

Asian financials: time to shine in China and Hong Kong

To the point

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Coming out of the recent global financial crisis, Asian banks on the whole are proving to be more resilient and healthy than their Western counterparts. Having learned their lessons from the Asian financial crisis more than a decade ago, banks across much of Asia are a lot better capitalized, with lower loan-to-deposit ratios (LDR) and a large captive deposit base.

To be sure there are weak links, such as the South Korean banking system's dependence on short-term foreign funding. But by and large, Asian banks have a very low dependence on wholesale funding in international capital markets and lower exposure to riskier foreign debt investments. As a result, we expect banks in Asian countries — particularly China and Hong Kong — will continue to play a vital role in expanding consumer credit, enabling these economies to further develop domestic demand as a source of economic growth. Here, we look at some of the attributes generally found at Asian banks.

Deposit bases: Asian banks are supported by hefty deposit bases. Bloomberg data shows that Industrial and Commercial Bank of China (ICBC) has surpassed JPMorgan Chase and Mitsubishi UFJ to become the largest in the world by deposits. For the majority of Asian banks, the LDR — which indicates the percentage of deposits used to make loans versus purchasing securities — is well below 100%, with China and Hong Kong having the lowest LDRs at less than 75%, according to data from Morgan Stanley. By comparison, the LDR is more than 100% in the U.S. and Europe, with the highest ratios found in the U.K. and Germany. Russia and several former Soviet republics, meanwhile, have LDRs between 150% and 200%, according to figures from ING.

Asset quality: Another strong suit for Asian banks is their balance sheets, which are typically more conservative than those of their U.S. and European counterparts.

Only 5% of the approximately \$500 billion written off by banks globally from January to August 2008 — the period in which the majority of bank write-downs occurred — came from companies based in Asia (including Japan). In contrast, banks in North America accounted for half of the total write-offs, according to Bloomberg; European banks accounted for the remaining 45%. It is perhaps unsurprising, then, that the 23 banks with the most asset write-downs and credit losses during that period were all North American and European.¹ In addition, Asian banks have had to raise the least amount of capital — about \$76 billion as of June — against losses of \$37 billion. In Europe, the amount of capital raised is nearly equal to losses of \$420 billion, while in the Americas, losses have outpaced capital raisings, \$582 billion to \$500 billion.²

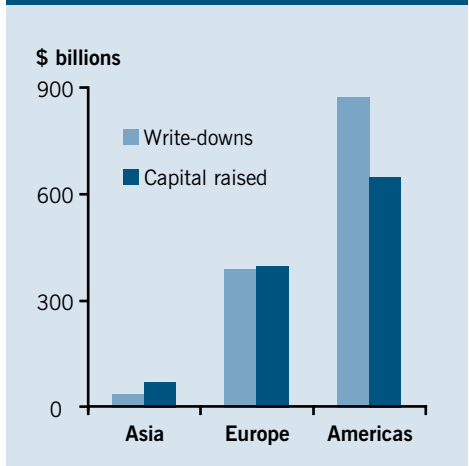
Profits: In addition to avoiding write-downs, Asian banks have also managed to accumulate profits during these difficult times. The total net profit of the 300 largest banks in Asia increased by nearly 40% to \$162.5 billion in the second half of 2007 — the peak of the U.S. subprime mortgage troubles that triggered the global financial and economic crises. Since then, Asian bank profits have fallen back closer to \$100 billion, mostly weighed down by Japan and Taiwan. China's share of the profit pool, however, has risen nearly 70% and now accounts for two-thirds of the total.³ In fact, Chinese banks led the globe with \$85 billion in aggregate pretax profits last year, holding three of the top four spots. These strong results during a time of crisis can be partly attributed to business improvements the banks made as a result of lessons learned from the last major financial crisis, which began in Asia some 10 years earlier. Asian banks largely stayed away from complex products, such as subprime loans and related derivatives, and stuck to the basics of corporate loans and retail deposits.

Debt: Asian companies in general also have lower leverage and more dividend yield support than those in Europe, the Middle East and Africa (EMEA) and Latin America. In a study by Morgan Stanley of companies in emerging markets with low net debt-to-equity ratios and relatively secure, above-average dividend yields for 2009, five Chinese banks appeared among the top 15 by market capitalization: ICBC, China Construction Bank, Bank of China, Bank of Communications, and China CITIC Bank.⁴

China leading the way

Chinese banks are considered to be among the strongest in Asia, not to mention the world — a drastic improvement from only a few years ago. They are now well capitalized and have strong liquidity positions, as well as one of the lowest LDRs in the region at 67%. While China was less affected than other countries by the 1997 Asian financial crisis, it convinced the Chinese government of the need to improve areas of weaknesses in its financial system, such as having too many nonperforming loans (NPL). Banks have since gotten their bad loans under control, leading to a sharp decline in NPL ratios.

