Implementation of Basel III in China: Differences and Advantages

Ba Shusong, Zhang Xiaolong

**Abstract:** Based on the regulation standards’ consistence between China’s banking sector and Basel III, we state the implementation of Basel III in China, and discuss the challenges as well as advantages considering China’s current financial environment

Since the implementation of Basel I standardized with 8% capital adequacy ratio in 2004, qualified banks were required to comply the new framework—Basel II by CBRC in 2007, and these banks are planned to operate under the double disciplines in 2011, then Basel capital accord is a no more new word in China’s banking sector. However, the financial crisis erupted in 2008 brought a new challenge for International financial supervision. Basel committee firstly published new documents aiming at the problems exposed in the crisis. The new files were called Basel III, which was approached by the G20 leaders at Seoul Summit in Sep. 2010. How may it affect China’s banking sector which is still at the beginning stage of the implementation of Basel II? Choosing Basel II or Basel III? If both, is it possible that a new financial crisis might incur during transition period? Based on Basel II capital accord and the essences of Basel III, how could supervisors to regulate China’s banking sector effectively and internationally? It’s urgent for China’s banking sector to make revolutionary measurements in regulatory area and an overall upgrade in risk management.

1 **Regulatory system in China’s banking sector**

The stable-developing risk management system of China’s Banking sector is consummated gradually since the setup of CBRC in 2003 and the new form of China’s finance supervision (consisted of PBC, CBRC, CSRC, and CIRC). Concepts, methods and tools of regulation are improved effectively and quickly. Nowadays, China’s banking sector build up a regulation system focused on risk management while taking consideration of compliance management.

1.1 **Consistency between Current Regulatory Framework and Basel Capital Accord**

Before CBRC’s foundation, regulation methods on China’s banking sector changed from

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Supervision policies referenced in this paper should be checked in the updated website for their continuing to be consummated.

Authors’ standpoints in the paper don’t represent seated institutions.
mixing-supervision to separating-supervision. Operation environment of financial institutions changed from irrational to scientific and risk-controlling. Financial legislation gradually consummated. These experiences contribute much to banking supervision system.

Based on these experience, The China Banking Regulatory Commission (CBRC) made a supervision plan called ‘4-4-6’ at the beginning of its foundation. The first ‘4’ means to achieve four goals which were ensuring depositors and consumers’ benefits, enhancing market confidence, furthering public’s understanding of modern finance and reducing commercial crimes. The second ‘four’ means regulation objects include focusing on consolidating group, managing risk, internal controlling and operation transparency. These regulation concepts are highly in accordance to Basel capital accord.

Corporations are required to be the main regulatory objects and also under consolidate financial administration, which are also stipulated in Basel capital accord. Risk management refers to consider risk as main supervision content, in addition to banks’ institutional recognition, riskiness detecting and risk managing skills. On CBRC’s standpoint, regulation should be proceed as ‘classification → sufficient provision → profit → qualifying capital adequacy ratio’. It quite follows Basel II’s first pillar’s capital adequacy ratio requirement. Internal Controlling mean optimizing banks’ internal management system, cultivating banks’ risk-preventing ability. It’s complying with Basel II framework’s second pillar’s requirement: Supervisory review. Enhancing banks’ transparence means according to international criteria and routine, CBRC should conduct banks’ information disclosure to increasing the market’s restraint which is the essence of Basel II’s third pillar. The ‘6’ represents six regulation criteria on effectiveness-judgment containing increasing financial stability and creativeness, promoting China finance industry’s competitiveness in global market etc. Obviously, administration concepts of China’s finance industry are in chorus with Basel Capital accord in logical and content.

### 1.2 Localization of Basel I in China

The localization of Basel I in China was already completed in 2004. There are two main points in Basel I: one is the definition of Capital, the other one is capital provision ratio on credit risk and market risk. These are already embodied in “Regulation Governing Capital Adequacy of Commercial Banks” (“Regulation”, in short) announced in Feb. 2004.

First, “Regulation” is similar but not totally with Basel I on the definition of capital. Capital is divided into core capital and Tier 2 capital, which is also called subordinate capital. Core capital is mostly consisted of paid-up capital, capital reserve, surplus reserve, undistributed profit and minority stake. Subordinate capital mainly contains revaluation reserves, general reserves, priority stocks and convertible bonds.

