From laggard to primus -
Why is China exceeding global banking standards?

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Abstract

As a G-20 member, China is engaged in financial regulatory reform since the end of the global financial crisis. A core piece of this reform is the new banking regulatory standard that is issued by the Basel Committee on Banking Supervision. Chinese regulators have recently published prudential rules to implement Basel III standards domestically. A comparison between Basel III and domestic regulation shows that rather than merely compliant, China's banking regulation is stricter than the global standards and will be implemented ahead of the internationally agreed timetable. Why is China voluntarily subjecting itself to tougher regulatory standards than the rest of the world? This paper shows that low adjustment costs and an unusual alignment of domestic interests in the quest for international reputation drive this phenomenon. The troubled institutional history of China's financial system motivates all relevant stakeholders, both regulators and the regulated, to seek external validation of soundness and credibility, albeit for different reasons. The paper examines the power of reputation to enrich the debate on China's integration into international institutions.

Keywords: China, financial regulation, Basel III, global economic governance, regulatory politics, government networks

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

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

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

The remainder of this article starts with a review of current scholarship regarding the emergence of China and its position in the liberal world order. Further, it examines the key debate on the international political economy of financial regulation. An introduction of the Basel Accords on banking regulation is followed by a brief history of China's development in this issue area. The paper then presents four explanations for the country's drive to over-comply with Basel III regulatory

standards. First, it shows that after ten years of domestic banking reform and the global financial crisis, adjustment costs for China's banks are relatively low. Second, macroeconomic policymakers need tight capital standards to reign in credit expansion and prevent the economy from over-heating. Third, because China's banks lack a track record as well-governed corporations in the marketplace, they need to rely on international standards as the reputational basis for future regional and global expansion. Finally, promotion of and adherence to strict financial standards can be an instrument for Chinese regulators to attain status and prestige both in international regulatory bodies and at home. This peculiar alignment of interest among major stakeholders in the state and the financial sector helps explain why China is gold-plating in the realm of banking regulation.

China as a global financial power

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

In addition to the liberal argument for China's peaceful rise, constructivist IR scholars make a case for a harmonious integration of this emerging power into the international system. For example, Johnston (2008) argues that as a "novice" in international regimes, the People's Republic is subject to processes of mimicking, social influence, and persuasion that constitute China's socialization into the Western world order.

Both the liberal and constructivist-oriented IR scholarship described above regard China as a country that is willing to adjust to global norms and standards. It challenges the realist argument that rising powers tend to upset the status quo (Mearsheimer 2001). Acharya's (2014) consociational security order approach explores the middle ground between the two. That means, however, that the spectrum of the debate ranges from China as a challenger to the international system to a conforming player within. Surprisingly few scholars to date have contemplated the option of a rising power that exceeds and over-complies with the norms and standards of the established global order. Yet new evidence in the realm of financial regulation suggests that China is doing exactly that.

Financial markets have been the spearhead of globalization since the 1970s, and liberalization of financial markets, along with business innovation and technological change has led to the prominence of transnational networks in the global economy (Castells 2000). The operation of these networks is framed by rules and regulations that are set by governments.

But the rule-making process does not share the transnational qualities of the networks themselves. Rather, regulators in the dominant centers of the world economy engage in regulatory innovation as first movers. Simmons (2001) explains that the existence of market incentives conditions whether other jurisdictions choose to follow or not. For example, adherence to strict prudential regulation and compliance with stringent capital requirements are considered quality indicators of banks, generating market incentives for emulation in other jurisdictions.

The present article will argue not only that Simmons' intuition regarding market incentives for emulation is highly relevant in the case of China, but that the benefits of reputation can drive countries to over-compliance with global standards.

Drezner (2007) approaches the politics of global regulation by distinguishing between the rewards and adjustment costs of policy coordination among jurisdictions. Market size determines the balance rewards and costs of adjustment and thus the state incentive to engage in global harmonization of regulatory standards. In addition, big states can rely on their go-it-alone power and resort to economic coercion, threatening market closure if other states refuse to adhere to their domestic standards.

