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Article

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I. INTRODUCTION

In October 2008, China celebrated the 60th anniversary of the founding of the People's Republic of China.[1] The celebration at Tiananmen Square featured many familiar staples of the National Day ceremony—soldiers marching in perfect unison, children performing traditional Chinese dances, and countless displays of affection for "the Great Helmsman," Mao Zedong.[2] Despite the fanfare, one wonders that if Mao were aware of the changes that have taken place in the Communist empire he built, he might turn over in his glass-encased grave. On National Day, young people don Mao hats adorned with red stars, but outside these celebrations they are more likely to wear baseball caps with Nike swooshes. The Central Chinese Communist Party (CCCP) still maintains power, but the fundamental tenets of the party that Mao established have been massaged or have given way to modern ideas of free market and personal wealth. Though the "Five Star Red Flag" Mao hoisted on the first National Day in 1949 still waves over "Red China,"

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1. Michael Wines, *On Day for Chinese Pride, Little Interest in Ideology*, N.Y. TIMES, Oct. 1, 2009, at A10.

2. *See* Sharon LaFraniere, *No Detail Is Overlooked as China Prepares to Celebrate*, N.Y. TIMES, Sept. 29, 2009, at A4; *See also* Emily Rauhala, *Mao: The Great Helmsman of Kitsch?*, N.Y. TIMES, Sept. 30, 2009, http://www.nytimes.com/2009/10/01/world/asia/01iht-mao.html (discussing the variety of Mao Zedong memorabilia for sale).

the country is significantly less "red" than it was sixty years ago.[3]

The financial reforms that occurred since the "Opening Up" period of the 1980s have ushered in a new era of market capitalism in the former communist stronghold.[4] The difficulties accompanying these massive changes have shifted the economy even farther from its centrally-planned roots and the transition continues to send ripples through the domestic and international economies.[5] Not surprisingly, this movement necessitated sweeping changes in the banking system.[6] The state-owned commercial banks (SOCBs) dominate the country's financial landscape due in part to their fifty-four percent ownership of all banking assets in China.[7] The SOCBs also share a special relationship with the Central Government and often play the dual and sometimes conflicting roles of test pilot and mouthpiece for new regulations.[8] One such set of regulations implements the recommendations of the Basel Committee, an international body established in 1974 "to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide."[9] The latest

3. *1949: Highlight of the PRC Founding Ceremony*, CHINACULTURE.ORG, http://www.chinaculture.org/focus/2009-09/09/content_347434.htm (last visited Sept. 24, 2010).

4. *See* Douglas Zhihua Zeng, China's Employment Challenges and Strategies After the WTO Accession, (World Bank, Working Paper No. 3522, 2005) (discussing the growing economy since entrance into the WTO).

5. Christopher Duncan, *Out of Conformity: China's Capacity to Implement World Trade Organization Dispute Settlement Body Decisions After Accession,* 18 AM. U. INT'L L. REV. 399, 415–16 (2002).

6. *See* YUANYUAN PENG, THE CHINESE BANKING INDUSTRY 29–36 (2007) (noting that in recent years several prominent state-owned commercial banks suffered corruption scandals, some of which effected transactions with banks around the world).

7. *See* Yan Li & Yumin Zhuang, The Reform of State-Owned Commercial Banks in China, Presentation at ASEAN+3 Workshop on Reform and Development of Banking System in China (May 24–26, 2005), *available at* http://www.afdc.org.cn/afdc/cn/UploadFile/200932535829469.ppt [hereinafter Zhuang & Li, Reform of State-Owned Commercial Banks] (presentation containing asset percentage statistics distributed by the People's Bank of China).

8. Two of the main banks were the country's first to engage in international transactions, and more recently have been the first subjected to new capital adequacy requirements. *See* INST. OF FIN. & BANKING, CHINESE ACAD. OF SOC. SCIS., CHINA'S BANKING & FINANCIAL MARKETS: THE INTERNAL RESEARCH REPORTER OF THE CHINESE GOVERNMENT 74–76 (Li Yang & Robert Kuhn eds., 2007).

9. *About the Basel Committee*, BANK FOR INT'L SETTLEMENTS, http://www.bis.org/bcbs/ (last visited Sept. 23, 2010).

regulations, the "International Convergence of Capital Measurement and Capital Standards" (Basel II), set forth provisions for assessing risk and calculating capital adequacy.[10] The seemingly narrow measurement belies the great complexity of the resulting provisions and their broad influence on the banking world in China and worldwide.

This Article seeks to explore the implications of Basel II not only on the SOCBs' capital adequacy but also their corporate governance. The background section tracks the evolution of SOCBs over the last couple decades, while also looking at the Central Government's historical approaches to international standards. Section I of the analysis explains how the specificity of Basel II's capital adequacy requirements will create stronger capital assets and diminish instances of bank corruption among SOCB managers.[11] In Section II, the supervisory review requirements are shown to advance China's recent pursuit of stronger corporate governance practices. Section III explores how the nonbinding international standards engendered a new legal framework in China for regulating banks even before the standards themselves were adopted as law. The final section posits that China's interest in greater global economic power will compel full compliance with international regulations, evidenced by their accelerated implementation of Basel II.

II. THE EVOLUTION OF THE STATE-OWNED COMMERCIAL BANKS

A. COMMUNIST BANKING PRACTICES AND EARLY REFORMS

The history of China in the twentieth century and the important changes in the twenty-first reflect the intimate relationship between law, politics and economics in the Middle Kingdom. The twentieth century saw China's government move from imperialism to fragile democracy to communism, the last of which has undergone major reforms since the founding of the

10. Basel Comm. on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework*, at Introduction, ¶¶ 1, 4–7 (June 2004) [hereinafter Basel II].

11. For a discussion of recent fraud committed by upper level SOCB managers, see PENG, *supra* note 6, at 29–36.

People's Republic of China in 1949.[12] Each political transition brought new thoughts and different economic systems, which directly influenced banking practices and the legal regulation thereof.[13] The movement back and forth between centralization and diversification illustrates the ideological shifts regarding Chinese banking and the attendant changes in corporate governance.[14] During the first decade of Communist rule, the government consolidated all banking control under the People's Bank of China (PBOC).[15] The PBOC managed all banking and monetary policy throughout the entire country.[16] While the PBOC remained the sole bank in the country for a number of years, eventually the National People's Congress formed three other large state-owned commercial banks—the China Construction Bank, the Agricultural Bank of China, and the Industrial and Commercial Banks of China—creating what is now called "The Big Four."[17] The Big Four's main purpose was to fund the policies of the Central Planning Committee, and in this sense, they did not operate like modern banks at all. Instead of managing risks, incentivizing savings, or performing other financial services, these institutions essentially served as state credit-granting agencies blindly funding government projects.[18]

During the early decades of Communist rule in China, the Central Government dominated corporate governance in all companies, including the banking industry.[19] During this time, corporate governance took the form of the Central Government handing out marching orders to Communist party officials serving as owners, supervisors, managers, and creditors of

12. *See generally*, Duncan, *supra* note 5, at 402–06, 411–30 (highlighting recent changes in the Chinese legislative and administrative systems).

13. *See* FINANCIAL RESTRUCTURING AND REFORM IN POST-WTO CHINA 14–15 (James R. Barth et al. eds., 2007) (tracking the changes in SOCBs since the days of Mao's rule). [hereinafter FINANCIAL RESTRUCTURING].

