Singapore Banking Sector

Challenges to Loans and Net Interest Income Growth

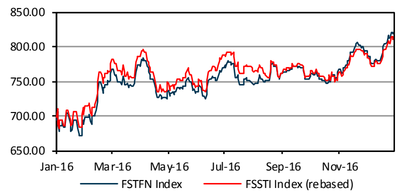
16 January 2017

UNDERWEIGHT

INDEX PERFORMANCE (%)

	1 MTH	3 MTH	1 YR
FSTFN RETURN	2.5	9.2	18.0
STI RETURN	2.6	8.3	16.5

FSTFN VS. STI



Source: Bloomberg

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SINGAPORE | BANKING | UPDATE

- Singapore banks' high Loan-To-Deposit Ratio amid credit cycle contraction indicates performance has peaked and are entering a phase of low net interest income growth.
- Rising non-performing loans amid weak net interest income growth implies weaker ability to set aside provisions to increase coverage ratio.
- Debt overhang adds headwind to loans growth while rising interest rates lowers credit quality.
- Expectations of a strengthening USD weakens demand for USD loans by Asian borrowers.

Banks' net interest income entering low growth phase.

The Singapore banks' Asian markets are in a credit cycle contraction and Singapore banks have less ability to stretch the already high Loan-To-Deposit Ratios (LDR) further to boost net interest income growth. In this situation, ***a rising interest rate would likely worsen performance rather than improve it***. We expound the following two key risks to a muted net interest income growth:

a) **Expectation of higher deposit rates amid impending US Fed rate hikes and intensified competition.** Higher interest rates would make depositors more sensitive to deposit rates relative to other aspects of banking services. We opine that the Singapore banks' LDRs are still trending on a high side therefore they have less bandwidth to lose deposits faster than loans. We expect periodically intense price competition for deposits if LDRs remain elevated. Therefore deposit rates should have more upward bias relative to loan rates, and negatively impact net interest income.

b) **Deleveraging as loans shrink and deposit rise.** As interest rates increase, demand for credit could fall further and deposits rise as rates become more attractive. The Singapore banks' LDRs have a stronger downside bias due to the fact that it is now on the high side. A falling LDR would further weigh against net interest income growth while rising interest rates would add a double whammy wherein non-performing loans (NPLs) growth accelerates.

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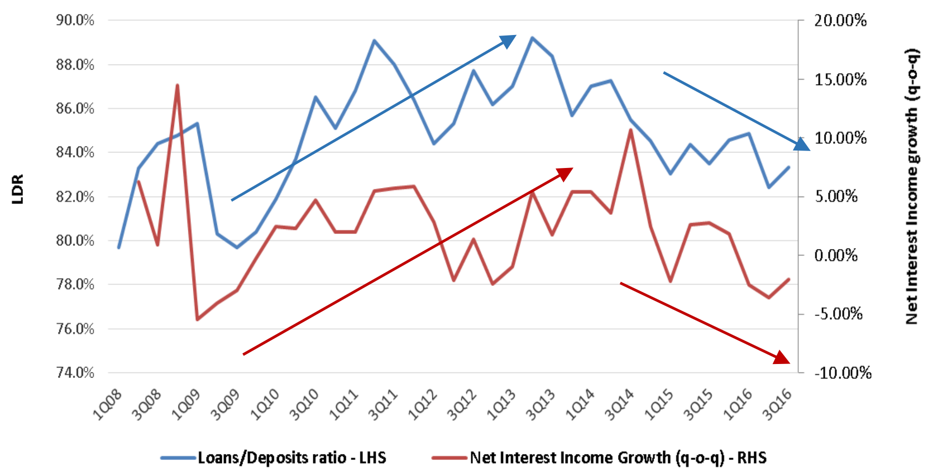
OCBC: Lowest LDR among the local banks as at 3Q16; but waiting to strike