Figure 1: Bank write-downs and capital raised, July 2007 to March 2009



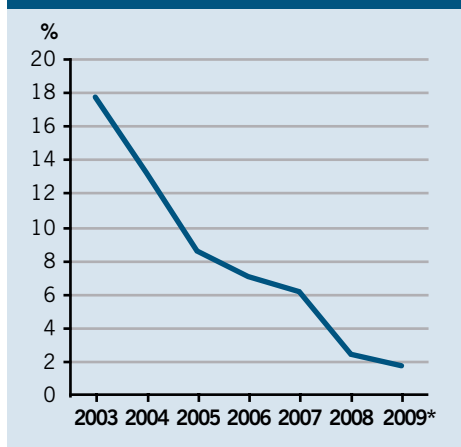
Source: Bloomberg

According to the China Banking Regulatory Commission, the NPL ratio for commercial banks has fallen below 2%, down from 2.5% at the end of 2008. As recently as 2007 the NPL ratio was above 6%, while at the end of 2004 it was more than 13%. Estimates before the CBRC was formed in 2003 are harder to come by, but range between 30% and 50%.

The Chinese financial sector also has benefited from recent government measures to boost the economy through targeted bank lending, in combination with the \$586 billion fiscal stimulus program announced last November. Loan growth has also increased, tripling to \$1.1 trillion in the first half of 2009 from a year ago. Whether China can resume higher growth rates in the near future remains to be seen, especially since the government has indicated plans to rein in stimulus and tighten capital requirements for banks. What is less in doubt, however, is the strength of the banking system and its ability to contribute to a robust economy over the longer term.

In addition to mortgages, credit cards and auto loans are also becoming increasingly

Figure 2: Ratio of nonperforming loans in the Chinese banking system



*As of June
Source: Chinese Banking Regulatory Commission

popular in China and other parts of Asia. While some of this loan growth may cause margins to decrease and potentially increase credit costs in the medium term, there are no signs that Chinese banks have abandoned risk management principles as most loans are directed toward lower-risk segments and the NPL ratio has remained at low levels. We also expect the rapid pace of new loans to slow somewhat yet remain strong overall, a trend that has already started.

As a result, while we remain selective and cautious toward most financials in developed markets, we have a more positive view of banks in China and other Asian countries. Several Chinese banks serve as proxies for economic growth. The World Bank has increased its forecast for China's GDP growth to 7.2% for 2009, up from 6.5%; by 2010, it expects China's GDP to accelerate to 7.7%. Other estimates are even higher, including the Asian Development Bank's 8.2% and 8.9% forecasts for this year and the next. State-owned banks should have an advantage as their government ties give them an inside track with higher-yielding infrastructure project loans. In the property sector, Chinese banks and real estate companies are well positioned to benefit from the sharp rebound that has taken place.

Hong Kong benefits from close ties

The financial industry in Hong Kong is among the strongest in Asia, benefiting from its close ties to mainland China as well as the strong presence of British banks — a relic of the territory's colonial past. These banks remain very liquid and are enjoying higher net interest margins on loans. The Hong Kong Monetary Authority has taken steps to ease short-term funding pressures and assure the market of liquidity. Financials are also benefiting from excess liquidity out of China, especially in the property and retail sectors, due to tourists from the mainland visiting Hong Kong.

China continues to open its financial system to Hong Kong, introducing measures to strengthen ties between the two markets. A plan to allow residents of mainland China to invest directly in the Hong Kong market is also on the table. Other measures have been announced, including: a three-year currency swap deal valued at nearly \$30 billion for China to provide liquidity to mainland operations of Hong Kong banks; a plan to allow Hong Kong banks more leeway to establish branches just across the border in the Guangdong province; and a pilot program allowing the settlement of trade with China in Hong Kong using the renminbi.

Remember the past, but look ahead

An oft-cited measure of global liquidity — the ratio of a country's international short-term debt to its foreign exchange reserves — paints a very different picture of Asia today compared to 1997, when excessive investment, currency appreciation, overleveraging of banks and weak corporate governance all contributed to the Asian financial crisis. Before the last crisis, short-term debt was climbing more rapidly than reserves for an average of eight Asian countries, including China. Since the crisis ended in 1998 this trend has reversed, with short-term debt falling well below foreign exchange reserves as current accounts have swung into a surplus and official reserves have climbed.⁵

In short, Asia did not have to overstretch itself in the current economic cycle due to measures taken since its own financial crisis more than a decade ago. As a result, Asian countries have gained more economic and political power. For the global financial industry, we are seeing a return to the basics of prudent lending — which Asian banks were already practicing. This has now put them in a stronger position to emerge from the recent crisis and to play an increasingly larger role on the global financial stage. ■

¹ Clive Rough and Lea-Anne Lee, "A rethink of capital requirements for Asian banks?," Freshfields Bruckhaus Deringer LLP, November 2008.

² Geraldine Lambe, "Top 1000 world banks 2009," *The Banker*, June 2009.

³ Peter Hoflich, "The Asian Banker 300," *The Asian Banker Journal*, September 2009.

⁴ Jonathan Garner and Michael Wang, "GEMs Equity Strategy: 2009 Outlook: Fight Back—Particularly in Asia," Morgan Stanley, Dec. 4, 2008.

⁵ Robert N. McCauley and Jens Zunkunf, "Asian banks and the international interbank market," *BIS Quarterly Review*, June 2008.

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