Current Issues

Asia

Deutsche Bank Research

June 19, 2009

Hong Kong's banks during the financial crisis

The banking sector plays a prominent role in Hong Kong's economy. While the sector accounts for only 2.5% of employment, its share of nominal GDP has been rising steadily from 7.5% in 1997 to close to 12% in 2007 and Hong Kong's banks experienced strong growth throughout recent years as they expanded their business to mainland China. It is therefore important to follow developments in the financial sector and assess the potential implications of the current crisis for the territory's prospects as Asia's global financial centre.

While HK's banks entered the crisis in a healthy condition, profitability slumped in H2 2008. Whereas net interest margins remained largely unaffected, banks suffered from declining fee income as demand for wealth management, brokerage services, security issuance, and trade finance broke down.

First signs of asset quality deterioration – but from a low level. Despite their low direct exposure to subprime and structured credit products (with a few exceptions), Hong Kong banks are affected by the economic and trade-related slump. Fortunately, banks are sufficiently capitalised and have raised their provision levels and should thus be able to weather the crisis.

The short-term outlook for banks depends on the recovery path of the economy. With the recovery of Hong Kong's and mainland China's economy expected in H2 2009, we expect a rebound in banks' profitability. This is also due to banks' historically prudent management and continuing regulatory and tax advantages, which allow them to further expand in mainland China.

In the longer term, Hong Kong's banks will probably face increased competition from mainland China. A lot will depend on the ability of Hong Kong's banks to maintain and expand their long-standing ties not only with corporations and SMEs from the territory that have moved their production facilities to adjacent Chinese provinces, but also with foreign investors and companies using Hong Kong as a gateway to mainland China.

At the same time, Beijing's initial steps towards an internationalisation of the RMB open up new opportunities for HK's banks. RMB deposit taking, currency exchange and remittances services started in February 2004, and seem to be promising niches. RMB trade settlement which became recently available as a pilot project to Hong Kong's banks, may soon prove a valuable business if and when trade flows rebound.

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Introduction

The impact of the global recession has also been felt across emerging Asia. As could be expected, small and open economies were particularly hard hit. In Q1 2009, real GDP contracted by 10.2% yoy in Taiwan, 10.1% in Singapore, and 7.8% in Hong Kong – following already negative growth rates in Q4 2008 – and made these the three most severely affected countries within Asia-10.[1] In all three cases, the main transmission channel has been waning external demand, reflected in slumping exports and massive declines in investment growth.

HK's four key industries

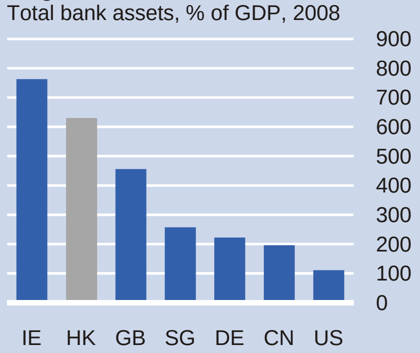
Industry	Share of GDP ('07)	Share of total employment
Trade and logistics	25.8%	24.2%
Financial services	19.5%	5.5%
thereof: Banking	*11.6%*	*2.5%*
Professional services	11.0%	11.7%
Tourism	3.4%	5.6%

Source: Census and Statistics Department Hong Kong 1

The financial services sector plays a crucial role in Hong Kong. While it accounts for only 5.5% of total employment, the sector generates close to 20% of GDP. The banking sector's growing importance is reflected in its rising share in GDP which grew from 7.5% in 1997 to close to 12% in 2007. Total bank assets stand at 630% of GDP, much higher than in Singapore, Asia's other financial centre. At the same time, this high share also indicates that a banking crisis would pose a large shock to Hong Kong's economy and weaken its position as an international financial centre.