OCBC's LDR improved to 83% in 3Q16 after it hit a high of above 88% in 2Q13. Despite having relatively more room to leverage, we expect OCBC to conservatively manage its loan and deposit volume/rates dynamics to maintain LDR at c80%. We expect OCBC's defensive stance to result in weak net interest income growth in 2017 but ***the defensive strategy is in line with a contracting credit cycle.***

Figure 1: OCBC's Net Interest Income q-o-q growth and LDR

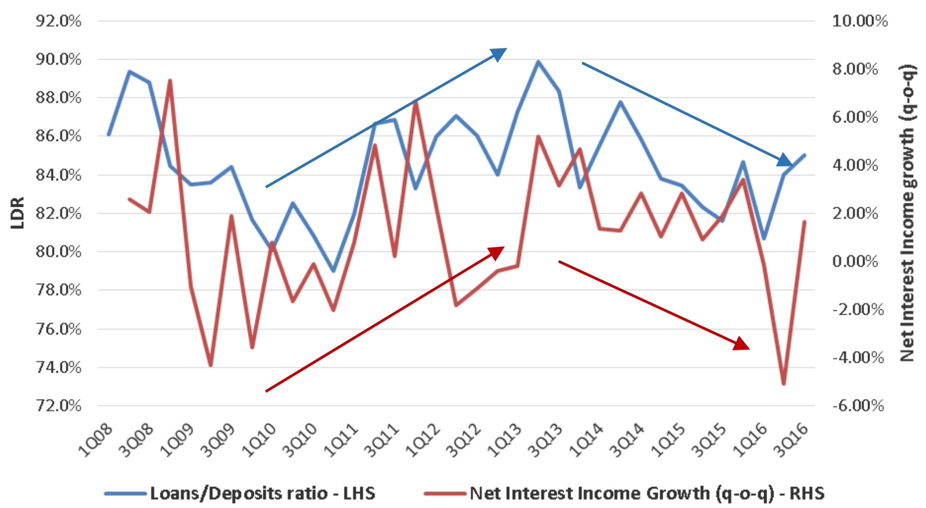


Source: Company, PSR

UOB: Lending aggressively to riskier borrowers to support net interest income growth

In our previous UOB 3Q16 earnings report, we indicate that UOB was willing to accept higher yields from riskier loans. UOB has the highest average All Currency Liquidity Coverage Ratio (LCR) of 148% by 3Q16 (OCBC: 133% and DBS: 115%). Minimum All Currency LCR required by regulation will be 80% by 2017. As of 3Q16, UOB also have a coverage ratio of 111%, above DBS' 100% and OCBC 101% (See Figure 6). With higher LCR and coverage ratio compared to peers, we suspect UOB is attempting to manage an optimal balance between higher yields from riskier loans and a high LDR c.85% to keep net interest income growth positive. ***But the corollary would be the resulting net interest income growth is able to feed the higher provisions needed for the riskier loans.***

