David Carse: The Hong Kong banking sector - performance and outlook

Speech by Mr David Carse, Deputy Chief Executive of the Hong Kong Monetary Authority, at the Asia Pacific Loan Markets Association, Hong Kong, 9 July 2003.

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Ladies and Gentlemen:

I have had the privilege of speaking to the Association on two previous occasions, beginning at its inaugural lunch five years ago. I am pleased to have the opportunity to do so again, particularly since the fifth anniversary of the Association marks another milestone in its presence in Hong Kong. During this time, the Association has done much to promote the development of the syndicated loan market in Hong Kong and in the region more generally. As I noted in my speech to the Association last year, its work in establishing common standards for documentation has been particularly commendable.

I want to use this occasion to talk about the current state of the Hong Kong banking sector and about its prospects. This is something whose significance extends beyond the interests of those, such as yourselves, who are directly involved with the industry. The banking sector plays a vital role in the service-based economy of Hong Kong, and its profitability is something in which all of us have a stake. A profitable banking sector is better able to withstand negative shocks, and this helps to preserve the stability of the financial system.

The last few years have been challenging times for Hong Kong and for the banks that operate within it. So far 2003 has shown no signs of being an exception to this. Indeed, the environment in the first half of the year has been more than usually turbulent. Attention at the beginning of the year was focussed on geopolitical uncertainties, and in particular on the implications of the war in Iraq for both the global and the local economy. No sooner had concerns eased on this score - for the time being at least - than we were confronted with the escalating impact of the SARS epidemic.

Hong Kong banks are used to dealing with unexpected shocks, but the threat of disease is something new in modern times. The immediate need for the banks was to keep their business going and to protect the health of their customers and staff. Business continuity plans were therefore activated, including the setting up of command centres to monitor the situation and the formation of plans to deal with confirmed or suspected cases of infection among staff. Critical to this process was the creation of back-up teams of staff who could man key operations in an emergency from separate offices or even from home. Face-to-face meetings among staff and with customers or clients had to be curtailed. Teleconferencing helped to keep things going, including in the syndicated loan market.

The need for such arrangements demonstrated that banks must be able to react quickly and flexibly to unexpected situations. While they were able to cope with the impact of SARS without major disruption, a certain amount of improvisation had to take place, and lessons were learned that should be incorporated into business continuity plans for the future. But the main point is that the banks did meet the immediate test posed by SARS, and for that management and staff deserve our congratulations.

The banks have now been able to wind down their emergency arrangements, but the effects of SARS on their financial performance in 2003 will linger for a bit longer, albeit the impact is now much more muted than at the height of the outbreak.

Despite the underlying economic difficulties, the banks actually managed to turn in quite a good performance in the first quarter of the year. Profits of the retail banks in aggregate rose compared with the same period of 2002, helped by increased fee income, higher treasury profits, reduced operating costs and a lower bad debt charge. Towards the end of the quarter, and going into April, SARS began to have an impact of increasing intensity. The demand for bank loans, which was already not very buoyant, slumped even further; credit card spending plummeted as consumers cut back on shopping and entertainment and tourists disappeared; and branch traffic dried up, hampering the efforts of the banks to market their products. Asset quality also began to show initial signs of deterioration as would be expected given the fall in property prices and the increased strain put upon the cash flow of the affected companies and their employees.

From mid-May however the operating environment of the banks improved as SARS was brought under control. It would be premature to say that the SARS effect has dissipated entirely. In particular, the full effects on asset quality may take some time to show through. But most of the banks that we have talked to are now saying that the impact of the specific factor of SARS on their results for 2003 is expected to be relatively mild.

However, the underlying problems in the economy, which SARS helped to magnify, are still with us. Thus, while the balance sheets of the banks remain strong, the earnings outlook for 2003 remains uncertain; and the banks continue to face a number of challenges.

One of these is the state of the property market. The heavy reliance of the banks on property lending is well known: residential mortgage lending, in particular, accounts for 35% of the total domestic loans of the retail banks. Property prices have fallen sharply since the Asian Crisis, and the effect of SARS was to produce a further downward spiral. In the three months from March to May, property prices are estimated to have fallen by 8%. It is not surprising therefore that the figures for negative equity reported to the HKMA by the banks have shown a significant increase from the 83,000 cases (representing $135 billion of loans) recorded at the end of March.

The negative equity problem affects the banks in various ways. Most obviously, it poses an increased credit risk since loans in negative equity have a greater tendency to go into default; and if they do, the banks will suffer a loss since the loans are no longer fully covered by the value of collateral. Negative equity also has a deterrent effect on the demand for new loans since it makes property a less attractive asset to hold, and by locking in existing homeowners reduces market turnover. More generally, it has a pervasively depressing impact on consumer confidence and is thus a drag on the economy and on loan demand as a whole.

