THE IMPACT OF THE ASIAN CRISIS ON THE HONG KONG BANKING SECTOR[1]

Although the Hong Kong economy and banking system have remained in good health, they have not been totally immune to the Asian financial crisis. There is bound to be an impact on the banks' funding and liquidity, their loan growth, asset quality and ultimately their profitability. The current adjustment process is necessary as well as painful. However, the Hong Kong banking sector is robust enough to withstand this. It will not only survive the process, but also go on from strength to strength in the future.

I am pleased to have the opportunity to talk to you about the impact of the Asian financial crisis on the Hong Kong banking sector.

The Asian financial crisis is one year old this month, though this is a birthday that we do not want to celebrate. The crisis can be dated from late May when the Thai Baht came under severe pressure. A renewed attack in early July, while we were celebrating the success of the Handover in Hong Kong, led to the floating of the Baht, which promptly plunged in value. The contagion then spread to neighbouring economies, and although Hong Kong was for a time immune, it eventually reached us too.

Explaining the origins and causes of the Asian crisis has become a major growth industry and I have no intention of adding to the debate today. Suffice to say that one point on which almost all the commentators are agreed is that weakness in banking systems in the region has been one of the main reasons which explains the intensity of the crisis and the speed with which it took hold. In the words of Alan Greenspan, "what turns otherwise seemingly minor imbalances into a crisis is an actual or anticipated disruption to the liquidity or solvency of the banking system". 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 further 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 "credit-crunch", and resultant shrinkage of the real economy that we are seeing in so many countries in the region.

The reasons for the banking sector weaknesses are various. Lending excesses drove up asset prices and allowed companies to become over-leveraged. Poor risk management on the part of the banks themselves was compounded by ineffective banking supervision and lack of transparency which provided little scope for market discipline to be exercised until the problems were glaringly obvious. At that point, the market reaction was extreme. Even if supervisors did have the will to tackle banking sector problems in their countries, they were often subject to political interference that stood in the way of prompt corrective action. Government influence also directed bank lending into uneconomic projects and non-viable companies. This government involvement lent credence to the view that regional banks were effectively government guaranteed, which made it easier for these banks to borrow in the global interbank market. This provided the fuel for the irresponsible lending which took place.

Hong Kong did not suffer from these structural and systemic weaknesses. But it is the case that imbalances had emerged in the economy, and this became particularly evident during 1997 as confidence grew that the Handover would proceed

[1] This is the text of the speech by David Carse, Deputy Chief Executive of Hong Kong Monetary Authority, at the Sixth Conference on Pacific Basin Business, Economics and Finance on 28 May 1998.

smoothly - as indeed it did. This was reflected in soaring residential property prices - up by an average of 48% during the year to October 1997 - and a record level for the Hang Seng Index of 16,820 in August 1997. The boom in asset values was to a large extent financed by the banks.

The sharp escalation in asset prices and in bank lending was clearly unsustainable. A downward adjustment would have been necessary and would have happened sooner or later. All that was required was an external shock to bring it about. This of course is precisely what happened in the third week of October when the Hong Kong dollar came under speculative attack. The operation of our currency board system meant that the sales of the Hong Kong dollar depleted the clearing balances which the banks maintain with the HKMA for settlement purposes and the resultant shortage of liquidity caused interest rates to rise sharply. You will recall that the overnight rate reached 280% on 23 October 1997. Although the overnight rate quickly subsided, term rates remained high for some weeks thereafter and the stock market experienced considerable volatility and property prices fell. Renewed exchange rate pressure in January again saw interest rates spike upwards, though the reaction this time was less severe. Nonetheless an inverse yield curve persisted during much of January with the interbank rates higher than the prime lending rate.