Figure 2: UOB's Net Interest Income q-o-q growth and LDR

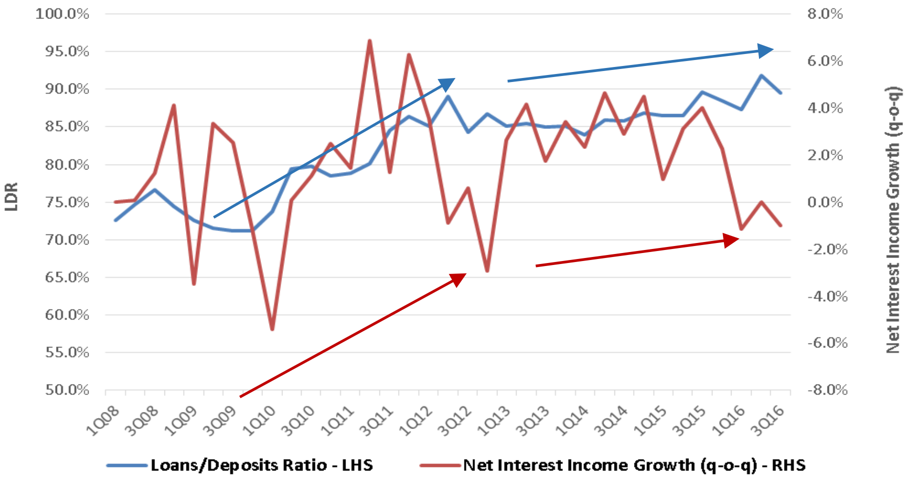


Source: PSR, company

DBS: Highest LDR among the banks; likely to seek growth from acquisitions

DBS had pushed its LDR up aggressively since 2010 and it is at 89.5% as of 3Q16, the highest amongst the Singapore banks. We believe DBS' aggressiveness to drive up performance by maintaining high LDR could leave it more vulnerable to liquidity risks and less bandwidth to manage a stable net interest income growth. However, we can expect some support from DBS' acquisition of ANZ's wealth management and retail banking business in Singapore, Hong Kong, China, Taiwan and Indonesia. The acquisition provides DBS access to additional S$11bn worth of customer loans, representing 3.74% of DBS' customer loans and S$17bn worth of customer deposits, representing 5.24% of DBS' customer deposits. The acquisition is slated for progressive completion from 2Q17 to early 2018. We also expect ***DBS' acquisitive trail to continue in order to bolt on more deposits and loans to grow net interest income if they decide to defy the credit cycle contraction in their Asian markets***.

Figure 3: DBS' Net Interest Income q-o-q growth and LDR

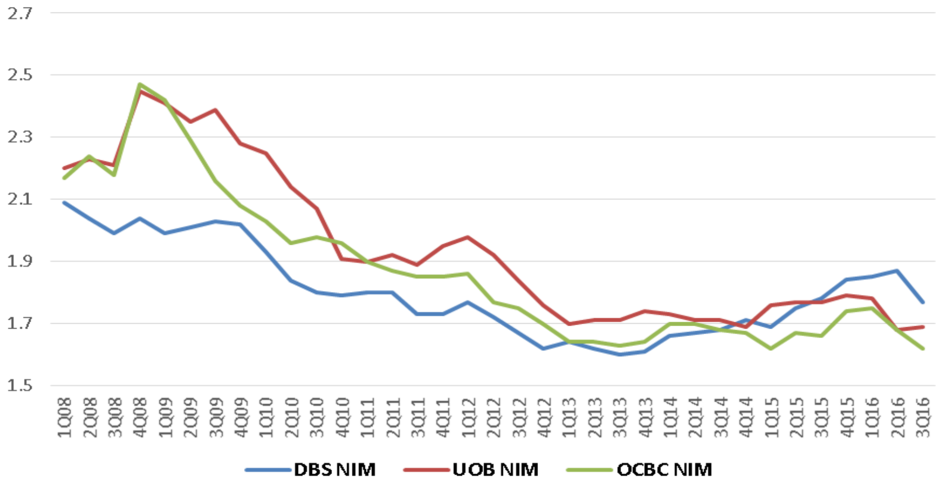


Source: PSR, company

NIM expansion could be crimped by faster rising cost of funds

We think that stiffer competition for deposits would result in deposit rates rising faster and narrow the spread between the loan rates and deposit rates. So we do not expect NIMs to expand at the pace interest rates are rising in 2017.

