Transcript of Analyst Briefing for 2022 Interim Results

Question and answer session of analyst briefing

Jemmy Huang from JP Morgan: Congratulations on the strong results. My first question is on the margin outlook, specifically, will the margin expansion be bigger in the second half as market interest rates have increased much faster since the third quarter. In addition, what will be the swap impact in the second half. My second question is on fee income outlook. Your net fee income dropped sequentially in the second quarter whereas wealth business showed bigger decline, but some fee income businesses already saw rebound, what is the outlook for fee income?

Chief Financial Officer Liu Chenggang: Since 2022, driven by US dollar interest rate hikes, Hong Kong dollar interest rates also were on the rise despite some delay. In the first half, our adjusted net interest income grew 8.7% year-on-year. Our net interest margin (NIM) widened both on year-on-year and half-on-half bases. Second quarter NIM increased by 11 basis points quarter-on-quarter. The NIM improvement was due to three reasons. First, we secured steady deposit and loan growth of 3.0% and 5.1% respectively in the first half, continuing to outperform the market. Affected by the interest rate hikes, though time deposit migration occurred and drove down our CASA ratio, the magnitude of the fall was in line with the market, and our CASA ratio remained at a level of 62%. Second, our asset returns were higher with improvement seen both in customer loan and bond investment yields. Third, we dynamically managed funding cost, by duly extending the tenors of liabilities in the early stage of interest hike cycle. Our Hong Kong dollar composite rate remained better than the market average level. Last Friday, the Federal Reserve Chairman gave out hawkish signals which induced higher interest rate rise expectation. Under Hong Kong's Linked Exchange Rate System, Hong Kong dollar aggregate balance in the interbank market continued to shrink while Hong Kong dollar interest rate rose. In the second half, we will continue to monitor the changes in the market environment and adhere to our asset and liability management principles targeting business stability and income growth while optimising KPIs and controlling risk to cope with opportunities and challenges stemming from interest rate hikes. Regarding liability management, we will continue to stabilise CASA deposit base and increase personal deposit mix. On the asset side, we will dynamically manage the mix, and enhance bond investment yield while ensuring liquidity, and maintaining steady loan base. We will ensure that our loan pricing can reasonably reflect market conditions and interest rate hike expectation. Multiple measures will be taken to ensure steady growth of net interest income and NIM.

Regarding the impact of foreign currency swap, our reported NIM was 0.99% in the first half, and the adjusted NIM was 1.13%. As we operate in a multi-currency market, aside from Hong Kong dollar business, we are also a Renminbi clearing bank while having a substantial position in the US dollar. Therefore, we need to manage the liquidity across different currencies, and align currency and tenor mixes. By using foreign currency swap, we can redeploy excess funds in certain currency into other types of currency which have broader uses. In the first half, we generated swap income through swapping among Renminbi, Hong Kong dollar, US dollar and Japanese yen, which led to a higher adjusted NIM compared with the reported NIM. Since we had a stronger growth in swap income compared with the same period of last year, it explains why there is a bigger gap between the two. As swap income and net interest income are booked in different lines in our profit and loss statement, therefore, when we analyse swap income movements, we shall always look at these two lines together. Since the income generated from the Hong Kong dollar/US dollar - Japanese yen swap has become smaller, in the second half we will increase the deployment of the original currency types, and expand loan-to-deposit spread, which means the swap income could be reduced. Overall speaking, our NIM trend is determined by a number of factors such as market interest rate trends, adjustment of prime rate, loan and deposit pricings, as well as the changes in our asset and liability mix.

In the first half, banks in Hong Kong were facing severe challenges in their fee income businesses, which came from two areas. First, both equity and bond markets were under tremendous pressure. Second, certain bank branches suspended services during the pandemic which reduced the wealth product sales via face-to-face client interaction. During the period, the average daily turnover of Hong Kong stock market decreased by 26.5% year-on-year, and the retail sales value also dropped. Facing this challenging market environment, we continued to consolidate our foundations by enhancing segmentation of wealth customers and optimising our customer base. We leveraged our online and offline channel advantages by developing Insurance Online and Investment Online platforms. Capitalising on the opportunities from Cross-boundary Wealth Management Connect and RMB businesses, we satisfied the diverse customer needs for investment and wealth management services. At the same time, we enhanced our integrated service capability and vigorously expanded bond underwriting, and trust and custody services. By business types, income from investment and insurance related businesses fell by 34% year-on-year, and loan commissions and income from non-credit traditional business decreased slightly by 1.3% and 3.2%, respectively. Net fee income showed signs of recovery in the second quarter as we took advantage of an easing pandemic situation and relaxation of social distancing rules, and stepped up business expansion, with fee income from card business, bills commissions, payment, trust and custody services, currency exchange broadly rebounding, while insurance fee income strongly grew by 20%. In the second half, given the sluggish investment market and weak market demand for borrowing, we continue to see headwind in our fee income growth. We will continue to enhance our integrated financial service capability and expand sources of fee income, striving to narrow the magnitude of year-on-year decline of net fee income and outperform the market.

