Hong Kong Banking Outlook 2016

Our views on the year ahead

December 2015

Overview and summary

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We see the performance of the Hong Kong banking sector being under more pressure in 2016, with a strong likelihood that financial performance will be down from prior years.

Firstly, loan growth in Hong Kong is slowing and we expect this trend to continue. In particular, we anticipate that lending into mainland China will slow as demand drops in line with slightly slowing economic growth, and as Hong Kong banks increase their focus on what mainland China exposures they want to take on. Linked to this, we do not see net interest margins increasing significantly in 2016. There is no consensus on US interest rate rises in 2016, and there is a very real prospect of 'lower for longer' interest rates, which may curtail Hong Kong banks' ability to generate revenue growth.

Secondly, we can expect to see higher credit costs in 2016 as non-performing loans (NPLs) in mainland China increase and impact Hong Kong banks and their mainland China subsidiaries. Although we do not think the quantum will be large, it will be an increase and will weigh on banks' earnings.

Costs are the third element of the performance puzzle for banks. While costs are rising, mainly due to regulatory pressure, this is an area where there are real opportunities to improve financial performance. However, any benefits are likely to come in future years, rather than in 2016. Dealing with banks in Hong Kong can sometimes be a time-consuming, paper-chasing exercise. Banks which modernise and digitise their processes can make their processes more efficient and better controlled, and can provide a better customer experience. For this to happen, 2016 will have to be a year of investment, and we are not sure many CEOs would want to do this given the gloomy outlook for revenues and loan impairments.

M&A activity

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We are not predicting new 'landmark' bank transactions in Hong Kong in at least the first half of 2016. Instead, we see the year ahead as one of continued restructuring and repositioning, driven by the pressures of regulation, a rising USD interest rate environment and the impact of a softening economy in China. This softening will undoubtedly put loan provisioning in the spotlight, resulting in an increased supply of NPL portfolios to the market. Though pricing will come off as a result, there seems to be no shortage of buyers for portfolios, large single credits and long-dated assets. Indeed, the emergence of credit funds and other speciality lenders could have a profound effect on banks' traditional lending activity, putting further pressure on peripheral players that could lead to market exits and perhaps some opportunities for new players, principally from mainland China, to expand into Hong Kong.

As Hong Kong continues to develop as a key global financial centre, we expect to see corporate fundraising through initial public offerings (IPOs) and corporate bond issuances. These should attract deal activity in investment banking and asset management, where again we see the emergence of PRC institutions in particular seeking to support the outbound ambitions of PRC corporates. Other areas such as wealth management and private banking, where scale is increasingly important, could see a further round of consolidation.

Finally, after years of playing second fiddle, 2016 might well be a breakthrough year for investment in Hong Kong financial technology (FinTech), building on the strong momentum developed in 2015 from institutional and government support.

Regulation

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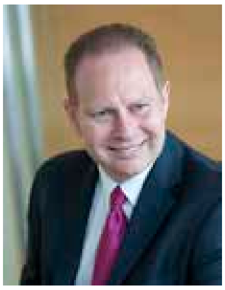


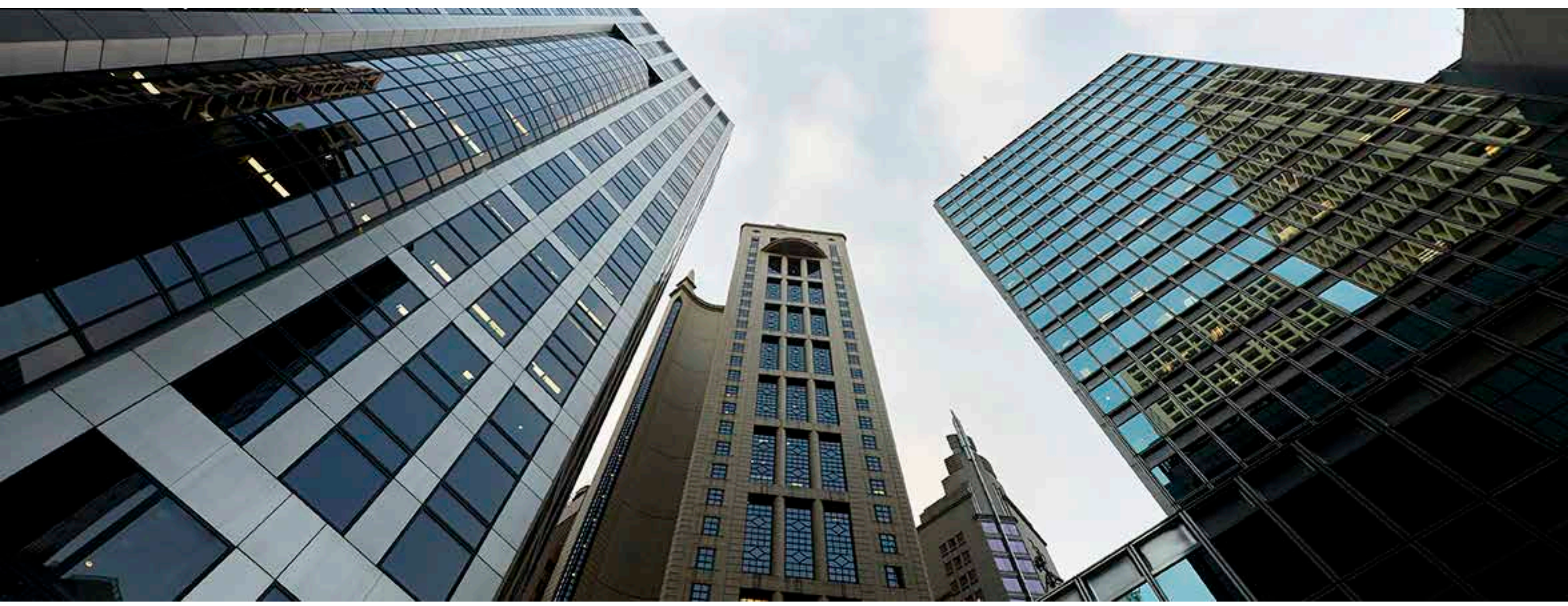
For quite some time, the Hong Kong Monetary Authority (HKMA) has been drawing attention to the need for banks to take account of possible future changes in the operating environment. The recent extended period of steady growth, benign economic conditions, plentiful liquidity, and super-low interest rates is unlikely to go on forever, and it is important that the sector is not caught out in a situation of slower growth, higher NPLs and potentially higher interest rates.