Figure 4: Singapore Banks' NIMs (%)

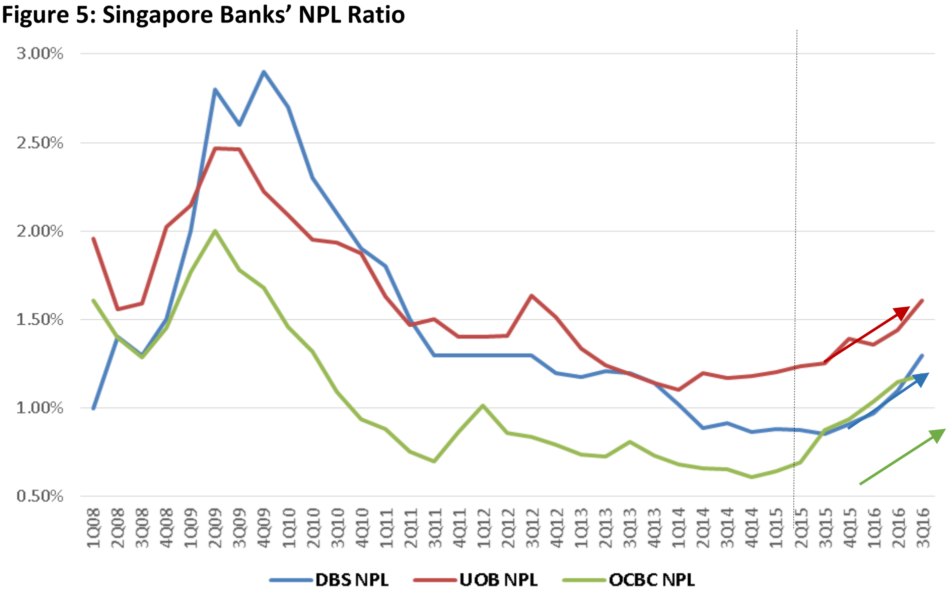


Source: PSR, company

Rising non-performing loans amid weak net interest income growth

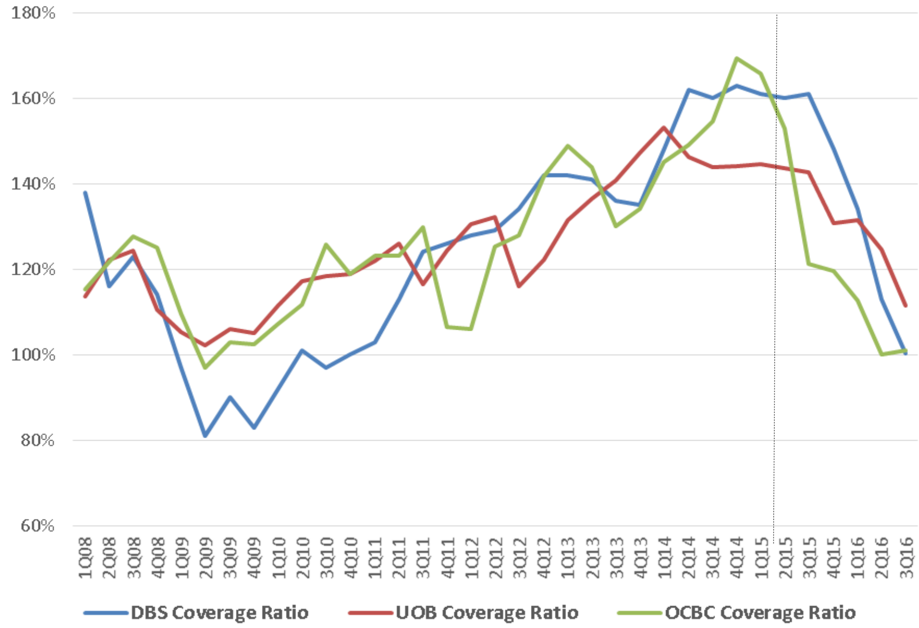
We expect the rising interest rates amid credit cycle contraction to accelerate the formation of NPLs for the Singapore banks. However***, with limited room to drive up net interest income growth, we suspect the banks would likely trim provisions lest it affects their overall profit performance and allow the coverage ratio to decline. We opine that low net interest income growth not only affects banks' performance but also affects their ability to rebuild the coverage ratio.*** Figure 5 show NPLs began to rise by 1Q15 and Figure 6 shows banks' coverage against NPLs began to decline by 1Q15.

