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Miami (Etats-Unis), 14-18 Septembre 2003 

The new Basle Capital Accord and risk management of Chinese state-owned commercial bank 

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Introduction
With the globalization of finance as well as derivatives instruments widely used, the accumulation of the financial risks spread widely all over the world. Therefore, enforcing banking supervision is a big task in the new financial environment. In June 1999 the BIS published a consultation document (named as A New Capital Adequacy Framework) to prompt risk management in banking. The new Basle Capital Accord has three basic pillars: minimum capital requirements; supervisory review process; market discipline. Internal Ratings based (IRB) approach is the heart of New Basle. Chinese state-owned commercial banks have a big gap in risk management compared with international big banks, especially when entering WTO, the competition of global banking will have a great impact on China banking. How to supervise financial risks according New Basle, is a great challenge for chinese state-owned commercial banks.

With respect to all the developments mentioned above, this thesis is structured as follows, the first chapter illustrates the background of New Basle as well as the weakness of 1988 Accord.

The second chapter discusses three basic pillars of New Basle: Minimum capital requirements, supervisory review of capital adequacy and market discipline, mainly focuses on the Internal Rating approach. IRB system is discussed respectively from five perspectives: features of IRB system, how does the IRB approach work, the objectives of IRB approach, some comments by BIS and some problems in practice with bank’s internal rating system.
The third chapter deals with risk management of Chinese state-owned commercial banks under the new Basle Framework. The measures of risk management as well as new challenges of risk management under New Basle will be discussed.

The final chapter provides a conclusion.
Chapter 1  Background

1.1  The background of New Basle

The unprecedented surge in the globalization of financial market as well as the accumulation of the great financial risks, and the emergence of episodes of financial distress can be witnessed from Mexico financial crisis, Asia financial crisis and the collapse of Baring. All these accidents proved that enforcing banking supervision is a big task in the new financial environment. In June 1999 the BIS published a consultation document (named as A New Capital Adequacy Framework) to prompt discussion among market participants concerning a replacement for the original 1988 Basle Accord which had been the cornerstone of banking supervision for over a decade. While the 1988 Accord established minimum levels of capital for internationally active banks, incorporating off-balance sheet exposures and a crude risk-weighting system, it focussed mainly on credit risk among G10 banks but over the next decade or so was extended to cover banks in over 100 countries and to also include market risk, interest rate risk, foreign exchange risk and operational risk. More generally, there is also a trend towards “regulatory devolution”(e.g. internal models).

New Basle inherits the basic principles of supervision from the original 1988 Basle Accord, and continued to focus on the capital adequacy and controlling the credit risk. Moreover, there are three basic pillars to New Basle: Minimum capital requirements; supervisory review process; market
discipline. The new way and method for evaluating capital adequacy has been presented in New Basle, and this effort will prompt capital adequacy and the measures for risk management more effectively and more efficiently in current financial market.

1.2 the weakness of 1988 Accord

Financial innovation over the last 10 years have led to a possible divergence between a bank’s capital ratio and its true financial condition. For example, asset securitisation structures, which has led to traditional capital requirements not being closely related to a bank’s true risk profile. The weaknesses are as follows:

(a) The minimum risk-weighted capital ratio (8%) is arbitrary. The profit and other risks are ignored. For example, the capital ratio of Baring was above 8% by the end of 1993, and it is considered safely by Jan, 1995, but it collapsed by Feb, 1995.

(b) Banks can arbitrage their regulatory capital requirement and exploit divergences between true economic risk and risk as measured by the Accord, e.g. via securitisation. This can lead to a shift in bank’s concentration to lower quality assets. They replace low-risk/low-return loans by high-risk/high-returns, leaving total capital required unchanged but higher portfolio risk present. Providing credit enhancements to securitised debt which tend to reduce capital requirements but no reduction in economic risk. All in all, the rapid growing nature of capital arbitrage was undermining the meaningfulness of the Basel capital ratios.
(c) The risk weights are crude and largely unrelated to risk and in general do not take maturity or collateral into account. For sovereigns, there is a crude distinction between OECD and non-OECD which makes no economic sense. Consider the following table as of April, 2000, showing S&P ratings:

