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Hong Kong Banks To Continue On A Bumpy Ride In 2017

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Hong Kong Banks To Continue On A Bumpy Ride In 2017

The slowdown in China's economy continues to cast a shadow on the performance of Hong Kong's banking sector. S&P Global Ratings expects 2017 to be another year where Hong Kong banks will see subdued loan growth, flat profitability, and modestly deteriorating asset quality. However, solid capitalizations, robust funding and liquidity, and prudent underwriting policies, together with Hong Kong regulatory authorities' effective supervision, should help these banks to maintain their credit profiles.

Overview

- Hong Kong banks' credit profiles continue to be supported by these banks' solid capitalization, robust funding and liquidity profiles, and prudent underwriting policies, together with regulatory authorities' effective supervision of the banking sector.
- China exposure remains a risk to Hong Kong banks, given the close linkage of the two economies.
- Volatility in property prices is likely to have a limited impact on Hong Kong banks' property-related loan quality.
- We could revise our assessment of government support to supportive from highly supportive upon the implementation of Hong Kong's resolution regime.

We expect a continuing slowdown in China's economy to modestly weaken asset quality and elevate credit costs for Hong Kong banks in 2017. We believe asset quality of loans to corporate borrowers is closely linked to economic conditions in the mainland. This is because of Hong Kong banks' direct lending to mainland borrowers, and indirect exposure through loans to Hong Kong borrowers with close business linkage to the mainland.

That said, we expect Hong Kong banks' property-related loan portfolio to remain sound in 2017 despite volatility in property prices. We base our view on Hong Kong banks' prudent underwriting practices and the banking sector's effective and vigorous regulatory measures, such as tight limits on the maximum loan-to-value (LTV) ratio on residential mortgage loans.

We believe the implementation of the resolution regime in Hong Kong would reduce the likelihood of government support to the banking sector. That said, we expect most Hong Kong banks to maintain their ratings, either due to the availability of parent group support or the degree of government support largely remaining unchanged after taking into consideration individual banks' stand-alone credit profiles.

Exposure To China Remains A Key Risk

We believe a sustained slowdown in China would continue to pressure the loan quality of Hong Kong banks. As supply-side reform continues in China, we expect credit quality of loans to sectors such as industrial to remain under pressure. In addition, unexpected turbulence in China's economic rebalancing agenda--potential causes include slower economic growth, heightening volatility in the renminbi, or tightening funding conditions—could further hit business performance of both mainland China and Hong Kong borrowers. This could rapidly deteriorate asset quality of Hong Kong banks and push up their credit costs.

Hong Kong banks' direct lending to mainland China remains material, in our view. As of Sept. 30, 2016, the Hong Kong banking sector's direct lending to the mainland was Hong Kong dollar (HK$) 3.55 trillion, equivalent to about 16% of its total assets (see table 1). This number has been continuously rising in recent years, despite a slowdown in growth since the second half of 2015.