Second, these two systems share the same conversion-ratio of transforming off-balance-sheet credit into risk-weighted capital. Based on Basel I, “Regulation” according to four different risk levels set the ratios as 0, 20%, 50% and 100% separately.
Third, “Regulation” stipulates the lowest capital adequacy ratio as 8% together with the lowest core capital ratio as 4% which are identical to Basel I’s requirement.

Fourth, there is also notification on market risk capital in “Regulation”, which elaborates methods of taking capital provision on interest-rate risk, equity risk, foreign exchange risk, commodity risk and option risk. However, the capital requirement for market risk is only required for the big banks which assets are more than a certain threshold.

“Regulation” could be considered as the localized Basel I, representing an eminent progress on China banking sector’s supervision level to international standard. It also represents the beginning of China’s banking sector to implement Basel capital accord.

1.3 Promoting of Basel II

Since “Guidelines on the Measurement of Regulatory Capital of Specialized Loans of Commercial Banks” (“Guidelines” in short) announced in Feb.2007, CBRC has announced more than ten guidance documents such as “Notice of China Banking Regulatory Commission on Issuing the Guiding Opinions concerning the Implementation of the New Capital Accord by China Banking Sector (draft for discussing)”. Basing on these, qualified banks start to comply with the new Basel capital accord (Basel II) and implement in double disciplines. Other banks are promoted to join the regulation system.

However the basic data, risk-calculation models and information technology are still the same as Basel II, only micro-adjustments on weights and quantity requirements are made in Basel III. Up to now, CBRC have received the application of five biggest state-owned commercial bank and one joint-stock commercial bank for implementing the Chinese edition of Basel II. The verification and acceptance for the application is on the process now. After the process of double discipline, the qualified bank will implement the Basel II formally.

2 Basel III in China

As a member of G20, China and its supervision authorities participate and learn from the latest achievement of Basel committee. The authorities clarify the coordination between micro-prudential and macro-prudential supervision, capital and liquidity regulation as well as quantity and quality improving; also bring in capital adequacy ratio (such as conservation buffer, counter-cyclical buffer etc), leverage ratio, liquidity converge ratio and net stable funding ratio etc. Building on the original regulation system, the new framework is formed consisted of four principal supervision tools (capital adequacy ratio, leverage ratio, provision ratio and liquidity ratio).

On the view of the requirement of these tools’ implementation, qualified commercial banks should follow these four tools’ and the new capital accord’s requirement simultaneously during the transition period. For example, banks qualified for implementing new capital
accord should follow both the capital computation method in new capital accord and capital adequacy ratio requirement in Basel III. Though till to now, the four tools hadn’t be written formally, and our discussion is based on media reporting, in addition more rules and subtle regulation need to be stipulated, these four tools will come into effect officially with huge possible. Therefore, it’s necessary and worthwhile to discuss the measures should be done reacting to the implement of these four tools.

2.1 Capital Adequacy Ratio

CBRC has already taken many measures to consummate China’s banking sector’s capital adequacy system corresponding to Basel III regulatory framework.

First, regulatory capital are planned to be divided into core tier-1 capital, tier-1 capital, total capital by CBRC according to Basel III, in which additional cost of systemically important institution and surplus requirement are also included. The surplus requirement contains both conservation buffer and counter cyclical buffer. Deduction standard of core tier-1 capital and tier-2 capital are executed strictly.

Second, regulation criteria on core tier-1 capital, tier-1 capital and total capital are 5%, 6%, 8%. It also stipulates 2.5% conservation capital buffer and 0%~2.5% counter cyclical capital buffer, as well as 1% supplementary capital for systemically important institutions.

Table 1: Basel III in China –capital adequacy ratio

<table>
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<tr>
<th>Capital</th>
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<tr>
<td></td>
<td>Core tier-1 capital</td>
<td>Tier-1 capital</td>
<td>Total capital</td>
<td>buffer</td>
<td>cyclic buffer</td>
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<tr>
<td>Systemically important banks</td>
<td>5%</td>
<td>6%</td>
<td>8%</td>
<td>2.5%</td>
<td>0%~2.5%</td>
</tr>
<tr>
<td>Non-systemically important banks</td>
<td>5%</td>
<td>6%</td>
<td>8%</td>
<td>2.5%</td>
<td>0%~2.5%</td>
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Third, new capital supervision system (quantity, quality and criteria) comes into effect recently, maybe in the mid of 2012. In the earlier edition of consulting draft, systemically important banks should achieve those standards before the end of 2013, while non-systemically important banks should be up to standards before 2019.