Figure 5: Singapore Banks' NPL Ratio



Source: PSR, company

Figure 6: Singapore Banks' Coverage Ratio



Source: PSR, company

Low LDR prepares banks to perform better when interest rates increase

Large US and European multinational banks have eschewed growing loans faster than deposits during the extensive low interest rates environment and today their LDRs average 74% (See Figure 7). In comparison, Singapore banks' LDRs have risen to an average of 86%. We believe it is strategic for banks to maintain low LDRs during periods of low interest rates so they may have headroom to expand it when interest rates increase. Essentially, banks could actively expand their LDRs by cutting high cost deposits faster than loans to counter the downside bias on LDR as the credit cycle contracts. In this situation, an expanding LDR would boost net interest growth by maintaining a lower volume of deposits relative to loans while keeping loans that can accept a pass-through of higher interest rates. The boost in net interest income growth also helps banks increase their provisions against rising NPLs.

We opine that the Singapore banks have expanded their LDRs too early to boost performance when interest rates were low. As a result, the Singapore banks have less bandwidth to cut high cost deposits faster than loans. More downside bias to LDR would further reduce net interest income growth and crimp the ability for the banks to set aside more provisions just as NPLs are rising. We expect a challenging operating environment for the Singapore banks ahead.

Figure 7: Multinational Banks Comparison Table

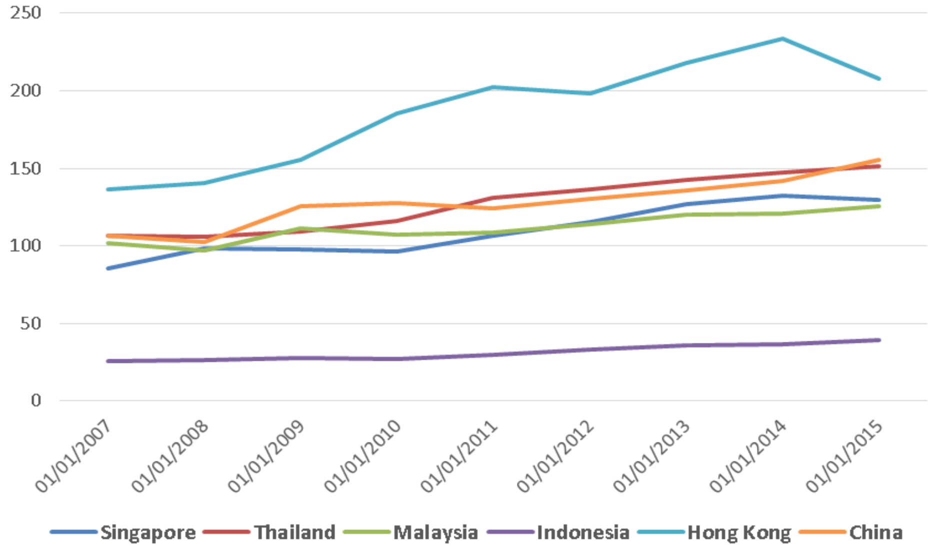
Multinational Banks	Ticker	Country	NIM (%)	Total Loans to Total Deposits (%)	NPL to Total Loans (%)	Market Cap (bn)
U.S. Bancorp	USB US Equity	USA	3.10	82.75	0.45	US$88.45
The Bank of Nova Scotia	BNS CN Equity	Canada	1.71	79.23	1.11	C$92.86
Deutsche Bank AG	DBK GY Equity	Germany	1.61	76.33	1.88	€ 23.80
Canadian Imperial Bank of Commerc	CM CN Equity	Canada	2.09	78.13	0.54	C$44.47
Wells Fargo & Company	WFC US Equity	USA	2.90	77.51	1.22	US$286.97
Bank of Montreal	BMO CN Equity	Canada	1.77	76.19	0.65	C$62.12
Bank of America	BAC US Equity	USA	2.28	74.26	1.03	US$233.33
UBS Group AG	UBSG VX Equity	Switzerland	0.94	74.22	0.52	CHF64.88
Citigroup Inc.	C US Equity	USA	2.86	71.74	0.81	US$171.1
Royal Bank of Canada	RY CN Equity	Canada	1.77	69.15	0.75	C$101.79
Toronto-Dominion Bank	TD CN Equity	Canada	2.01	69.08	0.60	C$122.14
HSBC Holdings PLC	HSBA LN Equity	UK	1.61	68.63	2.54	£129.64
JPMorgan Chase & Co.	JPM US Equity	USA	2.17	64.53	0.77	US$305.91
Standard Chartered PLC	STAN LN Equity	UK	1.73	74.32	4.83	£21.44
Simple Average			**2.04**	**74.00**	**1.26**	