14. *Id.* (explaining the strong central control of the People's Bank of China and subsequent diversification and recentralization over the past couple decades).

15. HAIQUN YANG, BANKING AND FINANCIAL CONTROL IN REFORMING PLANNED ECONOMIES 13 (1996).

16. *Id.*

17. *See* FINANCIAL RESTRUCTURING , *supra* note 13, at 10, 12; ZHONGFEI ZHOU, BANKING LAWS IN CHINA, at xxi (2007).

18. FINANCIAL RESTRUCTURING, *supra* note 13, at 10–11.

19. *See* Yuwa Wei, *An Overview of Corporate Governance in China*, 30 SYRACUSE J. INT'L L. & COM. 23, 29 (2003) (discussing the Communist nationalization of corporations and death of private ownership).

businesses.[20] Eventually, many problems arose from this centrally-planned system.[21] In addition to the problems of the State assuming several conflicting roles, there was a general absence of discipline or incentive mechanisms for state-run companies to maximize economic efficiency.[22]

Without legal ramifications for shirking fiduciary duties, managers focused more on lining their own pockets, and thus, allowed their banks to approve extremely high risk loans to those who could provide political favors.[23] Also, knowledge that the central government would simply issue more loans if ever they faced economic hardship undercut any motivation for the banks to increase productivity or profit.[24] Concentrating control over the SOCBs in the Central Committee mirrored the philosophy upon which the country was founded, but the practical application proved less than satisfactory.[25]

The chronic lack of efficiency and achievement during the early decades of the People's Republic of China lead the once staunchly communist regime to rethink its methods.[26] The result was the "Opening Up" period, the gradual economic liberation that began under the leadership of Deng Xiaopeng in 1978.[27] During this period China took its first shaky steps away from centrally-planned economics and toward the increasingly integrated world of free trade.[28] Recognizing the need to embrace the free market in order to build a stronger nation, China reformed many of its economic policies and moved toward

20. *Id.* at 32.

21. *See* HAIQUN YANG, BANKING AND FINANCIAL CONTROL IN REFORMING PLANNED ECONOMIES 21–24 (1996) (generalizing that all centrally controlled economies eventually fall victim to the similar patterns of low profitability and subpar production levels); ZHONGFEI ZHOU, BANKING LAWS IN CHINA, at xx–xxii (2007) (explaining the chronic inefficiency and underperformance for SOCBs and other state-owned enterprises).

22. Wei, *supra* note 19, at 32–33. *See also* PENG, supra note 6, at 8-108–10 (discussing conflicting roles and other problems facing state-owned banks).banks).banks).

23. *See* PENG, *supra* note 6, at 3, 29–31 (discussing bribery and fraud in Chinese banks and detailing the specific case of issuing risky loans in the BOC Shanghai branch).

24. *Id.* at 12–13.

25. *See id*. at 7 ("[S]tate-owned banks are facing daunting challenges . . . .").

26. *See* Wei, *supra* note 19, at 30 (discussing economic reforms and corporatization during the 1970s and 1980s).

27. *See* INST. OF FIN. & BANKING, *supra* note 8, at 3.

28. *See generally* NICHOLAS D. KRISTOF & SHERYL & WUDUNN, CHINA WAKES: THE STRUGGLE FOR THE SOUL OF A RISING POWER (1994).

privatization.[29] In the banking world, this lead to tentative liberalization and diversification including a more limited role for the PBOC, and the creation of the other three state banks, which were eventually allowed to run as fully-functioning businesses.[30] Throughout the 1980s, the government slowly gave banks more agency over their business dealings, which allowed the institutions to grow and set up local branches throughout the nation.[31] The incremental reform ushered in the first wave of Chinese economic growth, during which industries and banks flung off the shackles of government control, or at least enjoyed a slightly longer leash.[32] The creation of the new, free enterprise system demanded a new legal framework that would allow the government to maintain strong control while giving businesses more freedom.[33] In 1986, the Central Government's State Council issued the "Provisional Regulations on the Control of Banks," the first comprehensive legislation regulating the Chinese banking industry.[34] Yet, the first round of reforms only mitigated, and did not eliminate, the problems that plagued the early communist-era industries.[35]

B. ASIAN ECONOMIC CRISIS AND THE MID-90S REFORMS

As China's influence and economy grew, so too did the demand for further reform of the financial system.[36] The banks could not support the rapid liberalization and privatization that both lead China to this period of relative prosperity and were

29. *Id.*
30. *See* PENG, *supra* note 6, at 13.
31. *Id.* at 14–15.
32. *See*YANG, *supra* note 15, at 67 (discussing independence of central banks during transition).
33. *See* FINANCIAL RESTRUCTURING, *supra* note 13, at 16 (explaining the new banking regulations following the enactment of the PBOC).
34. Provisional Regulations on the Control of Banks (promulgated by the State Council, Jan. 7, 1986, effective Jan. 7, 1986) ASIAN LEGAL INFO. INST.(China), *available at* http://www.asianlii.org/cn/legis/cen/laws/protcob477/.
35. *See* Zhongfei Zhou & Jingwei Li, *In Search of Approaches to Improving Corporate Governance in China's State-Owned Commercial Banks*, 36 INT'L LAW. 215, 224–25 (2002) (forming sound corporate governance as an issue still plaguing banks today).
36. *See* Lawrence L. C. Lee, *Adoption and Application of a "Soft Law" Banking Supervisory Framework Based on the Current Basle Accords to the Chinese Economic Area*, 16 WIS. INT'L L.J. 687, 687–88 (1997)7 (growing financial markets in general necessitate increased supervision).

pushing it toward greater growth.[37] Free from the constraints of policy lending, the Big Four state-owned commercial banks now needed to rework their own internal structures in order to continue their aggressive pursuit of modernized banking practices and the related goal of accession to the WTO.[38]

This began with centralizing the structure which had previously let local branches operate too far outside the control of the PBOC.[39] One such problem was the habit of many local officials essentially using the state-owned banks as local policy banks, which in turn lead to a great increase in the percentage of non-performing loans taken on by the local branches.[40] These and other troubles spurred the government to pass a second wave of banking laws in China in the mid-90s, the "Law of the People's Republic of China on the People's Bank of China" and the "Law of the People's Republic of China on Commercial Banking."[41] While this eliminated the agency problems at the local level, the laws were vague and lacked the strength necessary to instill proper corporate governance in the SOCBs from the top down.[42]

While the historic passing of the banking laws constituted a large step toward industry reform, the decade would bring more warnings that the system needed further reform to fully realize its potential. The Asian Economic Crisis of 1997 provided a

37. *See* FINANCIAL RESTRUCTURING, *supra* note 13, at 9–11 (discussing the evolution of banking system due to globalization and shift to market economy).

38. *Id.* at 12–13.

39. *Id.* at 10–11, 15. *Cf.* CHINA'S FINANCIAL TRANSITION AT A CROSSROADS 87 (Charles W. Calomiris ed., 2007) (stating that China's recentralization is the cause of their economic troubles).

40. *See* FINANCIAL RESTRUCTURING, *supra* note 13, at 13–14 (discussing inefficient lending practices by local banking institutions).