<table>
<thead>
<tr>
<th>OECD</th>
<th>Ratings</th>
<th>Current Weight</th>
<th>Proposed Weight</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mexico</td>
<td>BB+</td>
<td>0%</td>
<td>100%</td>
</tr>
<tr>
<td>Turkey</td>
<td>B</td>
<td>0%</td>
<td>100%</td>
</tr>
<tr>
<td>Poland</td>
<td>BBB</td>
<td>0%</td>
<td>50%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Non-OECD</th>
<th>Ratings</th>
<th>Current Weight</th>
<th>Proposed Weight</th>
</tr>
</thead>
<tbody>
<tr>
<td>Singapore</td>
<td>AAA</td>
<td>100%</td>
<td>0%</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>A</td>
<td>100%</td>
<td>20%</td>
</tr>
<tr>
<td>Taiwan</td>
<td>AA+</td>
<td>100%</td>
<td>0%</td>
</tr>
</tbody>
</table>

From these two figures, it can be seen that for sovereign, the OECD includes (as of April, 2000) ‘B’ Turkey with a current weight of 0% while non-OECD ‘AAA’ Singapore has a 100% weight. The new proposed weights are 100% and 0% respectively. You can imagine how dramatic was the effect of these proposals on bond and loan spreads for particular countries.
But under the 1988 Accord all corporates received the same 100% risk weighting.

(d) There is no benefit for portfolio diversification or penalty for excessive concentration of risk. Clearly internal models have a role here.

(e) **Chapter 2 Three basic pillars of New Basle**

**2.1 Minimum capital requirements**

**2.1.1 Extension of new risks**

Although credit risk is the main risk that the banks have to deal with, market risk and operational risk are also the key elements that can worsen and destroy the banks. The definition of the elements of capital is unchanged from 1988, but Capital adequacy is measured as:

\[
\text{Total capital (unchanged)} = \text{Capital ratio (minimum 8%)} = \text{Credit risk} + \text{Market risk} + \text{Operational risk}
\]

**2.1.2 Credit risk Measurement**

There are three approaches to credit risk measurement: Standardised approach (a modified version of the existing approaches), Foundation IRB (internal rating based) approach and Advanced IRB approach. Standardised approach belongs to external rating method and Foundation IRB and Advanced IRB belong to internal rating methods.
2.1.2.1 Standardised approach

The standardised approach is conceptually the same as the present (1988) Accord, but is more risk sensitive. The bank allocates a risk-weight to each of its assets and off-balance sheet positions and produces a sum of risk-weighted asset values. A risk weight of 100% means that an exposure is included in the calculation of risk weighted assets at its full value, which translates into a capital charge of 8% of that value. A risk weight of 20% results in a capital charge of 20% of 8% or 1.6%. The risk weights depend on the credit ratings given to borrowers by external credit assessment agencies (i.e. credit rating agencies).

Individual risk weights

<table>
<thead>
<tr>
<th></th>
<th>AAAtos</th>
<th>A+ to</th>
<th>BBBold</th>
<th>BB+ to</th>
<th>Below</th>
<th>Unrated</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAs to</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AA-</td>
<td>0%</td>
<td>20%</td>
<td>50%</td>
<td>100%</td>
<td>150%</td>
<td>100%</td>
</tr>
<tr>
<td>A-</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sovereigns</td>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Banks</td>
<td>20%</td>
<td>50%</td>
<td>50%</td>
<td>100%</td>
<td>150%</td>
<td>50%</td>
</tr>
<tr>
<td>Corporates</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>AAAtos</td>
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<tr>
<td>AAs to</td>
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<tr>
<td>A-</td>
<td>20%</td>
<td>50%</td>
<td>100%</td>
<td>150%</td>
<td>...</td>
<td>100%</td>
</tr>
<tr>
<td>BBBold</td>
<td></td>
<td></td>
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<td></td>
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<tr>
<td>BB+ to</td>
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<tr>
<td>BB-</td>
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<td>Below</td>
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</tr>
<tr>
<td>BB-</td>
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</tr>
</tbody>
</table>

Note that an option exists for banks to give a risk weight one category less favourable than its sovereign. Residential mortgages are risk weighed at 50% and commercial ones at 100%. There is also more detail for off-balance sheet and collateral items.
The External Credit Assessment (ECA) institutions (e.g. rating agencies) have to be approved by national supervisors with the following criteria: objectivity, independence, transparency, disclosure, resources, and credibility. This is becoming a contentious area of debate.

Supervisors will map an ECAI’s assessment into the standardised risk weighing framework. Banks must use the chosen ECAI’s and their ratings consistently and not “cherry-pick” the ratings from different ECAI’s. Banks must disclose at least once a year the ECDI’s which they use, the mapping process determined by supervisors, and the proportion of risk-weighted assets that are based on the assessments of each eligible institution. If there are split ratings, the lowest one should be used.

2.1.2.2 An alternative approach: Internal Ratings

The BIS recognises that for some sophisticated banks it may be useful to base capital requirements on the banks’ own quantitative and qualitative assessment of credit risk. This is called the Internal Ratings Based (IRB) approach.