Source: Bloomberg

Debt overhang adds headwind to loans growth while rising interest rates reduces credit quality.

Singapore banks' major markets in Asia have rising private sector debt levels against GDP and the private sector debt levels are more than 100% of GDP. ***As growth of debt outpaces the growth of GDP, debt loses its effectiveness to drive returns on the assets it finances***. In this situation, interest rate increase will make debt servicing ability more vulnerable and loans' quality is at risk of deteriorating. ***The high debt level relative to GDP creates an overhang that limits further loans growth because it narrows the pool of quality loans for the banks***. Singapore banks' major markets: Malaysia, Thailand, Hong Kong, China and Singapore have a high levels of *Domestic Credit to Private Sector as a percentage to GDP* and rising (See Figure 8).

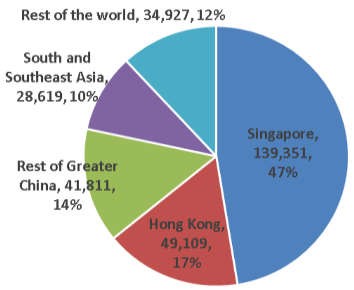
Figure 8: Domestic Credit to Private Sector (% to GDP)



Source: Bloomberg, PSR

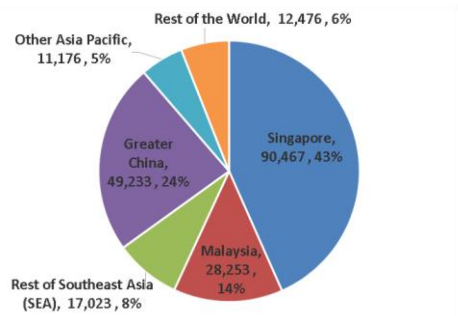
As of 3Q16, DBS' customer loans from Singapore, Hong Kong and Rest of Greater China make up 78% of the total customer loans. OCBC's customer loans from Singapore, Malaysia and Greater China make up 81% of the total customer loans. UOB's customer loans from Singapore, Malaysia, Thailand and Greater China make up 85% of the total customer loans.

