Mr Carse gives a speech on the subject of credit risk during the Asian crisis

Speech by Mr David Carse, a Deputy Chief Executive of the Hong Kong Monetary Authority, at the Asian International Conference & Trade Credit Workshop in Hong Kong on 5 May 1999.

Ladies and gentlemen,

I am very pleased to have the opportunity to speak to you today on the subject of credit risk during the Asian crisis. Given the fact that just about every economy in the region has been affected by the crisis to a greater or lesser extent, this is rather a large topic; and I hope that you will forgive me therefore if I begin with some generalities about the region as a whole, but then make some specific observations based on my own direct experience of credit risk as it has affected banks in Hong Kong. Hong Kong is a melting pot of international and regional banks and you can be sure that any credit problems that surfaced in Hong Kong during the crisis manifested themselves elsewhere in the region, and probably in a much more virulent form.

It is a sobering fact that we are only two months away from the second anniversary of the Asian crisis, and we are still analyzing what went wrong. Explaining the origins of the crisis has helped to maintain many academics, particularly in the United States, in gainful employment. Their explanations emphasize different factors in the crisis, but one point on which there seems to be general agreement is that banks were at the heart of the problem. A highly stylized description of their role in the Asian crisis might run as follows. When banks are already weak, for example because of a high level of non-performing loans, an external shock such as an attack on the currency will severely damage confidence in the banking system. Banks will lose domestic deposits and will find themselves unable to rollover short-term external borrowing. The resultant capital outflows will put further downward pressure on the exchange rate, force up interest rates and drive down asset prices. The customers to whom banks have lent will get into financial difficulties, further weakening the position of the banks. With their capital and liquidity impaired, the banks are in no position to lend, and this leads to the phenomenon of the “credit-crunch” and resultant shrinkage of the real economy that we have witnessed in so many countries in the region.

Banks can get into difficulties in many ways. But, as is usually the case, the principal culprit in banking weakness in the region was weak credit policies and procedures. Although the particular way this manifested itself varied from country to country, some of the common themes were as follows:

- First, banks overlent to unproductive sectors, notably the property and stock markets. This created the familiar pattern of boom and bust. Moreover, much of this was funded by short term capital inflows. When the asset bubble collapsed the banks and the companies or individuals who had borrowed foreign currency to finance the investments were unable to repay. The problem was compounded by the depreciation of domestic currencies that increased the real burden of debt repayments.

- Second, banks in a number of economies were ordered or persuaded by governments to lend heavily to companies that were not commercially viable. This “policy” lending destroyed the banks’ incentive to exercise credit judgment and allowed the companies concerned to become overleveraged and thus vulnerable to economic downturn.

- Third, over-exposure to connected parties was endemic in some economies. Such lending is not usually made at arm's length and will seldom satisfy normal credit criteria.

- Fourth, partly because much lending in the region was politically influenced or insider in nature, there was not much opportunity to develop a proper credit culture or adequate credit skills. Name lending and relationship lending were widespread. This went hand in hand with an over-reliance on collateral whose value of course diminishes sharply when asset values collapse - assuming of course that the security can be enforced in the first place, which has certainly not been the case in countries such as Thailand.

- Fifth, a feature of the lack of credit skills was a failure to recognize bad debts and to face up to the full scale of the bad debt problem. Banks did not classify loans properly or make adequate provisions against them. This allowed insolvent or near-insolvent banks to continue in business and to build up further losses.

The end-result of this has been the need for large-scale restructuring of banking systems across the region, a process that is still going on. Inevitably, this involves use of public funds, to take over or recapitalise the banks that might have a chance of survival, or to pay off the depositors of those banks that are hopeless cases and have to be closed.

Let me now turn to how Hong Kong's experience has compared with that of other banking systems in the region. The first point to make is that our banks have by no means escaped unscathed from the Asian crisis. This could hardly be the case when the scale of the recession of the last 18 months has been the deepest since records began in 1961. Real GDP fell by 5.1% in 1998 after rising by about the same percentage in the previous year. Unemployment has risen to 6.2%, a level unprecedented for Hong Kong. This was accompanied by plummeting asset prices that at their lowest had fallen by 50% in the case of residential properties and 60% in the case of the Hang Seng Index. In an economy as used to prolonged economic growth and full employment as Hong Kong and so heavily dependent on asset values, it is not surprising that this translated into a sharp rise in bad debts for the banks. The bad debt charge for our locally incorporated banks in respect of their Hong Kong business more than tripled in 1998, albeit from a low base. Non-performing loans (measured by those that have been classified as substandard, doubtful and loss) rose from around 2% at end-1997 to 7.3% at the end of last year.