41. *See id.* at 16–17 (noting the promulgation of the Law of the People's Republic of China on the People's Bank of China and Law People's Republic of China on Commercial Banking); Zhonghuá rénmín gònghéguó zhongguó rénmíng yínháng fa (中华人民共和国中国人民银行法) [Law of the People's Republic of China on the People's Bank of China] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 18, 1995, effective Mar. 18, 1995) http://www.isinolaw.com/isinolaw/detail_ce.jsp?iscatalog=0&statutes_id=131692&channelid=76608&skind=110&catalogid= (China); Zhonghuá rénmín gònghéguó shangyè yínháng fa (中华人民共和国商业银行法) [Law of the People's Republic of China on Commercial Banks] (promulgated by the Standing Comm. Nat'l People's Cong., May 10, 1995, effective July 1, 1995) http://www.isinolaw.com/isinolaw/detail_ce.jsp?iscatalog=0&statutes_id=131692&channelid=76608&skind=110&catalogid= (China).

42. *See* FINANCIAL RESTRUCTURING, *supra* note 13, at 16–19 (noting specific weaknesses in the newly promulgated laws).

wake-up call for the entire region, including the Chinese government leaders.[43] The Chinese took stock of their current financial sector and realized that further reforms were necessary to avoid the problems that crippled their Asian neighbors.[44] Thus, after a period of recentralization, China began to diversify its financial practices, always keeping an eye on WTO.[45]

Important reforms during this time included the introduction of the asset liability management system, which replaced the old credit planning system still lingering from the early communist days.[46] Also, as part of the plan to gain credibility in the eyes of the WTO members, the government improved its banks' capital adequacy by complying with the first Basel Committee's "The International Convergence of Capital Measurement and Capital Standards," or Basel II.[47] Compliance here necessitated an injection of 270 billion renminbi (approximately $39 billion USD) into the SOCBs. This measure along with the other reforms implemented by the PRC, eventually helped China gain accession into the WTO.[48]

C. ENTERING THE FREY: WTO ACCESSION AND POST-WTO REFORMS

43. *See* PENG, *supra* note 6, at 1 (noting the effect the 1997 Asian Financial Crisis had on the policies and attitude with respect to financial regulations amongst China's leadership).

44. *See FINANCIAL RESTRUCTURING*, *supra* note 13, at 20.

45. *Id.* (discussing a series of administrative regulations that took place to bring Chinese regulations in line with international standards); Raj Bhala, *Enter the Dragon: An Essay on China's WTO Accession Saga*, 15 AM. U. INT'L L. REV. 1469, 1491–92 (2000) (discussing the conflict between China's SOEs and banks and the initiative taken by the PRC to remedy this conflict in order to appeal to the WTO, in particular the United States, which was already a sitting member of the WTO and it did not approve of China's SOE policies).

46. FINANCIAL RESTRUCTURING, *supra* note 13, at 15; *See* Lee, *supra* note 36, at 729 (discussing the need for China to develop a more stable banking system since it will serve as the foundation for China's future economic development).

47. *See* FINANCIAL RESTRUCTURING, *supra* note 13, at 124 (discussing China's implementation of Basel as part of its larger measure to place its bank system in line with international standards); *See also* Basel II, *supra* note 10, at Introduction, ¶ 1–4 (discussing implementation of framework to measure capital and determine capital adequacy).

48. *See* ZHOU, *supra* note 17, at xxi (discussing issuance of special government bonds to recapitalize the big four to end the dependence of SOEs on government subsidies); Bhala, *supra* note 45, at 1481 (noting the demands made by the WTO of the PRC to become a working member, specifically the issue of government subsidies to SOEs).

In a reverse of the early communist era stance, the government made the previously mentioned reforms in the late 1990s to make the country more competitive and better able to engage other countries on the world stage.[49] An important transition in that process has been the changes made to gain acceptance into the WTO.[50] China's accession and the resulting consequence provide a helpful background against which to compare the Basel II framework and how its implementation faces similar successes and difficulties.[51]

Though China made great strides in reforming its banking system to gain accession into the WTO, their accession nevertheless came with several strings attached.[52] In an unprecedented move evidenced by the lack of trust the international community still held toward China and its banking system (particularly in the area of reliable corporate finance and enforceable legal sanctions), the WTO designed a Transitional Review Mechanism ("TRM") specifically for China. [53] The fairly strict TRM called for annual meetings during China's initial eight years "protection period," during which China had to answer questions and challenges brought by other members.[54] With the "probationary period" soon coming to an end[55],China now has the opportunity to show the world that it is capable of solely regulating its economy, specifically its financial sector, under the strict standards of the international community.[56]

49. *See* ZHOU & LI, *supra* note 35, at xix n.2 (noting the PRC's awareness that financial reforms need to be implemented); PENG, *supra* note 6, at 3 (discussing the need for China to reform its bank, especially in light of poor financial reviews from prominent international financial corporations).

50. *See generally* World Trade Organization, Ministerial Conference Accession of the People's Republic of China: Decision of Nov. 10, 2001, WT/21/432 (Nov. 23, 2001) [hereinafter WTO Protocol] (listing financial changes China must make in order to gain full membership into the WTO); Bhala, *supra* note *45*, at 1474 (discussing the purpose and significance of the provisions enumerated in the protocol).

51. *See* PENG, *supra* note 6, at 4 (discussing the use of business history, which is the study of the operation and administration of business in the past, to explain and guide present and future business operations).

52. *See generally* WTO Protocol, *supra* note 50 (listing fulfilling obligations required of China in order for it to become a working member of the WTO).

53. *Id.* at § 18; FINANCIAL RESTRUCTURING, *supra* note 13, at 117.

54. FINANCIAL RESTRUCTURING, *supra* note 13, at 119–20.

55. *See* WTO Protocol, *supra* note 50, § 18(4) (stating that the TRM will only be in effect for the first eight years of China's memberships).

56. *See* WTO Protocol, *supra* note 50, § 18(4) (stating that the TRM will only be

Part of this determination depends on the actions of the Chinese Banking Regulatory Commission ("CBRC") and its ability to use the legal power granted to it by the government and distance itself from the sometimes domineering presence of the Chinese Central Communist Party.[57] While the government itself acknowledges "the distance between international [Basel] standards and the effectiveness of CBRC has noticeably decreased," it still recognizes a distance remains.[58] While complete compliance with the Basel II Revised Framework remains the goal, the question not often asked is whether full compliance will remedy the problems still troubling China's financial system in general and the banking system in particular.[59]

Basel II sets out a standardized framework for banks, with a major push for uniform adequate capitalization standards.[60] While the Second Pillar of the Basel II explicitly deals with the supervisory framework, the underlying philosophy of Basel II is that the capitalization standards serve as both a measuring stick for judging a bank manager's risk management, and the punishing stick if they consequently fall below the prescribed levels.[61] With a uniform measuring standard, nations will be better able to oversee their internal banking systems. Also, investors will be able to use the same measure to determine what banks are solid investment prospects or judge how well a nation is maintaining its domestic banking system.[62]

in effect for the first eight years of China's memberships).

57. *See* Wang Zhaoxing, *China's Banking Industry; Moving Forward in Accord with Reform & Opening*, *in* CHINA'S EMERGING FINANCIAL MARKETS: CHALLENGES AND GLOBAL IMPACT 73, 82–84 (Zhu Min, Cai Jinqing & Martha Avery eds., 2009) (discussing CBRC's implementation of programs with little to no interference from the CCCP).

58. *Id.* at 83.