With the recent slowdown in China, the depreciation of the RMB and a pick-up in NPLs in several markets around the region, market conditions are becoming more changeable and volatile, and banks will need to focus more than before on credit risk and interest rate risk, as well as operational and technology risks. As many commentators have been pointing out, times have been so good for so long now that many bankers in Asia have little experience of managing in more difficult and turbulent times. This requires different skills – credit management rather than credit generation, risk management rather than marketing.

In addition, customers too have become used to the plentiful availability of credit and low interest rates, and again may not be used to managing their finances if credit availability reduces and interest rates rise. This is why the HKMA has urged borrowers to consider their payment ability if interest rates were to rise when they take on debt. Banks will need to closely monitor any early warning signals of changes in market conditions and the operating environment, and adjust accordingly. It is important, however, that there is not an overreaction (for example, a sharp cutback on new lending), as this could be damaging to the economy and to trade.

Globally, much of the focus in terms of regulatory reform has been on the increased levels of capital that banks now need to maintain. In Hong Kong, where banks have traditionally maintained quite conservative capital levels, this has not, as a consequence, been a pressing issue, and lack of capital could not be said to be constraining activity. However, another key aspect of regulatory reform – new liquidity requirements – is requiring more adjustment by banks in Hong Kong as they come into line with the dual requirements of the 'liquidity coverage ratio' and 'net stable funding ratio'. Growing their business as they had planned, while at the same time meeting these two ratios, will be challenging for some, forcing them to reassess how they fund their balance sheet and, particularly, how they fund their longer-term lending. This is having a knock-on effect on the deposit market, the interbank market and the lending market.

An issue that has arisen from the introduction of these new liquidity ratios is that the behaviour of deposits/liabilities in Hong Kong (i.e. the volatility of different types of liabilities, both in normal times and in times of stress) may be quite different from that which is assumed in the calculation of the ratios, which are based on global averages. Banks will therefore need to undertake some fundamental behavioural analysis of their institution's own cash flows to better understand how stable their deposit base would be if market conditions were to become more stressful, and then adjust their asset and liability/liquidity strategy accordingly.



FinTech: An opportunity, not a threat

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FinTech has seen rapid but steady growth over the past five years, expanding from an estimated USD 1 billion in investments in 2010 to more than USD 6 billion in 2014, according to CB Insights. This trend has continued in 2015, where venture capital-backed investment was nearly USD 10.5 billion by the third quarter. To date, a significant amount of this funding has been Asia bound, with USD 3.3 billion being allocated to the region – a sure sign that Asia is a significant market for FinTech innovation.

FinTech is not only an opportunity for financial services industry players, but also opens up the market to many other participants. In China, some of the biggest news has been the moves made by Tencent and Alibaba to offer services other than just payments through their WeBank and MYBank offerings respectively over the last year.

With continued growth in FinTech expected in 2016, participants will be watching to see where the major developments will be and how the market will take shape. It is likely that we will increasingly hear how blockchain technologies will be further developed beyond the support of cryptocurrencies, into mainstream support for smart contracts and support of asset management capabilities. Payments innovation and further adoption of current schemes will continue, with greater cross-border usage, and will likely become the norm rather than the exception. Also, changes in regulation will see more alternative credit and investment opportunities appearing in more markets – here, the focus is more on innovating the 'Fin' rather than the 'Tech'.

