reserve System (Federal Reserve). In their supervisory capacity, the FDIC and the Federal Reserve generally alternate examinations with the states.

Several federal and state agencies regulate banks along with the Federal Reserve. The Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corp. (FDIC), the Office of Thrift Supervision (OTS) and state banking authorities also regulate financial institutions. The OCC charters, regulates and supervises nationally chartered banks. The FDIC, the Federal Reserve and state banking authorities regulate state-chartered banks. Bank holding companies and financial services holding companies, which own or have controlling interest in one or more banks, are also regulated by the Federal Reserve. The OTS examines federal and many state-chartered thrift institutions, which include savings banks and savings and loan associations.

## **Umbrella supervision mode**

### **1. Federal Reserve as Umbrella supervisor**

Gramm-Leach-Bliley<sup>17</sup>, namely GLB, offers exciting opportunities for banking organizations to expand their lines of business and their range of customer services. It

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<sup>17</sup> The Gramm-Leach-Bliley Act, also known as the Gramm-Leach-Bliley Financial Services Modernization Act, Pub. L. No.106-102, 113 Stat. 1338, is an Act of the United States Congress which repealed the Glass-Steagall Act, opening up competition among banks, securities companies and insurance companies.

permits certain bank holding companies to affiliate with securities firms and insurance companies. Expanded permissible activities for these holding companies include securities underwriting and dealing, insurance agency activities and insurance underwriting, acting as a futures commission merchant, and merchant banking. The Federal Reserve Board and the Secretary of the Treasury have the authority to determine whether other activities are financial in nature or incidental to financial activities and hence permissible for these holding companies to engage in. To take advantage of the new powers, a bank holding company must become a financial holding company (FHC)<sup>18</sup>, which requires that each of its subsidiary banks is well-capitalized and well-managed and that all of its insured subsidiary banks maintain a Consumer Reinvestment Act (CRA) rating of at least satisfactory.

The rationale for umbrella supervision is that most large and sophisticated financial services companies take an umbrella or consolidated approach to managing their risk. As a practical matter, the Federal Reserve expects all FHCs to evolve toward comprehensive, consolidated risk management in order to measure and assess the range of their exposures and the way those exposures interrelate.

Umbrella supervision seeks to balance the objective of protecting the depository subsidiaries of increasingly complex organizations engaged in a greater number of interrelated activities and incurring different risk with the objective of not imposing an unduly duplicative or onerous burden on the nonbank entities that are part of the organization. The legislation clearly intends that functional regulators, primary bank

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<sup>18</sup> A financial entity engaged in a broad range of banking-related activities, created by the Gramm-Leach-Bliley Act of 1999.

and thrift supervisors, and the umbrella supervisor will respect each other's responsibilities and will acknowledge and make use of each other's expertise.

Moreover, umbrella supervision requires strengthened relationships between primary bank and thrift supervisors and the umbrella supervisor and enhanced relationships with functional regulators and foreign nonbank supervisors. Finally, the Federal Reserve needs to place greater reliance on recent initiatives that promote a more risk-focused supervision process and market discipline.

The activities of the Federal Reserve as the umbrella supervisor fall into three broad categories: information gathering and assessment, ongoing supervision, and promotion of sound practices and improved disclosure. The Federal Reserve will interact closely with, and obtain information from, the primary bank and thrift supervisors and the functional regulators as well as from FHC senior management and boards of directors.

Examiners may conduct targeted transaction testing, to verify that risk-management systems are adequately and appropriately measuring and managing areas of risk for the organization and to confirm that laws and regulations within the jurisdiction of the Federal Reserve are being followed. There will also be periodic discussions with FHC senior management and boards of directors and with personnel responsible for centralized management and control functions such as heads of business lines, risk management, internal audit and internal control.

## 2. Mutual coordination of different supervisors

The Federal Reserve Board, FDIC, Department of Justice, SEC<sup>19</sup>, CFTC<sup>20</sup>, OTS, NCUA<sup>21</sup> and FT<sup>22</sup>, even FBI regulate and supervise commercial banks from their respective responsibilities, among which The Fed and FDIC are the main supervisory institutions.

All the national banks are members of Federal Reserve System, whereas state banks have the options to be the member or not and those who choose to join are called state member banks.<sup>23</sup> The Fed is responsible directly and basically for all the member banks. Meanwhile, the Fed acts as the supervisor for bank holding companies and financial holding companies, granting business charters.<sup>24</sup> Up to now, more than 1,500 financial holding banks have been set up in US. Because of the vastness of objects to be supervised, in actual practice, the Fed focuses its supervision mainly on big commercial banks and institutions, for instance, Citigroup has routine meeting with the Federal Reserve examiners every other week. However, the supervision on small banks is mostly from the perspective of liquidation and capital circulation and on-site test of their detailed activities.

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<sup>19</sup> The United States Securities and Exchange Commission is a US government agency having primary responsibility for enforcing the federal securities laws and regulating the securities industry/ stock market.

<sup>20</sup> The Commodity Futures Trading Commission is an independent agency of the United States Government, created by Congress in 1974. It is responsible for recording and monitoring the trading of futures contracts on United States futures exchanges.

<sup>21</sup> The National Credit Union Administration is the United States federal agency that supervises and charters federal credit unions and insures savings in federal and most state-chartered credit unions across the country through the National Credit Union Share Insurance Fund (NCUSIF), a federal fund backed by the full faith and credit of the United States Government.

<sup>22</sup> The Federal Trade Commission is an independent agency of the United States Government, established in 1914 by the Federal Trade Commission Act, its principle mission is the promotion of consumer protection and the elimination and prevention of anticompetitive business practices.

<sup>23</sup> In 1999, there are 1010 state member banks and 5199 state non-member banks.

<sup>24</sup> Till the end of 1999, there were 5116 bank holding companies in US, which controlled 6764 banks, holding more than 96% commercial bank savings, namely that out of the 8000 US banks, more than 80% owned by bank holding companies.

The vast number of bank failures in the Great Depression spurred the Congress into creating into an institution which would guarantee banks. The FDIC provides deposit insurance which currently guarantees checking and savings deposits in member banks up to \$100,000 per depositor. In order to absorb deposits, the banks in U.S. should firstly join the federal deposit insurance, therefore all the commercial banks are insurant of the FDIC. For the safety and soundness of the whole financial system, except insuring the deposits, FDIC is also responsible for financial surveillance and early warning, as well implementing strict and direct supervision on insured banks. Insured banks should report forms to FDIC periodically, receive examinations unconditionally.

There were two separate FDIC funds; one was the Bank Insurance Fund (BIF), and the other was the Savings Association Insurance Fund (SAIF). The latter was established after the savings & loans crisis of the 1980s. The existence of two separate funds for the same purpose led to banks attempting to shift from one fund to another, depending on the benefits each could provide.

