David Carse: The state of the banking industry in Hong Kong

Speech by Mr David Carse, Deputy Chief Executive of the Hong Kong Monetary Authority, to the Hong Kong Foreign Bank Representatives Association, Hong Kong, 6 May 2003.

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Ladies and gentlemen,

Thank you for the opportunity to speak again to the Hong Kong Foreign Bank Representatives Association. I want to use this opportunity to take stock of the state of the banking industry at what is a more than usually uncertain period for Hong Kong as it battles with the impact of atypical pneumonia.

In Hong Kong you need to be prepared for the unexpected. At the beginning of the year, we were all worried about the looming war in Iraq and the damage that it might cause to the global economy and to Hong Kong. Little did we know that the main threat to the people and the economy of Hong Kong would come from the SARS virus.

The recent performance of the banking industry

The outbreak of the disease is one of a number of shocks that the banks in Hong Kong have had to cope with over the last five years. I will not dwell on the list, which will be familiar to you, but it includes two recessions, five consecutive years of consumer price deflation, a collapse in property prices of 65% from the peak in October 1997 and a surge in personal bankruptcies. All this has taken place against the background of various upheavals in the global economic and political environment, the war in Iraq being just one manifestation of this.

The defining characteristic of Hong Kong banks during this difficult period has been their resilience. Despite the ups and downs, banks' balance sheets have remained strong. For the locally incorporated authorized institutions, the aggregate capital ratio remains around 16%, twice the minimum international standard. Many of the smaller banks have ratios well above this.

Capital strength has not been impaired by losses during this period. The banks have continued to make money and earn a reasonable return on assets from their Hong Kong operations, averaging around 1.25% (before tax) over the last three years.[1]

However, this has not been easy to come by. Growth in mortgage lending, the mainstay of profits in the 1990s, has stagnated, and the spread on new mortgage loans has fallen to 2.6% below prime - barely enough to earn a decent return on capital employed.

Other sources of loan demand have also dried up as corporates have deleveraged since the Asian Crisis.

So the banks have had to change their focus in order to generate revenue. Attention has switched to the liabilities side of the balance sheet as the banks seek to make best use of the large amounts of surplus funds that have built up. Banks have been managing down the cost of their liabilities in order to improve deposit margins. They have been helped by a switch by customers from time deposits to savings and current accounts as the opportunity cost of holding liquid balances has fallen.

By some reckonings surplus deposits in Hong Kong are the highest in the world in relation to GDP. A lot of these funds have been invested in increased holdings of debt securities, which now account for about 22 % of the total assets of retail banks compared with only 8 % at the end of 1997. The upward sloping yield curve has encouraged this process and made it profitable.

Another approach adopted by a number of the retail banks has been to develop sources of non-interest income by moving into the wealth management business. This means using the branch network to cross-sell products like mutual funds, insurance and securities to the client base. These

[1] Relates to "retail banks", which comprise all locally incorporated banks and branches of foreign banks which are active in retail and commercial banking in Hong Kong.

efforts are paying off, particularly for the larger banks, and are now having a discernible impact on the bottom line.

A less successful aspect of the increased emphasis on the consumer has been the foray by a number of banks into the credit card business. Prior to 2002, this provided the only area of buoyant lending growth in Hong Kong. In retrospect, this should perhaps have flashed more of a warning signal, but with credit card receivables starting from a very low base, it was not surprising that the amount outstanding should expand rapidly.

The quality of the card portfolio actually held up well for some time. But the cumulative effects of deflation, rising unemployment and increasing indebtedness were taking an increasing toll. Coupled with the delayed impact of the more permissive bankruptcy regime introduced in 1998, these factors produced an explosion of personal bankruptcies in 2002. Bankruptcy petitions jumped to almost 27,000 in that year and the charge-off ratio for credit cards rose to 13.25%, compared with 5.46% in 2001.

In the first quarter of this year, the bankruptcy situation seems to have improved a bit, with the number of petitions falling to 6,119. Credit card charge-offs have also shown signs of slackening off. The average charge-off ratio for the first two months of 2003 was down to about 11.3% - still not good, but an improvement on the final quarter of 2002. The question facing the banks is whether this can be sustained in the current environment.

Apart from credit cards, asset quality has generally been benign. In particular, the all-important mortgage portfolio has held up well, with the three-month delinquency ratio standing at just over 1.1 %. This is despite the ominous rise in the number and amount of mortgages in negative equity. At end-2002, we estimated that there were around 78,000 cases of negative equity with a value of $129 billion. Note that this takes into account only first mortgages held by the banks. If loans with second mortgages were included, the number of cases would undoubtedly be larger.

Residential property prices fell on average by 7% in the first quarter of this year. So the negative equity problem will have got worse, as the latest figures to be published shortly will show. This poses some threat to the profitability of banks. So far, however, even mortgage loans in negative equity have continued to perform reasonably well, although the delinquency ratio of around 2.5% is worse than for those with positive equity.