There are six broad claims of classes: corporates, banks, sovereigns, retail, project finance, equity. Banks must apply the IRB approach to all business classes and business units (or not at all). There are two IRB approaches: foundation and advanced. Under the IRB model a bank estimates each borrower’s creditworthiness and the results are translated into estimates of a potential future loss, which form the basis of minimum capital requirements.

(a) Foundation IRB approach (to corporates, banks, sovereigns)
A bank must internally estimate the probability of default (PD) associated with a borrower grade, while the supervisor states other key parameters (such as Loss Given Default (LGD)). This is designed for sophisticated banks which can prove to supervisors that they meet certain minimum requirements concerning the IRB system, risk management processes and the ability to measure the components.

(b) Advanced IRB approach

A bank with a sufficiently well-developed internal capital allocation process will be allowed to supply other necessary inputs as well: loss given default (LGD), exposure at default (EAD), and the treatment of guarantees/credit derivatives. If a bank wants to calculate one of these itself, it must move quickly to calculate all three. This is for the most sophisticated banks.

Banks using the advanced approach must also calculate the foundation quantity in parallel for two years and meet extensive public disclosure requirements.

2.1.2.2.1 Features of an IRB system

1. Completeness and integrity of rating assignments, including coverage and independence of assignment (and at least once a year).
2. Managerial oversight of the rating system and processes by senior management, and clear documentation of the process. There should be an annual internal audit of the bank’s rating system.
3. Each internal grade must have a probability of default (PD’s) over one-year associated with it, and be well grounded on historical evidence. Banks can map their internal grades into external rating agency grades.
and use their PD’s. 5 year’s data should be used.

4. The internal ratings must be an integral part of daily credit risk measurement and the credit approval process. PD should be used in the pricing of credit risk and internal ratings should be used in the assessment of capital adequacy. A bank must have in place sound stress testing procedures, for assessing capital adequacy, including tests against economic or industry downturns, market-risk events, and liquidity conditions. An independent unit should conduct these tests and report in detail every 6 months. The IRB model should have been in use for at least 3 years.

5. To be eligible for the IRB approach, banks must meet the disclosure requirements for the foundation IRB approach set out in Pillar 3. For the Advanced IRB approach, there are similar requirements but also additional ones regarding the LGD, EAD and the treatment of guarantees etc. There have to be systems in place for LGD and EAD calibration, and also their use.

2.1.2.2.2 How does the IRB approach work

1. Group exposures into one of the six categories above.

2. Evaluate the credit risk of each one.

3. Calculate PD, LGD, EAD, M, etc. Map these into a table of regulatory
capital risk weights: e.g. for corporates this is:

\[ RW_c = \frac{LGD}{50} \times BRW_c(PD) \times (1 + b(PD) \times (M - 3)) \]

4. The bank has to ensure minimum requirements for IRB treatments are met for each exposure.

5. The supervisors ensure the whole process is compliant with the minimum requirements and the risk estimates are appropriate.

2.1.2.2.3 The objectives of IRB approach

The IRB approach is set to meet two key objectives:

1. Additional risk sensitivity, in that capital required based on internal ratings can prove to be more sensitive to the drives of credit risk and economic loss in a bank’s portfolio;

2. Incentive Compatibility, in that an appropriately structured IRB method can provide a framework that encourages banks to continue to improve their internal risk management practices.

US banks already were using internal models extensively. These ratings are not made public or communicated to the rated entities. Banks estimate each borrowers’ creditworthiness internally and then convert this into an estimate of potential future loss. These are similar to external ratings but the main difference is:

The external rating is based on a downside scenario involving “looking
through the cycle”, whereas internal ratings are based on a borrowers’
current conditions and “most likely outlook”.

2.1.2.2.4 Some comments by BIS

Many banks already use IRB systems for loan approval and pricing, risk
management etc. IRB methods may use information beyond the reach of
external rating agencies, such as knowledge of customers’ accounts or of
collateral or guarantees; they will also cover a much wider range of
borrowers, especially small to medium sized companies. In 1989 around
3000 international bond issues were rated by leading agencies, rising to
15000 by 2000, but this is still only a few percent of the world’s banks and
corporates.

2.1.2.2.5 Advantages and disadvantages of IRB approach

Advantages: A closer link between regulatory and economic capital.
Disadvantages: Substantial data requirements. Many banks not yet
equipped.