This is a sharp increase but it is important to put it into regional perspective. The equivalent figure for non-performing loans in Thailand at present is around 46%. The picture in Indonesia is even worse. Hong Kong has therefore fared better in respect of credit risk than its neighbours. It has no doubt been helped in this by the solid regulatory framework in Hong Kong and the infrastructure of business laws that makes it relatively easy to take and realize collateral and to put defaulting borrowers into liquidation. Banks are also free to carry on their business without political interference. I believe that Hong Kong has also benefited from its openness as a financial centre, though this can also have its drawbacks. Major international banks are allowed to play a full role in our banking system, including in many cases participating as full retail banks. This has allowed cross-fertilization of talent, systems and products between the local and foreign banks. Finally, another point in Hong Kong's favour is that it had already gone through a banking crisis in the early 1980s, in which abuses such as connected lending had played a part. This provided a stimulus to major reform of the banking law and to improvement of supervisory standards, a process that has continued to this day.

We should not however allow the relatively better credit performance of Hong Kong during the crisis to lull us into a sense of complacency. Much of the blame for the rise in bad debts in Hong Kong can indeed be laid at the door of the recession, as is shown by the rise in non-performing loans at even our best-managed banks. But it is also possible to argue that the rise in bad debts has been accentuated by certain weaknesses in the credit environment during the 1990s.

What sort of things am I talking about? As Alan Greenspan has suggested in his usual oblique manner, the period prior to a financial crisis is often characterised by "over-exuberance". Hong Kong in the years prior to the Asian crisis was no exception. The mood of the times was well captured in a magazine article from 1997:

"Prospects couldn't have been rosier. In the early 1990s, the stock market was booming. China's economic reforms were in full swing, opening up enormous opportunities for the risk-takers. Liquidity was abundant, corporate bankers were eager to lend and listed companies were keen borrowers."

In such a mood of euphoria, it is typical that too much money is borrowed from too many banks. Newly listed companies were a prime lending target of both local banks and the many foreign banks that had established offices in Hong Kong. Having done so, local management needed to justify the existence of these offices and were keen to lend to companies whose newly listed status seemed to provide an image of financial respectability. During this period Hong Kong experienced the shift away from relationship banking that has been seen in other markets around the world. It was not unusual to find even medium sized companies with dozens of bankers. Companies often ended up with more cash than they needed and in a number of cases this was channeled away from core businesses into ill-advised diversification or into speculative ventures in the stock and property markets. Typically these property ventures were in Mainland China and came to grief when austerity measures began to be enforced there from 1993 onwards.

Problems with medium-sized corporates in Hong Kong had therefore surfaced even before the onset of the Asian crisis. But the crisis accentuated the problems and reduced the chances that the companies concerned could turn themselves around.

In the light of this, coupled with the fact that the prolonged nature of the crisis is putting the finances of even well-managed companies under strain, it should come as no surprise that the main bad debt problems of the Hong Kong banks have surfaced in their corporate lending. It may be of interest to this audience to know that trade finance has been a particular problem area and has attracted higher than average bad debt provisions. On the face of it, this seems strange since trade finance is normally seen as being short-term, self-liquidating and secured on the underlying goods. In practice, companies found it possible to obtain trade lines from a multiplicity of banks in excess of their underlying needs. In this situation, trade finance becomes in effect part of the general working capital of the company and can be siphoned off into the kind of speculative activities I have already described. In many cases, short-term trade finance financed long-term property developments in China.

What lessons can be drawn from this? Banks should obviously have a thorough knowledge of their customers' business and of their real funding needs. Banks should know what their lending is being used for and try to ascertain the borrowers' facilities from other banks.

However, in situations where banks are too anxious to lend, it is all too easy for the borrower to deny information to the banks and to play the banks off against one another.

In granting credit, banks thus need to undertake proper financial review of their customers based on reliable information. Particular attention needs to be paid to cash flow and the ability to service debt in stress situations as well as normal conditions. As in many countries in the region, some banks in Hong Kong have placed too much emphasis on collateral in making their lending decisions. Collateral does of course have an important part to play in providing secondary protection to the lender if the borrower defaults. But the primary consideration should be debt servicing capacity of the borrower. The drawbacks of over-reliance on collateral become all too clear when asset values collapse as they have done during the Asian crisis. The act of realizing collateral can in itself be destabilizing as we have seen when banks have sold shares in listed companies pledged by their owners to secure their private borrowing. In such cases, confidence in the company concerned can be seriously undermined.

I should point out however that some of the worst fears that had been expressed about the property exposure of banks in Hong Kong have so far proved to be unfounded. The major property developers have come through the recession relatively unscathed and the performance of the all-important residential mortgage portfolio has been much better than other types of lending. At end-March of this year, the delinquency ratio for mortgages was only 1.13%. This seems to confirm that homeowners will do all they can to avoid default, though this may be at the expense of cutting back on other forms of discretionary spending. Bad debt problems due to strains on personal finances have therefore cropped up in other areas, such as loans to the retail or restaurant trades that have borne the brunt of the reduction in consumer spending. It is however important not to take the good quality of the mortgage portfolio for granted. As we have seen in Hong Kong, mortgage loans can fall into negative equity and the banks would suffer a loss if they had to foreclose. Banks must therefore maintain sound lending criteria in granting new loans, including paying careful attention to the debt service ratio and requiring income proof from the applicant.