In an alternative approach, historical institutionalists argue that market size is a necessary but not sufficient condition for bargaining leverage on the international stage. The crucial element that holds explanatory power is the historical evolution of domestic regulatory institutions. Farrell and Newman (2010) emphasize two mechanisms at the core of historical institutionalism: policy feedback and relative sequencing.

Policy feedback refers to the propensity of institutional reform to create client groups that then have a strong incentive to lobby for its maintenance in the future. The domestic beneficiaries of any given institutional setting thus influence state preferences at the international level.

Relative sequencing as a mechanism highlights the differences among jurisdictions in terms of degree of development and regulatory capacity. For example, newly emerging economies have only recently started to build a sophisticated financial regulatory institutional framework and often lack the capacity to assess policy alternatives to adopting the dominant standards. Ceteris paribus, this situation puts developed countries at an advantage.

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

None of the above approaches however contemplates the possibility that China exceed global regulatory standards. This is because the power of reputation is not taken into account. Outstanding performance in the formulation and implementation of standards that carry global legitimacy provides states with peer recognition that has both tangible and intangible benefits. Recent studies of sovereign debt show conclusively that credibility in financial markets has tangible benefits, both for developing (Cho 2013) and advanced countries (Breen and McMenamin 2013). And as mentioned above, Simmons (2001) highlighted the tangible benefits of reputation by explicitly incorporating market incentives for emulation in her model. Subsequent approaches of regulatory politics however fail to pay sufficient attention to the payoffs of reputation in the cost-benefit analysis that actors are assumed to undertake.

Moreover, no approach to date has taken into account the intangible benefits of over-compliance. Arguably, such activity is a source of reputation that is highly valued by newcomers to the exclusive clubs of global economic governance. In the wake of the global financial crisis, leading powers successfully resisted attempts to make the United Nations a relevant forum for global economic issues (Knaack and Katada 2013). At the same time, they widened the perimeter of involved stakeholders, granting membership in all relevant financial governance bodies to all G20 nations, including developing countries such as China and India (Kahler 2013). This paper argues that newcomers to exclusive global economic governance bodies such as the Basel Committee have a clear incentive to attain reputation as a stellar club member, even though the benefits of such reputation are not tangible, at least in the short term.

While the benefits of reputation are straightforward in the world of financial market regulation, they are harder to pin down in other issue areas of global governance. Furthermore, the benefits of

reputation vary in degrees of intensity and tangibility as they reach domestic actors in a given political economy. Only if the interests of relevant domestic stakeholders align in the search for reputation can we expect a state to over-comply with global standards. The remainder of this paper shows that this is the case for China in the realm of prudential banking regulation.

The Basel Accords

Facing serious disturbances in the international currency and banking markets, the leaders of ten developed economies (the so-called G-10) decided to meet in the quaint Swiss town of Basel in 1974. They agreed to establish a committee in order to institutionalize transnational cooperation in the field of banking supervision, thereby creating one of the first government networks (Slaughter 2004). The Basel Committee published its first Accord in 1988 and released Basel II in 2004. In the wake of the 2007-9 financial turmoil, the G-20 mandated the Basel Committee to build on the lessons learned from the crisis to establish a new set of regulatory standards.

The Basel III standards, finalized in 2010, are more encompassing and stricter than their predecessors. In addition to a wider definition of assets and a more stringent one of capital, Basel III raises the minimum standards for capital as a percentage of risk-weighted assets. Banks must hold highly loss-absorbing (Common Equity Tier 1) capital equivalent to 7% of risk-weighted assets, up from 2% under Basel II. This risk-based capital measure is complemented by a new leverage ratio that requires banks to hold Tier 1 capital equivalent to 3% of total unweighted assets. Finally, in order to curb liquidity risk, new minimum liquidity requirements are introduced under Basel III (BCBS 2011; BIS 2012).

China and Basel III

China was largely isolated from the global economy until the late 1970s. After three decades of Maoist planned economy and a decade of Cultural Revolution, the flow of capital was almost completely under the direct control of the central government, and banks merely served as accounting institutions. In October 1979, one year after embarking on the path of economic reform, Deng Xiaoping declared that "we must turn the banks into real banks" (Qiao, Su, and Zhang 2010, 73). When the first Basel Accord was released in 1988, China's financial system barely counted on a few "real banks", and the central bank was merely four years old. A commercial banking law was not in place until 1995. It is thus not surprising that domestic regulatory authorities did not engage with Basel standards until the mid-2000s. One of the first acts of the China Banking Regulatory Commission (CBRC), created in 2003, was to implemented Basel I standards domestically (Rana 2012). As for Basel II, a CBRC statement from 2007

reads: "Obviously, it is a gradual and long-term course to meet all the standards; therefore, banks must, based on their own situation, make an overall plan and gradually meet the Basel II standards in a phased, well sequenced manner." (CBRC 2007).