So China’s capital regulation is much stricter than Basel III’s requirement on quantity and urgency, based on the basically the same capital definition.

2.2 Leverage Ratio

As a risk-neutral tool, leverage is one of the most important content of Basel capital accord. The methodology for calculating leverage ratio in China is basically accordance with Basel III,
while the tier-1 capital definition is the same as its definition in capital ratio.

As a supplement for capital adequacy ratio, leverage ratio could be considered as a micro-prudential supervision tool which restricts banking business’s extraordinary expanding and also could be thought as a macro-prudential supervision tool which enhances China’s banking sector’s risk management ability. In China, leverage ratio is 4% as comparing with 3% set by Basel Committee. Leverage supervision will begin at the beginning of 2012, and be up to requirement at the end of 2013 for systemically important banks, while the deadline for non-systemically important banks is the end of 2016. Comparing with Basel III’s planning deadline (2018), China’s banking sector’s requirement is quite strict.

| Table 2: Basel III in China—Leverage Ratio, Provision Ratio and Liquidity Indicator |
|-----------------------------|-----------------|--------|---------------------------------|
| Item                        | Content                          | Level  | Arrangement During Transition Period                          |
| Leverage                    | Core Capital, Total Capital (Including off-balance sheet asset) | 4%     | Systemically Important Banks: the end of 2013 Non-systemically Important Banks: the end of 2016 |
| Provision Rate              | Provision Ratio, Credit Balance   | 2.5%   | Systemically Important Banks: the end of 2013 Non-systemically Important Banks: the end of 2016 Dynamically adjustment under second pillar |
|                            | Provision Coverage Ratio          | 150%   | Dynamically Adjustment                                    |
| Liquidity Indicator         | LCR                              | 100%   | the end of 2013                                           |
|                            | NSFR                             | 100%   | the end of 2016                                           |

2.3 Loan Provision Ratio

Though Basel III doesn’t infer provision supervision, enacting a dynamic and perspective provision regulation system always draw attention of Basel Committee during after the crisis.

Currently popular-adopted supervision indicators weighting loan loss provision to banks’ risk compensation are provision coverage ratio, loan loss reserve adequacy ratio etc. (Provision coverage ratio=loan loss provision/non-performing loans, Loan loss reserve adequacy ratio=Loan loss specific reserve/(pass loans*1%+special mentioned loans*2%+substandard loan*25%+doubtful loan*50%+loss loan*100%). Now with the decreasing of non-performing loan ratio, the two indicators become less important. CBRC creatively proposed loan provision ratio bearing the nature of counter-cyclical buffer. Loan provision ratio=Loan loss reserve/sum of all loans. Different with provision coverage ratio, loan provision ratio doesn’t weight non-performing loans but also many other loans.

CBRC plans to use loan provision ratio and provision coverage ratio to supervise banking sector. Moreover, CBRC stipulates the minimum loan provision ratio and provision coverage ratio for commercial banks as 2.5% and 150%, while the standard for loan provision ratio may varies for non-systemically important banks. Loan provision ratio could be below 2.5%, which means if banks have a legitimacy loan structure, low degree of deviation, fine risk management system. The ratio also varies under the second pillar according to
macro-prudential supervision’s requirement and institutional riskiness. Distributed profit compensates the excessive loan loss which couldn’t be covered totally by the provision. CBRC had made a timetable for dynamic adjustment. According to the schedule, dynamic provision’s token will be completed in 2012 and systemically important banks will be up to the provision ratio standards in 2013 while the deadline for non-systemically important banks is the end of 2016 (2 more years for some banks).

2.4 Liquidity Supervision Indicator

After the crisis, Basel Committee has brought many isolated and also supplementary supervision indicators (such LCR and NSFR). China’s supervision authorities had already set a liquidity regulation system which may not match up with China’s banking sector perfectly now. This time, CBRC brings in liquidity coverage ratio and NSFR which is in accordance with Basel III.

