Hong Kong's soaring bank exposure to China sparks credit concerns
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In just a few years, Hong Kong banks have ramped up lending to China from near zero to US$430 billion (RM1.4 billion), fuelling concerns about their credit exposure to the mainland at a time when sliding economic growth and defaults are making investors nervous.

Even a modest increase in non-performing loans would have a significant impact on Hong Kong bank profits, suggesting the sector will be a sensitive indicator of China's debt markets in the year ahead.

A landmark domestic bond default earlier this month and headlines of bankruptcies – highlighted last week by Zhejiang Xingrun Real Estate Co – have underscored concerns that an unprecedented surge in company debt in China is now showing signs of unravelling.

"The quality of these loans extended by Hong Kong banks to Chinese companies has not been tested," said Mirza Baig, head of foreign exchange and interest rate strategy at BNP Paribas in Singapore. "That is a concern in the backdrop of the rapid rise in exposure."

Foreign bank claims on China hit US$1 trillion last year, up from nearly zero 10 years ago, and the biggest portion was provided by Hong Kong, Bank of International Settlements data shows. The US$430 billion in loans outstanding represents 165% of Hong Kong's GDP, BIS figures show.

Data from the Hong Kong Monetary Authority (HKMA), the city's de-facto central bank, showed a similar astonishing rise. By the end of 2013, Hong Kong banks' net claims on China as a percentage of their total loan book was nearing 40%, compared with zero by 2010.

The rival financial centre of Singapore has also ramped up its China loans as well, but its exposure is the equivalent of 15% of its GDP, figures from its monetary authority show.

Local banks in both these centres have taken over lending that foreign banks once dominated, drawn by cheap funding rates following the global financial crisis, a voracious appetite from Chinese borrowers and healthy growth in the world's second-biggest economy.

"Hong Kong banks have pounced on arbitrage opportunities between on-and offshore renminbi funding rates," said Cathy Holcombe, a strategist at Gavekal Dragonomics in Hong Kong.

There is no breakdown of the type of loans behind the US$430 billion figure. But Stephen Long, managing director of financial institutions at Moody's Investor Services, said "a substantial part" is in lower-risk categories such as trade finance. This would include loans to Hong Kong blue-chip companies operating on the mainland or loans supported by guarantees from Chinese banks.

However, trade finance may also hide speculative flows that bet on a rise in the yuan – a popular trade encouraged by the currency's 2.9% rise against the dollar last year. In this trade, investors and companies falsify trade receipts to convert foreign currency into yuan and avoid capital controls.

This year's slide in the yuan may also pinch debtors' ability to service their loans. The yuan has dropped nearly 3%, wiping out its 2013 gains, putting it on track for its worst March quarter since 1992.

"Most of these loans are not hedged completely on a currency basis even if they are collateralised and the currency volatility means some of these banks may be sitting on large currency losses," said a trade banker at a large European Bank. He declined to be identified because he was not authorised to speak openly to the media.

Stock and credit analysts also say a big chunk of the loans has ended up in China's property and financial sectors, as well as industries with surplus production capacity, such as steel – all areas where regulators are trying to control lending.

To be sure, capital buffers at Hong Kong banks are much higher than minimum international standards and the central bank has not shown any alarm about the lending.

The HKMA said it has been "closely monitoring" the sector's credit exposure and it expects banks "to maintain sufficiently robust system of controls to manage the specific risks that they are facing".

Investors are showing more concern though. An index of financial stocks in the main Hong Kong bourse had fallen by more than 13% this year through to the end of last week. It perked up yesterday on hopes for government stimulus to support the Chinese economy.

Analysts said Bank of East Asia and Bank of China (Hong Kong) have the biggest exposure to China among the lenders based in the territory, at 46% and 27% of their loan books, respectively. The latter is also the clearing bank for all yuan-related transactions appointed by the China's central bank. The banks did not return calls seeking comment.

Hong Kong's non-performing loans (NPLs) ratio is currently a record low of 0.5%. But if it returned to the long-term average of 3.5%, it would cut nearly 20% off current expectations for local bank pretax profits for the financial year starting this April, Barclays Capital said.

Larger global banks in Hong Kong, such as Standard Chartered Bank and HSBC are less at risk because of their big balance sheets.

Under a scenario whereby NPLs return to 3.5%, Bank of East Asia would take a 10% hit to its pretax profit, while Dah Sing Financial Group and Wing Hang Bank could lose nearly a sixth, Barclays says. Dah Sing and Wing Hang did not return calls seeking comment.

Sharnie Wong, a banking analyst at Barclays, said the two biggest risks to asset quality of Hong Kong banks are a sharp downturn in China's economy and a rise in US interest rates. The first factor could reduce the ability of borrowers to service their loans and the second point would raise bank funding costs, squeezing profit margins.

Although China's official NPL ratio is 1.0%, bankers estimate the real figure is anywhere between 5% and 10%.

Wong and other analysts argue that interest rates, and with them NPLs, are set to rise as rates globally increase, partly in response to healthier US and European economies.

That means Hong Kong banks will have to put more aside to offset debt risks and so readings on their NPLs and provisions against bad debt will provide a window on the state of China's credit market. – Reuters, March 25, 2014.

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