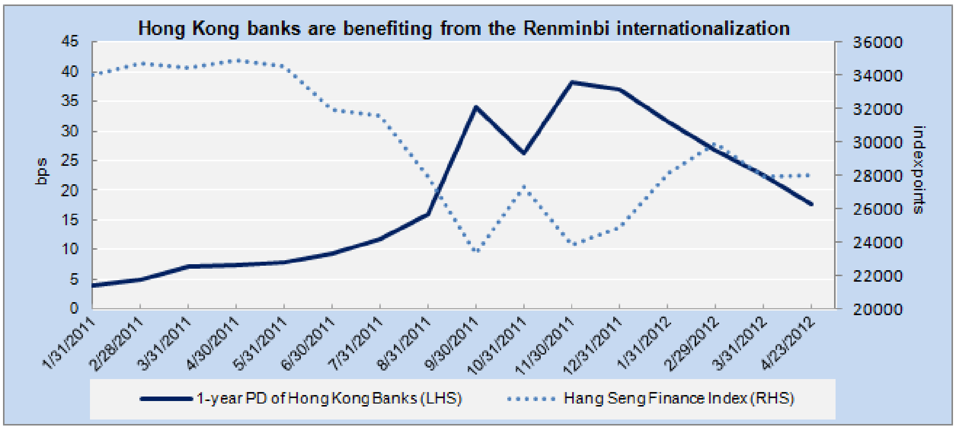
Stories of the Week

Hong Kong banks' credit outlook improves as the Renminbi internationalization deepens

The credit outlook for Hong Kong banks has improved since the beginning of this year, according to RMI CRI data. The aggregate 1-year probability of default (PD) for Hong Kong banks fell steadily from a high of 37bps on December 31 to 17.7bps on April 23. The decline in PD over the last quarter reflects our favorable view of the business position of Hong Kong banks, as they benefit from their unique role in the internationalization of the Renminbi, as well as their strong capital positions. At the same time, the combination of these two factors supports an accelerating improvement in the credit outlook of Hong Kong banks from the end of 2011, when intensifying competition and low interest rates, combined with other factors, heightened the banks' credit risks and pushed the sectors aggregate 1-year PD to 38bps on November 30, a record high since the start of 2010.



The upgraded view of Hong Kong banks' credit outlook coincides with a noticeable rally in the Heng Seng finance index since 2011 – a year that witnessed dismal performance in the Hong Kong banking sector. Competition among Hong Kong banks intensified last year and interest rates stayed at historical lows due to Hong Kong's currency pegged to the US dollar. As a result, Hong Kong banks suffered a squeeze in their lending profitability, as reflected in a decline in net interest margins (NIM). The problem was particularly acute at smaller banks. For example, the NIM of Wing Hang bank fell to 1.79% in 2011 from 1.84% in 2010, a drop comparable to the one witnessed in 2008 during the global financial crisis. Reflecting this deterioration in business performance, these banks are currently trading below their book values, which has fuelled market speculation that they are likely acquisition targets of larger local banks and overseas rivals. Another challenge facing Hong Kong banks has been a drop in Hong Kong dollar liquidity that caused a nearly two-fold rise in the 3-month HIBOR (Hong Kong Interbank Offer Rate) last December.

Nonetheless, we believe the credit outlook for Hong Kong banks is positive overall due to the sector's growing ability to withstand the aforementioned business and financing challenges, as they capitalize on the robust momentum of the Renminbi internationalization and continue to strengthen their already-close economic and financial ties with the mainland China.

With a huge pool of RMB deposits (RMB 576bn by the end of January) and close ties with the mainland, Hong Kong banks are uniquely positioned to benefit from the internationalization of the Renminbi. The position could be reinforced by a potential surge in Renminbi financing demands from mainland companies. The Chinese government is gradually relaxing capital controls, and may allow more mainland companies to tap Hong Kong for financing. This will facilitate companies seeking to borrow at lower interest rates in Hong Kong - the 1-year SHIBOR (Shanghai Interbank Offered Rate) was 5.13% vs. 0.86% for the 1-year HIBOR on April 20. The potential rise in Renminbi financing demands, which would correspondingly increase demand for Renminbi loans or Dim-sum bonds, contributes positively to Hong Kong banks' business prospects as they profit from issuing such loans or underwriting bonds.