In order to receive this benefit, member banks must follow certain liquidity and reserve requirements. Banks are classified in 5 groups according to their risk-based capital ratio: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, critically undercapitalized. When a bank becomes undercapitalized the FDIC issues a warning to the bank. When the number drops below 6% the FDIC can change management and force the bank to take other corrective action. When the bank becomes critically undercapitalized the FDIC declares the bank insolvent.

The Federal Reserve need to coordinate its activities with those of other regulators and to work with them to understand the risk profiles of the individual regulated entities and their relation and importance to the FHC's overall risk profile. The Federal Reserve shall review and discuss the examination findings of primary bank, thrift, and functional regulators, together with other relevant information, to arrive at a consolidated assessment of an FHC's financial condition and risk profile, the effectiveness of its risk management, and the implications of its activities for affiliated depository institutions. The Federal Reserve will also make available to other supervisors pertinent information regarding the financial condition, risk-management policies, and operations of an FHC that will have a direct effect on individual regulated subsidiaries within the organization. In addition, the Federal Reserve will participate in the sharing of information among international supervisors to ensure the consolidated supervision of an FHC's global activities and to minimize material gaps in supervision.

General limitations similar to those on the Federal Reserve's ability to obtain reports also apply to defining when the Federal Reserve may or may not directly examine a functionally regulated subsidiary. Federal Reserve will first seek to obtain the needed information from the appropriate functional regulator. If the information is not provided or an examination is still determined to be necessary, Federal Reserve will coordinate such actions with the functional regulator. It may also be appropriate, when working with a functional regulator or with another associated supervisor, to

participate in joint examinations so as to minimize regulatory burden. Information flows and effective communication will be critical for all these relationships.

OCC mission is to ensure a safe and sound and competitive national banking system, OCC charters and is the primary federal regulator of national banks. It is responsible for examining the financial records of banks and for maintaining the integrity of FDIC deposit insurance. It is not unique in that other agencies, including OTS, FDIC, NCUA and Federal Reserve Bank, perform similar types of regulatory functions in the banking industry.

Therefore, federal banking regulatory agencies, including the OCC, the OTS, the NCUA, the Fed, and the FDIC, will work together to align outcome goals and related measures to allow for greater comparison of program performance<sup>25</sup> in the industry.

## **Main Characteristics of U.S. banking supervision**

### **1. Strict concession of entry into banking**

The first step of bank supervision procedure in U.S. is banking concession. Federal government requires banks to get particular grant for entry into banking business. To be granted the concession, there are usually two measures: firstly, from federal government, submit application to OCC according to National Banking Act<sup>26</sup>. Secondly, apply to state governments according to state banking regulations. No matter from which measure the application is granted, the regulatory requirements for

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<sup>25</sup> It incorporates measures for: capital, asset quality, management competence, earnings, liquidity, and sensitivity to market risk, commonly known as CAMELS.

<sup>26</sup> National Banking Act was a US federal law that established a system of national charters for banks. It also established the OCC as part of the Department of treasury.

entry into banking are: adequacy of capital structure, \$ 1 million as minimum; applicant should submit clear business plan; illuminating the bank's capability to meet customers' need of commercial and credit services and to keep earning benefits; reputable board of directors.

The factors considered in charter application are: a. bank's future earning prospects; b. general character of management; c. \$1 million capital sufficiency; d. convenience and needs of community to be served; financial history and condition of bank; compliance with National Banking Act. Denial of application cannot easily be overturned in courts.<sup>27</sup>

## **2. Thorough and prudent regulation & capital adequacy ratios**

For many years, U.S. prudent supervisory regulations, mostly came out aiming at excessive risk, false pretences and internal dealings in banking. In order to secure banks' steadiness, many laws and supervisory regulations have been established to restrict banks' risky actions in providing loans, investment and other deals.

In U.S., the scope covers broadly related to making and implementing prudent policy, including capital adequacy ratio, bad debts reserve, assets concentricity, liquidity, risk management and internal control and so on. A good case in point, capital adequacy ratio standard which is based on risks plays a significant role in U.S. banking supervision. The purpose of making the prudent policy is neither to manage banks from the microcosmic angle, nor to eliminate risks purely, but that to control the risks by banks' management. As Federal Deposit Insurance Corporation

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<sup>27</sup> See *Camp v. Pitts* (1973), court not effective method of disputing agency decision to deny charter because standard of review of arbitrary or capricious.

Improvement Act of 1991 (FDICIA)<sup>28</sup> requires the FDIC to use the method least costly to the insurance fund when merging insolvent banks into healthy ones.

It allowed the FDIC to borrow directly from the Treasury department and mandated that the FDIC resolve failed banks using the least-costly method available. It also ordered the FDIC to assess insurance premiums according to risk and created new capital requirements. Once supervisory agencies notice capital falls down below the minimum standard, then will examine the bank on a much stricter standard.

### **3. Effective onsite examination**

Bank supervision in the United States exemplifies the formal approach to supervision that requires an active, on-site presence to verify conditions existing within banks. In the U.S. model, periodic onsite examinations have been the cornerstone of the supervisory process. The American approach is justified by the large number of small banks and on unit banking within particular states, both of which result from restrictions on geographic expansion.

Unlike countries where the authorities rely on outside experts, bank supervisors in the United States must themselves possess the skills to evaluate asset quality and other areas of a bank's activities. A major disadvantage of this approach is that it can be labor intensive and can be inhibited by budgetary constraints. U.S. supervisory agencies have responded to resource constraints in recent years by targeting on-site examinations, making greater use of off-site surveillance and early warning analysis,

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<sup>28</sup> FDICIA, passed during the S&L crisis, strengthened the power of the Federal Deposit Insurance Corporation.

and taking advantage of advances in computer technology. These steps have permitted the supervisory agencies to hold the number of examining staff relatively constant despite the growth in assets and growing complexity of the financial system.

The more than 14,000 banks supervised by U.S. regulators is a major reason that a formal approach to supervision has been required. It also explains the adoption of the CAMEL rating system and the use of the Uniform Bank Performance Report. The CAMEL rating quantifies a supervised institution's condition in five critical areas and assigns an overall composite rating. This report compares and ranks each bank against its peers. There are twenty-five peer groups, bringing together institutions with similar characteristics. These reports are publicly available and the computer tapes are made available to stock analysts and others, while the Uniform Bank Performance Report (UBPR) is a statistical analysis of bank performance that is based on data from quarterly prudential reports.

a. Safety/ Soundness CAMELS

Two major focuses of banking supervision and regulation are the safety and soundness of financial institutions and compliance with consumer protection laws. To measure the safety and soundness of a bank, an examiner performs an on-site examination review of the bank's performance based on its management and financial condition, and its compliance with regulations.