Also during this period, the banks have had to contend with the blows to confidence from continuing regional upheavals, most notably the liquidity crisis in Korea around the turn of the year and the dramatic events in Indonesia which are still being played out. Coupled with mounting evidence that the domestic economy is slowing down, it is not surprising that the banks in Hong Kong are going through more difficult times. The severity of the Asian crisis is a once-in-a-lifetime event and no banking system in the region can hope to be unaffected by it. There is bound to be an impact on the banks' funding and liquidity, their loan growth, their asset quality and ultimately their profitability. Apart from the effect on individual banks, the Asian crisis will also have repercussions on Hong Kong's position as an international financial centre, given that so many regional and international banks affected by the crisis are based here.

How precisely has the Asian crisis impacted on banks in Hong Kong? In the first place, banks have become much more conscious about the need to remain liquid. The spikes in interest rates that occurred in October 1997 and in January 1998 have made the banks more reluctant to rely on borrowing from the interbank market to meet their funding needs. This is because of the interest rate risk that this entails and because of the reduced amount of funds in the market that are available to be borrowed. In particular, the supply of funds to the longer maturities in the interbank market has greatly diminished. Banks that do have liquidity prefer to place it at very short term, even overnight, to ensure that it is readily available. The banks also wish to improve, or at least avoid further deterioration in, their loan to deposit ratios. Taking the various factors together, there is now much greater competition for customer deposits than there was six months ago. This is not confined to the smaller banks: the large banks and the foreign banks are also involved. It is happening at a time when the overall growth in customer deposits has slowed down in line with the economy.

The effect of this is evident in the additional margin over HIBOR which banks are prepared to pay in order to attract deposits. This clearly has an effect on profitability: the net interest margin of the local banks fell to 2.33% (annualized) in the first quarter of this year compared with 2.43% in 1997 as a whole. The banks are caught in a vicious circle. On the one hand they want to boost or at least maintain their liquidity. But if they do this by paying over HIBOR for deposits that they then place in the overnight interbank market at HIBOR, this is clearly costing them money. Banks do have the option of not paying the going market rate for deposits. But if they do this, their customers may go elsewhere. The deposit base is therefore less stable than it was.

The banks' desire to stay liquid also means that they are more cautious about lending. Generally speaking, they will want to lend only if they can raise the deposits to do so, and deposits are growing more slowly. This caution also reflects their perception that credit risks have increased in the current economic environment. Of course, the demand for borrowing has also declined as the economy has slowed and the property and stock markets have weakened. But the supply of loanable funds has probably fallen even more, partly because of the decision of some foreign banks to cut back their lending in Hong Kong. This does not represent a loss of confidence by these banks in Hong Kong. Rather, it reflects the need of some banks to downsize their balance sheets and to concentrate more in the future on profitability rather than volume growth and market share. It also reflects the fact that some banks are wanting to cut back on their Asian exposure and Hong Kong is one of the few markets where it is possible to do so.

This will have the benefit, from the local banks' point of view, that it will push up lending margins; and over time this will attract more banks back into the market and encourage them to lend. But the appetite for new lending is likely to remain subdued in the short-term.

As already mentioned, the fear of increased bad debts is another factor which is making the banks wary about increasing their credit exposure. The combination of regional difficulties and domestic slowdown makes it inevitable that asset quality will deteriorate this year. In the first quarter of the year there was a noticeable rise in loans overdue for more than 3 months, although as a percentage of total loans the figure for the local banks (less than 2%) is still reasonable by international, let alone, regional standards. As to how much worse the situation will get as we go through the year, it is difficult to say. But we can take comfort from the fact that although loan arrears in the all-important residential mortgage market are creeping up, the amounts involved are still very small in percentage terms (only around 0.3% of the local banks' mortgage portfolio at end-March). Even if property prices do fall further, there is a strong incentive for homeowners to continue to service their mortgages.