2.1.2.2.6 Some problems in practice with bank’s internal rating systems

as a part of its capital adequacy review process in 1999, the BIS undertook
an in-depth analysis of the practice of internal rating systems by 30 G-10
banks identified as having well-developed methodologies. Here we
summarise key issues and findings: There is no single standard at
present, different banks have very different rating systems; there is also
the subjective influence on scores and hence comparability across
institutions and counties is a significant problem. Lots of practical issues
arise for bank supervisors: how do internal models translate into a common benchmark? Is the internal scale sufficiently finely graded? Is the model reviewed by experienced managers who are independent of the credit approval/pricing decision? Is there historical data on the loss experience for each grade?

2.2 Supervisory review of capital adequacy

The supervisory review is an integral part of the capital framework: it is the interaction between bank and supervisor to ensure that the bank’s capital is consistent with the overall risk profile and to enable early intervention by supervisors if capital adequacy problems arise. Three principles are listed:

2.2.1 Capital to be held above the regulatory minimum

Factors influencing this include: experience and quality of management, quality and volatility of earnings and capital, access to new capital, liability and liquidity profile, diversification of activities, exposure concentration, shareholder support, degree of supervision by other supervisors. Business cycle and macroeconomic effects should also be considered, together with forward-looking stress testing, including the impact of ‘worst case’ scenarios arising from changing market conditions.

2.2.2 Bank’s internal assessment of capital adequacy

Each bank has to show that it has a process for assessing internal capital adequacy and future capital needs in the light of its risk profile and business plan; this will be in ‘a systematic, disciplined manner, taking account both qualitative and quantitative risk factors’. Banks should have
a credible and clearly defined internal capital allocation methodology. A bank should also be able to incorporate changes in its risk profile, e.g. due to product innovation or macroeconomic developments, and to perform rigorous stress tests to identify possible events or market changes which could impact on the bank.

### 2.2.3 The supervisory review process

This includes periodic reviews with bank management including on-site examinations or off-site surveillance to examine capital adequacy, and talk to both internal and external auditors. In addition they should review a bank’s internal models and assess whether a bank treats similar risks in a consistent fashion. Stress tests and sensitivity analyses will also be reviewed in detail, as will a bank’s accounting and valuation principles.

### 2.3 Market discipline

For markets to assess a bank’s capital adequacy, there is a need for information about a bank’s risk profile and its capital structure. Such disclosures, at least annually, are important for achieving market discipline:

(a) capital structure

A bank should disclose summary information about its capital structure, (e.g. components of capital, Tier 1, Tier 2, Tier 3 capital), its reserves for credit losses, and its accounting policies.

(b) risk exposures

This should include both qualitative (e.g. management strategies, appetite for risk) and quantitative (e.g. position data), including its evolution over
risk-based capital ratios calculated as prescribed in the 1988 Accord should be disclosed by banks; qualitative disclosures about internal processes used by a bank for assessing its own capital adequacy should also be presented. These will aid market participants in judging how well a bank’s management of its capital adequacy is being performed, whether available capital is sufficient to meet credit, market and other risks, and how well it will stand future volatility.

Chapter 3  risk management of Chinese state- owned commercial banks under the new Basle framework

3.1 the measures of risk management

China as a member of BIS, is reforming the banking system according the core principles of Basle since Basle Accord formally practiced from 1992, and does its efforts to build new rules of banking businesses and new principles of banking supervision. In recent years, China has implemented a series of measures in state-owned commercial banks. The measures are as follows:

(a) Chinese government and people’s bank of China as the supervision of authority presented specific methods for calculating capital and risk – weighted assets according Basle Accord, and specified the minimum capital adequacy requirements(8%). Especially for the low capital ratio of state-owned commercial banks, Finance Ministry provides four big state-
owned commercial banks with 270,000 million RMB in order to improve capital adequacy and enforce the ability against the risks.

(b) China constructs the facilities of classified loan for risk management. The local branch banks that are supervised by central bank are merged and acquired in different regions. All these efforts are to improve the ability of supervision and decrease the interference of local government.

(c) China built four Assets Management Companies to deal with the assets of poor quality of state-owned commercial banks, this measure means that China stepped rapidly in solving the problems of poor quality assets of state-owned commercial banks.

(d) Since 1995, more than 200 laws and rules concerning financial supervision have appeared on the stage, incorporating <the law of people’s bank of China>, <the law of commercial banks>, and <insurance law> etc.

3.2 New challenges of risk management under New Basle

From above all, it can be seen that china banking has implemented some measures in according with Basle Accord. Meanwhile, with reference to New Basle Capital Adequacy Framework, Chinese state-owned commercial banks have to face a series of new challenges in risk management.