Anti-money laundering and counter-financing of terrorism (AML/CFT)

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Short- to medium-term AML/CFT Hong Kong regulatory outlook

In June 2014, the HKMA's anti-money-laundering and financial crime risk division, said the body would "consider using the full range of powers afforded to it under both the Banking Ordinance and Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance (AMLO), including disciplinary and prosecution action" in the event that breaches of the AMLO were discovered. In August 2014, the HKMA announced its first action against a bank for breaches of the AMLO, when the State Bank of India was fined HKD 7.5 million. It is expected that further action will be taken against other regulated financial institutions for breaches of the AMLO in the next 6-12 months.

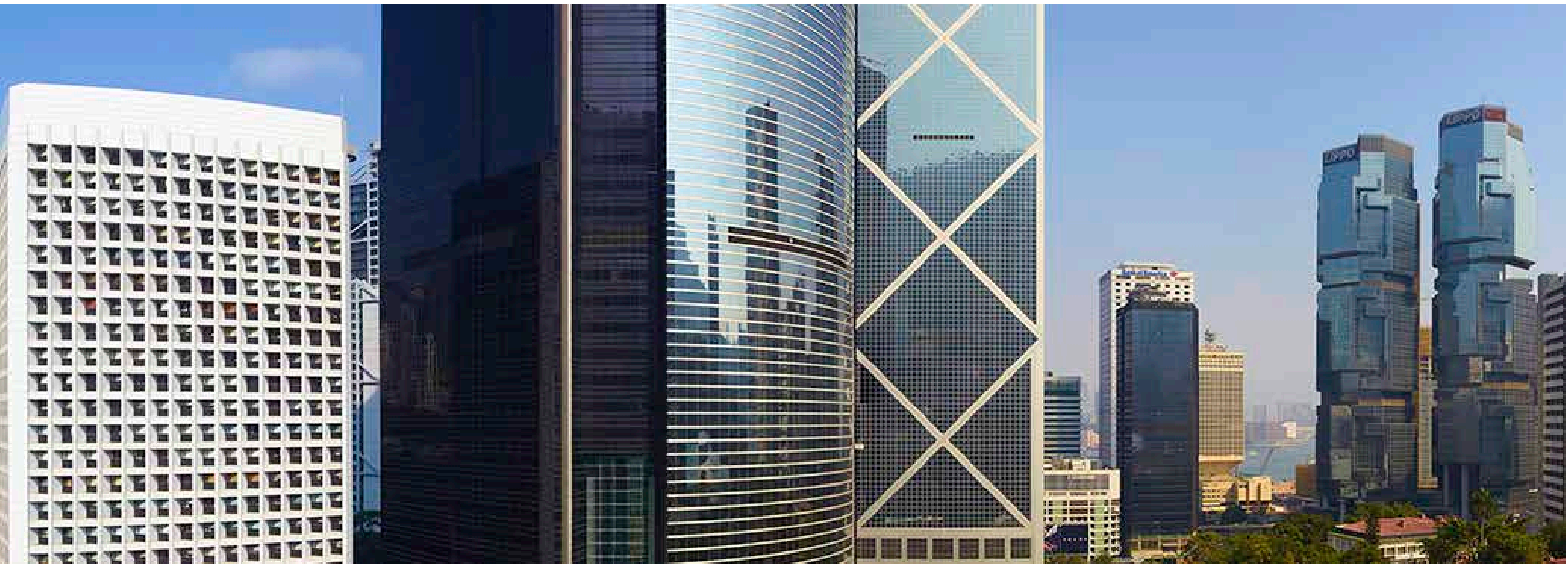
Given the trends seen in other jurisdictions with similar legislation to the AMLO, regulatory and prosecution action against individual members of financial institutions is also to be expected.

Medium- to long-term AML/CFT Hong Kong regulatory outlook

The Financial Action Task Force (FATF) conducts peer reviews of each of its member countries on an ongoing basis. The FATF's next mutual evaluation of Hong Kong is scheduled for July/August 2018 – with results due to be published in February 2019.

The FATF's mutual evaluations typically drive new laws and regulations to address identified weaknesses. Hong Kong's last assessment in 2007 resulted in the enactment of the AMLO in 2012 and the regulation of Money Service Businesses.

In the lead-up to the next mutual evaluation, we expect Hong Kong regulators to increase their onsite supervision and to fully use their powers under the AMLO to demonstrate the effectiveness of Hong Kong's AML/CFT system. Key focus areas will continue to include institutional risk assessments, payment processing, client due diligence, AML/CFT surveillance and senior management oversight.



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