The main problem loans we have seen so far have been in the corporate sector and in trade finance. Some companies have run into unavoidable problems because of the regional situation while others may have over-extended themselves. However, it is worth noting that the corporate sector in general in Hong Kong has avoided the excesses seen in the rest of the region. In general, companies in Hong Kong are not highly leveraged compared with their counterparts in the region and have not poured resources into an indiscriminate build-up of fixed assets. The banks have also tended to follow more prudent lending policies than those elsewhere and are better protected by their ability to take and realize good collateral. We do not therefore expect to see the collapse of asset quality that has occurred in some regional economies where corporates and the banks have also had to contend with massive exchange rate depreciation.

The local banks in Hong Kong also have the benefit of the cushion provided by their high capital adequacy ratios. This means that even if the banks do have to make higher provisions this year, it will be their profitability rather than their solvency that is affected. While lower profitability is by no means welcome, it is not, by itself, a cause for concern in terms of the stability of the banking system.

It is important to keep in mind that the local banks are still making money so far this year despite the more difficult operating conditions. Equally, you will not be surprised to hear that profits are generally lower than the same period of last year due to a combination of increased funding costs, flat lending volume and increased bad debt provisions. The outlook for the year as a whole is uncertain. If banks can record the same profits as last year, they will be doing very well. Certainly, nobody should have exaggerated expectations about the 1998 outturn. It will be a tough year, but I am confident that the banks can manage their way through it.

What kind of strategy are the banks adopting to achieve this? I have already mentioned some of the steps: namely, to build up liquidity and to be more selective and cautious in their lending. Loan review and collection procedures are being stepped up to ensure that banks can identify problem loans at an early stage and take action to safeguard their position. Banks are also being more proactive in their asset and liability management, particularly in terms of their funding strategy and how to price their deposits against the competition. Although banks in Hong Kong are highly efficient in terms of the cost-income ratio, the pressure on revenues means that they need to pay even more attention to costs. A number of banks have therefore frozen headcount and some have felt obliged to lay off staff. Some branches have been closed. This is an unfortunate aspect of the adjustment process that Hong Kong is currently undergoing.

However, not all the moves are purely defensive. Banks are also trying to find ways of delivering products and services to customers more cheaply and efficiently, for example through telephone call centres, electronic banking and segmentation of the branch network. There is also more emphasis on using the branch networks to cross-sell other products such as unit trusts and insurance so as to build up non-interest income. Geographically, ambitions to expand in the region have obviously been dampened by the financial crisis. But there is a wide recognition that the Mainland of China offers substantial opportunities for banks in Hong Kong both to develop new business and to expand their relationship with existing customers.

Underlying all the banks' strategies at present must be the recognition that the Year 2000 issue has to be tackled successfully. This is an issue of basic business survival. I believe that banks in Hong Kong are aware of this and are working actively to meet the HKMA's deadline of end-December 1998 to achieve Year 2000 compliance.

How is Hong Kong's position as an international financial centre going to be affected by what is happening in the region? It is clear that the number of foreign institutions in Hong Kong will shrink to some extent. A number of foreign banks have already given up their banking licences but this has been largely due to problems in their home market or mergers with other institutions. The Asian crisis is likely to result in further rationalization among the banks from the region as they are merged and restructured in their home countries. The reduction in business activities such as syndicated lending and trading in regional debt securities may cause other marginal players to leave Hong Kong, simply because they can no longer make money.

However, I am sure that the bulk of foreign banks remain committed to Hong Kong and will want to retain a substantial presence here. This is not wishful thinking, but rather founded on hard logic. First, it simply does not make sense to suggest that within the space of a few months, Asia as a whole has become less relevant to banks with global aspirations. Second, within Asia, Hong Kong retains its unique attractions as the main centre for banks to do business with China. Leaving aside short-term cyclical fluctuations, the economy of the Mainland is clearly on an upward path. Foreign, and indeed local, banks will want to share in the financing and advisory opportunities which this brings, and Hong Kong will remain the best location from which to launch these activities. The costs of doing business in Hong Kong must however be reasonable; and that it is why the current adjustment process is necessary as well as painful. I am sure that the Hong Kong banking sector will not only survive the process, but also go on from strength to strength in the future.