The impact of SARS

Even before SARS arose as an issue, 2003 was expected to be another challenging year for the banks. But the prospect of lower charge-offs for credit cards encouraged a number of banks to forecast that they would achieve higher profits. Performance in the first quarter seemed to bear this out. As usual, some banks did better than others, but aggregate profits in the first quarter did show an improvement over the same period of last year.

The SARS outbreak is now affecting the business of the banks in various ways and the banks are having to react to this.

The first priority has been to maintain business continuity and to protect the health of bank staff and customers. Banks have therefore activated, and where necessary reviewed and updated, their business continuity plans, demonstrating in the process that these are not just paper exercises.

Among the measures taken, banks have established command centres to monitor the situation and to take appropriate action following reports of confirmed or suspected cases of infection among staff. Typically, this involves sending home colleagues in contact with the infected staff member and cleansing the office or branch concerned. This is part of a more general increased focus on office and personal hygiene. Staff are generally being required or strongly encouraged to wear masks and gloves for their own protection and to limit the spread of the disease.

The banks have also activated back-up sites for critical operational areas such as computer systems, dealing and settlement. Teams of staff that could man these operations in an emergency have been identified and have been segregated in locations outside the main office such as the back-up site or other branches. Some staff have also been working from home. In some cases, arrangements have been made with overseas branches to cover at least part of the activities of the Hong Kong operations in case of need. The number of overseas trips and meetings has been cut back.

So far these special arrangements seem to have been effective. Banks have been able to maintain their operations without major disruption, except for the temporary closure of a few branches. Hopefully, it will be possible to wind down the arrangements in the near future. No doubt lessons have been learned from the experience that can be incorporated in the banks' contingency plans.

Apart from the need for banks to avoid interruptions to their business, they are also having to cope with the impact of SARS on the volume of their business and on their balance sheets. Based on our discussions with the banks, the main effects have so far been as follows:

- Customer traffic in the branches has been reduced, which is limiting face-to-face contact with the customer and thus hampering efforts to sell wealth management products. The positive side is that use of internet banking is up, which provides the opportunity for banks to reach out to customers in a cost-effective way. While the potential of the internet was undoubtedly over-hyped during the tech boom, it is increasingly demonstrating its value as an alternative delivery channel.
- Loan demand has fallen further from its already low levels. In particular, demand for mortgage loans has dropped, which is not surprising since buying, or even viewing, new flats has not been uppermost in people's minds in recent weeks.
- Credit card volume is down as people cut back on retail spending, restaurants, entertainment and travel. There are indications from some banks however that the amount of credit card spending may be beginning to pick up as people begin to venture out again.
- Asset quality may suffer if businesses go bust and more individuals become unemployed. SMEs in the most badly affected sectors of the economy, credit cards and mortgage loans are potential areas of vulnerability. So far there has been little sign of significant deterioration in these areas. But as you know, bad debts are a lagging indicator of the state of the economy. The most reasonable assumption is that bad debt provisions and charge-offs will increase, though we do not yet know to what extent.
- Provisions may also increase as a result of a decline in property prices and collateral values caused by SARS. The value of bank premises may also be affected.

Some of these effects may prove to be short-lived. Others may take longer to emerge, as in the case of the impact on asset quality. The overall impact on earnings is thus difficult to quantify. As of now, and assuming that the SARS problem does not drag on for too long, most banks seem to think that the adverse effect on profits will not be too severe.

It bears repeating that the balance sheets of the banks remain strong. We have updated our stress tests to take account of the SARS outbreak, and these continue to show that the banks can withstand a great deal of pressure from a variety of sources. We do not expect that this will actually be put to the test in practice, but it is comforting to know that the banks are more than adequately capitalised in case of need.

What can the banks do to limit the potential downside risk from SARS? This is something on which individual banks will have to take a view, but I would like to offer some general advice. First, banks should accept that profits for 2003 may not reach budgetted targets as a result of the outbreak; and they should not strain too much to make up the difference. When profitability comes under pressure, it is important to avoid the mistakes that might arise from over-aggressive business tactics. Keep the bank healthy from a capital and liquidity point of view in order to benefit from the business recovery when it comes, as it surely will.

Banks should also monitor closely the financial position of their customers and adopt a supportive attitude to those experiencing financial difficulties as a result of the SARS outbreak. This means being prepared to offer temporary relief arrangements to borrowers who find that they cannot service their debts in the current environment. This should not be seen as soft option for customers since the banks will certainly not benefit if those customers go bankrupt. Nor do I suggest that relief should be offered indiscriminately. The long-term viability of the customer or his business, his track record and his willingness to cooperate with the bank are all factors to be taken into account in deciding whether to restructure debts. Each case thus needs to be looked at on its merits.

It is important that banks adopt a consistent approach to dealing with restructuring requests across the organisation and provide ready access for customers in difficulties to approach the bank to discuss relief. Working together, banks and their customers can help one another to deal with the effects of

SARs and position themselves for recovery. I am confident that the banks have been taking the right action, and will continue to do so.