The examiner uses the CAMELS rating system to help measure the safety and soundness of a bank. Each letter stands for one of the six components of a bank's

condition: Capital adequacy, Asset quality, Management, Earnings, Liquidity and Sensitivity to market risk. When performing an examination to determine a bank's CAMELS rating, instead of reviewing every detail, the examiner evaluates the overall financial health of the bank and the ability of the bank to manage risk. A simple definition of risk is the bank's ability to collect from borrowers and meet the claims of its depositors. A bank that successfully manages risk has clear and concise written policies. It also has internal controls, such as separation of duties. For example, a bank's management will assign one person to make loans and another person to collect loan payments.

b. Safety/ Soundness "5-Cs"

A safety and soundness examiner also reviews a bank's lending activity by rating the quality of a sample of loans made by the bank. When a bank reviews a loan application, it uses the "5-Cs" to assess the quality of the applicant. The 5-Cs stand for: capacity, collateral, condition, capital and character.

- 1) Capacity. Measures the borrower's ability to pay, including the borrower's payment source, such as a job or profits from a business, and amount of income relative to amount of debt.
- 2) Collateral. What are the bank's options if the loan is not paid? What asset can be turned over to the bank, what is its market value, and can it be sold easily? Available asset might be a house or a car.
- 3) Condition. This refers to the borrower's circumstances. For example, if a furniture

storeowner was asking for a loan, the banker would be interested in how many chairs and sofas the store is expected to sell in the area over the next five years.

- 4) Capital. The applicant's assets (house/ car/ savings) minus liabilities (home mortgage, credit card balance) represent capital. If liabilities outweigh assets, the borrower might have difficulty repaying a loan if his regular source of income unexpectedly decreases.
- 5) Character. Measures the borrower's willingness to pay, including the borrower's payment history, credit report and information from other lenders.

Every time a bank makes a loan, the bank is at some risk that it will not get paid back. A majority of most banks' assets are in loans; therefore, a loss of loans could hurt a bank's financial condition. After an examiner assesses the quality of a loan made by a bank, the loan is assigned one of the following ratings: Pass, Substandard, Doubtful or Loss. Pass, the best rating, is a loan that favorably meets the conditions set out in all of the 5-Cs. Loss, the worst rating, is a loan that has significant concerns relating to the 5-Cs and has a history of late payments. When a loan is classified Loss, the examiner does not expect the bank to get paid back.

When a problem is found within a particular area of a bank, examiners offer recommendations for improvement; however, penalties can be assessed for significant noncompliance.

Over the long run, bank supervisors can use the on-site examinations process as a catalyst for changing the fundamental ways in which banks operate by recommending actions for financial institutions to upgrade their operations. This usually involves the

strengthening of management systems in banks, including written policies and procedures, formalized planning and budgeting, internal controls and audit procedures, management information, and loan review.

#### **4. Offsite supervision and credit information**

The advent of the “information age” has brought a new bank supervision technique: offsite bank surveillance systems for the collection and interpretation of regular reporting returns and other statistical data. A critical component is effective offsite supervisory capacity. Offsite monitoring systems complement examinations’ focus on the bank’s current condition, e.g. credit, income, and capital, and are designed to accomplish a number of objectives. Foremost, they serve as an “early warning device” to detect emerging bank financial problems. At a more aggregate level, offsite surveillance systems employed by regulatory authorities can monitor the financial condition and the performance of the entire banking system. The aggregate data offer evidence on the condition of the banking system-and show changes or shifts that might require prompt adjustments in overall bank monetary or supervisory policy.

The offsite surveillance in the U.S. and analysis can serve as illustration of the process. Offsite analysis precedes onsite examinations and inspections. This offsite system is used as well in evaluating application filed for mergers and acquisitions. The regulatory agencies prepare a Uniform Bank Performance Report (UBPR), which is an analytical tool created for offsite surveillance and monitoring. Examiners can use this report to further their understanding of a bank’s financial condition and go on to identify risk areas. Bank examiners uninterruptedly run after banks’ financial

conditions, to find out potential problems in good season. To the problem banks, offsite examiners will implemented particular surveillance, make a very detailed supervisory plan, including requiring banks to increase the frequency of reporting, closely tracking banks' outstanding achievements and financial conditions and helping banks to frame the remodeling measures.

The success of an offsite system hinges on several elements. First, the accuracy and timeliness of the data submitted by banks. Second, the technology used to capture the data and compile the comparative ratios, trend analyses and percentile ranks relative to peers. Finally, the analyst makes a judgment based on a variety of financial ratios and trends, and combines the findings to offer compelling evidence of a specific bank's financial condition.

Regulation and supervision are one element of the institutional infrastructure for sound banking. In many developing countries, the capacity to evaluate credit risk is hampered by the absence of audited Financial Statements that meet International Auditing Standards. Further, credit markets in developing countries suffer from lack of credit discipline. Poor credit performance is attributable not only to adverse economic conditions, but also to the lack of credit discipline in the system. Many banks, foreign and domestic, involved as creditors had limited knowledge of borrowers' total loans or total number of creditors. The benefits of transparency are evident and the role of Credit Information Systems essential.

## **5. Comprehensive credit auditing**

First of all, to thoroughly examine banks' formal loan policies and the situation how director of management implements them. Next, to evaluate the quality of every single loan provided. The steadiness of loan operation plays an important role in the soundness of the whole banking system. U.S. accounting and auditing standards are central to the integrity of its financial system. They are also important to the Federal Reserve's efforts to supervise and regulate banking organizations.

Financial Accounting Standards Board (FASB)<sup>29</sup> standards and proposals affecting banks have been issued at a blistering pace in such areas as loan-loss accounting, asset securitization, mortgage servicing, securities activities, and derivatives. Bankers and examiners have felt the impact of these accounting developments and have seen business strategies and transaction types change as a result.

The Federal Reserve recognizes that accounting, auditing, and disclosure play a crucial role in the financial marketplace. Accounting standards provide the foundation for credible financial statements and other disclosures that are key means for communicating a firm's operating results and its overall health, as well as for making more transparent various operating activities. Disclosure of reliable information facilitates market discipline, strengthens confidence, and reduces the chance that misleading information could cause market instability. Such results have obvious implications for supervisors' abilities to oversee the safety and soundness of

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<sup>29</sup> It is a private, non-profit organization whose primary purpose is to develop generally accepted accounting principles in the public interest. The SEC designated the FASB as the organization responsible for setting accounting standards for public companies in the US.

depository institutions and for the Federal Reserve in its responsibilities for financial market stability.

## **6. Consumer protection**

Customers deposit money in a bank, and then the bank makes loans with these deposits to qualified borrowers. Whether a customer deposits money in a bank or applies for a loan, there is a lot of information to consider. For instance, let's say you deposit money into a savings account at a local bank. What minimum balances are you required to keep? Also, are you charged a penalty if your account falls below the minimum amount? When you apply for a loan for a used car, do you know if the interest rate is allowed to vary, or is it fixed for the life of the loan? If it is allowed to vary and interest rates go up, the total amount of interest you owe will increase.