Since China joined the Basel Committee in 2009, along with all other emerging countries of the G-20, it has changed its position significantly. The country is evolving from laggard to primus inter pares in financial regulation. China's new banking standards will not only be stricter than Basel III, they will be implemented ahead of the internationally agreed schedule.

In October 2009, the CBRC published a notification "On improving the commercial bank capital replenishment mechanism", preparing banks for recapitalization in line with expected higher capital requirements. In June 2011, half a year after Basel III standards were published, the CBRC released the "Commercial Bank Leverage Ratio Management Method". After circulating consultation papers in April 2012, the CBRC followed up with the "Capital Rules for Commercial Banks", approved by the State Council in June 2012. All relevant rules for the domestic implementation of Basel III were thus published ahead of the FSB-mandated deadline of end-2012 (State Council Development Research Center 2013b).

A striking feature of China's implementation of Basel III is that domestic rules are stricter than the international standards in several categories. The following three gold-plated rules stand out. Basel III raised the common equity capital ratio from 2% to 7%, but China's minimum ratio is set at a 7.5% level. Domestic systemically important banks (D-SIB) face a capital requirement of 8.5%. Second, Chinese authorities require a leverage ratio that is one percentage point higher than the international standard. The third difference concerns loan loss provisions. China's regulators do not impose a fixed provisions rate and coverage rate on banks. However, they promote a model of dynamic provisions regulation with the goal of loan loss provisions equal to 2.5% of total loans, and a 150% coverage rate of these loans. In contrast, Basel III refrains from setting any specific standard in this area. Instead, the Basel Committee merely states that it is "[…] addressing incentives to stronger provisioning in the regulatory capital framework." (BCBS 2011, 6).

Table 1: Basel III standards and Chinese standards (selection)

Regulatory Standard	Basel II	Basel III	China
Common Equity Tier 1 Ratio	2	7	7.5
Leverage Ratio	n/a	3	4
Provisions Rate	n/a	n/a	2.5%
Provisions Coverage Rate	n/a	n/a	150%

Source: People's Bank of China Research Institute

The Basel Committee visited China in 2013 to undertake a consistency assessment as part of its new peer review program. The Committee gave Chinese regulators the best possible overall grade of "compliant" and duly noted a total of 17 points where China is gold-plating Basel III standards (BCBS 2013b). Even this long list is incomplete because it fails to incorporate the above-mentioned leverage ratio and provisioning rules.

In addition to stricter regulatory standards, China also commits to a tighter implementation schedule. Basel III is scheduled to be gradually phased in between the beginning of 2013 and end-2018. Beijing originally envisioned implementation to start a year ahead of everybody, in 2012, but later recognized that this is overly ambitious (Rabinovitch 2012). Nevertheless, the Chinese schedule stipulates full implementation by end-2016, two years before the global deadline. Beijing further beat the international standard setters by implementing the 4% leverage ratio in 2012 (PBOC Research Institute 2012e; BIS and BCBS 2013; BCBS 2013a).

The ambitious implementation schedule in China contrasts with the reality of Basel III implementation in the rest of the world. According to an FSB report from October 2012, only 8 out of the 27 Basel Committee member jurisdictions issued the final set of Basel III-related regulations before the stipulated deadline (FSB 2012). However, China is not the only country that is gold-plating Basel standards. Currently, nine jurisdictions have issued rules that exceed Basel III, including Sweden, Hong Kong, Singapore, and the heartland of banking that applies a so-called "Swiss Finish". Almost all of them are high-income countries with fully developed financial markets can rather easily afford gold-plating. Other than China, India is the only exception to this pattern. Indian authorities decided in 2013 to gold-plate Basel III, but implementation will lag behind the global schedule (IMF 2014; Reserve Bank of India 2014). Why India follows China's path as the only other emerging market economy that exceeds Basel standards is a topic well worth academic attention in the future.