Table 1

Hong Kong Banks' Mainland-Related Lending

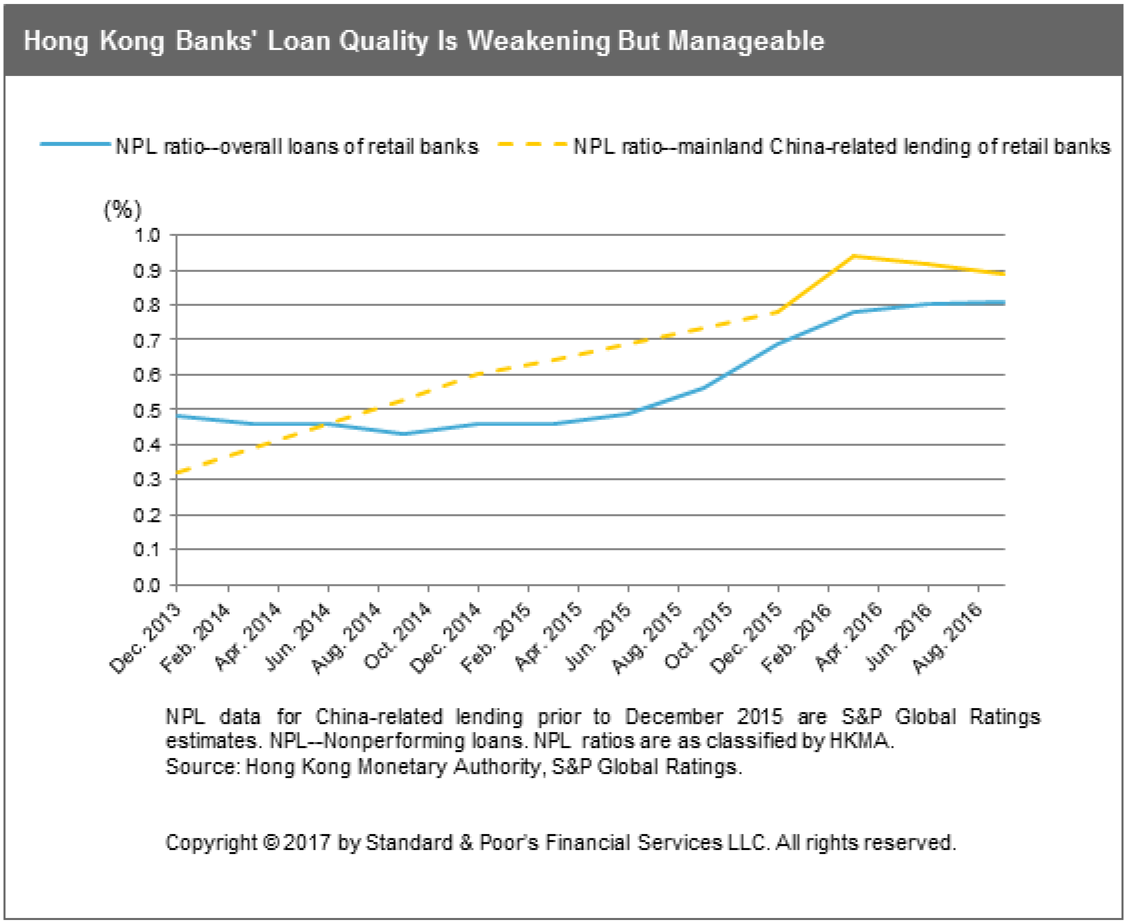
(Bil. HK$)

Borrower type	**2014**	**2015**	**2016***
Mainland state-owned entities	1,480	1,398	1,422
Mainland private entities	585	658	718
Non-mainland entities	1,160	1,275	1,304
Total	3,224	3,331	3,443
Mainland related lending as a % of total assets	15.4%	15.5%	15.6%

*As of June 30. Source: Hong Kong Monetary Authority.

That said, we forecast a manageable deterioration in asset quality and a modest rise in credit costs for Hong Kong banks in 2017 in our base case, despite the weakening economic growth outlook in China and Hong Kong. This is because of our view of Hong Kong banks' prudent underwriting practices and risk appetite, supported by the Hong Kong banking sector's stringent regulatory requirements. We estimate that China's economic growth will soften to 6.4% in 2017 from 6.7% in 2016; Hong Kong's growth will also likely dip to 1.3% in 2017, from 1.9% in 2016. The larger Hong Kong banks that we rate generally have proactive de-risking initiatives, and their growth in exposure to mainland China has slowed down since the second half of 2015.