59. Wilko Bolt & Alexander F. Tieman, *When Basle II Doesn't Work: Contingency Rules versus Fixed Requirements,* THE ECONOMETRIC SOCIETY 3 (Feb. 12, 2002), http://www.econometricsociety.org/meetings/esem02/cdrom/papers/952/NoteBankComp3.pdf ("[I]n a complete information setting . . . the outcomes under the new Basle II capital adequacy framework will be *Pareto inferior* to the outcomes when a regulator assesses the risks in the asset portfolio of a bank and subsequently prescribes it a fixed CAR.")

60. Basel II, *supra* note 10, at Introduction, ¶ 4.

61. *Id.* at Pillar II, ¶ 719–21 (discussing the applicable uses and purpose of creating a supervisory framework).

62. *See id.* at Introduction, ¶ 4 (noting that the underlying purpose and use of Basel regulations will help domestic banking systems and international

With respect to the supervisory review process, Basel II places the onus on bank management to develop transparent and systematic methods for assessing risk.[63] The framework lists numerous factors that banks should use in developing these internal measuring devices, which should lead to greater uniformity across international banking systems.[64] These factors and the framework as a whole have been revised in light of the recent global financial crisis.[65] The revisions place greater emphasis on avoiding concentration of risk in specific market sectors,[66] which is a problem that already plagues the Chinese financial system.[67] In this instance, similar to China's relatively unscathed escape from the Asian financial crisis of the 1990s, China's problems proved to be its protection.[68] Because it lacked financial complexity and limited international investment, China's separation from the outside world reduced its liability when the U.S. market began to plummet.[69]

Though China has made much about its accelerated schedule for implementing the Basel II accord, it has been relatively silent on the exact measures it will take to implement the new framework, still not having released the specific 2009 regulations to the public.[70] An analysis of Basel II, however, provides a basis for analysis as to its effectiveness in reforming

investments).

63. *Id.* at Pillar II, ¶ 721.

64. *Id.*

65. *See* Basel Committee on Banking Supervision, *Revision to the Basel II Market Risk Framework* ¶ 1 (July 2009) [hereinafter Basel II Revisions] (noting that the old framework did not take into account key risks, which the new framework does take into account).

66. *Id.* § V, ¶ 21(9)(c).

67. *See* Elizabeth Ho, Article, *The International Effects of the Credit Crisis*, 28 Rev. Banking & Fin. L. 102, 110 (2009) (noting China's heavy reliance on one particular sector, exports and manufactured goods).

68. *See id.* (noting that China's conservative fiscal policies and heavy investments in one sector kept its economy safe from the international credit crisis).

69. *Id.*

70. *See* Samuel Shen, *Update 1 – China Chooses 7 Banks for Basel II Rules – Sources,* Reuters (Mar. 3, 2009, 6:12AM), http://www.reuters.com/article/idUSSHA35421220090303 (noting that China wants to have banks implementing Basel II by the end of 2010); A search of rules and regulations that mention the term "bank regulations" five sources from 2009 concerning bank regulations were retrieved. The available regulations neither mention Basel II nor resemble Basel II's general framework for capitalization regulatory. The search, conducted September 27, 2010, is in the "iSinolaw Primary Resources" database, with a general keyword search of the term "bank regulations."

Chinese banking corporate governance.[71] Again, lack of transparency remains an issue.[72] Furthermore, as with much international law, the Basel II accord provides few specifics as to how transgressions and failures to comply should be dealt with, either domestically or internationally.[73] Though some will claim that the market will right itself in regards to inadequate capital levels in banks, there are still dangers for noncompliance with such widespread standards.[74] The current global economic crisis highlights the interconnectedness of the economies of disparate nations.[75] With regard to China, failure to develop a strong legal system with which to enforce the standards laid out in Basel II could lead to trouble worldwide.[76]

D. CREATING THE CHINESE BANKING REGULATORY COMMISSION

In order to better regulate the banking industry and improve the legal framework, while preventing the government from directly interfering with the business of banking, the National People's Congress (NPC) created the Chinese Banking Regulatory Commission (CBRC)–a supervisory body with powers to regulate the evolving banking world.[77] It is no

71. *See* Kevin S. Buehler, Vijay D'Silva & Gunner Pritsch, *The Business Case for Basel II*, MCKINSEY QUARTERLY (Feb. 2004), http://mkqpreview1.qdweb.net/Financial_Services/Banking/The_business_case_for_Basel_II_1396 (discussing the use of the frameworks mentioned in Basel II as an analytical tool to hypothetically assess credit, market and operational risk, and how banks in turn should respond to such measurements).

72. *See* PENG, *supra* note 6, at 4 (noting the issue of transparency with Chinese governance).

73. *See generally* Basel II, *supra* note 10 (noting that Basel II provides a general supervisory process for domestic regulation and compliance measures, but in the end, largely relegates the duty of ensuring compliance, through the creation of a supervisory process, in the hands of bank supervisors).

74. Goksel Tiryaki, *Basel Regulations, Economic Capital and Their Implications for the Turkish Banking Industry*, 10(1) DOGUS UNIVERSITESI DERGISI J. 118,119–20 (2009), www.dwlogic.com/community/articles/Basel_Turkey.pdf.

75. *But see* Ho, *supra* note 67, at 102 (discussing that globalization and its accompanying effects is a misleading theory, because of the growing economic heterogeneity of different countries).

76. *See id.* at 110 ("In fact, China has become an attractive option for foreign direct investment within the last year as the full effects of the credit crisis have emerged."); *See also* FINANCIAL RESTRUCTURING, *supra* note 13, at 22 (noting the success foreign banks have had in China after WTO accession, and the positive effect promulgations of rules and regulations have had on foreign involvement).

77. *See* Pieter Bottelier, *The Evolution of Banking and Finance in China: Domestic & International Aspects*, *in* CHINA'S EMERGING FINANCIAL MARKETS: CHALLENGES & GLOBAL IMPACT 53, 57 (Zhu Min, Cai Jinqing & Martha Avery eds.,

coincidence that the creation came in the same year that the main Chinese banking laws were amended, and the year before a revised Basel II was released.[78] Furthering the development of modernized banks, the NPC realized the need to divest the People's Bank of China (PBOC) of its regulatory duties for two important reasons. Firstly, in order to focus on developing more complex financial services and improve its ability to compete on an international level, the PBOC could not also be burdened with the responsibility of creating, implementing, and regulating banking policy for the whole country.[79] Secondly, since the Central Government remained the majority stockholder in the PBOC, agency issues arose as to whether the bank could both monitor itself and others, in keeping with the regulatory goals of the government, while still attempting to be a competitive business, demanded by the government as primary stockholder.[80]

The creation of the CBRC accomplished both of these goals. By assuming the regulatory responsibilities formerly held by the PBOC, the CBRC relieves the bank of those concerns.[81] More importantly, with its sole charge being banking regulation, the CBRC is better able to focus on that task and is therefore more efficient in designing, implementing, and enforcing regulations.[82] Also, as a regulatory body and not a state-owned business, the CBRC holds a different relationship with the Central Government.[83] While it is still controlled by the government in the sense that it acts as a branch of the NPC, its goals and mission focus solely on regulation.[84] The CBRC accomplishes these goal through disseminating regulations and guidelines, which have the same legally binding force as congressionally-approved statutes.[85] Through these regulations

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2009) (noting establishment of an independent banking regulator).

78. *See generally Id.*; Basel II, *supra* note 10; Joseph J. Norton, *Forward* to ZHONGFEI ZHOU, BANKING LAWS IN CHINA ix, xi (Kluwer Law Int'l 2007) (noting 2003 amendments).