The requirements for these two ratios both are 100% which is the same as Basel III’s requirement. According to “Liquidity Risk Management of Commercial Banks (for trial implementation) (draft for discussing)” which is published in CBRC this year, deadline for banks meeting liquidity coverage ratio is 2013 and the NSFR requirement should be achieved before 2016.

In addition to liquidity coverage ratio and NSFR, CBRC also proposed many other indicators such as liquidity ratio, deposit-loan ratio etc. to building an efficient and comprehensive risk-detecting and risk-managing system. Moreover, CBRC plans to set up an internal liquidity risk managing system suiting for different time-spans, methods, circumstances and currencies.

3 Basel III in China: Prospects and Proposals

Obviously, Basel III in China is Basel II’s upgraded version which newly brings the specification of capital adequacy ratio and the introduction of new regulation indicators, however it doesn’t conflict with former econometric models and talent development scheme. China economy’s quick recovery and banks’ less loss as well as robust developing momentum provide a fine external environment and preconditions for the implementation of Basel III in China. But nowadays many problems existed in banking sector and supervision authorities damage the efficiency of Basel III in China. The problems are related to the legitimate of regulation indicators and supervision differentiation etc.

3.1 Capital Adequacy Ratio

By the end of 2011 Q4, capital adequacy ratio of commercial banks reached 12.7%, while core capital adequacy ratio reached 10.2%. In short term, capital adequacy ratio of Chinese banks is maintained in a high level which meets the final requirement Basel III (ignoring counter-cyclical buffer). Though many internal models are adopted during the implementation
of Basel II in China which saves lots of capital, financing problems are still tough during banks’ implementation of Basel III. According to CRBC’s regulation, counter-cyclical surplus capital ratio should be 2.5%; systemically important surplus capital rate is 1%, i.e. lager-sized bank is 13.5%, and medium-sized bank is 12.5%, while capital gap will reach 1000 billion RMB in China’s banking sector by the end of 2015 under some simple hypothesis.

At current speed, even China’s regulation standard is much stricter than Basel III, still the planned deadline of Chinese banks meeting the standard is earlier. On the one hand, it is meaningful for China’s banking sector meeting the standards in advance because of the rapid changing finance environment. For example, Basel II was proposed in 2004, but was planned to be implemented in 2009. Eventually, subprime lending crisis erupted in 2007 which made Basel II not as suitable as before. So, it’s necessary and worthwhile to implement Basel III as quick as we can.

On the other hand, great financing depressing is caused by the transition period’s shortening. First, a good capital status is accumulated by last two years’ asset stripping and the high spread’s accumulation which are not last for long. Second, capital structures of commercial banks among developed countries are different. Mostly Tier-1 capital is common stock equity which is of high quality. However, it could also cause the similarity of core tier-1 capital and tier-1 capital. Though common stock equity has an eminent character of risk-absorbing, its high cost set China’s banking sector in a disadvantage place under current uniformed regulation system, and also its dull capital structure caused difficulties in capital supplementing.

Many problems such as incomplete deduction items, unqualified debt capital tools, randomness of equity investment etc. exist in Chinese commercial banks by standard of Basel III. New capital accord increases commercial banks’ capital adequacy ratio and decreases the substitutions’ categories for supplement capital, which causes the requirement for more attention on supervision coordinate between CRBC and CRSC. The capital requirement needs the support of capital markets for financing. Cost of external financing channel will increase according to the upgrading of debt capital tools standards.

*Figure 1*: Ratio of retained earnings to tier-1 capital
So we can see, external financing should make contribution to release capital pressure while building a new capital supplement system, increasing profitability, strengthening risk and cost management are the rational methods could be adopted in long term. Higher capital adequacy ratio provides less time for banks to adjust their capital structure, profit model etc. which goes against banks’ sustainable development. Moreover, too high capital adequacy ratio may cause banks to choose capital market reversely and final cost will be transferred to investors and consumers.

In addition, because deposit-absorbing ability is low for small-sized banks which financing on the inter-bank money market. Meanwhile, common stock financial ability of small-sized banks is lower than large-sized banks. So, generally speaking, new capital regulation system is much more influential in small-sized banks.