Chart 1

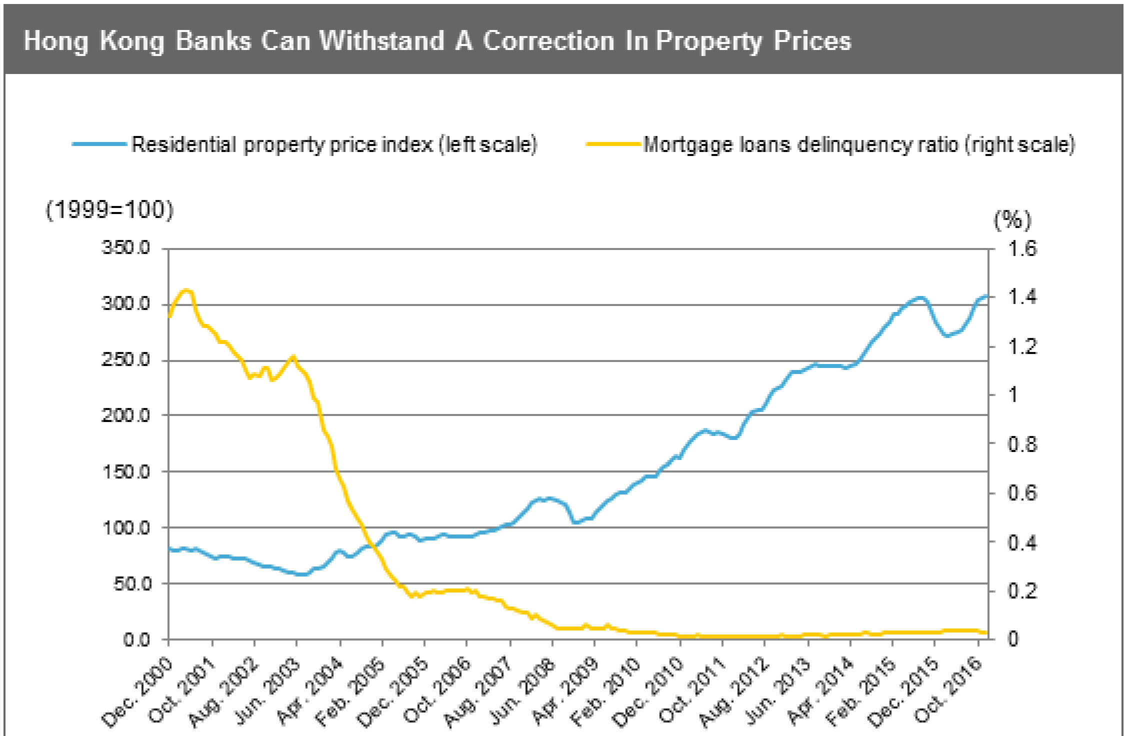


Volatility In the Local Property Market To Have A Limited Impact

We believe any correction in property prices in Hong Kong will likely have a limited impact on the quality of property-related loans. Our base case forecasts property prices will decline by 5%-10% in 2017. Property-related loans account for about 30% of the Hong Kong banking sector's loan book. We believe Hong Kong banks' prudent risk management should help support their asset quality. Our view also considers the recourse status of mortgage lending in Hong Kong, and the region's low and fairly stable unemployment and track record of low credit losses during times of stress.

We project that most large banks in Hong Kong would be able to maintain their credit profiles even if property prices were to decline by up to 30% (see chart 2). In our view, Hong Kong regulatory authorities' implementation of countercyclical measures over the past years, such as the tightening LTV requirements, has been effective in pushing the region's banks to adopt prudent underwriting standards. Hong Kong banks' average LTV ratio of new mortgages was 51% in December 2016, notably improved from 64% in 2009. The residential mortgage loans delinquency ratio is also low, at 0.03% in December 2016. Most mortgage borrowers and the larger property developers in Hong Kong have been able to withstand volatile property movements over the past two decades.

Chart 2



Source: Rating and Valuation Department, Hong Kong Monetary Authority; S&P Global Ratings.