79. Bottelier, *supra* note 77, at 57.

80. *See* Zhuang, Reform of State-Owned Commercial Banks*, supra* note 7.

81. *See* Bottelier, *supra* note 77, at 57 (noting that by assuming the regulatory responsibilities formerly held by the PBOC, the CBRC relieves the PBOC of those concerns, allowing it to focus more on other matters).

82. Zhaoxing, *supra* note 57, at 82.

83. *Id*.

84. *Id.* (noting that the commission's purpose is to properly supervise the banking industry).

85. *See* FINANCIAL RESTRUCTURING, *supra* note 13, at 17 (discussing the broad

the Commission effects changes including overseeing the implementing of the Basel II framework, which occurred primarily in two phases.[86]

III. "VOLUNTARY" COMPLIANCE WITH INTERNATIONAL STANDARDS

China is moving away from its communist roots and into the international free market at a time where globalization is compelling the development of new requirements and standards for all countries, including those who have participated in the global market for centuries. This places a new comer to the global market like China in a unique position to create a free-market system that complies with emerging international standards.

The largest challenge for China is building a reputation that other countries can trust.[87] Increased investor confidence leads to increased investments, which leads to a stronger economy.[88] Though countries are already eager to invest despite problems such as corruption and government interference, an open China with a trustworthy banking system would lead to an even stronger Chinese economy.[89] Especially given the government's reluctance to alter policies such as floating the yuan and its history of policy loans and "meddling" with the banking system, voluntary implementation reveals an encouraging change in China's approach to the global economy. Basel II assists the SOCBs in strengthening their economic performance and reputational reliability through highly detailed and practice-oriented requirements and, perhaps surprisingly, through heavy reliance on self-regulation.

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regulatory powers of the CBRC, which largely draw from powers formerly held by the PBOC).

86. *See id.* at 21 (discussing the CBRC's role in overseeing the implementation of Basel II).

87. *See* Zhou, *supra* note 35, at 217 ("[C]orruption, and the like have been frequently described as characteristics of the four biggest wholly state-owned commercial banks.")

88. *See Busy Week Ahead for U.S. Markets Amid Important Fundamentals,* ecPulse, Sep. 26, 2010, *available at* 2010 WLNR 19128413 (noting the relationship between investor confidence and investments).

89. *See* Lee, *supra* note 36, at 692 (claiming that an efficient financial sector will lead to economic growth and development).

A. BASEL II'S FRAMEWORK STRENGTHENS SOCB PERFORMANCE AND MITIGATES SOCB PROBLEMS

Basel II provides specific provisions for calculating minimum capital requirements, designing proper risk management strategies and implementing sound supervisory review processes.[90] The level of detail provided by the Basel Committee reflects the collective work of banking experts from around the world who have repeatedly tested and revised the framework over several years.[91] The resulting regulation provides a framework whose specificity itself combats lingering banking problems facing China today—lack of transparency, threats of corruption, and even failure to fully comply with international regulations.[92]

This is not to suggest Basel II contains overly rigid and unbending provisions requiring absolute submission of the world's banks.[93] Allowances for cultural and market differences lend the framework a degree of flexibility necessary for widespread acceptance and global compliance.[94] The Basel Committee granted China and other developing countries an extended timeline for fully implementing the framework in recognition of the unfairness that would result in immediately holding those states to the same standard as developed countries.[95] Pillar 1 of the Basel II framework even includes

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90. *See* Basel II, *supra* note 10, Pillar I and II, at 12, 26 and 158, *available at* http://www.bis.org/publ/bcbs107.htm.

91. Basel II, *supra* note 10, *Introduction*. *See also History of the Basel Committee and its Membership*, BIS.COM, http://www.bis.g/bcbs/history.htm (last visited Sept. 18, 2010) (talking about the membership, the development process and testing) [hereinafter *Basel Committee History*].

92. *See* Raj Bhala, *Enter the Dragon: An Essay on China's WTO Accession Saga*, 15 Am. U. Int'l L. Rev. 1469, 1534 (2000) ("[T]he Chinese government has failed to implement fully the 1992 US-China trade agreements . . . because its trade laws and regulations lack 'transparency' and non-tariff barriers still exist."); PENG, *supra* note 6, at 12, 16 (detailing several recent high profile corruption cases in China involving SBBCs).

93. *See* Basel II, *supra* note 10, *Introduction*, ¶ 6 ("It is not the Committee's intention to dictate the form or operational detail of banks' risk management policies and practices.").

94. *Id.* § 2 ("The Committee expects its members to move forward with the appropriate adoption procedures in their respective countries.").

95. *See The Responses to the Press by the Senior Official of the China Banking Regulatory Commission on Issues Relating to the New Capital Accord*, CBRC.GOV.CN (2004), http://www.cbrc.gov.cn/chinese/home/jsp/docView.jsp?docID=468 (explaining that "[Basel II] places the one-size-fit approach with a menu of options for countries to choose for calculation of capital adequacy.").

alternative methods for calculating adequate capitalization and developing risk management depending on the type of market being regulated.[96] Yet, even when providing alternative methods, Basel II details each plan with equal specificity. The Basel Committee's ability to account for such differences illuminates the benefits of solely focusing on banking regulations.[97] Obviously, the Committee deals exclusively with such issues, but this expertise allows it to be more specific than the WTO, which also oversees banking issues, though under its much larger purview of global trade regulation.[98] Both organizations play important roles in shaping Chinese economic and trade policies.[99] Unlike the broad WTO regulations, however, the Basel Committee's framework narrows its regulatory gaze on specific aspects of banking, making it all the more effective in that area.[100] With its sights trained on the Middle Kingdom, Basel II's level of detail helps China overcome problems with its banking system and avoid historic roadblocks to implementation of international standards.[101]

1. Capital Adequacy Specifically and Simply Defined

The specificity of Basel II begins with its simply stated minimum capital requirement: "The total capital ratio must be no lower than 8%."[102] For China, this ratio provides a straightforward standard by which the China Banking Regulatory Commission and outside investors can evaluate

96. Basel II, *supra* note 10, Pillar I, ¶ at 15 ("The Committee proposes to permit banks a choice between two broad methodologies for calculating their capital requirements for credit risk").

97. *See Basel Committee History*, *supra* note 83, *available at* http://www.bis.org/bcbs/history.htm (stating that the Committee pursues "two basic principles: that no foreign banking establishment should escape supervision; and that supervision should be adequate.").

98. *See What is the WTO?,* WTO.ORG, http://www.wto.org/english/thewto_e/whatis_e/whatis_e.htm (stating that "The goal [of the WTO] is to help producers of goods and services, exporters, and importers conduct their business.").

99. *WTO Ministerial Conference Approves China's Accession*, WTO.ORG, http://www.wto.org/english/news_e/pres01_e/pr252_e.htm (quoting Minister Moore who said that "Now [China's] economy will be subjected to the rules-based system of the WTO, something which is bound to enhance global economic cooperation . . . .").

100. *See Basel Committee History*, *supra* note 83.