Banks are required to provide customers clear and accurate information about services, such as savings accounts, loans and credit cards. For example, a bank's brochure for a savings account should include information on any minimum balance required, monthly service fee and the average percentage yield. In addition, *the Truth in Lending Act* requires banks to disclose the finance charge and the annual percentage rate so that a consumer can compare the prices of credit from different sources. It also limits liability on lost or stolen credit cards. These laws ensure that consumers and banks make decisions based on the same information.

If consumers have a complaint about a financial institution they can contact the Federal Reserve. Together with the twelve Federal Reserve Banks, the Board of

Governors can answer questions about banking practices and investigate complaints about specific banks under its supervisory jurisdiction.

## **7. Community Reinvestment**

At the time the Community Reinvestment Act (CRA)<sup>30</sup> was passed in 1977, the banking industry and community groups were concerned about “redlining” or the refusal of a bank to lend money to low-income communities, while, at the same time, accepting deposits from those areas. CRA requires that financial institutions help meet the credit needs of their entire communities, including low-and moderate-income areas. Examiners review the bank’s lending in its community, such as the number and amount of loans made to low-, middle- and upper-income borrowers. CRA provides the bank flexibility in meeting requirements, such as allowing a bank to define its community and how to determine the credit needs of the low-and middle-income neighborhoods. Rebuilding and revitalizing communities through sound lending and good business judgment benefits both communities and banks.

## **IV. Banking Supervision in China**

### **Regulations and execution of Chinese banking supervision**

China’s entry into WTO has put forward a higher requirement to Chinese banking

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<sup>30</sup> The Community Reinvestment Act (or CRA, Pub.L. 95-128, title VIII, 91 Stat. 1147, 12 U.S.C. § 2901 et seq.) is a United States federal law that requires banks and thrifts to offer credit throughout their entire market area and prohibits them from targeting only wealthier neighborhoods with their services, a practice known as "redlining." The purpose of the CRA is to provide credit, including home ownership opportunities to underserved populations and commercial loans to small businesses.

supervisory regulations. How to perfect the banking regulation law is the first task of the China Banking Regulatory Commission (CBRC). Standardized and systemic legislation should be paid more intension to perfect the banking supervisory regulations system, improve the supervisory skills and the overall quality of personnel in order to adapt the development of new situation.

The year of 1995 is known as the year of financial lawmaking. China successively passed *The Law on People's Bank of China*<sup>31</sup> and *The Law of the People's Republic of China on Commercial Banks*<sup>32</sup>, indicating China's banking supervisory law system initially formed. They become the core of China's banking supervisory system. In addition, except them, the current system still comprises the administrative regulations issued by State Council and bank supervisory regulations issued by the People's Bank of China<sup>33</sup>. From the form's point of view, it seems perfect for China's banking supervisory law system. However, in the practice, many circumstances exist like overlapping of regulations, lacking in harmony and incompatibility.

After China's entry into WTO, foreign banks and financial institutions come into China constantly, which will not only change China's current financial institutions, but also affect the actual financial functional regulations. The international development of banking supervisory regulations will be the necessary option for high-quality and effective supervisory framework. The regulations should be revised

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<sup>31</sup> Adopted at the 13<sup>th</sup> Meeting of the Standing Committee of the Eighth National People's Congress on May 10, 1995, promulgated by Decree No. 47 of the President of the People's Republic of China on May 10, 1995.

<sup>32</sup> Adopted at the Third Session of the Standing Committee of the Eighth National People's Congress and promulgated by Decree No. 46 of President of the People's Republic of China on March 18, 1995.

<sup>33</sup> Such as Guidelines on Financial Innovation of commercial banks; Rules for Implementing the Regulations of the People's Republic of China on Administration of Foreign-funded banks; Law of People's Republic of China on banking regulation and Supervision.

to meet the new requirements.

On April 28<sup>th</sup> 2003, China Banking Regulatory Commission (CBRC) was formally established. The establishment of CBRC is a milestone of China's financial system reform. The main functions of CBRC are as follows: 1) Formulate supervisory rules and regulations governing the banking institutions; 2) Authorize the establishment, changes, termination and business scope of the banking institutions; 3) Conduct on-site examination and off-site surveillance of the banking institutions, and take enforcement actions against rule-breaking behaviors; 4) Conduct fit-and-proper tests on the senior managerial personnel of the banking institutions; 5) Compile and publish statistics and reports of the overall banking industry in accordance with relevant regulations; 6) Provide proposals on the resolution of problem deposit-taking institutions in consultation with relevant regulatory authorities; 7) Responsible for the administration of the supervisory boards of the major State-owned banking institutions; and Other functions delegated by the State Council.

The supervision of CBRC focuses on: Conduct consolidated supervision to assess, monitor and mitigate the overall risks of each banking institution as a legal entity; Stay focused on risk-based supervision and improvement of supervisory process and methods; Urge banks to put in place and maintain a system of internal controls; Enhance supervisory transparency in line with international standards and practices.

Moreover, for the purposes of improving banking regulation and supervision, standardizing banking supervisory process and procedures, preventing and mitigating financial risks in the banking industry, protecting the interests of depositors and other

customers, as well as promoting a safe and sound banking industry in China, the *Law of the People's Republic of China on Banking Regulation and Supervision*<sup>34</sup> is enacted.

### **Current Problems**

In 2007, the Chinese economy continued to grow in a steady and rapid manner. Financial reform, financial management, financial supervision and regulation, and opening-up progressed smoothly and financial system remained stable. However, the deep-rooted structural problems in the financial and economic systems were yet to be resolved, while the economic and financial environment became even more complex both at home and abroad with uncertain factors increased.<sup>35</sup>

#### **1. Neglect of market competition**

The current situation of Chinese banking supervision still bears the characteristic of strong planned economy, getting adrift from the rule of market competition. Only for instance of “civilian banking industry”, it reflects that the minimum amount of registered capital required by *The Law of the People's Republic of China on Commercial Banks*<sup>36</sup> is too high. The minimum registered capital for setting up a commercial bank is RMB 1 billion yuan, which is 122 times higher than the minimum capital requirement of U.S. national banks; for urban cooperative commercial bank RMB 100 million yuan, and for rural cooperative commercial bank RMB 50 million

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<sup>34</sup> It was adopted at the sixth session of the Standing Committee of the Tenth National People's Congress on December 27, 2003 amended at the Twenty-fourth Session of the Standing Committee of the Tenth National People's Congress on October 31, 2006.

<sup>35</sup> See 2008 China Financial Stability Report, Financial Stability Analysis Group of the People's Bank of China.

<sup>36</sup> See Article 13.

yuan, which is 6 times higher than the same requirement of U.S. national banks.