High asset-to-GDP ratio

Total bank assets, % of GDP, 2008



Sources: National statistics, Fitch 2

Banking sector structure

Hong Kong operates a three-tier banking system which distinguishes between licensed banks, restricted license banks (RLB) and deposit-taking companies (DTC). Whereas there are no lending or investment restrictions, RLBs and DTCs are constrained with regard to the amounts and terms of deposits they may accept. There was a fair amount of consolidation in the banking sector throughout recent years, with the total number of banking institutions being almost halved between 1994 and 2008. This consolidation was, however, more pronounced for DTCs and less so for licensed banks.

Banking sector has consolidated

		1994	2001	2008
Licensed banks	in HK	32	30	23
incor-porated ...	outside HK	146	121	121
All authorized institutions*		376	257	202
Local representative offices		156	115	75
Total		**532**	**372**	**277**

*Comprising licensed banks, RLBs, and DTCs

Source: HKMA 4

Foreign subsidiaries dominate

	Subsidiary of (country)	% of total assets (2008)	Local branches
HSBC (HK)	HSBC (UK)	39.7%	126
Bank of China (HK)	Bank of China (China)	10.4%	226
Hang Seng Bank	HSBC (UK)	7.1%	118
Bank of East Asia		3.9%	90
DBS (HK)	DBS (Singapore)	2.0%	64
ICBC Asia	ICBC (China)	1.8%	46

Source: Fitch, HKMA 3

Many of the large domestic banks are subsidiaries of large foreign banks. HSBC (HK) is by far the biggest bank in terms of total assets, accounting for close to 40% of total assets, followed by the Bank of China (HK), the Hang Seng Bank, and the Bank of East Asia.

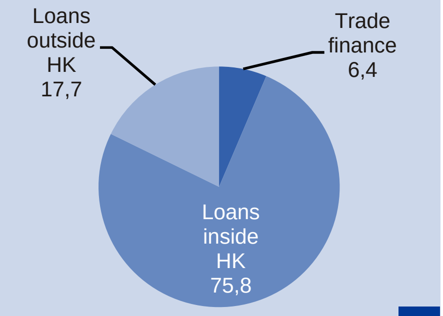
[1] Asia-10 includes China, Hong Kong, India, Indonesia, Malaysia, Philippines, Singapore, South Korea, Taiwan, and Thailand.

Hong Kong's banks and the current crisis

Hong Kong's banks entered the crisis in a healthy condition with returns on assets above 1.5%, sufficient capitalisation, strong but prudently managed loan growth and very low impairments. Even though margins were narrowing slightly due to stiff competition for loans and deposits, banks profited from rising fee and commission incomes from wealth management, brokerage services, trade finance and others. Loan growth was particularly strong in mainland China as banks financed the expansion of their customers. Many of these customers (not only large companies but increasingly SMEs) opened up or extended their manufacturing or property businesses in Southern China.

Relatively high foreign lending share

Loan destination in 2008 (% of total)

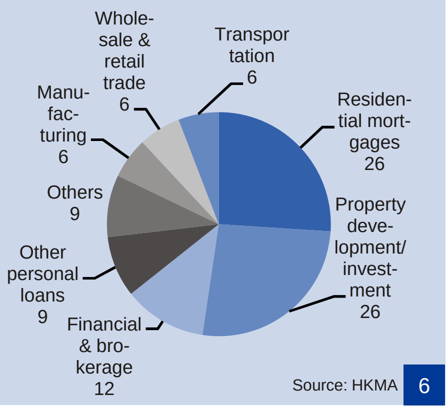


Source: HKMA 5

Out of loans for use inside HK, more than half are residential mortgage and property development/investment loans, making a big share of banks' loan books vulnerable to the volatile property market. Gross classified exposures (including substandard and doubtful loans and losses) were very low (below 1% throughout the last 4 years).