101. See *supra* note 13, at 114–15 (noting China's problems complying with WTO transparency requirements).

102. Basel II, *supra* note 10, Pillar *1*, at 12.

SOCBs.[103] Basel II presents its ultimate goal in the first paragraph, though greater complexity and specificity lie in the calculation of that 8% standard.[104] Guidelines for determining the standard's two main components–capital assets and risk-weighted assets–comprise the remaining one-hundred and forty-five pages of the First Pillar.[105] The sheer volume of material evinces the complex risk calculation of Basel II compared to Basel I, the whole of which totaled twenty-six pages.[106]

While the "central focus" of Basel I was credit risk, Basel II adds operational risk and market risk in the total risk calculation.[107] Each category of risk receives full explanation of the numerous factors banks must take into account in order to properly assess their risk and thereby adequately capitalize themselves.[108] The provisions governing calculation of operational risk provide three avenues for calculation–the basic indicator approach, the standardized approach, and the advanced measurements approaches–and sets out specific parameters for each.[109] For example, in laying out the second most stringent approach, the standardized approach, the framework states that banks must divide their activities into eight distinct categories, demands they calculate total capital charge with a multiple-year average, and even provides an "alternative standardized approach" in the footnotes.[110]

2. Devil Is (Not) In the Details: Specificity as a Defense Against Corruption

Basel II and its documentation requirements prevent SOCBs from only seeming to comply with the regulations.[111] Even after WTO accession, the Central Chinese Government

103. *Id*. (stating several times the need for proper documentation and ability of supervisors and investors to have access to the documents).

104. *Id*. at 15–157 (detailing proper methods for risk calculations).

105. *Id*.

106. *See* International Convergence of Capital Measurement and Capital Standards (Basel I) (1988), *available at* http://www.bis.org/publ/bcbsc111.pdf?noframes=1.

107. *See id.*; Basel II, *supra* note 10, Pillar I at 12.

108. *See* Basel II, *supra* note 10, Pillar I (detailing proper methods for risk calculations).

109. *Id*.

110. Basel II, *supra* note 10, Pillar I at 139–40.

111. *See* KRISTOFF & WUDUNN, *supra* note 28.

used prudential loopholes in the WTO's Annex of Financial Services to justify certain loans that banking branching restrictions and approval procedures would not otherwise allow.[112] Through detailing the specific requirements of capital adequacy and risk management, Basel II shrinks such loopholes and provides a level of defense against corrupt directors.[113] Its intricately planned framework and narrow focus on capital adequacy leave little room for corrupt or even ineffective directors to hide.[114] Additionally, Basel II's single focus demands a high level of banking expertise, which guards against wholly political appointments of SOCB directors.[115]

The Commercial Banking Law and the Law Governing the People's Bank of China deserve due credit for divorcing the government from the banks' reforms, laying the groundwork for Basel II.[116] The statutes added teeth to the regulations and imposed stiff penalties on managers who improperly used bank funds or engaged in other types of corruption.[117] Those 2003 amendments also created the China Banking Regulatory Committee (CBRC), which now oversees all banking, and implemented the Basel II framework through a series of guidelines and regulations.[118] Basel II's focus on capital adequacy provides the CBRC with a concise measurement by which it can judge SOCBs and evaluate corrupt managers.[119] Instead of capricious political judgments or nebulous statutes

112. *See* FINANCIAL RESTRUCTURING, *supra* note 13, at 114–15 (blaming the vagueness of this WTO provision for enabling China to circumvent its own restrictions and procedures).

113. *See* Basel II, *supra* note 10, Pillar II (granting supervisors the ability to demand documentation of methodologies of bank managers and directors).

114. *Id.; Cf.* FINANCIAL RESTRUCTURING, *supra* note 13 (claiming that the adequate capitalization requirements are too narrow and thus ineffectual).

115. Basel II, *supra* note 10, Pillar I. *See also* PENG, *supra* note 6 (noting the political nature of past banking directors appointments).

116. *See* Lifa Fa Law on Commercial Banks (promulgated by the Standing Comm. Nat'l People's Cong., 2003).

117. *Id*.

118. *See* Decision on Institutional Restructuring of the Government Agencies under the State Council, April 28, 2003; Law on Banking Regulation and Supervision (2003) (granting the CBRC unambiguous powers over the banking industry); The Guidelines on the Implementation of the New Basel Accord by China's Banking Sector (2007) *available at* *http://www.cbrc.gov.cn/chinese/home/jsp/docView.jsp?docID=200703190C335698 6BEDAB3AFF45DA32BF983500*.

119. Basel II, *supra* note 10, Pillar I (detailing the requirement that must be included in any bank's capital adequacy calculation methods).

that used to govern Chinese banks, Basel II's beacon of capital adequacy slices through previously murky regulations, and exposes corrupt and inadequate bank managers and underperforming SOCBs.[120]

3. Basel II Specificity Eases Implementation

Chinese laws often promote grand ideals such as "safety, fluidity and efficiency," but fail to explain how banks and businesses should attain them.[121] While the Basel Committee commits itself to grand goals, in Basel II it provides a specific blueprint for countries and banks to follow and reach those broad goals.[122]

Firstly, the specificity produces a type of ready-made regulatory system that works for their market and history and complies with the regulatory provisions.[123] Furthermore, Basel II restricts the government's ability to alter the regulations beyond recognition or undermine the larger goals of standardized international regulations.[124] Such details benefit China since the framework provides not only goals, but specific methods for attaining those goals.[125]

In a letter to the Chairman of the Basel Committee, the CBRC expressed China's great desire to implement the new standards, but also pleaded for assistance in designing proper

120. *See* Law on Banking Regulation and Supervision (2003) (Article 4 listing "compliance, openness, impartiality and efficiency" as the guiding principles of supervision, but then failing to expand upon them).

121. *See* YANG, *supra* note 15.

122. *See* Basel II, *supra* note 15, at *Introduction*, ¶ 4 ("The fundamental objective of the Committee's work to revise the 1988 Accord has been to develop a framework that would further strengthen the soundness and stability of the international banking system while maintaining sufficient consistency that capital adequacy regulation will not be a significant source of competitive inequality among internationally active banks.").

123. Basel II, *supra* note 10, at *Introduction,* ¶ 7 ("[F]ramework also allows for a limited degree of national discretion in the way in which each of these options may be applied, to adapt the standards to different conditions of national markets.").

124. *See* US TRADE REP., 2007 REPORT TO CONGRESS ON CHINA'S WTO COMPLIANCE (2007) [hereinafter 2007 REP. TO CONG.] (noting significant gaps between Chinese commitments under the WTO and corresponding laws).

125. *See* Letter to Jaime Caruana, Basel Committee on Banking Supervision Chair, (July 31, 2003), *available at* http://www.cbrc.gov.cn/english/home/jsp/docView.jsp?docID=466 (stating that "the risk management of [Chinese] banks has begun to evolve at an accelerated pace.") [hereinafter CBRC Letter].

and adequate methods for applying them to their relatively simplistic yet evolving banking system.[126] More than Basel I, WTO regulations or Chinese banking laws, Basel II provides the techniques and principles needed for obtaining the globally recommended ends of standardized, adequate and risk-sensitive capitalization.[127] In China, such specificity assists in mitigating a wide array of banking and business regulatory problems, particularly those related to improving corporate governance.[128]

B. BASEL II'S DOCUMENTATION AND TRANSPARENCY REQUIREMENTS[129]

Lack of transparency remains a major complaint from states and businesses doing business with China, especially those engaging with SOCBs.[130] The more China opens up its economy to trade, however, the more other states will demand that they open up their ledgers and law books.[131] Basel II not only requires greater transparency through its documentation requirements, but also specifically states the information that must be documented and who may access it.[132]

For example, banks must document procedures used for

126. *Id*.