Properly increasing the competitors of banking market can solve the problem of “underground finance” in some degree, since those emerging competitors can naturally circulate as well as take in and send out abundant idle funds, which will stimulate the development of banking retail business and increase the equity capital of emerging banks. Moreover, it is far from enough to just lower the entry level, many regulations need to be perfected to maintain the proper competition of banking industry, such as antitrust law, regulations of bank mergers and acquisitions, bank holding companies and bank deposit insurance.<sup>37</sup>

## 2. The hysteretic construction of supervisory regulations

There are many overlaps, incompatibility and even direct conflicts between bank supervisory rules and regulations<sup>38</sup> themselves and with *the Law of People’s Bank of China* and *the Law of PRC on commercial banks*.<sup>39</sup> Gross Settlement Procedures which came into force in 1997 directly copied many regulations of PRC Negotiable Instruments.

*The Law of PRC on Commercial Banks* and relevant department regulations emphasis excessively on supervision of commercial banks’ business. Most of the rules in Chapter III “protections for the depositors” and Chapter IV “basic rules governing

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<sup>37</sup> Many U.S. laws are of great value to learn from, such as The Bank Holding Company Act of 1956, The Bank Merger Acts of 1960 and 1966; 1970 Bank Holding Company Act Amendments; Justice Department Merger Guidelines, 1968, 1982 and 1984; Depository Institutions Deregulation and Monetary Control Act of 1980.

<sup>38</sup> Since there are only two specific banking supervision law in China and the administrative regulations are not large, which triggered regulatory disharmony within the legal system from the main reason of a series of bank supervision regulations by people’s bank.

<sup>39</sup> Such as section 4,5,13,24-1,29-1,62,63,64,68,69 in Lending General Provisions overlap with relevant regulations in the Law of the People’s Bank of China.

loans and other businesses” are the regulations on the private relationship between banks and clients. This tropism of legislation reflects the fact that legislators try to realize its supervisory objective by strictly regulating private relationships which otherwise shows its administrative intervention on private area.

China is in the process of transition from the planned economy to the market economy system, the current laws, in particular for the regulations before the introduction of "the People's Bank Law," "Law on Commercial Banks" are necessary for cleanup. Again, the specific regulations of People’s Bank on detailed area are ripe to be systematic. U.S. Federal Reserve Board’s 26 letter serial numbers listed in the management is worth learning from.

There is another important issue with regard to the scope of banking business. While the bigger the scope is, the more chances the profits will be gained, the more risk will occur. Currently, China still implements business by division of occupation. As for the tendency of international banking from separation to harmonization, China should pay great attention on it.

Banking supervisory regulations are also incompatible with WTO national treatment principle. Domestic and foreign financial institutions have been strictly distinguished. Current regulations are very administrative and flexible on national treatment principle.

### 3. Lack of perfect mechanism for withdrawal from the market

*The law of PRC on Commercial Banks* regulates particularly on this kind of

supervision in Chapter VII “take-over and termination”, but it is too simple on its supervision of withdrawal from the market due to bankruptcy or voluntary withdrawal by only four principle of regulations. There is no regulation on redemption of debt, recombination, effective capital take-over, trusteeship of closed banks. Additionally, banks are different from normal enterprises, its bankruptcy may erect a series of social problems. Therefore, supervision should be set up for the whole lot of the bankruptcy procedure. The authorities should take tough measures to establish the market withdrawal mechanism and to create a portfolio investment environment.

### **Measures to perfect the banking supervisory regulations system**

#### 1. To perfect the on-site examination in China

Building of the on-site examination is urgent, procedures of screening and protection of the power of inspection are the core of the system, It can draw on the experience of the United States, granting regulators the absolute right to inspect without advance notice, and once a bank is checked, Inspection Administration will have control of all information and property of the bank, to avoid intervention forces hampering the inspection process. Meanwhile, the law should also strengthen the responsibility of the inspectors.

The banking regulatory authority may take the following measures to conduct on-site examination for the purpose of exercising prudential supervision: (1) to enter a banking institution for on-site examination; (2) to interview the staff of the banking institution and require them to provide explanations on examined matters; (3) to have full access to and make copies of the banking institution’s documents and materials

related to the on-site examination, and to seal up documents and materials that are likely to be removed, concealed or destroyed; and (4) to examine the banking institution's information technology infrastructure for business operations and management.

## 2. To perfect the offsite surveillance in China

A critical part of the offsite process is the analytical skills of the individual financial analysts requested to make judgments regarding the bank's financial condition. It follows that credible systems have to be complemented by skilled and trained financial analysts, and China's unique economic and social factors will invariably help shape its offsite surveillance practices.

*The Law of the People's Republic of China on Banking Regulation and Supervision* stipulates<sup>40</sup> that the banking regulatory authority shall conduct off-site surveillance of the business operations and risk profile of banking institutions. For this purpose, it shall establish a supervisory information system to analyze and assess the risk profile of banking institutions.

Development of an offsite system carries the promise that the periodical financial reports currently generated by the banks could be used even more efficiently to generate an early warning system, using, for example, peer group analysis to detect broad trends affecting the financial sector. Implementing an effective offsite system in China requires overcoming some obvious, though surmountable, impediments. Just the vastness of our nation presents a major obstacle. Also, in China, the headquarters

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<sup>40</sup> See Article 23.

of the state-owned banks have traditionally delegated control to the local branches. The strong tradition of local autonomy has impeded comprehensive consolidated risk management systems, preparing timely consolidated financial statements and generating comprehensive supervisory reports.

Chinese banks are hindered by the information collection and dissemination systems for timely internal risk control analysis. Chinese banks are aware of the need to modernize the banking technology, including setting up a modern information system with real-time risk monitoring. Although the impetus for developing internal risk management can come from prescribed regulatory reporting requirements, the end result can be a banking system with more sophisticated risk management tools.

Up-to-date, after the operation testing in 2006, the national off-site surveillance information system for China's banking industry officially started operating, which is a great reform in the history of China's supervisory methods<sup>41</sup>.

### 3. Credit Information System

In order to be successful, a Credit Information Bureau should adhere to several principles. First, clear and transparent rules governing the management of the Bureau, collection of information and the procedures for sharing it with the banking community. Second, the bureau should cooperate with the banking industry and address explicitly up-front the banking industry's concerns. Enhancing the transparency of credit exposure (including contingent liabilities), collateral and

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<sup>41</sup> See latest news, April 20, 2007, the official website of China Banking Regulatory Commission.

delinquencies of borrowers through a Bureau is highly desirable in China.

When a banking institution is experiencing or likely to experience a credit crisis, thereby seriously jeopardizing the interests of depositors and other customers, the banking regulatory authority under the State Council may take over the banking institution or facilitate a restructuring. The take-over or restructuring shall be carried out in accordance with applicable laws and administrative regulations.

