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Banking on turmoil

Imagine a capitalist island set down in a communist sea. Recall the American real-estate bubble of the mid-2000s. Observe the mighty Swiss franc, bane of Switzerland's exporters, central bankers and ski-lodge operators.

Imagining, recalling and observing these things, you have a fair taste of the financial tribulations of the Special Administrative Region of the People's Republic of China, better known as Hong Kong. In preview, we're bearish on the Hong Kong dollar and on Hang Seng Bank.

The analysis comes in two parts, the scene-setting macro and the action-oriented micro. Not every reader of *Grant's* wants to go gallivanting halfway around the world to lay down a bet on an adverse event (we have so many opportunities at home). But every one of us has a pocketbook interest in the outcome of the long-running Chinese financial drama, including the big-money sidebar in Hong Kong.

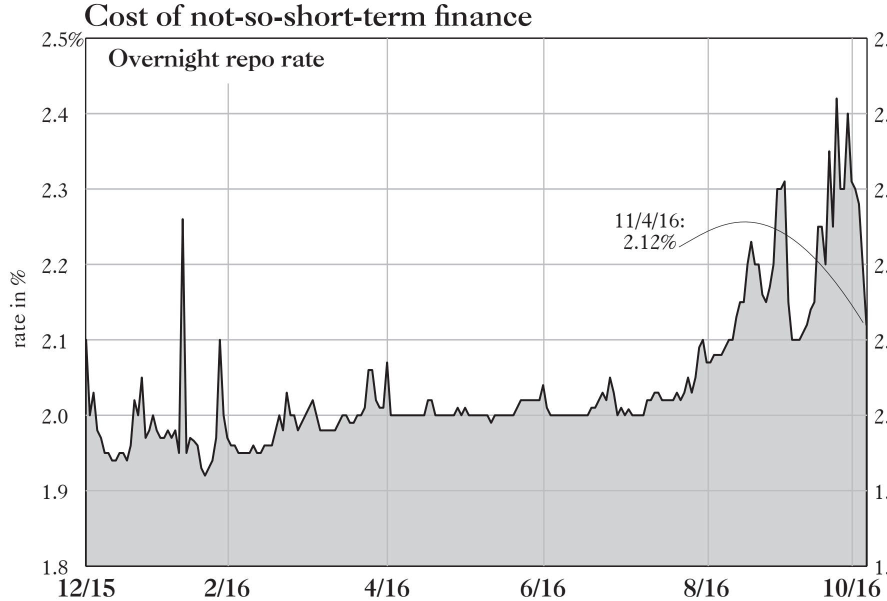
We proceed from the conviction, well known to even intermittent readers of these pages, that something is wrong in China. That something encompasses many facets of the Chinese phenomenon. We now leave aside social and political unrest (including periodic antitotalitarian demonstrations in Hong Kong), ghost cities, man-made islands, absurdly elevated fixed investment, astonishing (truly incredible) reported rates of economic growth and the brute nature of Marxist dictatorship—indeed, all but the issues surrounding credit, real estate, interest rates and exchange rates.

The Chinese renminbi is given to floating or sinking. The value of the Hong Kong dollar is fixed. It is attached to the movable anchor of the U.S. dollar. Our bearish thesis proceeds from the fact that the renminbi is falling against the U.S. dollar and therefore against the Hong Kong dollar. A symptom of the resulting monetary strain is that renminbi are leaving the People's Republic.

On Nov. 8, the RMB/U.S.$ exchange rate fell to 6.787, weakest since Sept. 8, 2010. On Monday, the People's Bank, China's own Federal Reserve, announced a $45.7 billion decline in its foreign-currency reserves for October. This declension flattened the Chinese monetary mountain to $3.1 trillion, lowest since March 2011. The news surprised no one, as the People's Bank is printing money with which to shore up the mainland's banks. Whether or not these efforts strengthen the banks, they are contributing to weakness in the currency.

To plug the fast-multiplying holes in China's monetary dike, Beijing keeps commandeering fingers. On Oct. 29, China UnionPay Co., the People's Republic's own Visa-cum-MasterCard network, prohibited cardholders from buying overseas investment assets, including some life-insurance policies. The Chinese had been using investment-linked insurance to move cash out of China, much to the profit of Hong Kong financial institutions. On the news, AIA Group Ltd., the Hong

Cost of not-so-short-term finance



source: The Bloomberg

Kong-listed former Asian insurance subsidiary of American International Group Inc., fell by 4.8%.