High loan concentration in property sector

Loans for use in HK in 2008 (% of total)

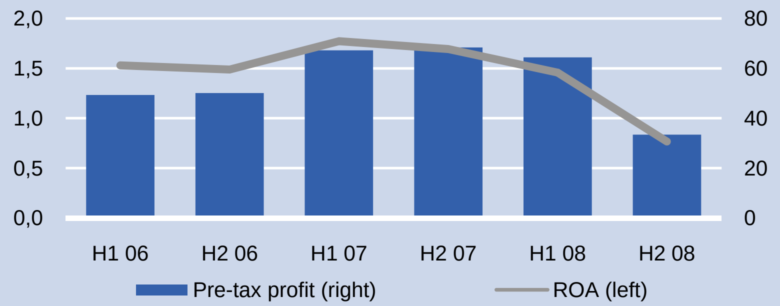


Source: HKMA 6

The crisis hit HK's banks in H2 2008, weighing heavily on banks' income statements. Pre-tax profits of the 10 largest banks[2] deteriorated in H2 2008, falling by almost 50% compared to H1 2008. Whereas net interest income remained quite stable, the decline can largely be attributed to slumping fee and commission incomes (included in other operating income) and higher impairment charges in light of rising non-performing loans and a grim economic outlook.

Income and profitability deteriorating

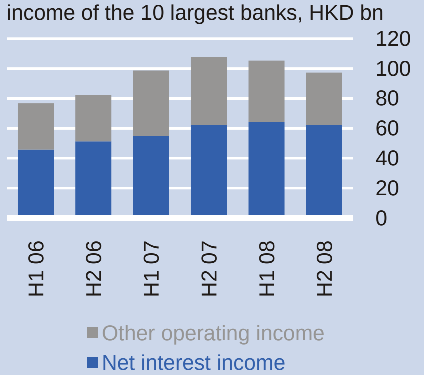
Pre-tax profit (HKD bn) and annualized ROA of the 10 largest banks



Source: Calculations based on Fitch 7

NII stable, fees declining

Net interest income and other operating income of the 10 largest banks, HKD bn



Source: Calculations based on Fitch 8

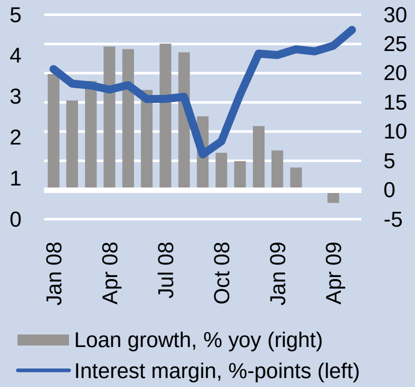
Interest margins are currently higher than in Q1 2008 following a strong decline in September 08 when the failure of Lehman Brothers led banks to hoard their liquidity, with the HIBOR closely following rising U.S. interbank rates due to the HKD-USD peg. The Hong Kong Monetary Authority (HKMA) responded by injecting liquidity into the banking system via several operations (see box on next page), which brought the overnight HIBOR below 0.5% while lending rates for prime borrowers remained almost unchanged at 5%. Constant lending rates reflect banks' greater prudence, lower risk appetite, and better bargaining position as a price setter particularly vis-à-vis riskier SMEs. Funding problems of banks combined with the increasingly bleak economic outlook led banks to reduce lending.

[2] HSBC (HK), Hang Seng Bank, Bank of China (HK), Bank of East Asia, DBS HK, ICBC Asia, Wing Hang Bank, CITIC Ka Wah Bank, Shanghai Commercial, Dah Sing Banking Group.

Bank support measures

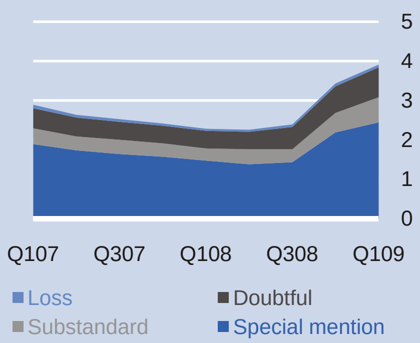
- The HKMA aimed to support bank liquidity by buying USD for HKD and expanding repurchase facilities through 5 temporary windows in order to provide collateralized liquidity to banks.
- The Financial Secretary announced a temporary 100% deposit guarantee to strengthen public confidence in the banking system (extending the HKD 100,000 covered by the Deposit Protection Scheme).
- The Exchange (Reserve) Fund may be used to provide a contingent capital facility for banks. However, no specific amounts or terms have been determined and are to be decided case by case. Due to sufficient capitalisation and liquidity, it is considered unlikely that banks will use the facility.
- The HK government announced a HKD 100 bn loan guarantee to SMEs of up to 70% of the notional loan with a maximum of HKD 6 m for each loan.