#### 4. Isolation from non-bank activity risks

The US authorities have adopted the holding company framework as a solution to non-bank financial institutions (NBFIs) activities. The governing principle is that non-bank activities and affiliations should not take place through subsidiaries of banks. The U.S. regulatory framework requires that organizations that conduct financial business should organize in a holding company form where the bank and the other activities are subsidiaries of the holding company. The holding company is subject to capital adequacy and other prudential norms. Profits and losses of the business lines accrue to the holding company and thus do not directly endanger the bank, nor the deposit insurance system. One major advantage is that any losses in an affiliate do not flow to the bank, as in the case of direct subsidiaries of banks, where the risk is not isolated and can be transmitted to the parent.

Banks, in the presence of explicit deposit insurance such as in the US, or implicit deposit insurance such as in China, have an economic advantage in the form of lower funding costs. This advantage is not directly available to the non-depository affiliates. Such a situation undermines the competitive playing field between bank subsidiaries

and independent firms engaging in the same business, defying the purpose of competition in financial services. Therefore, a policy objective of creating a level playing field, while at the same time preserving the integrity of the deposit insurance system, leads to segregation, regulation and supervision of non-bank activity. No matter what mode China elects to isolate banks from non-bank activity risks, the challenge for Chinese policy-makers will anticipate the inevitable and fast-paced transformation now under way in financial services and to update the regulatory and supervisory framework to respond to innovative markets.

#### 5. Transparency

Transparency is another important component of the infrastructure that permits market mechanisms to function fairly and efficiently. Customers can make informed decisions, utilizing publicly disseminated information. Improved transparency in market options will help attract international investor interest. The common themes of improving oversight and market transparency are extremely pertinent, but they are often overlooked and neglected in the supervisory practices adopted in China. Taking a global perspective, hope it will help perfect and effective China's regulatory and supervisory initiatives.

#### 6. Consumer protection

In China, the shortage finance phenomena mainly embody in three parts: first, the existing banks would not like to invest and finance in small-scale counties and countryside. Second, the existing banks have very high doorsill and complicated

procedures. Third, the rural cooperative financial organizations have strong characteristic of administrative financial organizations, bad assets increase and severely deficit. At this time, legislators should regulate and modulate in time, to protect consumers, especially the disadvantages' rights. It can be better represented by the U.S. *Regulation B*<sup>42</sup>, *The Equal Credit Opportunity Act of 1975*, and *Anti-redlining Legislation*. At first, financial institutions should be honest and let consumers know all the information and risks. China should also learn the regulations from the U.S. 1968 *Truth-in-Lending Act* and *Regulation Z*<sup>43</sup>.

Moreover, the credit record system, rating system and report are also very advanced compared to China, the related regulations should be considered to establish in order to protect the consumers and the disadvantages. U.S. *The Fair Credit Reporting Act of 1970*<sup>44</sup> and *The Right to Financial Privacy Act of 1978*<sup>45</sup> are both of great value for reference. To sum up, how to protect the consumers and to establish the corresponding regulations is a big issue for China's banking supervision.

## 7. Cooperation among different supervisory departments

From China's supervision practice, banking supervisory department, market surveillance and internal auditing haven't realized effective cooperation. People's bank, Board of supervisors, auditing administration and internal auditing department in banks all conduct on-site examination to commercial banks, but the objects to be examined and schedules are not communicated beforehand, even the same for the

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<sup>42</sup> It is known as the Regulation B-Equal Credit Opportunity

<sup>43</sup> FDIC, consumer protection, {{2-28-02 p.6641}}, Part 226, Truth in Lending.

<sup>44</sup> FCRA is designed to promote accuracy, fairness and privacy of information in the files of every "consumer reporting agency" (CRA).

<sup>45</sup> See U.S. Code Chapter 35-Right to Financial Privacy.

results of examination and the solutions. The role of market supervision and intermediary agencies is not enough. Except the listed banks, the disclosure of information of non-listed banks is not enough, sometimes even false. External intermediary organs such as external auditing firms own a lot of professional information and resources, the supervisory department hasn't noticed this would be a good method to increase the efficiency of supervision.

In this respect, communication of information should be smooth among internal and external supervisory departments, realizing information share, such as to establish joint conference, to report examination schedules, conditions and results and to adopt uniform data indicator and uniform information bank.

#### 8. To improve the market withdrawal monitoring system

*The law on commercial banks* builds up the bankruptcy for banks in principle, but there are still so many issues not involved. Future legislation should improve the bankruptcy proceedings of the procedures. The law should require banks to apply for bankruptcy rather than by the banks to directly apply to the court. The insolvency of banks should be taken careful and strict review. At the same time, China should build a corresponding reconciliation procedure and period calculated. Bank debt settlement, debt restructuring, effective asset take-over and trusteeship also requires standardization.

#### 9. To draft the regulations on deposit insurance

Regulations on Deposit Insurance should be speedily drafted to regulate behaviors

of stakeholders in the deposit insurance system through legal means, promote the establishment of insurance deposit system so as to stimulate small and medium-sized banking financial institutions to strengthen risk prevention and maintain the equity and stability of financial market.<sup>46</sup>

The major market participators in China are state-owned banks. The majority of depositors believe their money is securely taken care of by the government. Their confidence is high. The state-owned banks don't seem to need any insurance, since their owner is the insurer. However, it doesn't negate the trend to set up the deposit insurance system in China. Accordingly, U.S. FDIC system shall have great implications on Chinese draft.

### **Chinese foreign bank supervision law system after its entry into WTO**

Globalization posed challenges for the capacity of the region's supervisory apparatus to oversee the international affiliates of domestic financial institutions. The Basel Committee made initial progress in the area of home/ host reciprocal supervision of banking entities in several earlier documents, starting in 1975 and most recently in 1996. The gradual liberalization of the financial system in China is leading banks to establish an international presence. Already, several Chinese banks have established international branches. The regulatory authorities in China might be advised to consider the Basel Committee's approach and guidance on the subject, including harmonization of capital standards and initiatives to improve cross-sector supervision. Similarly, China might benefit from international efforts to harmonize

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<sup>46</sup> See 2008 China Financial Stability Report, Chapter V.

national rules that are under way, such as Core Principles developed under the auspices of the Basel Committee.

When China entered into WTO, promises had been made to open up its banking industry fully by the end of 2006. It has been a big challenge for China to prudently supervise foreign banks coming forth, based on the basic principles of WTO. For the purpose of meeting the needs of opening up to the outside world and economic development, strengthening and improving supervision and regulation over foreign-funded banks, and promoting safe and sound operation of banking industry, *Regulations of the PRC on Administration of Foreign-funded Banks*<sup>47</sup> was enacted by CBRC in 2006. In its chapter IV, supervision and regulation has been particularly stipulated. Using for reference from common international practice, BBRC has distinguished its treatment of wholly foreign-funded bank or joint venture bank from the branch of foreign-funded bank. The former ones can engage in foreign exchange and RMB businesses, without examination and approval, whereas branches have to be approved individually and engage in limited retails business. Therefore, the regulations are aiming at leading foreign banks to register sub-bank domestically in China.