"There ain't no free lunch" is an international truism; it pertains in the East as it does in the West. Creating redundant cash balances, China's monetary mandarins blow bubbles, whether in garlic, iron ore, real estate, coal, equities or (as recently observed) in Bitcoin. These price derangements the authorities do not always rue. Bounding markets tempt money to stay put.

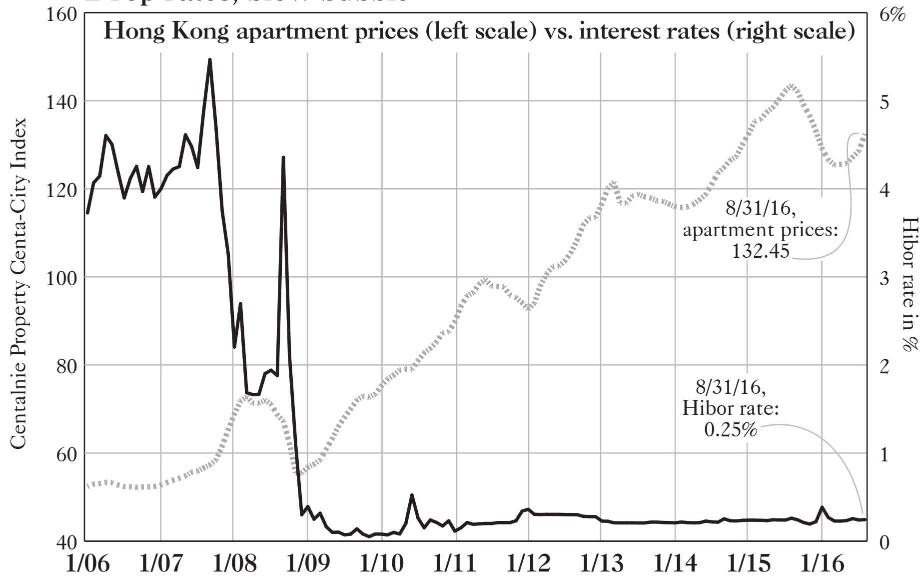
One manipulation sets up the need for another—this, too, is a universal home truth. For many years, China's banks have suffered from a paucity of deposits. To fund booming asset growth, they have turned to short-term secured finance, i.e., repurchase, or repo, borrowing [(*Grant's*, May 20)](). Between December 2014 and August 2016, the monthly value of repurchase agreements almost tripled to RMB 63.2 trillion ($9.3 trillion) from RMB 23.8 trillion.

August brought a U-turn. Between September and October, the volume of outstanding repo plunged by 37%, to RMB 39.9 trillion. Nobody seems to know why. Observable is a lengthening of repo maturities with which the People's Bank infuses its banking charges with liquidity, to 28 days in mid-September from the previously standard seven or 14 days. And as maturities have lengthened, interest costs have risen, to 2.9% for long maturities from 2.1% for the short ones. "What it tells you," Logan Wright, a director of the Rhodium Group, remarks to colleague Evan Lorenz, "is there is less credit demand for the higher-cost funding."

These goings-on in China have outsized effects in Hong Kong. The mainland purchased 43% of the island city's merchandise exports in the first eight months of 2016. As the renminbi sinks against the U.S. dollar—and so against its Hong Kong counterpart—Hong Kong's mainland-bound goods become less competitive. So it is that in the first half of 2016, Hong Kong's exports of goods and services registered a 4.4% year-over-year decline.

Tourism has suffered a double blow. Beyond the appreciating currency, Beijing is thwarting the channels of high-end commerce by attacking political corruption. Hong Kong jewelers and art dealers had grown

Drop rates, blow bubble



source: The Bloomberg

used to serving the wealthy and well-connected communist cadres. It must seem small consolation to the out-of-pocket merchants that sin has entered a cyclical bear market. In the nine months through September, the number of visitors to Hong Kong from the mainland dropped by 5%. Retail sales slumped by 8.3%.

All these factors have taken their toll on Hong Kong's once vibrant growth. Indeed, growth was slowing down even before the latest bout of renminbi weakness started; in 2013, 2014 and 2015, real growth successively came in at 3.1%, 2.7% and 2.4%; in the first half of 2016, it dwindled to 1.2%. You begin to wonder if Sir John James Cowperthwaite, libertarian financial secretary of Hong Kong in the 1960s, wasn't on to something in refusing to allow the collection of economic statistics, lest the gatherers become central planners [(*Grant's*, Jan. 15)]().

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All of which implies a course of speculative action. "One could," Lorenz ventures, "buy put options on the Hong Kong dollar. What reasonable, modern central banker would defend an exchange rate in the face of economic pain? The trouble is that the Hong Kong Monetary Authority (HKMA) is no ordinary central bank."