Renminbi trade settlement could be another area of growth for Hong Kong banks. Despite an economic slowdown in its major trading partners, China's international trade volume has continued to see robust growth. Combined with the Chinese government's determined effort to promote the usage of Renminbi in trade and investments internationally, this translates into a bright outlook for the Renminbi trade settlement businesses of Hong Kong banks.

Our positive credit outlook for Hong Kong banks is also underpinned by their strong capital position, particularly compared with international standards. The consolidated capital adequacy ratio of Hong Kong banks was 15.8% as of December 2011, considerably higher than the 8% stipulated by the Basel II accords currently in force.

Notwithstanding the above-mentioned positive factors, the 1-year PD for Hong Kong banks remained elevated on April 23 compared to early last year when the PD was below 10bps, as we believe that significant risks lie ahead for Hong Kong banks' business prospects boosted by the Renminbi internationalization. A 2% fall in Renminbi deposits at Hong Kong Banks in January highlighted a recent cooling in market anticipation for a continuous Renminbi appreciation, which may well continue in the future, with the PBOC's (People's Bank of China) recently introducing measures to broaden the two-way trading band of the Renminbi. Although the fall may not be significant given the total size of Renminbi deposits held by Hong Kong banks, it is a non-negligible risk that is clouding Renminbi liquidity profile and Renminbi lending capability of Hong Kong banks. Meanwhile, competition from Singapore is an ongoing threat to Hong Kong's status as the largest offshore Renminbi hub, a possibility increasingly plausible after a number of companies recently relocated their settlements of Renminbi trades to Singapore.

Sources:
Companies To Get Yuan Loans In Hk (Global Times)
China Surprises With Export-Led March Trade Surplus (Reuters)
More Steps Considered In Push To Open Yuan (WSJ)
Bank Capital Adequacy Ratio Up In Hong Kong (AIA)
Singapore Threat To HK Role As Yuan Trading Hub (South China Morning Post)
Hong Kong's Rmb Deposits Down 2% In Jan (China Daily)
China Doubling Yuan Band Signals Drive For Convertibility (Bloomberg)
Bankers Sneeze At Yuan Liquidity Concerns (China Daily)
Singapore To Become Second RMB Trade Hub After Hong Kong (Asia Briefing)

In the News
Private equity swoops for toxic mortgage debt **Apr 19.** Investors in a commercial mortgage-backed bond issued by Uni-Invest, a Dutch real estate investment fund, agreed last week to restructure repayments on the bond's overall structure, including payments to all senior and junior debt holders. Under the agreement, the bond will also be sold to two private equity funds, TPG and Patron at a discount. The restructuring marked the first overall default by a European CMBS bond. More significantly, the resolution of the defaulted obligation with CMBS holders is the first to have involved private equity funds, and could see more distressed CMBSs following suit, due to private equity funds' comparative advantage in restructuring these assets. (FT, PropertyEU)
European banks could trigger fresh credit crunch, warns IMF **Apr 18.** In its Global Financial Stability Review released on April 18, the International Monetary Fund (IMF) warned that risks continue to weigh on the global financial system, despite actions taken to fight the European debt crisis. It cautioned that continued deleveraging at European banks, if not guided by cautious policies, could seriously damage the economy, credit supply and asset prices in Europe and beyond. (The Guardian)
Banks seen dangerous defying Obama's too-big-to-fail move **Apr 17.** The US banking industry has become increasingly concentrated with the growing balance sheets of large US banks, despite a pledge by the US government to end the 'too-big-to-fail' conundrum, which led to large taxpayer-funded rescues during the global financial crisis. This has attracted criticism that despite massive bailouts, banks whose failure will have unaffordable consequences to the economy will still need taxpayer-funded rescues in future crisis. (Bloomberg)

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