Figure 9a: 3Q16 DBS Loans by Geography



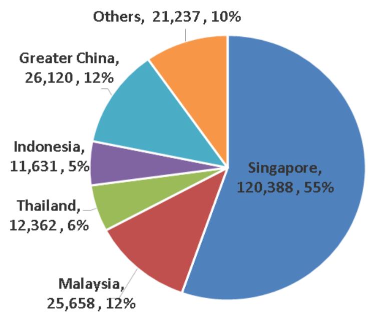
Source: PSR, company

Figure 9b: 3Q16 OCBC Loans by Geography



Source: PSR, company

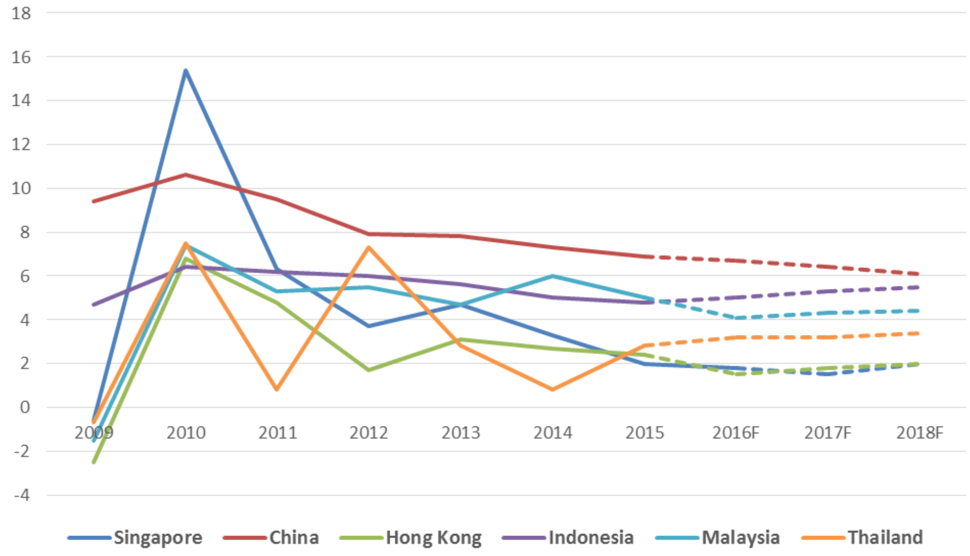
Figure 9c: 3Q16 UOB Loans by Geography



Source: PSR, company

Flattish GDP growth forecast in Singapore banks' major markets does not support the high private sector debt to GDP levels (See Figure 10).

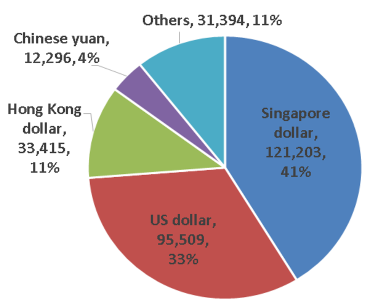
Figure 10: Real GDP Indicator y-o-y growth (%)



Source: Bloomberg, PSR

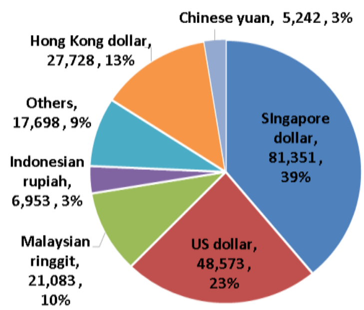
Expectations of a strengthening USD weakens demand for USD loans by Asian borrowers. USD loans are the 2nd largest component in each of the Singapore banks' customer loans. The USD being a global currency is a critical medium for Singapore banks to provide loans to regional borrowers. A strengthening USD makes USD dollar loans more risky for borrowers from Asia. Figure 12 shows the relationship between the USD strength and USD loan growth for the Singapore banks. 4Q15 and 1Q16 periods experienced a volatile USD amid uncertainty over the number of Fed funds rate hike in 2016. 2Q16 and 3Q16 periods experienced a relatively stable USD as expectation for a Fed funds rate hike was pushed to September 2016. Presently, USD is strengthening after the December 2016 Fed funds rate hike and expectation for it to strenghthen further thoughout 2017 remains high. We expect the Singapore banks' USD loans growth to be negatively affected in 2017 as Asian borrowers cut USD borrowing and the loss of USD loans would offset the benefits of earning interest from USD loans.