127. Basel II*, supra* note 10, *Introduction*.

128. *See supra* note 116 (stating that "Basel is more about risk management than capital regulation . . ."); Basel II, *supra* note 10, Pillar II at 159 (explaining that proper supervision and corporate governance are necessary to implement a proper risk management system).

129. Basel II, *supra* note 10, Pillar I at 27, 34, 42, 82 and 86–87 (discussing, respectively, requirements for legal certainty, implementing qualitative criteria, standardized procedure, documented divergence from standard rating systems, and documented rating systems in general).

130. *See* WTO Protocol, *supra* note 50, at 2–3 (devoting an entire section dedicated to transparency).

131. *See* 2007 REP. TO CONG., *supra* note 124, at 11–12 ("When bilateral dialogue is not successful, the Administration will not hesitate to employ the full range of enforcement tools available.").

132. *See* Basel II, *supra* note 10, at Pillar II, ¶ 91 (highlighting that "individual assessments should be available to both domestic and foreign institutions").

their chosen risk-weighing methodology, the designs of their ratings systems, reasons for employing multiple ratings systems, and processes utilized in developing their ratings systems, just to name a few.[133] These detailed requirements alert China, and all Basel Committee members, not only to the high level of documentation required, but also to the formula used for risk calibration.[134] Comparatively, the WTO accession agreement merely lists vague areas where documentation should be provided upon request of another member country.[135]

IV. HOW DO YOU SAY "MINIMUM CAPITAL REQUIREMENTS" IN CHINESE?: TRANSLATING BASEL II INTO CHINESE LAW

The demand for supervisory review fomented the creation of the CBRC in 2003.[136] One of the first acts of the CBRC was releasing regulations incorporating Basel II principles.[137] Recently, that organization set forth guidelines for accelerated wholesale implementation of Basel II in all Chinese banks.[138]

A. BASEL BEFORE BASEL – BASEL II IMPLEMENTATION FIRST PHASE

Just months before the Basel Committee released Basel II, the CBRC issued capital adequacy provisions titled, "Regulation Governing Capital Adequacy of Commercial Banks."[139] The regulation contains key components of Basel II, such as disclosure of information requirements and supervisory review

133. *See id.* at ¶ 43 (detailing the internal ratings-based (IRB) approach to credit risk, for example).

134. *Id.*

135. *See* WTO Protocol, *supra* note 50, at 3 ("Replies to requests for information shall generally be provided within 30 days after receipt of a request.").

136. *See generally* Law of the People's Republic of China on Banking Regulation and Supervision (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 31, 2006, effective Jan. 1, 2007), http://www.cbrc.gov.cn/english/home/jsp/docVIEW.jsp?docID=2916.

137. *See* Regulation Governing Capital Adequacy of Commercial Banks (promulgated by the Chinese Banking Regulatory Comm'n, Feb. 27, 2004, effective Mar. 1, 2004), http://www.cbrc.gov.cn/english/home/jsp/docView.jsp?docID=558 (implicitly adopting Basle II guidelines) [hereinafter Capital Adequacy Regulation].

138. *See* *Guidelines*, *supra* note 118 (establishing a timetable for Basel II implementation).

139. Capital Adequacy Regulation, *supra* note 137.

provisions,[140] but does not mirror the complexity of capital adequacy calculation of Basel II.[141] On the day the provision was released, a senior CBRC official spoke to the press about the goals of the regulation, citing Basel I and Basel II as the bases for the Chinese regulations, though admitting that the "Regulations" are transitional.[142] This approach to Basel II shows the willingness of the Chinese government and the SOCBs to adopt better corporate governance standards, and some success has been achieved.[143] Most importantly, these regulations prepared SOCBs and the banking industry as a whole for the more recent CBRC guidelines advising implementation of the Basel II framework.[144]

B. THE FULL BASEL – CBRC IMPLEMENTATION OF BASEL II AND RECENT PUSHES FOR FULL COMPLIANCE

In 2007, the CBRC issued "The Guidelines on the Implementation of the New Basel Accord by China's Banking Sector" ("Guidelines"), requiring large-scale banks, with operational entities in other countries or regions, and including those banks with a large proportion of international business, to implement the entire Basel II framework.[145] The Guidelines caution that the "implementation of Basel II . . . should be proceeded gradually" and SOCBs should refrain from "irrationally rushing into the implementation."[146] While the regulations preach some caution, they also impute all the specific requirements of Basel II, such as the internal ratings based ("IRB") approach, onto the large, international banks.[147] Instead of translating the provisions into separate regulations,

140. *Id*. at Ch. III , Art. 36, Ch. IV., Art. 43.

141. *See id.* (using a basic capital adequacy formula, but not the detailed formulae of risk management put forth in Basel II).

142. Senior official of the China Banking Regulatory Commission (CBRC) Speaking to the Press on the Newly Issued *Regulation Governing Capital Adequacy of Commercial Banks*, http://www.cbrc.gov.cn/chinese/home/jsp/docView.jsp?docID=506 (last visited, Sept. 25, 2010).

143. *See* Zhuang, Reform of State-Owned Commercial Banks, *supra* note 7 (detailing progress of reform).

144. *See Guidelines, supra* note 118. (preparing SOCBs for the implementation of Basel II).

145. *Id.*

146. *Id.* at II.ii.

147. *See id.* at IV (imputing the internal ratings approach to risk assessment).

the guidelines encourage SOCBs to implement Basel II as a whole.[148]

Following their principles of methodical implementation, the 2007 Guidelines essentially gave the large-scale banks with operational entities in other countries or regions, and those banks with a large proportion of international business, until 2013 to implement Basel II.[149] Later, China surprised the global banking community by announcing that Chinese banks are likely to carry out Basel II by the end of 2010,[150] perhaps spurred on by the amazing growth in China's economy.[151] While full implementation will prove beneficial for the global banking community, it does raise the question of why China accelerated their implementation, especially considering the state of the financial market over the past year. The reasons for the accelerated implementation also suggest answers to questions about whether China will in fact be faithful to the commitments Basel II demands.

V. FULL COMPLIANCE

Much focus on China's emergence in the global market focuses on foreign countries' desire to access the large, and largely untapped, market.[152] On the flipside of that assumption, China wants to be part of the global market and is willing to comply with Basel II.[153] While deficiencies in labor law compliance or copyright infringement may not stop a purchaser from buying goods made in China, banking is a service industry with different dynamics.[154] China needs to address the

148. *See id.* at III.i ("Those large banks with operational entities in other countries or regions (including Hong Kong, Macao and Taiwan) and with large proportion of international businesses, should adopt Basel II.").

149. *Id.* at V.iii.

150. *Chinese Banks to Execute Basel II Before 2010*, NANFANG DAILY, July 30, 2009.

151. *See* Keith Bradsher, *China's Economy Roars Back, While U.S. Still Ails*, N.Y. TIMES, Sept. 18, 2009, at A4 ("The Chinese central bank said the county's economy surged at an annual rate of 14.9 percent in the second quarter.").

152. *See* JAMES MCGREGOR , ONE BILLION CUSTOMERS, 1–2, (2005) (noting the great potential of the largely untapped Chinese consumer market).

153. *See* CBRC Letter*, supra* note 125 (assuring the Basel Chairman that China will incorporate Basel II's risk management provisions).