I have mentioned name lending as one source of credit problems in the region. A particular case of this in Hong Kong has been the lending to Mainland related companies, including the investment and trust companies such as GITIC. Over a long period of time, a set of assumptions has grown up amongst banks, both inside and outside Hong Kong, about the readiness of state or provincial government shareholders to support Mainland companies if they got into difficulties. In short, it was believed that foreign creditors at least would be protected, and this seemed to be confirmed by a number of practical examples. The closure and liquidation of GITIC have overturned these assumptions. The Mainland authorities have told banks that they must now base their lending decisions on the intrinsic financial strength of the borrowers and disregard implicit guarantees.

It must be right in the longer term that lenders should get back to fundamentals of creditworthiness and apply conventional lending standards; indeed this is one of the themes of this speech. Implicit parental guarantees have enabled companies such as GITIC to borrow more than they should have done and the lending has not been sensibly used. However, the adjustment process cannot happen overnight. The transparency is not there in many Chinese companies; and even if it was there, it would not in many cases support the present levels of borrowing if the companies were looked at on a stand-alone basis. The banks will therefore need to be patient and allow borrowers sufficient time to manage their debts down to more sustainable levels. The banks will also need to cooperate in assisting distressed Mainland companies to work out their problems over time and to restructure their debts. The other side of the coin is that the companies and their shareholders must be prepared to be open and transparent with their creditors.

Dealing with the financial problems of companies in general has become a major preoccupation of banks in Hong Kong and elsewhere in the region. There is still not much new lending going on - in Hong Kong domestic lending has fallen for ten months in a row. The main priority for many banks is therefore to limit the damage from loans already on the balance sheet. To be successful in this objective requires a number of factors to be in place at both the individual bank and sector levels. In individual banks, there must be an effective system of credit monitoring and loan classification to detect problem loans at an early stage and to enable corrective action to be taken as soon as possible. As I have already indicated, the shift from relationship banking and the unwillingness of borrowers to supply sufficient information have been hindering factors in Hong Kong in enabling banks to pick up early warning signals. Once problems have been detected, it may be sufficient in the early stages to leave the handling of these with the account officers. But when the problems are too deep-rooted, there will usually be advantage in transferring problem loans to a dedicated loan recovery unit where specialist expertise attention can be devoted either to restructure the loans or to take recovery action and liquidate any collateral. This is the theory, but it is easier said that done to find loan recovery specialists when many bankers in the region have not experienced a prolonged period of economic decline. Outside experts, for example from the accounting firms, can help to fill some of the gap. But it is also essential that the banks build up their own resources and provide more training to their own staff on how to deal with problem loans.

At the sector level, it is necessary to have an effective insolvency regime to ensure that non-viable companies can be wound up in an equitable manner before they have the chance to build up even further losses. However, liquidation should generally be a last resort and there should be an alternative to insolvency that allows distressed, but commercially viable, companies to survive as going concerns, thus preserving employment and productive capacity. This requires a framework that encourages negotiation and compromise between distressed borrowers and their creditors. The objective should be to agree a standstill on debt payments and a moratorium on legal proceedings to provide a breathing space during which negotiations on a debt restructuring can take place. In Hong Kong, the Association of Banks has issued non-statutory guidelines for the conduct of debt workouts. These are based on the so-called London Approach to workouts that was developed by the Bank of England. Other countries in the region have also used this as a model for dealing with corporate restructuring. The success of some of these schemes has yet to be proved, but I can say that the Hong Kong approach has generally worked well. The increase in the number of companies requiring financial assistance and the multiplicity of banks involved are however putting some strains on the system. Workouts are becoming more protracted and more difficult to arrange. This is partly because of the shortage of workout specialists already referred to, but also because banks do not always display the necessary spirit of cooperation. I have therefore recently suggested to the Hong Kong Association of Banks that it would be timely to review the manner in which workouts operate in Hong Kong.

I will close by pulling together some of lessons that can be drawn from our experience during this difficult period. The Asian crisis has demonstrated weaknesses in banks’ credit controls and even Hong Kong has not been immune from these. Improvements need to be made to deal with the aftermath of the crisis and to reduce the chances of similar problems in the future. The key points I would recommend to the banks are as follows:

- Be clear about your lending strategy, including how much risk, and what types of risk, you are prepared to undertake.
- Know your customer, his business and, to the extent possible, his other financial commitments.
- Keep track of what your lending is actually being used for.
- Lend on the basis of cash flow rather than collateral.
- Maintain an effective early warning system for problem loans and make sure that the loan portfolio is properly graded.
- Devote sufficient resources to debt recovery and make sure that your workout staff are properly trained.
- Approach debt workouts in the right spirit of compromise and consensus.

These are very basic messages that should be familiar to any prudent lending banker. But the experience of credit risk during the Asian crisis shows that they are all too easily forgotten. Thank you for giving me the opportunity to issue this reminder.