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

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

1. Relatively low adjustment costs for banks

Adherence to stricter capital adequacy requirements implies costs for banks, and in the case of Basel III, these costs might be considerable. The world's number one bank lobby organization, the Institute of International Finance (IIF), produced a study showing that the implementation of Basel III would strangulate credit expansion, thus slowing down global GDP growth by more than three percentage points (IIF 2011). Recently, the assumptions underlying this and similar studies have been fundamentally questioned by Admati and Hellwig (2013; Modigliani and Miller 1958). In principle there is no risk-adjusted cost difference between equity and debt financing for any firm, but the authors themselves recognize that the existence of subsidies, signaling effects and "market imperfections" implies that meeting higher capital requirements is a costly endeavor for financial firms. Similarly, econometric studies undertaken by regulatory agencies and a variety of scholars indicate that even though the estimates of the bank lobby are exaggerated, higher capital requirements will indeed raise the cost of lending as banks pass on higher financing costs to their clients (BCBS 2010; Kashyap, Stein, and Hanson 2010; Allen et al. 2012; Elliott 2009).

While higher capital requirements affect banks in all jurisdictions, some are harder hit than others. In comparison to their Western competitors, China's banks have a balance sheet composition and income structure that greatly reduces their adjustment costs at this point in time.

Since its re-emergence in the 1980s, China's financial system withstood two crises. The reform process that took place in the period between these two crises helps explain why China's banks today are in a different position than their Western competitors. The Asian Financial Crisis of 1997 revealed that years of "policy lending" and "relationship lending" lead to the accumulation of massive amounts of non-performing loans (NPL) on the banks' balance sheets (Zhou 2007; Goodstadt 2011). In response, state authorities had to prop up banks with considerable capital injections twice, in 1998 and 2003 (Yi 2009; C. E. Walter and Howie 2011).

In addition to this measure, the authorities promoted corporate governance reform of the state-owned banks and prepared them to list on the stock market. The four big banks went public in 2005, 2006, and 2010, raising between nine and twenty billion dollars each for a total of over $60 billion on the stock markets of Shanghai and Hong Kong. Thus, the structure and timing of domestic banking reform left China's big banks flush with capital as the global financial crisis approached (Qiao, Su, and Zhang 2010; Ba 2010).

The 2007-9 financial crisis was mixed news for China's financial system. On the one hand, domestic financial institutions had little exposure to Western financial markets and none of them had to

be bailed out by the government. On the other hand, banks engaged in massive credit expansion under China's RMB 4 trillion ($586 bn) stimulus program, a move that observers qualified as a return to policy lending (Goodstadt 2011; Shih 2008). Even though the official NPL ratio has fallen to around 1%, doubts about loan performance are widespread. Concerned with the impact of the global financial crisis, the CBRC urged banks to further increase their capital adequacy ratio.

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

In addition to state-sponsored recapitalization and market-driven equity capital flows, China's big banks benefit from their position in the domestic market that guarantees a substantial net interest gap profit. Since the early 2000s, Chinese authorities have established a system of financial repression that involves fixing the rates at which banks lend and take deposits, providing domestic banks with an interest spread between 2.5 and 3.5 percentage points until 2009 and 2-2.5 since then whereas banks in the rest of the world must deal with a much less comfortable margin of around 1.45 on average (Qiao, Su, and Zhang 2010; PBOC Research Institute 2012a; PBOC Research Institute 2012c; BIS 2012).

The Banker Magazine revealed in its June 2013 report that Industrial and Commercial Bank of China (ICBC) has become the world's biggest bank in terms of Tier 1 capital, the first Chinese bank to reach this position in history. Furthermore, with double-digit net profit growth rates, China's big four banks ranked among the top 15 in profit as early as 2009. By 2013 they occupied the first four places in the profit ranking (The Banker 2013). The 2014 report shows that a third of the profits made among the world's top 1000 banks last year are accrued by Chinese firms. ICBC stands again at the top of the list in terms of Tier 1 capital, followed by China Construction Bank Corporation. Indeed, Chinese banks are the only ones that have moved upwards in the top 10 ranking, replacing Western banks such as JP Morgan Chase and Bank of America. The Banker Magazine states that by 2014, China is home to the largest banking sector in the world in terms of Tier 1 capital, overtaking the United States for the first time (Alexander 2014).