Margins back up, loan growth down



Source: HKMA 10

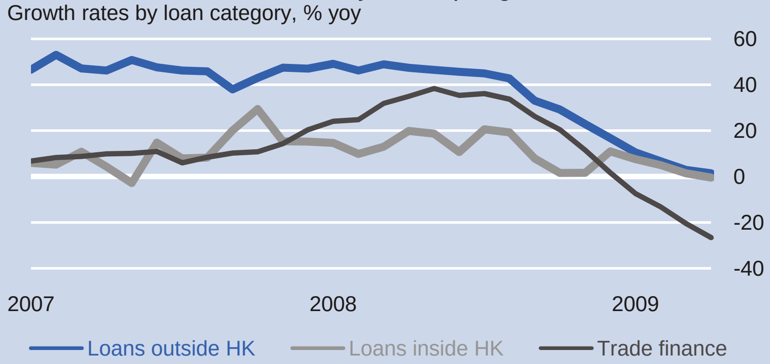
First signs of deteriorating asset quality
% of total loans



Source: HKMA 11

The decline in loan growth was particularly strong for loans outside Hong Kong, largely reflecting the lower demand for funds of Chinese manufacturers. Inside Hong Kong, manufacturing, financial and brokerage, and other loans (comprising electricity and gas, recreational activities, information technology, hotels, and others) declined most, falling by 5-10% qoq in Q4 2008. Loans for property development was the only category showing positive growth of 2.2% qoq, while the other large component – residential mortgages – fell by a relatively mild 1.5% compared to Q3 2008.

Trade finance hit hard by slumping trade flows
Growth rates by loan category, % yoy



Source: HKMA 9

Fee and commission income came under pressure. Wealth management and brokerage fees fell as people became more reluctant to invest (in structured products, for example) as some investors suffered heavy losses. Income from IPO and bond issuance declined as well due to the negative capital market environment. Fee income from trade finance suffered from slumping export orders.

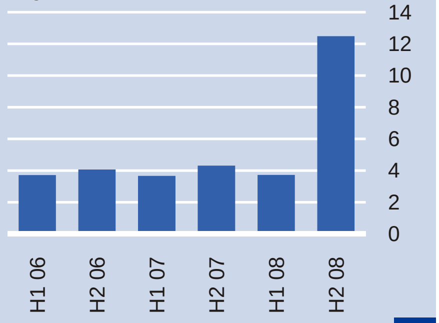
Asset quality showed first signs of deterioration in Q4 2008. HKMA does not publish a single non-performing loans figure, but instead distinguishes between pass, special mention and classified loans.[3] After being on a downward trend for many years, special mention and classified loans started increasing in Q4 2008. Particularly loans to the manufacturing and trading sector of export-oriented SMEs in southern China and property investments in China by HK companies are considered to be problematic as firms are struggling with lower export demand, rising labour costs, and the stronger CNY. However, the level of special mention and classified loans is still very low by historical and international standards.

Classified loans will keep increasing throughout 2009 as they lag GDP growth rates. Evidence from the Asian crisis shows that classified loans kept rising for 4 quarters, peaking in Q3 1999 after the decline in GDP growth rates reached its bottom in Q3 1998. As we expect the GDP decline in the current crisis to hit bottom in Q1/Q2 2009, classified loans could keep rising until at least Q1 2010 (depending strongly on the actual recovery path, though).