Gary Lam from HSBC: Congratulations on your good results, which showed the fastest earnings growth since the first half of 2018. My questions are, first, what was your NIM level for June and July? As Hong Kong dollar interest rates are rising rapidly, will you lock in swap income which help to expand your NIM even faster? Second, you reported a decrease in stage 2 loans and provisions during the period, will your asset quality pressure be reduced in the second half?

Chief Financial Officer Liu Chenggang: Generally speaking, bank's NIMs will steadily improve during interest rate hike cycle. Our NIM has improved in the first half on a year-on-year basis and in the second quarter on quarter-on-quarter basis, and the improvement was seen in the monthly trend as well. Our adjusted NIM for June was 1.22%, higher than the average level in the first half. With Hong Kong dollar and US dollar interest rates rising, we believe the NIM expansion is still sustainable. As to our foreign currency swap business, it is used to resolve the currency mismatch issue in our asset deployment. Specifically, we swap the excess funding in one type of currency with another type of currency for asset deployment. The durations of the swap instrument and the investment portfolio are matched while our foreign currency swap duration is managed below one year. Therefore, the impact on our profit and loss statement will also be reflected within one year. As Hong Kong dollar and US dollar interest rates are rising, we will reduce the size of our foreign currency swap business, and focus on the business development of the original currency type, which means the swap related earnings impact on our profit and loss will also be smaller.

Chief Risk Officer Jiang Xin: During the first half, our stage 1 and stage 3 provision charges increased respectively while the stage 2 provision charges dropped, with annualsed credit cost up 6 basis points to 0.21%. The increase in stage 1 provisions was mainly for two reasons. First, we downgraded the ECL parameters in the first quarter to reflect a deterioration of macro-economic outlook and second, our loan grew rapidly in the period. We also increased the stage 3 provision charges in response to the credit rating downgrading of customers including certain Mainland property customers, and certain Southeast Asian customers as a result of cancellation of relief measures in their countries. As of end of June, our total impairment allowance accounted for 0.67% of our total customer loans, remaining sufficient. Our non-performing loan (NPL) ratio was 0.46%, up 19 basis points from the end of last year. Such increase was due to the aforementioned credit rating downgrades of Mainland property customers and Southeast Asian customers to non-performing. Overall speaking, we do not see any systemic risk in our loan portfolio, and our asset quality risk remains manageable while we are confident to maintain NPL ratio at a better level compared with the market average.

Gurpreet Singh from Goldman Sachs: Thank you for your detailed disclosure of Chinese commercial real-estate (CRE) loans. My question is within the HK$102.9 billion loan exposure to Chinese CRE sector, how much of them were non-performing and special-mentioned category respectively? Also, did your July NIM increase, and can you share with us the specific number?

Chief Risk Officer Jiang Xin: We always attach great importance to the asset quality of our Mainland property customers, and have been adopting a business principle of prudent assessment, strict control and only dealing with the best developers. The majority of our property customers are leading real estate enterprises based in the Greater Bay Area (GBA), and tier-1 and tier-2 coastal cities with a nationwide presence and relatively stable financial health. As at the end of June, our total loans to Chinese CRE developers was HK$102.9 billion, down 2.7% from the end of last year, accounting for 6.12% of the group's customer loans. Specifically, 78% of them were SOE loans and 22% were private enterprise loans. Based on the definition of "three red lines", green-line loans accounted for 81%, yellow-line loans were 19%, and investment-grade customer loans were 71%. In response to the volatile situation of the Mainland property sector, during the first half, we duly reviewed the credit rating and loan classification of their loans, and continuously increased provisions. Of those loans, non-performing portion was amounted to HK$3.6 billion while special mentioned loans were HK$820 million, which accounted for a limited portion of the relevant loan exposure.

