David Carse: Bank consolidation in Hong Kong

Speech by Mr David Carse, Deputy Chief Executive of the Hong Kong Monetary Authority, at the JP Morgan Asian Financial Institutions Strategy Conference, Hong Kong, 1 June 2001.

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Ladies and Gentlemen

I am grateful to J P Morgan for giving me the opportunity to speak to you this morning on the subject of bank consolidation in Hong Kong.

Consolidation of the banking industry has been a prominent feature of many of the world's leading financial centres during the last decade. Hong Kong has been something of an outlier in this respect. My speech today will explain some of the reasons for this and will describe how and why this situation is changing. I will also discuss the attitude of the Hong Kong Monetary Authority towards the process of consolidation and what we can do to assist.

The G10 Report on Financial Consolidation

The trend towards amalgamation among the world's financial institutions prompted the G10 Finance Ministers and Central Bank Governors in September 1999 to commission a study of financial consolidation and its potential effects. A Working Party was formed for this purpose, which reported in January of this year. The Report[1] is available in both summary and detailed form on the BIS website.

The G10 Report notes that there was a high level of merger and acquisition activity in the 1990s among the financial firms in the 13 countries studied. Banks were the main participants in this. The annual number of M&A deals increased threefold during the 1990s and the total value of deals increased almost tenfold in the 13 countries as a whole. Moreover, the trend accelerated during the period, with a noticeable increase in activity in the last three years of the decade. As we proceed into the first years of the 21st Century, there is little sign of this trend abating.

The result has been the creation of a significant number of large and complex banking groups with a global reach. The host of today's conference is a living example of this. We also, of course, have our own homegrown example in the shape of HSBC.

Motivations for consolidation

The motivations behind all this activity are not hard to discern. Banks, like other companies, are in business primarily to generate value for their shareholders. M&A, it is commonly held, offers an effective means of achieving this through creating synergies that can increase revenue and reduce cost. In particular, larger banks may be able to achieve revenue gains by filling gaps in their product range and offering customers the opportunity of "one-stop shopping". Increased size and market share may give a bank more credibility in the eyes of larger customers, thus providing the opportunity for bigger and more value-added transactions. Size can also open the door into overseas markets. A case in point is that a bank needs to have assets of at least US$20 billion to be eligible to establish a branch in Mainland China, which is at present beyond the reach of most local banks in Hong Kong.

Future profits may also benefit from cost reductions arising from economies of scale – that is, the ability to spread fixed costs, including particularly those which are technology-related, over a larger scale of operations. Cost economies can also be achieved by eliminating duplications in branch networks, functions and staff. There may also be a reduction in risk, and therefore saving in costs, due to geographic or product diversification and the ability of larger institutions to invest in more sophisticated risk management systems. To the extent that risk reduction boosts a bank's credit rating, or increased size attracts the attention of investors, its cost of capital may be reduced, thus providing another means to increase shareholder value.

Of course, merger is not the only way to maximise value. Nor, must it be said, is M&A always pursued for this reason. Management may have its own motives for chasing size - personal ambition or herd

[1] "Consolidation in the Financial Sector": Group of Ten, January 2001, available at www.bis.org.

instinct may also be part of the story. This may help to explain one of the paradoxes of the consolidation boom. Lots of companies are doing it, but the success of M&A in achieving its stated objectives of cost and revenue synergies is not clear-cut.

Does M&A work?

The G10 Report to which I referred concluded, for example, that there was only weak evidence of cost reduction arising from increased size, except perhaps in the case of smaller banks. While there was stronger evidence for improvement on the revenue side, the gains were probably not as large as those anticipated by the practitioners. Not surprisingly therefore, there was not much to show that, on average, M&A generated significant shareholder value. Rather, what tended to happen was that there was a transfer of wealth from the shareholders of the acquirer to those of the target.

Other studies, and some well-publicised mergers that have failed to deliver the promised benefits, support this somewhat sceptical view. It is however equally possible to point to cases where mergers have been successful. Indeed, most, if not all, of the market leaders in the industry have got to where they are today through a series of mergers that have taken place over the years. The risk, however, is that banks may sometimes embark on a "merger too far". In other words, at some point the complexity of a merger may outstrip the ability of management to handle it, and diseconomies of scale set in.