154. *See* Ann E. Christoff, *The Chinese Automobile Industry and the World Trade Organization: China's Non-compliance with WTO Regulations through Its Subsidizing of Automobile Manufacturers*, 19 IND. INT'L & COMP. L. REV. 137, 137–

discrepancies that run throughout its banking system.[155] Especially in the wake of the global economic crisis, proper risk management tops the list of investor and government concerns regarding the financial industry.[156] With Basel II becoming the standard by which all nations and investors judge risk management (in its relation to capital adequacy), proper implementation becomes crucial for China and its SOCBs.[157] Thus, the economic benefits of complying with a globally recognized standard of risk management will reap rewards for China as it continues its ascendance in the global market.[158] As to why China chose 2009 as the year to push for accelerated Basel II implementation, we must look to an earlier international agreement that also brought international standards to China: WTO accession.[159] As mentioned above, the WTO created the Transitional Regulatory Mechanism as a special body to oversee Chinese compliance with WTO standards.[160] Over the years, China has confronted allegations by several countries complaining about lack of compliance.[161] China has historically deflected, denied and sometimes implemented change in the face of such challenges.[162]

38, 2009 (noting that despite non-compliance, China has still increased its automobile sales around the world since accession).

155. *See generally* Lee, *supra* note 36, at 729 ("The banking system operating in the CEA (Chinese Economic Area) needs work. China must develop a more stable banking system.").

156. *See* Stephen Labatton, *Fed Plans to Vet Banker Pay to Discourage Risky Practices*, N.Y. TIMES, Oct. 22, 2004 ("The Federal Reserve is working to ensure that compensation packages appropriately tie rewards to longer-term performance and do not create undue risks for the firm or the financial system.").

157. *See* Lee, *supra* note 36, at 728 ("To create a sound and safe financial integration in the CEA, the implementation of the Basle Accords will be essential.").

158. *See id.* at 708 ("Application of the Basle Accords to China's banking regulation will allow China to adopt internationally recognized standards of banking supervision which, in turn, will encourage foreign banks to conduct business in China.").

159. *See generally* WTO Protocol, *supra* note 50 (describing China's accession to the World Trade Organization).

160. *Id*. (detailing the TRM).

161. *See* World Trade Org., *Disputes by Country/Territory*, http://www.wto.org/english/tratop_e/dispu_e/dispu_by_country_e.htm (last visited Sept. 23, 2010) (listing China as a respondent in twenty claims).

162. *See* World Trade Org., *China: Measures Affecting Trading Rights and Distribution Services for Certain Publications and Audiovisual Entertainment Products* http://www.wto.org/english/tratop_e/dispu_e/cases_e/ds363_e.htm (last visited Sept. 24, 2010) (providing an example of China's willingness to adopt recommendations and rulings).

Significant to China's Basel II implementation is that the eight year period under which China must answer to the TRM ends this year.[163] This does not, however, mean China is completely free from WTO scrutiny, for in 2011, or possibly 2010, China will undergo its final TRM review.[164] Considering multiple countries have raised issues during each year of China's membership and this will be the final review, it is logical to presume China will come under stricter scrutiny than the previous years.

While this final review does pose a challenge for China, it also represents an opportunity. As mentioned above, over the past few years Chinese businesses, including SOCBs, and the government, have recognized the need for greater corporate governance.[165] If China is able to prove its banking industry meets the rigid Basel II standards, it should lead to better risk management.[166] Firstly, Basel II compliance indicates a robust and modern financial system, which would answer questions about China's ability to fully modernize a key industry, particularly with regards to SOCBs.[167] Secondly, and more importantly, given the context of WTO review, full Basel II implementation would demonstrate China's willingness and ability to comply with international standards, which has long been a question mark for the Middle Kingdom.[168] Since a comprehensive TRM review will almost certainly raise questions of banking, and about SOCBs in particular, China is seizing the global stage to display its ability to reform and prove to the world it can be a trusted and sophisticated financial service partner.[169]

163. *See id*.

164. *See id*.

165. *See Guidelines, supra* note 118. (concluding that Basel II is "consistent with the CBRC's supervisory concept of principle based supervision").

166. *See CBRC Letter, supra* note 125 ("We all believe that this rewarding exercise will yield long-term benefits both in terms of improved capital regulation and most importantly, better management of risks in banking.").

167. *See* Bhala, *supra* note 45, at 1471 (noting that the Middle Kingdom is a second-rank power that has mastered the art of diplomatic theater").theater").

168. *See id.* at 1470 ("No country currently seeking WTO membership—Saudi Arabia, Iran, and Russia, for example—could possibly raise a more complex array of issues than the People's Republic of China.").

169. *See* Lee, *supra* note 36, at 727 ("If [China] fully adopts the Basle Accords, investors seeking to optimize the return on their investment would be free to buy, sell and trade in financial assets through the region.").

170. The Basel III regulations were released as this article was going to print.

VI. CONCLUSION

Despite the best efforts of countries such as China and organizations such as the Basel Committee, the ultimate test of international standards remains the marketplace. Basel II represents a common standard by which all banks, regardless of country of financial system, can be assessed. The risk management standards in particular will provide greater uniformity of practices throughout Chinese SOCBs that should mitigate, or at least make more difficult, the corrupt practices that have brought harm not only to the banks' customers, but also to the reputation of the Chinese banking system as a whole. The government's desire to voluntarily address these issues and implement Basel II should prove encouraging to those looking to do business with the Big Four in the future.[170]

Questions still remain, especially considering whether or not the Central Government can be trusted to take its own members to task if and when violations occur. Aside from the financial and political impracticability of a watchdog organization, the best free market systems should regulate themselves. Of course, no system is perfect, and regulation is necessary, but concern about national integrity, security, as well as a greater familiarity with one's domestic system make host countries perhaps the best candidates to regulate their systems.[171] Furthermore, Chinese SOCBs and the Central Government have a unique relationship. The regulators want to enforce the rules that have been domestically ratified. At the same time, the bank owners or majority shareholder wants the bank to be as financially free as possible and thus as profitable as it can be. With Chinese SOCBs, the regulators and majority shareholders are one in the same: the Central Chinese government. While this does open the possibility of regulators shirking responsibility for profit, the ultimate goal of increased international banking business should provide proper

The CRBC stated that they see no short-term impact on China from the new regulations. *See* Esther Fung, *China Banking Regulator: Basel III Won't Have Immediate Impact on China Banks,* FOX BUSINESS Sept. 16, 2010, http://www.foxbusiness.com/markets/2010/09/16/china-banking-regulator-basel-iii-wont-immediate-impact-china-banks/

171. *See* Basel II, *supra* note 10, at Pillar II, ¶ 722 ("Supervisors are expected to evaluate how well banks are assessing their capital needs relative to their risks and to intervene, where appropriate.").

motivation for the government to fulfill its dual roles with equal diligence.

As in any industry, it is difficult to predict what future changes will occur in the global financial market. New financial products emerge constantly, some good (ATMs and online banking), some not (sub-prime housing loans). Whatever emerges, the global community must respond, and implementing standards such as Basel II prepare the world to better address changes and problems as they arise. One of the largest question marks moving is China itself. Though market forces and international pressure can effect some change, the increasing power of China may cause China to grow impervious or indifferent to the cries of the outside world. For this reason, the internalization of certain standards, such as the Basel II accords, but also those in a variety of areas, may be the best instrument for ensuring global stability in the future. This is not to suggest some nefarious plot of world domination by China, but we must acknowledge that the shifting of global powers has rarely been easy or peaceful.