Table 2: Top 10 World Banks 2014

Bank	Tier 1 Capital (USD bn)	previous rank
Industrial and Commercial Bank of China	**207.6**	**1**
China Construction Bank Corporation	**173.9**	**5**
JP Morgan Chase & Co	165.6	2
Bank of America	161.4	3
HSBC Holdings	158.1	4
Citigroup	149.8	6
Bank of China	**149.7**	**9**
Wells Fargo & Co	140.7	8
Agricultural Bank of China	**137.4**	**10**
Mitsubishi UFJ Financial Group	117.2	7

Source: The Banker

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

2. Macroeconomic Considerations

High capital and liquidity requirements are prudential instruments designed to enhance the resilience of the banking system, but these measures also affect macroeconomic variables, in particular credit and money supply. As mentioned above, the Basel Committee itself along with a variety of scholars recognizes that higher capital standards raise the price of loans, thus affecting credit supply and overall output expansion (BCBS 2010). In China however, Basel III is not an obstacle to growth but another convenient instrument in the hands of macroeconomic policymakers.

Although it might be tempting to regard China's development success as the consequence of a singular export-led growth model, in reality policymakers have constantly changed and adjusted macroeconomic management in a trial-and-error fashion (Wu and Ma 2013). Until the late 1990s, China's foreign exchange reserves were low, the current account was relatively balanced and it can be argued that the value of the renminbi was close to market equilibrium. It was only after the Asian Financial Crisis that policymakers adopted a macroeconomic management model that combined export promotion with foreign exchange reserve accumulation as a self-insurance policy against external shocks (State Council Development Research Center 2013e; Lardy 2013; Chin 2010).

China's current account surplus rose from 1.3% of GDP in 2001 to over 10% in 2007, and its capital account also registered a constant surplus throughout the 2000s. The consequence of this inflow

of capital, according to the Balassa-Samuelson effect, is either nominal currency appreciation or inflation, both of which are highly undesirable for the authorities. Because China adopted a fixed exchange rate from 1998 to 2004 and let the renminbi appreciate only slowly before and after the global financial crisis, fighting inflation by controlling money supply growth has become a formidable task for financial authorities.

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

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

An additional way to regulate credit expansion with prudential instruments is the loan-to-deposit ratio that currently imposes a limit on loans at 75% of bank deposits (J. Huang 2013). It complements the RRR as a prudential instrument that, together with nominal credit quotas and interest rate management forms the central bank's "three magic weapons" (三大法宝 *san da fabao*) in monetary policy (PBOC Research Institute 2013b).

Both the central bank and the State Council continue to favor a gradual liberalization of the capital account but the authorities are concerned that further opening and reform will raise the risk of volatility for domestic financial markets. In the face of this challenge, several internal documents highlight the importance of prudential supervisory instruments as a means of stabilizing the economy

(State Council Development Research Center 2013c; State Council Development Research Center 2013e; PBOC Research Institute 2012a; PBOC Research Institute 2012c).

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

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

Stringent prudential regulation and financial repression does not come without unintended side effects, however. In an environment where depositors lack profitable investment opportunities and where small and medium businesses face severe credit constraints, the shadow banking system is burgeoning. Chinese households use wealth management products (WMP) increasingly as deposit substitutes, and corporate savings enter the financial market through a variety of trust products and other, even less transparent instruments. Data from the PBOC shows that shadow banking accounts for 30% of the RMB 17.3tn in credit issued in 2013, up from 23% in the previous year (Mitchell 2014). This massive credit expansion outside of regulatory control poses a challenge for both the central bank's monetary policy and its financial stability objectives, as even top-level policymakers have recently admitted publicly (J. Zhang 2014; *Bloomberg* 2014). It does not however affect compliance with Basel III because the perimeter of Basel regulations is restricted to the formal banking sector. Chinese scholars and policymakers have made an effort to show why the Chinese shadow banking system is different from the West (Chinese Academy of Social Sciences 2013; PBOC Research Institute 2012d). Nevertheless, the growth of the shadow banking sector shows that even gold-plated Basel III regulations are of limited effectiveness in ensuring monetary and financial stability.