[3] Classified loans comprise loans or exposures classified as substandard, doubtful or loss.

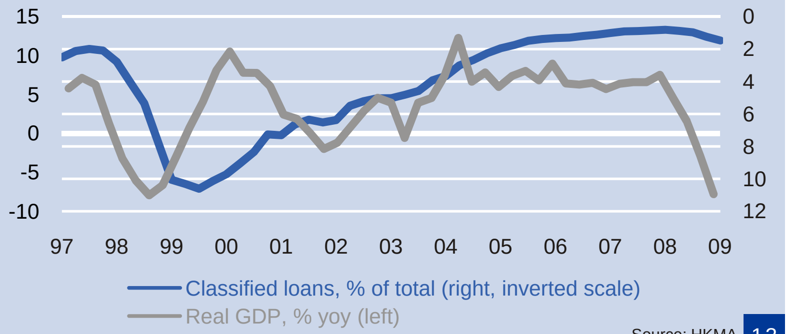
Well provisioned

Loan impairment charges of the 10 largest banks, HKD bn



Source: Calculations based on Fitch 12

Asset quality likely to deteriorate further



Source: HKMA 13

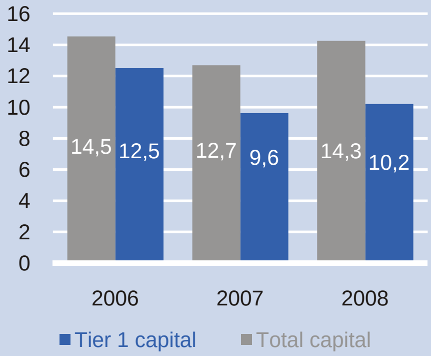
Hong Kong banks' provisions and sufficient capitalisation make them well prepared for the expected deterioration in asset quality. Loan impairment charges of the 10 largest banks have more than tripled in H2 08. Other impairment charges (mainly allowances for securities holdings) soared from almost zero in 2006 to over HKD 14 bn in 2008. Capital, the second buffer to losses was even raised in 2008, largely due to the adoption of the foundation of internal ratings-based approach (FIRB) for credit risk exposure calculations by HSBC (HK) and the Hang Seng Bank. However, capital ratios fell slightly for most banks in H2 08. As HK's banks have a rather low exposure to subprime and structured credit products (with a few exceptions) combined with the fact that most big banks are subsidiaries of large, sound international banks, we do not see major risks of a systemic banking crisis.

Further risk mitigating factors are the absence of any signs of credit card distress and the lack of an overheated residential mortgage market in HK. The number of credit card accounts grew only moderately over the past years and delinquent amounts, while likely to increase, are currently still very low. The same – moderate growth and low delinquencies – holds true for real estate-related loans, which represent the biggest share in banks' loan books and account for more than 50% of total loans for use in Hong Kong.

Falling property prices may have a negative impact not only on consumption and investment but also on bank lending as using property as collateral for consumer and business loans is widespread in Hong Kong. However, prudential regulation (there is a maximum loan-to-value ratio of 70% incorporated in the HKMA's guidelines) and limited credit expansion during the boom should prevent a credit crunch now.