New Resolution Regime Could Affect Government Support

We are likely to revise our assessment of Hong Kong government support to the banking sector to supportive from highly supportive once the resolution regime is implemented. We expect a reduced likelihood of government support because "bail-in"--which would imply that senior unsecured creditors could be required to absorb loss in a bank resolution—would be one of the several options for the authorities to avert or respond to a financial system crisis. That said, we still see some room for potential government support because we expect that bail-in would not be a precondition for recapitalization or other resolution options. Moreover, we believe the Hong Kong government would maintain its full discretion to bail out a bank without asking senior unsecured creditors to absorb losses.

Our assessment of the likelihood of government support to banks is still subject to the timing of the implementation of the resolution regime and the finalization of some sub-legislations after Hong Kong passed its Financial Institutions (Resolution) Ordinance (FIRO) at LegCo in June 2016. The resolution regime in Hong Kong still ponders additional aspects of implementation, such as finalization of rules on protected liabilities, total loss-absorbing capacity (TLAC) requirements, and cross-border resolution strategy.

We believe most of the Hong Kong banks we rate are likely to maintain their ratings despite the potential implementation of the resolution regime. This is because these banks could either benefit from support from their respective parent groups or the degree of government support would remain unchanged--even with a reduced government support to the banking sector--after considering individual bank's stand-alone credit profiles.

We expect the implementation of the resolution regime to also trigger our review of hybrid instruments issued by various Hong Kong banks in relation to government support notching and any additional risks related to preservation of principal bond amount. We will progress our review of ratings as the practical implementation evolves and sub-legislations becomes clear.

Solid Capitalization And Funding Profiles Underpin Stable Outlook

We expect most banks in Hong Kong to maintain stable outlooks over the next 12 months despite the China economic slowdown and the implementation of the resolution regime. Hong Kong banks' solid capitalization, robust funding and liquidity, and prudent underwriting policies should support their credit profiles.

We expect large banks in Hong Kong to maintain their solid capitalization in 2017. We expect these banks to be well-positioned for the phase-in of various capital buffer requirements by the Hong Kong Monetary Authority, including a Basel III counter-cyclical buffer that many other jurisdictions are yet to impose. We forecast average loan growth to be around 5% in 2017, broadly unchanged year-on-year, but much slower than the 10%–16% annual growth during 2012-2014. We expect these banks to maintain a cautious risk appetite amid soft global trade and China's economic slowdown.

We expect Hong Kong banks' profitability to remain largely flat in 2017. Rising credit costs and intense competition will likely offset modest improvement in net interest margins brought by rising interest rates. We expect large Hong Kong banks to benefit from potential increases in U.S. interest rates given their solid deposit base; although such impact would be gradual because the hike in U.S. interest rates may not immediately flow through to Hong Kong, and the extent is subject to global market conditions and policy decisions. We expect intense competition in the local lending market and uncertainties in cross-border market sentiment--due to volatility in the renminbi and policy risks such as capital controls placed by China authorities--to drive down business volumes and squeeze bank margins. We estimate our measure of average return on assets (ROA) for Hong Kong banks to stay at about 0.8% in 2017.

We continue to view the strong funding profiles of Hong Kong banks, supported by their broad and solid customer deposit base, as a key strength. We believe the stable growth in customer deposits will continue to remain sufficient to support moderate systemwide loan growth. We also expect most leading Hong Kong banks to maintain their strong liquidity.

Related Criteria And Research

Related Criteria

- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011

- Bank Capital Methodology And Assumptions, Dec. 6, 2010

Related Research

- Hong Kong Developers Coping With Challenges From New Entrants, Feb. 28, 2017
- Economic Research: APAC Economic Snapshots, Feb. 21, 2017
- People's Republic of China 'AA-/A-1+' Ratings Affirmed; Outlook Remains Negative, Jan. 26, 2017
- Sector Review: Is This The Year For A Chinese Banking Crisis?, Jan. 18, 2017
- Hong Kong's Resolution Regime Could Strain Banks' Credit Profiles, Aug. 2, 2016
- Banking Industry Country Risk Assessment: Hong Kong, June 7, 2016

Only a rating committee may determine a rating action and this report does not constitute a rating action.