Let us only say that the short Hong Kong dollar trade has an unavailing history. The HKMA is, in fact, a currency board, not a central bank. The monetary authority is charged with protecting the exchange rate (set at HK$7.75–HK$7.85 to $1) and the banking system, not with fostering stable prices and maximum employment. It has never missed its foreign-exchange target since declaring the peg inviolable on Oct. 17, 1983. George Soros, the man who broke the pound, had no such luck with the Hong Kong dollar when he bet against it in 1998.

Lorenz inquired of the HKMA by email: How do you propose to deal with continued renminbi depreciation? The reply, by Yokee Wong, a member of the authority's communications unit, was as follows:

> Based on past experience, a weakening in the renminbi (RMB) against the U.S. dollar, together with the induced depreciation in Asian currencies, could cause an appreciation in the Hong Kong dollar (HKD) effective exchange rate and drag Hong Kong's exports. However, the negative impact could be offset by the improvement in the competitiveness of mainland goods re-exported by Hong Kong. In any case, Hong Kong's highly flexible prices and wages would help in part to offset the impact from HKD currency appreciation.

Still and all, the peg is a human contrivance, not a geological outcropping. In September 2011, the Swiss National Bank took its famous stand.

It declared that the franc would not be allowed to rally through 1.20 to the euro. At the prompting of reader Harlan Batrus, this publication subsequently observed that three-year, at-the-money calls on the Swiss franc were priced as if the Swiss authorities would never blink (*Grant's*, Sept. 19, 2014). Wouldn't it be nice to own some come the day that the SNB is forced to change course? At the time, the options cost 3.7% of notional value. The SNB duly blinked the following January, abandoning its peg and setting the franc to soar.

The form, then, is unpromising, but the HKMA's storied defiance may have its limits. For such a contingency, three-year, at-the-money puts on the Hong Kong dollar against the U.S. dollar are priced at 2.9% of notional value today. For better or worse, you have to be an institutional investor (with an International Swaps and Derivatives Association agreement in place) to buy them.

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Hong Kong banks offer another avenue of speculation on unscripted events in the Special Administrative Region. Hang Seng Bank Ltd., which means "ever growing" in Cantonese, is the former Crown colony's third-largest bank (its ticker is 11 on the Hong Kong Stock Exchange). It had 32 years of history under its belt when, in 1965, a run depleted a quarter of its deposits. The crisis sent the no-longer-growing institution into the arms of the Hongkong and Shanghai Banking Corp.

HSBC Holdings plc still owns a 62.1% interest in Hang Seng, though the latter is no mere captive of the former. Hang Seng commands a market capitalization of HK$268 billion ($34.5 billion) and an equity float of HK$101.3 billion ($13.1 billion). On a typical trading day, 1.4 million Hang Seng shares change hands for an average value of $24.5 million (the Hang Seng index of Hong Kong share prices is the bank's creation). In 2015, *The Asset* magazine ranked Hang Seng the best bank in Hong Kong for the 16th consecutive year.

Hang Seng serves 3.5 million customers, or about half of Hong Kong's population, through some 250 branches. It has a presence as well in Macau, Singapore, Taiwan, and the mainland. Retail banking and wealth management generate 47% of pre-tax profit, commercial banking 26.2%, global banking and "markets" (derivatives included) 26%. HK$136.7 billion in equity conservatively supports HK$1,321.4 billion in assets. Loans amount to 71% of deposits. Moody's and Standard & Poor's rate the bank Aa2 and AA-minus, respectively.

"From the end of 2008 through June 30, 2016," Lorenz observes, "Hang Seng's balance sheet ballooned by 73%, as loans and advances outside of Hong Kong and loans to finance trade jumped by a combined 243% to HK$187.7 billion from HK$54.8 billion. Then came the slowdown in China and the depreciation in the renminbi. Now, mainland demand for foreign financing is at a standstill—in fact, Chinese borrowers are repaying foreign-currency loans. Hang Seng's loans and advances outside of Hong Kong and trade finance declined by 7.1% in the 12 months ended June 30. In the six months ended June 30, foreign-exchange income plunged by 56% year over year.

"Having lashed its dollar to America's dollar, Hong Kong naturally imports American monetary policy," Lorenz points out. "As the Fed moved to zero-percent interest rates in 2007–08, the one-month Hong Kong interbank offered rate (Hibor) fell to 0.3% from 3.25%. Hibor-linked mortgage rates ignited an explosion in Hong Kong house prices, up by 139% since December 2008."

Moody's judges that Hong Kong's house prices are more expensive than they were at the previous housing-market peak, in 1997. Last week, a parking space at 55 Conduit Road in the very swell Mid-Levels district changed hands for HK$4.8 million ($620,000). News reports crowned it the most expensive parking spot on earth.