3. Reputation for Banks

Simmons (2001) points out that banking regulation entails high market incentives for emulation. This is because capital adequacy rules provide market participants with information about the

soundness of a financial institution. Investors and shareholders reward companies that comply (or over-comply) with regulatory standards and investment analysts and rating agencies provide better risk assessments for them. Risk is factored into the price of capital in financial markets, and therefore financial institutions that adhere to prudential standards enjoy access to cheaper capital (Brummer 2010).

China's banks have grown fast in the comfortable domestic environment described above, but have rarely expanded beyond the borders of the mainland and Hong Kong. In order to successfully compete in the financial sector abroad, Chinese banks need to rely on reputation. Their subsidiaries overseas need to attract deposits and secure cheap wholesale financing in capital markets, both of which require investor confidence. More fundamentally, they need to obtain a charter in order to operate in foreign jurisdictions. But how can Chinese banks build this reputation?

The historical track record is not an option, for two reasons. First, even though some Chinese banks were established as long as 100 years ago, they ceased operating as companies under the planned economy of the People's Republic. Only after Deng's call for turning them back "into real banks" did China's banks resume operations, and even then financial intermediation was subject to heavy state intervention until the commercial bank law of 1995 was passed. In other words, most Chinese banks have less than 30 years of a track record.

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

Adherence to purely domestic regulatory standards would not inspire investor confidence either. Domestic prudential supervision lacks credibility because the state has a double role as a regulator of the banks on the one side, and as the majority shareholder on the other. Under these circumstances, Basel III serves as a highly valuable external source of reputation.

China's biggest lender, ICBC, may be most suited to illustrate this phenomenon. The bank made first steps overseas by acquiring minority stakes in Standard Bank (South Africa) in 2007, ACL Bank (Thailand) in 2009, and by buying the broker-dealer operations of Fortis Securities in the United States one year later. More recently, ICBC purchased majority shares of banks in Canada in 2010 and Argentina

in 2012 and converted them into its first foreign subsidiaries. (Martin 2014). A bid to take over the US branches of the Hong Kong-based Bank of East Asia in 2011 however was blocked by the Federal Reserve on the basis of prudential regulatory concerns (Thomas and Guerrera 2011). In an interview with the author, a US banking regulator explains the reasoning behind these concerns:

> *"It's very hard to compare China to other economies because there's so many of their firms that still, if they're not state-owned they're very closely owned by the state. I don't think that there is a high degree of confidence in the data from China. I don't think you can believe their non-performing numbers are as good as they say they are. I don't have any personal experience but I don't know of anyone who doesn't view Chinese data with a great degree of skepticism." (US Regulator 4 2014)*

This lack of confidence poses a real obstacle for the expansion of Chinese banks in the United States and other developed countries. Asked about the relationship with US banking authorities, a Chinese regulator states:

> *"When the Chinese banks would want to open a branch in the States, for quite a long time the US regulators didn't agree, saying that you have a poor regulation. […] We negotiate with the Federal Reserve to push them open to Chinese banks."* (PRC Regulator 1 2013)

Basel III functions as an international seal of banking quality that Chinese banks can use to overcome resistance by foreign regulators. Furthermore, banks that are able to fulfill or even exceed Basel requirements can count on favorable treatment in international capital markets. Therefore, the adjustment costs of adherence to Basel III are outweighed by the benefits these standards confer to China's major banks as they pursue outward expansion in the future.

4. Reputation for Regulators

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

There is evidence that this leverage mechanism is at work in China's financial regulatory world, but the reputational dynamics surrounding Basel III go far beyond. Leverage in this sector can be thought of as a two-step process. First, rather than merely employing the ideas and rules of international standard-setting bodies, Chinese authorities are gold-plating them in order to gain

recognition and respect with their peers abroad. It is only as a second step that policymakers then use this international reputation to enhance their position vis-à-vis bureaucratic competitors and the leadership in the domestic realm.