National Treatment of WTO core principle requires China to treat foreign firms the same as domestic firms are treated in the Chinese market, which is a basic requirement of a global market. But meanwhile, due to China's status as emerging financial market, it is necessary and feasible for China to implement proper protection

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<sup>47</sup> It was adopted at the 155<sup>th</sup> Executive Meeting of the State Council on November 8,2006, are hereby promulgated and shall be effective as of December 11,2006.

through prudent supervisory regulation according to international practice.

The supervisory regulations for accommodating to globalization of banks are lacking. *The law of PRC on Commercial Banks* is standing for domestic banks, thus the effective supervision on foreign banks may hardly realize. An overview of the existing laws and regulations<sup>48</sup>, the shortcomings are: (1) the normative authority of the document is not high and (2) the monitoring content and the method for monitoring are too principle to operate. (3) the internal requirements for the foreign institutions are not clear.

The United States in 1991 "to strengthen the supervision of foreign banks" and 1996 Regulation K, not only required foreign banks must accept the annual inspection by the Fed, but also establish regulations for on-site and off-site inspection system, especially on-site inspection system is particularly perfect. They are very worthy learning from for China.

Globalization is a common challenge. It should be channeled or managed cooperatively. As a new member of the WTO and the global trade leadership community, China has the chance to shape globalization, not merely to be shaped by it.

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<sup>48</sup> April 1, 1994 implementation of the "management of foreign financial institutions" and the implementation details, "on foreign financial institutions in China to set up the Permanent Representative of Management", "Sino-foreign joint venture investment banking institutions Interim Measures", "Offshore financial institutions management procedures", "Shanghai Pudong foreign financial institutions to conduct RMB business in the provisional pilot Management", "Institutions in borrowing international commercial loans management methods" and "offshore banking business management practices."

## **V. Basel Agreement and New Basel Capital Agreement**

### **1. Evolvement of Basel Committee on Banking Supervision and New Basel Capital Agreement and its impact on international banking**

The Basel Committee<sup>49</sup> on Banking Supervision is an institution created by the central bank Governors of the G-10 nations. It was created in 1974 and meets regularly four times a year. The Basel Committee formulates broad supervisory standards and guidelines and recommends statements of best practice in banking supervision in the expectation that member authorities and other nation's authorities will take steps to implement them through their own national systems, whether in statutory form or otherwise.

Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. It seeks to do so by exchanging information on national supervisory issues, approaches and techniques, with a view to promoting common understanding. At times, the Committee uses this common understanding to develop guidelines and supervisory standards in areas where they are considered desirable. In this regard, the Committee is best known for its international standards on capital adequacy; the Core Principles for Effective Banking Supervision; and the Concordat on cross-border banking supervision.

The Basel II Framework describes a more comprehensive measure and minimum

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<sup>49</sup> Its membership is now composed of senior representatives of bank supervisory authorities and central banks from the G-10 countries, and representatives from Luxembourg and Spain. It usually meets at the BIS in Basel, where its twelve member permanent Secretariat is located.

standard for capital adequacy that national supervisory authorities are now working to implement through domestic rule-making and adoption procedures. It seeks to improve on the existing rules by aligning regulatory capital requirements more closely to the underlying risks that banks face. In addition, it is intended to promote a more forward-looking approach to capital supervision, one that encourages banks to identify the risks they may face, and to develop or improve their ability to manage those risks.

Basel II uses a "three pillars" concept - (1) minimum capital requirements, (2) supervisory review and (3) market discipline - to promote greater stability in the financial system. The Basel I accord dealt with only parts of each of these pillars. For example: of the key pillar one risk, credit risk, was dealt with in a simple manner and market risk was an afterthought. Operational risk was not dealt with at all.

The first pillar deals with maintenance of regulatory capital calculated for three major components of risk that a bank faces: Credit Risk, Operational Risk and Market Risk. The second pillar deals with the regulatory response to the first pillar, giving regulators much improved 'tools' over those available to them under Basel I. It also provides a framework for dealing with all the other risks a bank may face, such as reputation risk, liquidity risk and legal risk, which the accord combines under the title of residual risk. The third pillar greatly increases the disclosures that the bank must make. This is designed to allow the market to have a better picture of the overall risk position of the bank and to allow the counterparties of the bank to price and deal appropriately. It can be illuminated by the chart below.

Hence the new Basel Capital Accord comprises three mutually reinforcing pillars with a view to better safeguarding the stability of the national and international banking system. However, Basel New Capital Agreement will increase the capital requirements in developing countries as a whole, making some adverse affect on capital flows in developing countries. In some degree, it will put emerging countries' banking into an adverse competition status, especially to their abroad branches and affiliations. Basel II will also have an impact on regulatory systems across countries and on the BCP. Monitoring of the effectiveness of banks' risk management practices will take a more prominent place under Basel II, as well as the effectiveness of the supervisory review process, disclosure and market discipline.

## **2. Core Principles for effective banking supervision**

International recognition of the need for strong, effectively-supervised banking systems is the reason that the Basle Supervisors Committee issued its 1997 paper, "Core Principles for Effective Banking Supervision." (BCP)

The Basel Core Principles comprise 25 basic principles that need to be in place for a supervisory system to be effective. The principles relate to: objectives, autonomy,

powers and resources; licensing and structure; prudential regulations and requirements; methods of ongoing supervision; information requirements; remedial methods and exit and cross-border banking. In addition to the principles themselves, the document contains explanations of the various methods supervisors can use to implement them.

One of the key objectives of the BCP is to contribute to international financial stability. The Basel Committee believes that achieving consistency with the Core Principles by every country will be a significant step in the process of improving financial stability domestically and internationally. In many countries, substantive changes in the legislative framework and in the powers of supervisors will be necessary because many supervisory authorities do not at present have the statutory authority to implement all of the Principles. In such cases, the Basel Committee believes it is essential that national legislators give urgent consideration to the changes necessary to ensure that the Principles can be applied in all material respects.

## **VI. Global Financial Crisis**

As if overnight, those superior and reliable names on Wall Street became desperately ill. Starting in Wall Street, others followed quickly. Since the “black Friday” sometime in mid September, the world stock markets have dramatically fallen, large financial institutions have collapsed or been bought out, and U.S. government have had to come up with rescue packages to bail out its financial system. A \$700 billion bailout passed by the Senate was dropped off to big banks, brokers and big

insurers by buying up bad assets. For the first time, financial regulators realized how deeply the financial instrument<sup>50</sup> in sub-prime market had poisoned the global investment portfolios. It was somehow ironic that a financial instrument to reduce risk and help lend more securities would backfire so much. As problems spread, investor's confidence fell very quickly like riding on a roller coaster. Lending slowed, in some cases ceased for a while and even now, there is also a crisis of confidence.