This means that we cannot really generalise about the success of bank mergers. The answer, as a recent study[2] by UBS Warburg has indicated, seems to be that sometimes mergers work and sometimes they do not. It depends to a large extent on management capability. It also seems to be the case that the benefits of mergers, in terms at least of securing economies of scale, may be relatively more easy to exploit in the case of smaller retail banks. This may be relevant to the situation in Hong Kong, to which I now turn.

The situation in Hong Kong

As I mentioned at the beginning of this speech, the local banking system in Hong Kong has stood somewhat aloof from the general trend towards consolidation. The emergence of HSBC as a truly global player over the last decade is of course an outstanding example of what can be achieved with the help of M&A. But this has happened outside Hong Kong. Until recently, at least, the situation within Hong Kong has been more static.

The family ownership of a number of local banks is often cited as one of the reasons for this. It is true that family owners may be influenced by factors other than value maximisation, such as the desire to preserve the family heritage and to pass it on intact to the next generation. But an additional factor is that hitherto banks in Hong Kong have not been under economic pressure to merge because profitability has been satisfactory in absolute terms. Local banks recorded average growth in pre-tax profits of 15% per annum in the six years prior to the Asian crisis. Moreover, most banks remained profitable during the crisis itself and all continued to maintain high capital ratios. Financial distress was therefore not a driving force for merger, as it has been in other Asian countries.

But there are signs that the consolidation process is gathering pace in Hong Kong. The reasons for this are to some extent the same as those elsewhere. These include increased competition from both domestic and global players, deregulation, the need to invest in new technology and the increased focus, even for family-owned businesses, on generating shareholder value.

All this means that the life of a banker in Hong Kong is not an easy one at present. Some of the old certainties are breaking down. The removal of the remaining interest rate controls in a month's time will usher in a new era of full competition on the liabilities side of the balance sheet. While the surplus liquidity in the system may mitigate the immediate impact to some extent, banks will face new challenges on products, pricing, fees and charges, and asset and liability management.

This comes on top of the challenges that the banks are already facing to generate new lending business. The residential property market, which has been the mainstay of most of the local banks' business, is currently drifting without clear direction, and mortgage business is still sluggish, as the latest figures for April demonstrated. Margins on new lending have been slashed without generating much in the way of demand, and the effects of this on the overall net interest margin were evident in

[2] "The Urge to Merge - a Global Phenomenon": UBS Warburg, March 2001

the first quarter of this year. This in turn contributed to a moderate decline in the aggregate profits of the local banks' Hong Kong operations compared with the same period of last year.

In this environment, where organic growth is hard to come by, it is not surprising that the local banks should be asking themselves if they should merge or acquire or be acquired.

Coupled with this are global or regional developments that impinge on Hong Kong. When foreign banks merge in their home countries the combined entity may have operations in Hong Kong that are now surplus to requirements and that they want to sell. This may attract willing buyers from banks which want to get into the Hong Kong market or expand their existing presence here. Some foreign banks are in any case keen to acquire a presence in Hong Kong because they want to escape the confines of their domestic market, and see attractive business opportunities in Hong Kong, both in its own right and as a gateway to China. The latter may also be a reason for local banks to get bigger in order to meet the size criterion for entry or expansion into the Mainland market.

Whatever the motivation, a series of transactions have recently taken place that show that the pace of consolidation is picking up in Hong Kong. Last year, for example, we saw the acquisition by Standard Chartered of the credit card and retail banking business of Chase Manhattan and the purchase by Bank of East Asia of First Pacific Bank. This year, Development Bank of Singapore is in the process of acquiring Dao Heng Bank with the intention of eventually combining it with its existing locally incorporated subsidiary. Two of the Mainland banks, Bank of China and ICBC, are also consolidating their Hong Kong operations. The Bank of China move is particularly significant since it will create the second largest banking group incorporated in Hong Kong.