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

Since the G-20 was elevated to the prime forum of global economic governance, China has called for and achieved governance reform in the IMF and the World Bank in order to give greater voice for itself and other emerging economies (Wade 2011; Ferdinand and Wang 2013). The politics of influence in government networks however are more complicated than those of the big international financial institutions. In principle, all members of standard-setting bodies such as the BCBS are on equal standing, and decisions are made by consensus. In the absence of formal voting shares, voice is bestowed upon member countries according to their market size and legitimacy. The precondition for legitimacy in turn is compliance with the financial standards promoted by the government network itself. Because China's share of global financial markets is still negligible (Hong Kong is a separate member of the standard-setting bodies), legitimacy through compliance and, in fact, over-compliance is the only way for attaining voice in these government networks.

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

> *"I have an observation that China is keen on innovating domestic standard up to international standard at a fast pace in order to catch up with the international development. […] I think they have a case to be keen on implementing those international standards domestically to be treated more seriously than other developing jurisdictions in order to gain [a position for] the country as a major player in international forums." (HK Regulator 2 2013)*

As mentioned above, China's banks suffer from a reputational deficit due to a short and non-stellar track record. The same can be said for China's regulatory authorities. Especially in the realm of financial regulation, China is a latecomer in institutional development (He 2013; Brehm 2008; Pearson 2007; Heilmann 2005). Hence, over-compliance with a global standard was a costly but necessary signal to China's peers in the regulatory community. When asked about the main motivation for the massive regulatory upgrade that gold-plating Basel III implies, a Chinese regulator responds: *"It's international.*

Well, you see the foreign regulators went kind of, 'Okay, the Chinese regulators really made a lot of progress.'" (PRC Regulator 1 2013).

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

> *"The former and the first CBRC chairman, before his retirement, he had promulgated a Chinese banks capital adequacy rule, which I think largely just introduced the Basel III. […] I think that he has the ambitions that under his leadership the Chinese banks reached most higher standards so that will be his credit."* (PRC Regulator 1 2013)

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

Conclusion

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

As the above study shows, Drezner's (2007) point about the importance of adjustment costs to global regulation is well taken. Because of the timing and scope of domestic banking reform, Chinese banks face much lower adjustment costs.

At the same time, the Chinese example shows how difficult it is to establish a direct causal link between market size and the balance between adjustment costs and benefits. Drezner (2010) predicted that China as a major power would lack the incentive to converge to international regulatory standards, yet in the case of Basel III China is making more effort to comply and over-comply than most other jurisdictions.

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

Above all, this study highlights the importance of reputation as a driving force. More than merely an auxiliary to socialization that is embedded in what constructivists call the logic of appropriateness, it is an asset with clear economic benefits, at least in the world of financial regulation. Kahler (2013) correctly points out that the capabilities of rising powers in the ongoing bargain with incumbents rest not only on market size but a credible commitment to predominant liberal standards.

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

An important limitation of this study is that it cannot make inferences regarding the stability of the Chinese financial system. The reason is not that China emulate its neighbors' exercise in "mock compliance" with global financial standards (A. Walter 2008). Enhanced peer review mechanisms under the auspices of the G-20 and the IMF reduce the maneuvering space for domestic regulatory finagling. Moreover, China's accounting standards have substantially converged with International Financial Reporting Standards (IFRS) and International Standards on Auditing since 2005, and all stock listed companies have to meet international accounting and auditing requirements (IMF 2011). Rather, the new global regulatory standards themselves may be of limited effectiveness. Believing that compliance with or even gold-plating of Basel III protects China from the next financial crisis may be just as naïve as thinking the same of Basel II in the United States in 2006. Even though the Chinese financial system has

withstood a series of stress test simulations as part of the 2011 Financial System Stability Assessment, the country is facing massive challenges that range from reducing local government debt (Shih 2008), to internal rebalancing after years of debt-fueled overinvestment (Pettis 2013). Basel III does not effectively address these vulnerabilities, and a conservative implementation of its standards might even have the perverse effect of contributing to the concentration of systemic risk outside of its regulatory perimeter, in the shadow banking sector (*The Economist* 2013). The next steps of market-oriented reform and opening to global capital flows lead China's policymakers into unchartered and risky territory where no Basel plate can guarantee protection, no matter how golden it is.

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

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