Not that the rise in condo prices has been unchecked. Perturbations in lending rates and weakness in Chinese business activity led to a 12.6% drop in prices between August 2015 and March 2016. A subsequent rise of 5.6% is attributed to a price war among mortgage lenders. While the HKMA restricts loan-to-values on bank-issued mortgages to 60% for properties worth less than HK$10 million (and to 50% for pricier residences), non-bank lenders are not so constrained. Dow Jones reports that developers and real-estate agencies are offering mortgages with loan-to-value ratios as high as 123%.

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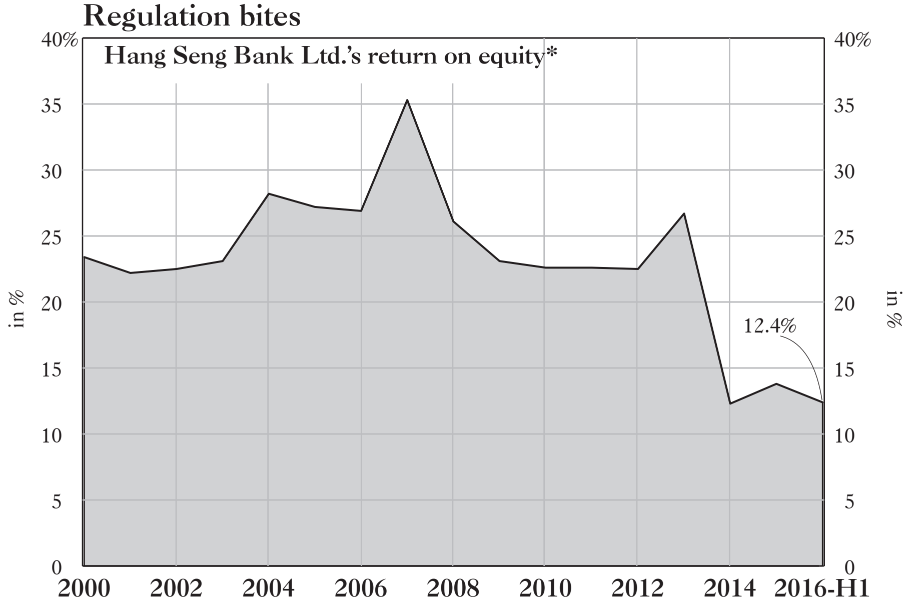
Hang Seng's property-related loans have grown by 69% since year-end 2008. The segment is still growing—it was up by 4.3% in the 12 months ended June 30—but it's a business that's increasing in risk and falling in return. Nor would a Federal Reserve rate hike next month do much to improve matters.

Regulation bites



*adj. for sale of Industrial Bank Co. Ltd in 2015
sources: The Bloomberg, company reports

"The tough macro and competitive environment is already weighing on Hang Seng's results," Lorenz relates. "In the two years to June 30, nonperforming loans as a percent of the total have doubled, to 0.56%. Excluding the sale of a stake in Industrial Bank Co. Ltd. in the first half of 2015, Hang Seng's net income dropped by 15% in the first half of 2016. Returns on equity have accordingly fallen, to 12.4% in January–June 2016 from 14.5% in the like period of 2015. Prior to 2014—fat years of real-estate lending growth—Hang Seng earned ROEs above 20%. At 196% of book value, the stock would seem to be priced for a return of those halcyon days. More likely, a slower China, a weaker renminbi and a more competitive and risky domestic-housing market will deliver disappointment."

Management is willing to concede that, owing to a tightening of the regulatory screws, a return to past profitability levels is unlikely. "I think it would be too aggressive for us to have a return-on-equity target above 20%," Hang Seng CFO Andrew Leung Wing Lok tells Lorenz. "Starting in 2015 the regulatory environment started to swing to additional buffers required by the Basel III, such as the conservation buffer and the counter-cyclical buffers. The introduction of those buffers demands more capital to support the same business. The return on equity will be reduced. We have not come to the end of the full implementation of Basel III."

There are other buffers to consider. Hang Seng's loan-loss reserve, which amounts to 0.26% of total loans, covers only 47% of nonperformers, well below the 74% coverage that, over the past decade, has been the Hang Seng norm. The last time the bank's coverage ratio dipped this low was in 2004. According to China International Capital Corp., Hang Seng's ratio of reserves to problem loans is the lowest among all Hong Kong banks.