3.2 Loan provision ratio comparing to non-performing loan ratio

On supervision authorities’ standpoint, the introduction of loan provision ratio represents improvement could be made on banks’ capital category based on five-class loan classification, so that loan provision ratio could be considered as the preparation for emergencies. Because loan provision ratio is based on all loan provision, so it has a nature of counter-cyclical. In the upturn of economy, though loan amount is large, non-performing loan is less as well as more loan provision rate could be taken, vice versa.

Figure 2: Loan Provision Ratios and Non-performing loan Ratios of List Banks (June-30, 2011)

Data Resource: Wind

Considered from the operation methods of Chinese listed banks, provision ratio varies eminently. It’s easier for banks which have a higher non-performing loan ratio meet the new regulation standard. For example, in 2010 only ABC’s provision rate reached 2.5% among the 16 listed banks, while its’ non-performing loan rate is also the highest which reached 2.32%. Therefore, loan provision may incur adverse selection because of its internal calculation
mechanism. Provision ratio=provision coverage ratio*non-performing loan ratio. Provision coverage ratio is always an important supervision tools in China. Nowadays most banks’ provision coverage ratios reach the standard and keep in a stable level (standard ratio: 150%). So provision ratio is directly proportional to non-performing loan ratio. In Figure 2, the correlation coefficient between non-performing and loan provision rate is high to 0.88. On this standpoint, the implementation of provision ratio might incur non-performing loan ratio’s increasing (Banks will expand high-risky business).

In the viewpoint of banks’ operation, commercial banks have several strategies reacting to the implementation of provision ratio. First, Banks would keep provision coverage ratio up to the standard while reduce total loan. In this way, commercial banks may stand aside when economy needs the credit support for their reluctance to lending. Second, banks might increase provision amount while slow down non-performing loan’s cancellation. Cancellation process’ slowdown is a good choice for some banks which have difficulties in meeting the standard of provision ratio. However, too much provision has negative effects on their profitability while the slowing down of cancellation keeps non-performing asset in the balance sheet for longer time. Though provision ratio increases, it doesn’t contribute to reduce banks’ accumulated risk.

How to improve provision ratio while optimize loan quality considering negative influence might incurred? First, at the very beginning of its implementation, authorities could adopt many instruments to weaken the influence on banking sector especially on some adverse selection activities. Protecting high-quality banks form the stroke of too urgent implementation of provision standard and providing longer transition period for these banks. Meanwhile, authorities could also try to take additional provision before tax. Second, varies loan provision standard for different banks. A flexible standard enacted according to loan ratio’s changing degree could let commercial banks put more attention to assets’ division. Based on commercial banks’ current asset division, banking sector supervision authorities could create a new indicator weighting some specific loan and loan division to subdivide loan category and put more asset under supervision, then it could contribute to risk’s optimization.

Surely, the proposal of provision ratio comes from the distrust on banks’ asset division. Asset division could be formed after a process of loan sector’s original dividing, risk management sector’s supervising and the board of directors and the general meeting of shareholders’ checking. It belongs to commercial banks’ internal activities. Supervision authorities could try to optimize some specific process to improve assets’ division which at last declines its dependence on provision ratio.

3.3 Leverage Ratio in Scope of Profit Model

Leverage is considered as a supplement for capital adequacy ratio to prevent off-balance sheet business expanding extraordinarily, in addition it could also help to identify risk didn’t detected because of the mistakes of econometric models. Based on the current profit model of China’s banking sector, the implementation of leverage regulation surely meets some
Most Chinese commercial banks' leverage ratio is high actually. In 2010, Chinese bank’s tier-1 capital leverage ratio is 4.13%, which is much higher than other countries’. It’s because Chinese commercial banks’ profit is mainly from high spreads in traditional loan-deposit business. In short term, leverage regulation’s contribution to Chinese commercial banks is not eminent and also is limited in long term.

China’ banking sector’s earning model is mainly rely on high-cost credit business whose spread constitutes its main profit. According to CBRC’s 2010 annual report, 66% of the financial institutions’ profit came from net interest income. It’s not a sustainable model for the globalization and the liberalization of interest rate which will cause the high-spread’s shrinking finally. China’s banking sector’s operation model needs to be changed and its off-balance sheet business should also be expanded which inevitably declines banks’ leverage. So, in this view, Chinese banks should expand creative businesses and build up various capital supplement mechanism to improve leverage handling ability.

