China Business & Finance

# IMF calls on China banks to boost capital after credit boom

Stress tests show most lenders under-capitalised despite compliance with Basel III


© Bloomberg

Gabriel Wildau in Shanghai
DECEMBER 6, 2017

The International Monetary Fund has called on China's banks to strengthen their capital buffers beyond what global rules require in order to fortify themselves against the risk of an economic shock.

In their first comprehensive assessment of China's financial system since 2011, the IMF described "unresolved tensions" between policies designed to promote employment and growth and those aimed at curbing financial risk.

"The overriding objective, especially at the local government level, [is] to achieve high growth rates that encourage credit expansion, particularly in the shadow banking sector," it said.

The report published on Thursday notes that Chinese authorities "have made financial stability a top priority this year" but that "some of the underlying causes of risks are yet to be fully addressed".

Zhou Xiaochuan, China's central bank governor, warned recently that complacency over risk amid strong economic growth could lead to a "Minsky moment" in which asset prices and growth fall sharply. The IMF has warned that China's rapid debt increase since 2008 is "dangerous".

At the five-yearly Communist party congress in October, authorities signalled that they intended to shift policy away from pursuing expansion at all costs, focusing instead on high-quality growth.

“The direction of policy change following the party Congress is clear — greater emphasis on sustainability, reducing inequality and risk control relative to top-line growth,” Andrew Tilton, Goldman Sachs chief Asia-Pacific economist, wrote in a report. “But the speed and effectiveness of this policy shift remains uncertain.”

The latest IMF assessment includes stress tests of 33 Chinese banks. It found that 27 were under-capitalised relative to what would be needed in a high-stress scenario, while noting that capital was adequate at the “Big Four” state-owned lenders. The fund praised Chinese authorities for implementing the Basel III standards on bank capital while calling for additional buffers beyond what those rules require.

“This would create a buffer to absorb potential losses that can be expected during the economic transition as credit is tightened and implicit guarantees are removed, as well as to better reflect the potential underestimation of risks from complex and opaque transactions.”

Many analysts have warned that widespread lending through off-balance-sheet channels — as well as creative accounting treatment of some on-balance-sheet loans — have left Chinese banks under-capitalised, even as they are technically compliant with Basel rules.

The People’s Bank of China praised the report but disputed some elements, including the interpretation of the stress-test results.

“We believe . . . that the (IMF’s) descriptions of the stress testing did not fully reflect the outcomes of the test,” the PBoC said in a statement.

The IMF report is the result of meetings that IMF and World Bank held with a slough of Chinese regulatory agencies between 2015 and early 2017. It was prepared before China’s four major financial regulatory agencies in November jointly issued the toughest rules to date aimed at curbing shadow banking.

“The IMF report highlights the deep tension between maintaining high growth and mitigating financial stability risks,” said Eswar Prasad, professor at Cornell University and former head of the IMF China’s office. “China’s growth model . . . served the country well in terms of headline GDP growth but at a significant cost in terms of potential financial system fragilities.”

*Follow @gabewildau on Twitter*