What we have not so far seen in Hong Kong is merger among indigenous banks that are more or less of equal footing. This is perhaps not surprising. Such mergers are generally more difficult to arrange than straightforward acquisitions of a smaller bank by a larger bank. In the latter case, the acquirer is in a position to decide what it wants to do as regards management and staff changes, harmonisation of systems and the introduction of new products. With a true merger, these matters have to be settled by consensus, which may not be easy. Who for example is going to be the chairman or chief executive? It is probably better to avoid the Japanese solution of sharing each of these responsibilities among more than one individual.

There is also the question of what is the end-result of the merger in terms of market share. It may be necessary for more than two banks to get together in order to achieve a significant increase in scale. But the more banks that are involved in a merger, the greater the complexity of achieving strategic fit and cultural harmony.

The attitude of the HKMA

This reinforces the general point made earlier that successful execution of M&A is not an easy task. However, despite the potential pitfalls, the HKMA continues to believe that consolidation of the local banking sector is desirable and probably inevitable. This is for the reasons I have already mentioned. In general, it is difficult to see how a banking system like Hong Kong's, which is open to the forces of global competition, can resist the pressures that are leading to consolidation in other banking systems. In terms of Hong Kong's particular situation, while it is always dangerous to extrapolate current market conditions into the future, it does appear that organic growth is going to be more difficult to achieve than it was in the years before the Asian crisis.

This lays greater stress on the need for smaller banks to find a strategy that will differentiate themselves from their competitors and enable them to earn an adequate return on capital. This will not be straightforward, particularly since a number of the potential business options such as wealth management involve heavy set-up costs that need scale to justify them. Such new businesses are also more demanding in terms of managerial skills and smaller banks may find it difficult to attract the right talent.

Consolidation by means of M&A is not the only way of grappling with these issues, as the Bank Consortium Trust has shown, but it is an option that the local banks in Hong Kong should keep very much in mind. This should be done as part of an ongoing process of strategic planning that looks ahead to the medium-term rather than simply the next year. The outcome of this process may be that the bank opts to stay as a stand-alone entity. This is a valid commercial decision if taken in a conscious and considered manner rather than by default. However, it should be kept under regular review in the light of the changing financial landscape.

Against this background, the position of the HKMA on bank consolidation can be summarised as follows:

- We continue to believe that we cannot, and should not try to, force healthy banks to merge or be acquired against their will. As noted above, this has to be a matter of commercial judgement by the banks concerned. It would be difficult for the HKMA to form a better view than market participants of how they should partner themselves, particularly since the success of individual mergers is by no means assured. Forced marriages between banks are even more unlikely to be successful.
- We will, however, where appropriate, raise the issue of consolidation in meetings with banks' board of directors and management, and will encourage them to make it part of their strategic planning.
- We will also do what we can to provide appropriate incentives for banks to think seriously about consolidation, in particular by removing potential barriers to competition such as the last remaining controls on interest rates.
- We will not erect artificial barriers to acquisition of local banks by foreign banks, which would be contrary to Hong Kong's traditional free market ethos and our commitments under WTO.
- We note the view that is sometimes expressed that it would be desirable for Hong Kong to retain a core of strong, locally owned banks. This is something that we would support, but it is not something that we can deliver. Rather, it would depend on whether the local banks can agree to merge among themselves.
- We will do what we can to facilitate individual transactions that are put to us for consideration. This will include giving prompt advice on what is acceptable from a banking regulatory point of view. We will also look sympathetically at the use of acceptable debt instruments to finance mergers as opposed to our previous preference for equity or cash. This reflects modern trends in capital management.
- We may also be prepared to relax our capital requirements for an acquiring bank on a strictly temporary basis provided that there are firm and credible plans by the acquirer to raise new capital. This would only apply where, for good reasons, the timing of the acquisition cannot coincide with the timing of the issue of capital.

Conclusions

To summarise, consolidation offers the banks, and perhaps especially smaller institutions, the opportunity to achieve cost reductions and revenue enhancements. This is not, however, something that can be taken for granted, and there will always be a certain element of execution risk. This is one of the reasons why it is difficult for banking regulators, like the HKMA, to take a heavy-handed approach towards mandating consolidation. Rather, proposals should emanate from the industry itself based on careful examination of strategic fit and quantification of the benefits that will flow from the merger or acquisition.

While the local banks are not under immediate pressure to consolidate, we believe that this is an issue that they should keep under close and continuing review.