Figure 11a: 3Q16 DBS Loans by Currency



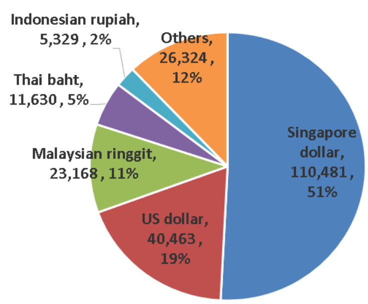
Source: PSR, company

Figure 11b: 3Q16 OCBC Loans by Currency



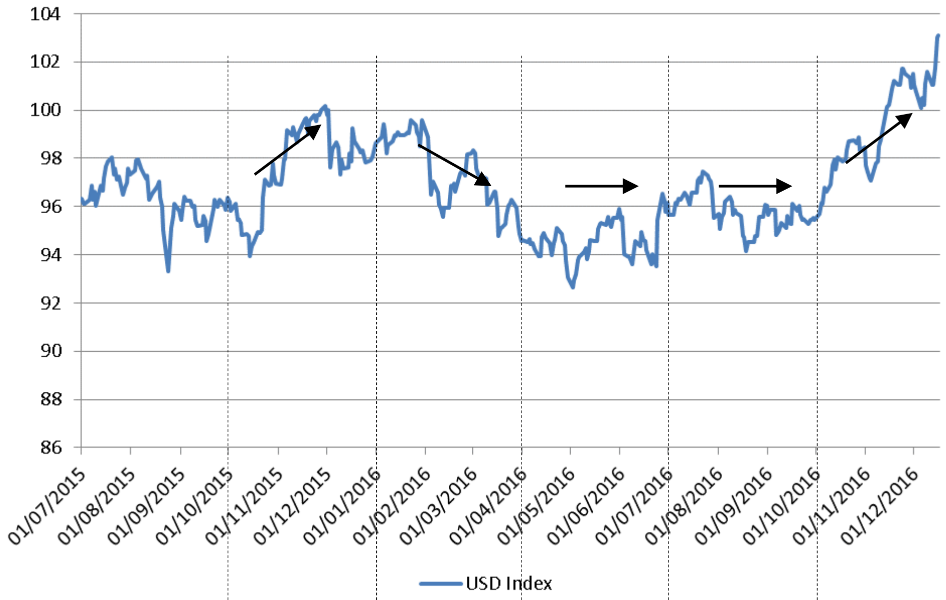
Source: PSR, company

Figure 11c: 3Q16 UOB Loans by Currency

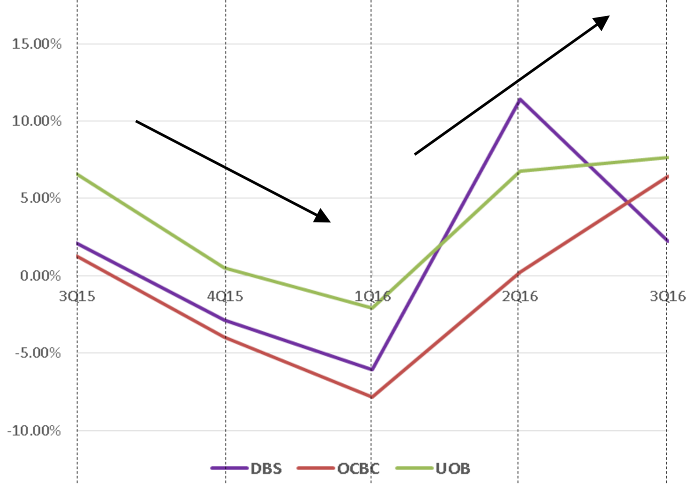


Source: PSR, company

Figure 12: USD Index vs Singapore Banks' USD loans q-o-q growth



Source: Bloomberg, PSR



Source: Bloomberg, PSR

Investment Actions

UNDERWEIGHT on Singapore Banking Sector – We argue that a low LDR is more strategic for banks during periods of low interest rate so that they may leverage on an expanding LDR to manage net interest income growth as the credit cycle contracts. We believe that the Singapore banks' LDR are on the high side and are in a weaker position to operate optimally during the credit cycle contraction. Our argument is reinforced by the fact that European and US banks now have a comparably lower LDR than Singapore banks.

Owing to the operating headwinds we presented in this report, we Underweight the Singapore Banking Sector. We maintained our Reduce rating on UOB and Neutral ratings on DBS and OCBC.

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