President Obama described the crisis as "the worst financial crisis in a century". He summed his message up in just a few sentences in his victory speech in November 2008. "If this financial crisis taught us anything it's that we cannot have a thriving Wall Street while Main Street suffers," he said movingly. "In this country we rise or fall as one nation, as one people."

During the recent convention speech addressed by Federal Reserve Chairman Bernanke<sup>51</sup>, he touched on numerous measures<sup>52</sup> the Fed has enacted since the market collapsed last fall, including cutting the Fed rate nearly to zero, buying up to \$300 billion in longer-term Treasury bills, and purchasing up to \$1.45 trillion in debt and securities issued by mortgage finance agencies, up from \$850 billion.

He said the largest financial firms, perceived as "too big to fail"<sup>53</sup>, should receive further risk-management assessments and guidance on compensation policies, while

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<sup>50</sup> The sub-prime crisis came about in large part because of financial instruments such as securitization where banks would pool their various loans into sellable assets, thus off-loading risky loans onto others.

<sup>51</sup> March 20, 2009 at Independent Community Bankers of America's National Convention and Techworld, Phoenix, Arizona.

<sup>52</sup> See <http://www.federalreserve.gov/newsevents/speech/bernanke20090320a.htm>, Federal Reserve Actions to Address the Financial Crisis

<sup>53</sup> See <http://www.federalreserve.gov/newsevents/speech/bernanke20090320a.htm>, Addressing the "Too Big to Fail" Problem

lawmakers and regulatory bodies should improve resolution procedures to wind down operations systematically, rather than watching a complete collapse unfold.

He further noted that “As the recent financial crisis has highlighted, risks to the financial system may arise not only in the banking sector, but also from financial firms that traditionally have been outside the regulatory and supervisory framework applied to banking organizations. Under federal law, all banking organizations--regardless of size--are subject to consolidated supervision for safety and soundness purposes. At a minimum, policymakers must ensure that a similar statutory framework is put in place for all systemically important financial firms organized as holding companies.”

He also suggested a new "resolution regime" to ensure robust framework for consolidated supervision of all systemically important financial firms organized as holding companies, with "clear authority to monitor and address safety and soundness concerns in all parts of the organization." Such an application would help "eliminate gaps in oversight that would otherwise allow risk-taking to migrate from more-regulated to less-regulated sectors."<sup>54</sup>

The worst of the contraction in world output and employment is yet to come. Financial turmoil may well continue. Government cooperation to mitigate the effects of the crisis is badly needed. The meeting of G-20 heads of state in London on April 2nd 2009 is a crucial opportunity for leaders to agree on actions that will fight the

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<sup>54</sup> See <http://www.cfr.org/publication/18733/>, March 10th, Federal Reserve Chairman Benjamin Bernanke speaks before the Council on Foreign Relations in Washington D.C.

crisis.

Expansion should likewise occur in the countries participating in the Basle Committee on Banking Supervision, the International Accounting Standards Board, the International Organization of Securities Commissions, and the International Association of Insurance Supervisors. The primary responsibility for improved financial standards and prudential oversight necessarily resides within individual nations.

## **VII. Conclusion**

### **Dangers and Prospects**

Weakness in the banking system of a country, whether developing or developed, can threaten financial stability both within that country and internationally. The need to improve the strength of financial systems has attracted growing international concern. It is clear that instability in systemically significant countries can spill over to other countries, either on a regional level or globally.

The global trading system faces danger. The working group on WTO accession reached a compromise with China establishing somewhat lower than normal permissible criteria for safeguards over the next 15 years. WTO member governments can impose "safeguards" against China—temporary import restraints in response to import surges. Furthermore, Taiwan has long since met the conditions for WTO membership, but China has not formally signaled its acquiescence. A belligerent attitude could stir up more anti-China sentiment in the U.S. Congress.

How the United States and its major allies handle the pressures associated with China's ongoing lurch toward globalization will influence not only the effectiveness of the WTO and the health of the Chinese economy, but also, more broadly, the future of U.S.-China relations, the evolution of China's political system, and the fate of Asia.

There are also many factors may influence the safety of global banking and finance, such as North Korea and Iran's nuclear testing, terrorism, the possibility of regional war.

In response to the reported nuclear test by North Korea, it is vitally important that the United States lead an intense and sustained effort with Japan, South Korea and China to clarify each other's intentions and policies in ways that avoid any nuclear competition. A nuclear chain reaction could take place in the form of an arms race, or, internationally, Iran could take a cue to be more provocative in the nuclear arena. Moreover, nuclear weapon states must pay more attention to steps they could take to prevent a chain reaction of other countries conducting nuclear weapon tests.

As to the Geopolitical risk in the global economy, China-Taiwan has been a political issue and has gone to the side pertaining the US-China relations. Right now, China is rising in every aspect, with economy power to political confidence. In my point of view, China is trying to become a soft super power essentially on economic interdependence. It is becoming the crucial link in supply chains around the world, to make it impossible for anyone to be doing something that is not in China's interest. Even China has passed a law which in effect says "Even if you think about seceding, we reserve the right to take all necessary means" to Taiwan, I always consider this

will be solved rationally in due course without the possibility of regional war. In other words, China-Taiwan issue will not be a prospect risk for global banking and finance.

In U.S., the opinions of Republican and Democratic in their China policies appear to different colors but also no lack of consensus. Both parties have acknowledged that U.S. and China have joint interest, as both have very good cooperation in anti-terrorism and promoting stability in Korea Peninsula. Both parties have expressed concern on China's "non-proliferation". U.S. has noticed the significance of developing a constructive relationship with China, from "strategic competitors" to "welcome to rise". But as to the Taiwan issue, there are notable differences between two parties' opinions. Democratic will adhere to one-China policy but will continue to provide Taiwan with defensive weapons whereas Republican will comply with "Taiwan Relations Act". With regard to China trade policy, Democratic is relatively tough for its preparation to investigate China's controlling trade policy and violation of workers' rights. But Republican pointed out China's entry into WTO benefits bilateral trade relationship. No matter which party comes to have power, its decision of relationship with China eventually falls on the consideration of U.S. consolidated interest. Moreover, U.S. policy to China will correspondently affect the global trade and finance tendency.

To conclude, there is a great deal of uncertainty around the nature of risks in the markets as well as many external risks, the adequacy of risk and what might trigger the next stress scenario. There is a lot that banks and supervisors can do in practice to better prepare for the inevitable next downturn. Banks and supervisors can focus their

efforts on strengthening risk management in areas that presents the greatest vulnerabilities to the deteriorating market liquidity scenario, as well as on those risks that are not well addressed using more traditional risk metrics. Moreover, there is significant value in the industry and supervisors sharing insights on issues and concerns around this type of a scenario. Finally, Basel II provides a structured framework for discussing some of the new risks we are seeing and creating incentives to better measure and manage those risks.