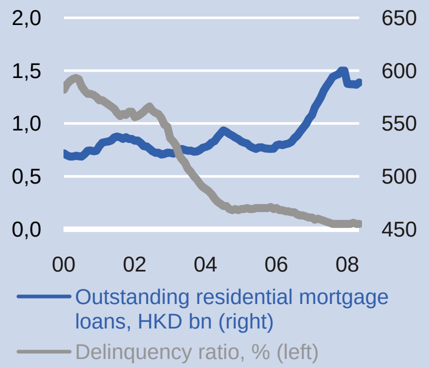
Well capitalised

% of risk weighted assets



Source: Fitch 14

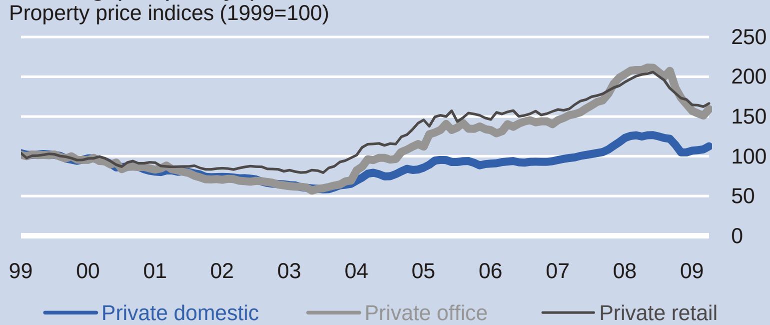
Low mortgage delinquencies



Source: HKMA 15

Falling property prices

Property price indices (1999=100)



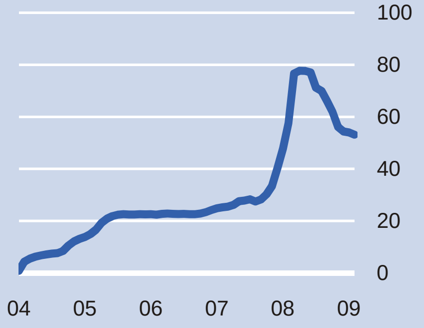
Source: R&VD HK 16

Outlook

Despite the negative impact of the current crisis and many remaining uncertainties about the actual economic recovery path, the medium-term outlook for Hong Kong's banks remains favourable. Banks are certainly going to keep struggling with depressed loan growth, low fee income and deteriorating asset quality for a year or so. But with the return of trade flows and the rebound of the Hong Kong and the mainland Chinese economies, which we expect in the second half of 2009 or early 2010, we also expect banks' profitability to increase again – although probably not to the levels witnessed during the boom years. This is also due to banks' historically prudent management and continuing regulatory and tax advantages which allow them to further expand in mainland China.

In the long run, Hong Kong's banks will have to deal with increasing competition from mainland Chinese banks. A lot will depend on the ability of Hong Kong's banks to maintain and expand their long-standing ties to corporations and SMEs from the territory that have moved their production facilities to adjacent Chinese provinces, but also with foreign investors and companies using Hong Kong as a gateway to mainland China. As these links not only are built on tradition, but also on trust in Hong Kong's superiority in terms of bank management and regulation, this advantage may erode as mainland Chinese banks catch up and enhance their international reputations.[4]

RMB business opportunities
Total RMB deposits of HK banks, HKD bn



Source: HKMA 17

Beijing's initial steps towards an internationalisation of the RMB open up new opportunities for Hong Kong's banks, for instance, in RMB deposits or RMB trade settlement. Since banks started offering RMB deposit taking, currency exchange and remittances services in February 2004, this business has boomed and might be a promising niche for Hong Kong's banks. RMB trade settlement, which became recently available as a pilot project to Hong Kong's banks, may soon prove a valuable business if and when trade flows rebound.

Taking a broader look at the financial sector as a whole, maintaining Hong Kong's existing competitive advantages and improving weaker areas will be crucial. This is especially important against the background of plans by mainland China's central government to transform Shanghai into a global financial centre by 2020. Hong Kong is widely regarded as being highly competitive, since the quality of human capital is relatively high and the business environment is seen as favourable. Further strengths of Hong Kong are financial sector research, a free press, and the already relatively strong linkages with the international financial system. Aside from preserving and refining a high-quality regulatory framework, ensuring the supply of skilled personnel will probably be one of the key issues in the future. This means continued investment in education and further improvements to the quality of life in order to attract and retain foreign professionals.

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[4] For our view on the future of China's financial markets, see Hansakul, Dyck, Kern (2009). China's financial markets – a future global force? Deutsche Bank Research. March 2009. Frankfurt am Main.

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Asia

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Printed by: HST Offsetdruck Schadt & Tetzlaff GbR, Dieburg

Print ISSN 1612-314X / Internet and e-mail ISSN 1612-3158