Leverage supervision might incur competition among banks of different operation models and different risk status. Capital adequacy ratio is based on risk. Low-risk banks need less provision, while high-risk banks need more. Because leverage is risk-neutral, so banks mainly operating low risk business need more capital which decreases its efficiency. In this case, these banks will replace low-risk credit business with high-risk or high-profit credit business which increases banks’ systemically risk. So, banks of different operation models need different leverage supervision.

3.4 Availability of Liquidity Supervision in Scope of Capital Structure

Deposit-loan ratio still plays an important role in China’s current liquidity supervision. With the variety of banking liability, deposit is not the only credit resource such as some stable and maturity-matched liability. And banks’ asset is also diversified besides securitized capital. So deposit-loan doesn’t represent banks’ capital or liability thoroughly, not to say liquidity status. In scope of liquidity management, even defining the correlation between deposit and loan is incorrect. In global vision of operational management and supervision, deposit-loan ratio loses its importance gradually. So, supervision authorities should shift attention from deposit-loan ratio to capital liability management which matches capital-liability decently.

Discussion on the implementation of Basel III in China is focus on business model. With the competition among Chinese banks becoming fiercer, different banks have different operation models, various capital-liability structures. Some may excel at retailing, liability, on-balance business, while some may good at wholesaling, capital, off-balance business. So, liquidity regulation standard should be adjusted considering different banks’ various operation models as well as capital structures.

3.5 Supervision Indicators’ Duplicate Effect
CBRC should consider the duplicate effect might be incurred by many supervision indicators’ emergence. This could cause excessive or insufficient supervision. For example, all these four regulation tools—capital adequacy ratio, leverage ratio, liquidity indicator and loan provision ratio increase banks’ operation cost as well as decreasing banks’ profitability. Their internal correlations are as follows: if want to increase capital adequacy ratio, decrease leverage, enhance liquidity and raise loan provision ratio simultaneously, banks might choose to shrink their lending business while adopting investing on national debts etc to ensure capital and provision requirement; it would cause eminent influence on real economy’s liquidity status.

On the one hand, multiple regulation tools may have the same influence, such as capital adequacy ratio and leverage ratio. Some might think indicators having same influence could ensure prudential supervision’s strengthens, but it turns to be wrong. 4% leverage ratio requirement could cause the ineffectiveness of capital adequacy ratios (at least for tier-1 capital adequacy ratio). Because both leverage ratio and tier-1 capital adequacy ratio are used to weight tier-1 capital, they have a kind of inborn sameness: leverage ratio’s denominator is on-balance together with off-balance asset while capital adequacy ratio’s denominator is risk-weighted asset. 4% leverage ratio is corresponding to 8% tier-1 capital adequacy ratio more or less. In this scope, only leverage supervision (capital adequacy ratio) is enough. Eventually, excessive supervision would be induced for the double regulation tools on provision and capital.

On the other hand, some indicators are mutual exclusive which force banks in predicament to be homogenized. Capital adequacy ratio together with leverage ratio still has this character. Capital adequacy incline to raise leverage for the sake of capital saving. While risk-neutral-leverage restricts the activities of capital saving, risk-managing concepts and econometric models are adopted to save capital. Provision coverage ratio and loan provision ratio are also mutual exclusive. Because non-performing loan provision ratio equals provision coverage ratio multiplied by non-performing loan ratio, while non-performing loan ratio is negative correlated to provision coverage ratio. So, by the influence of non-performing loan ratio, provision coverage ratio is opposite to loan provision ratio. During the implementation of the two indicators, authorities should pay attention to the might caused homogeneity among banks.

In fact, no matter the optimization, improvement of Basel II on Basel I, the upgrading or modification of Basel III on Basel II, they all represent Basel committee’s risk management thoughts. Though indicators are subdivided as well as standards and prospects are enhanced, the main thoughts of building a suitable and effective supervision system stands still with the help of regulation tools, external supervision and information disclosure. During the process of the implementation of Basel II accompanied by selective introduction of Basel III, though measuring methods might different, data base as well as information technology keeps unchanged. Earlier we implement Basel III, faster our banks meet the international regulatory standard. However, more attention should also be paid to China’s banking sector’s current environment during the implementation of Basel III.