What is encouraging however is that despite the current difficulties faced by homeowners most of them have made every effort to continue to service their loans. Although the overall mortgage delinquency ratio has edged up in recent months, it remained at a relatively comfortable 1.16% at end-May. The arrears for loans in negative equity are higher, as you would expect, but even so the delinquency ratio of around 2.5% is reasonable under the circumstances.

Nonetheless banks need to keep a watchful eye on the situation, and adopt a proactive and helpful approach to restructuring mortgage loans when borrowers start to exhibit signs of financial distress. What they should be trying to avoid is a repeat of the problems with credit cards, where many borrowers chose bankruptcy as a way out of their problems. The dynamics of the two products are different, but the warning signs are there.

As might have been expected, credit card charge-offs did increase during the SARS crisis as rising unemployment prompted a renewed increase in bankruptcy petitions. But the latest news on this front is somewhat more encouraging. The number of petitions continued to rise going into the first week of June, but has since fallen back and the daily average for June as a whole was back to around the levels that we saw before the SARS outbreak. If this improvement can be sustained, it would have a positive impact on profitability in 2003.

Asset quality is an important factor in explaining changes in profitability across banks and over time. But it is certainly not the only factor and not necessarily the most important in the long term. To generalise, changes in bank profitability depend on both macroeconomic influences and a variety of bank-specific determinants. The Research Department of the HKMA has recently been doing some work in this area based on published data of 14 banks that account for about half the market in Hong Kong. I would like to share with you some of the preliminary findings of the research since it casts an interesting light on how the performance of the industry might evolve over the next few years.

If we look at the performance of the banking industry over the last decade, the Asian financial crisis clearly marks a watershed. Between 1992 and 1996 our research indicates that the profitability of the average bank in our sample, measured by return on assets, improved by around 0.7 percentage points. It appears that this performance owed little to the macroeconomic environment of the time. Rather, it was due to improved performance at the individual bank level, driven by bank-specific factors such as more efficient operations and improving asset quality.

In contrast, between 1997 and 2002 the average return on assets declined by more than 0.7 percentage points. This deterioration was largely driven by macroeconomic variables, with deflation contributing most to the worsening profitability. Bank-specific factors were less significant during this period in explaining both average performance and variations in performance across banks.

It may seem somewhat obvious to say that the lower profitability of the banks over the last few years has been largely due to the poor economic environment. Certainly, as participants in the syndicated loan market, you will be well aware of the impact of the current sluggish state of the economy on loan demand and margins. But the conclusion does have important implications if we look to the future. If the profitability of the banks has gone down with the economy, equally it should go up with the economy as it improves. And this would benefit the banks in general, not just the select few with a large market share.

In fact, our research indicates that with reasonably conservative assumptions regarding growth and inflation over the three years from 2003 to 2005, the profitability for the average bank in our sample would get back to the average return on assets over the past ten years by around 2005. Obviously, the improvement in the economy would need to materialise for this to happen - and I cannot predict whether it will or not. But at least the banks can take comfort from the fact that the current difficult operating environment may to a large extent be due to cyclical factors, which should eventually reverse.

I would stress that this does not mean that banks should simply sit back and wait for the rising tide of the economy to lift them up, or that they should ignore the opportunities that may arise from merger and acquisition. Bank-specific factors will still matter in terms of explaining variations in performance across banks, even if their relative importance was less pronounced after the Asian crisis.

Among these bank-specific factors, operational efficiency, as measured by the ratio of non-interest expense to total assets plays the most significant role in determining profitability, at least for the banks in our sample. Surprisingly, the effect of credit quality seems to have diminished over time, perhaps reflecting improvements in the banks' ability to manage credit risk. But income diversification has become more important, with banks increasingly having to develop their fee-generating businesses to be more profitable. We are seeing this particularly in the move by a number of banks into wealth management, such as securities, unit trusts, insurance, pensions and private banking.

A further opportunity for business diversification for the medium-size banks will come from the ability to branch into Mainland following the relaxation of the asset size criterion under CEPA. The eight banks that will benefit from this would, according to our calculations, have the scope to open a total of as many as 20 branches in the Mainland over the next three years. This would be a significant addition to the 40 or so branches that banks from Hong Kong already have on the Mainland. We should certainly not regard Mainland access as a panacea, and the benefits will take time to come through. But the important point is that the medium-size banks now have an alternative avenue to grow their business outside the Hong Kong market.

Indeed, more generally, banks in Hong Kong will benefit from the increasing financial and economic integration with the Mainland. In the syndicated loan market, we can see this in the growing trend towards Mainland-linked borrowers. One development of this trend is likely to be the growth of the syndicated loan market in RMB. This should create opportunities for foreign as well as domestic banks within the Mainland.

Let me summarise the argument I have been making. Banks of all shapes and sizes have the opportunity to benefit from the recovery in the Hong Kong economy when it comes. Some banks will however do better than others, and our research indicates that a more efficiently operated and diversified bank will achieve higher profits. I hope that all the banks sitting here today will be among those that fall into this category.