3.2.1 promoting capital adequacy and improving the quality of assets

At present, capital adequacy of most Chinese state-owned commercial banks can not reach 8%, this is due to china economy is on the transition from planned economy system to market economy system. In general, China economy reform and rapid economic growth promote the
businesses of banks increase rapidly, market reform also leads to monetary economy and financial reform. As a result, the speed of increasing in financial assets is much higher than the speed of increasing in GDP, meanwhile, commercial banks accumulated much poor quality assets due to the mistakes in management during the transition period. On the other side, the capital of Chinese state-owned commercial banks lacks the channels to replenish. If New Basle is implemented, Chinese banking will face more high requirements for capital adequacy. The measures that Chinese banking should adopt incorporate: Raising money through going on list; improving the quality of assets.

3.2.2 Constructing IRB system for risk management

The heart of New Basle Capital Adequacy Framework is Internal Ratings System. From the empirical study of international big banks, Internal Ratings play an important role in credit risk management. For instance, IRB provides references for the price of financial instruments; reserves for bad debt and allocation for economic capital; services for customers; and for the decision of experienced managers. An effective IRB system incorporates the conceptual methodology, management processes, and systems that play a role in the assignment of a rating. Most of Chinese state-owned commercial banks have a big gap in applying IRB compared with international big banks, therefore the role of disclosure and controlling credit risk is in certain limits. When assessing risks, Chinese state-owned commercial banks lay particular stress on quantity analysis and simply assessment, this leads to risk disclosure in low level.
On the other hand, data inputs need to be equipped, the results of assessment need to be examined, and the application of assessment results is very limited. Therefore, a lot of new challenges that Chinese state-owned commercial banks have to encounter under the New Basle Capital Adequacy Framework.

3.2.3 From credit risk management to total risks management

In the businesses of banks, all kinds of risks are connected together and effect mutually, when drafting principles of internal risk management and external supervision, all the risks incorporating credit risk, market risk and other risks should be considered, this is called total risks management. In fact, this concept has been mentioned in New Basle Capital Adequacy Framework, for example, interest rate risk and operational risk is included in it.

At present, China mainly focuses on credit risk, and nearly did not consider interest rate risk and operational risk during the assessment of risk- weighted assets and capital adequacy supervision. With the capital market opening towards the world, the interest rate will become more volatile. With more businesses and more computers being operated, operational risk will increase. As a result, if risk status of banks can be reflected truly, interest rate risk and operational risk must be in consideration. During the specific operation, central bank can decide minimum capital ratio according the real status of the interest rate risk, and consider the capital ratio for operational risk. It can be seen that if interest rate risk and operational risk can not be managed very well the
risk of banks will increase, and more capital needs to be prepared.

**3.2.4 Improving the ability of supervision**

There is a trend towards ‘regulatory devolution’ in New Basle (e.g. internal models), on the other side, New Basle presented high requirements for supervision authority in every country. For the Chinese supervision authority, how to improve capital adequacy and reach the minimum level 8%, how to evaluate internal models system of commercial banks, and how to supervise foreign banks under New Basle and etc, are the new challenges.

**3.2.5 Establishing the sound open information system**

Because the accounting information is not complete and the accuracy needs to improve, the quality and quantity of open information of Chinese banking is far beyond the requirement of market. The whole markets lack enough materials to analysis the risk status of banks. Therefore, in the aspect of open information, banks should supply disclosure materials promptly, at the same time, market should enforce the power to analyze the information of banks, and improve the power of market constraint.

**Chapter 4 Conclusion**

The new Basle Capital Accord has three basic pillars: minimum capital requirements; supervisory review process; market discipline. This article attempts to search for the changes and merits of the new Basle Capital Accord compared to the 1988 Accord. For instance, although the definition of the elements of capital is unchanged from 1988, Capital adequacy is
measured not only for credit risk but for market risk and operational risk. It points out there is also a trend towards “regulatory devolution”. (e.g. internal models) From a theoretical and logical perspective, arguments for and against internal model are presented, which are also compared with empirical evidences.

According to the requirement of the New Basle Capital Accord, Chinese state-owned commercial banks face a series of challenges. This article put forward the suggestion on how the China state-owned commercial banks should do under New Basle. The details are as follows: Promoting capital adequacy and improving the quality of assets; Constructing IRB system for risk management; From credit risk management to the total risk management; Improving the ability of supervision; Establishing the sound open information system; which means to set up transparent financial structure of property rights and consummated corporate governance structure. Whether Chinese state-owned commercial banks can successfully carry out New Basle is strategic issue which is related to the national banking industry take part in the opening and international competition after China enters into WTO.
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