"IAS 39," Lorenz relates, "is the accounting standard governing loan provisions for banks, such as Hang Seng, that comply with Basel III accounting standards. This standard requires banks to take impairment losses based on the occurrence of some final, indisputable loss event. Mere missed payments aren't enough to force a bank to increase reserves or charge-offs. A customer actually has to go to the wall—to file for bankruptcy protection or otherwise combust. In contrast, U.S. banks must look at expected future losses and a borrower's ability to repay. In other words, IAS 39 looks at incurred losses while the U.S. standard includes projected losses.

"Regulators have worried that the current Basel III standard allows banks to provision too little and too late," Lorenz continues. "In 2018, IAS 39 will be replaced with IFRS 9, which includes estimated future loan losses into loan provisioning. Under the new regime, a bank must estimate and set aside provisions for expected losses over the next 12 months. For loans deemed more risky, a bank must also come up with a projection of lifetime losses and provision accordingly.

"These rules will require Hang Seng to set aside more funds for nonperformers, although it is too early to say by how much," Lorenz winds up. "If problem loans did not grow, and Hang Seng merely returned to its customary 74% ratio of loss reserves to nonperformers, management would have to set aside an additional HK$1 billion in reserves, an amount equal to 5.3% of estimated 2016 pre-tax profits. If loan quality continued to deteriorate, Hang Seng would have to set aside even more reserves. If economic prospects in Hong Kong worsen, IFRS 9 might force the bank to top up its reserve provisions by way of preparation for visible future losses."

If the bear case holds water, Hang Seng will soon face rising credit costs, slower loan growth in Hong Kong, declining loan growth in the mainland and lower reported earnings per share.

Management appears fully cognizant of these difficulties. "In the medium and short term, an investor can't be over-optimistic about investing in Hong Kong because of the factors you mentioned," CFO Leung acknowledges. "But, over the longer period of time, the continued integration of the mainland and the Hong Kong economy will produce a lot of cross-border banking opportunities. In fact, you may know that a lot of Chinese customers faced with the renminbi devaluation are trying to divest a certain portion of their wealth outside of China. Hong Kong, being so close to mainland China, is a place they want to invest or a place they will buy investment products or other wealth-management products. That trend is not being reduced in the immediate future." Our guess is that the long-term opportunity will be available at a considerably cheaper share price.

Not that the short-seller's road is ever an easy one. In this case, he or she must weigh the risk (among many other risks) that HSBC could tender for the 37.9% of Hang Seng shares that it doesn't already own. You can see the appeal of such a maneuver. Hang Seng boasts a Tier 1 common-equity ratio of 16.8%, considerably more presentable than the parent's 13.9% common-equity Tier 1 ratio. Buying the rest of Hang Seng would give HSBC access to its subsidiary's excess (or at least optically excess) capital.

However, it is not entirely clear that HSBC has the funds with which to swing an outright Hang Seng purchase, even if it wanted to. For one, HSBC does not cover its dividend (projected to be $0.51 per share in 2016) out of earnings ($0.49), much less have the cash flow available to make large acquisitions. Second, HSBC's existing capital is marooned around the globe and not necessarily available to the holding company. Consider that, according to management, HSBC's North American operations has a Tier 1 capital ratio "north of 24%." It's capital that, for now, is essentially imprisoned in a U.S. subsidiary. Third, HSBC appears more interested in boosting its own share price than consolidating its holdings in Asia. Monday brought news that management has earmarked the proceeds from the sale of the bank's Brazilian operations to buying back HSBC shares.

On the Nov. 7 earnings call, analysts quizzed HSBC CEO Stuart Thomson Gulliver as to whether he would consider an acquisition. He replied that the bank will continue "buybacks subject to regulatory approval" and maintain the dividend. "[B]uilding the business and increasing loans and advances would be a pleasant [scenario] to think about," he continued. "I think the suggestion you made that we could make an acquisition is probably the least likely.

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Do you wonder why Hang Seng, not HSBC, is the stock to bet against? In the past 12 months, HSBC's insiders have sold a net 1.4 million shares for proceeds of £6.5 million, whereas there have been no reported open-market buys or sells at Hang Seng. (We can find no short-interest data on either bank.)

Hang Seng, however, we judge, holds the bearish edge. At 196% of book value, it's priced for something close to perfection. HSBC, trading at 81% of book value, is not. Hang Seng is a pure play on the problems in the People's Republic and Hong Kong. HSBC is not: In the nine months ending Sept. 30, Asia contributed only 46% of HSBC's revenue.

Admittedly, the People's Republic is taking its sweet time in succumbing to the contradictions of Marxist management overlaid on an unprecedented binge of lending and borrowing. Bears on Hang Seng may find that it's worth the wait.

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