Chief Financial Officer Liu Chenggang: As to our NIM performance, on one hand, the market interest rates in particular Hong Kong dollar interest rates, have been rising since June. At the same time, our sensitivity to Hong Kong dollar interest rate was positive as reported in our last annual report. Therefore, an increase in Hong Kong dollar interest rate will be positive to us. On the other hand, our NIM in the first half improved on both year-on-year and half-on-half bases, and therefore as long as the market interest rates continue the uptrend, our NIM will be more likely to expand. As explained earlier, NIM changes are subject to the impact of many factors, including tenor mixes, asset-liability structure, deposit pricing, prime-based asset and liability structure. We will proactively manage our asset and liability and strive to increase our NIM and net interest income.

Tian Yafei from Citigroup: BOCHK has been using interest rate swap (IRS) to manage its bond investment risk. Looking into the second half, how much income will be generated from the IRS? What is the duration of the IRS? In addition, what was the reason for the loan growth moderation in the second quarter and what sorts of loan growth drivers will we see in the second half?

Chief Financial Officer Liu Chenggang: As at the end of June, our total bond investments exceeded HK$1 trillion. In the first half, we took advantage of the opportunities from the interest rate rise, and optimised our debt securities investment portfolio to increase investment income. During the period, adjusted for swap impact, the investment yield of our debt securities portfolio increased by 38 basis points year-on-year to 1.72%. Interest rate rise has various impact on banking operations, including the valuation risk on debt securities investment portfolio, and improvement on reinvestment return, therefore we need to strike a balance between risk and return. To address the debt securities investment valuation risk, since the last fourth quarter we started adopting various measures including downsizing bond investment scale, enhancing banking book structure, adjusting the proportions of debt securities investment across different accounting classifications. Specifically, we moderately reduced the size of FVOCI bonds, and utilised IRS for hedging purposes, so as to reduce the bond investment risk. It was proven effective as we achieved good performance in operating income, net interest income and other income. At the same time our capital ratios were higher. Since the expectation of interest hike impact has largely been reflected in the current market interest rates, IRS income is expected to decrease in the second half.

As to loan growth, thanks to our integrated and regional operating model, we witnessed balanced loan growth across Hong Kong, GBA, Southeast Asia and other overseas markets. In the first half, our customer loans grew by HK$82 billion or 5.1%, outperforming the market and expanding our local market share to 14.80% . New growth mainly came from large and high-quality corporate customers who have strong ability to withstand risk, and also from mortgages. Asset quality remained sound. Despite the challenging economic environment, we remain optimistic on the second half. This is based on the fact that Mainland China's economic growth is expected to recover, while the pandemic situation in Hong Kong is largely under control, and series of measures adopted by the HKSAR Government will support the local economy. At the same time, we will capture the opportunities from Regional Comprehensive Economic Partnership (RCEP), the GBA, and the

Northern Metropolis of Hong Kong, as well as those from Renminbi and green economy businesses. Also, we will strengthen our risk control and stabilise business growth bottom line. Considering the loan growth pace in the first half, and the external environment in the second half, we expect the full year loan growth will be mid-single digit while continuing to outperform the market.

Hou Dekai from CICC: Given a relatively high CET1 capital ratio, BOCHK has maintained its interim dividend payout unchanged, will you consider increasing dividend in the second half? In addition, your NPL provision coverage ratio dropped in the first half, given the continuous Mainland property credit risk issues, do you think your provision charges are enough?

Chief Financial Officer Liu Chenggang: For a long time, we attached great importance to stable long-term dividend returns. It is our long-term practice to distribute a fixed amount of interim dividend. For this year, our interim dividend per share remains HK$0.447, which is the same as the previous year. In the first half, despite a challenging and complicated external environment, we achieved market outperformance in core business and solid growth in earnings and profit. Meanwhile, we prudently managed risk weighted assets which moderately decreased and achieved capital return enhancement. As of end of June, our total capital ratio was 21.88%. Amid a volatile financial market, we continued to maintain our capital at a sufficient level and effectively increased our capability to withstand risk. In the future, we will continue to enhance our capital management and earnings growth, which is expected to help increase our capital position and maintain it at a sufficient level, therefore providing assurance for us to provide a steady shareholder return. BOCHK has always been adopting a prudent dividend policy. For the full year of 2022, the dividend payout ratio will remain between 40% to 60%. We will strive to increase shareholder returns and sensibly determine full year dividend payout after balancing shareholders' expectations, regulatory advice, changes in the external operating environment, our profitability and long-term development.

Chief Risk Officer Jiang Xin: As of end of June, our total impairment allowances were HK$11.235 billion, up 13.7% from the end of the previous year. Overall NPL provision coverage ratio was 144%, down by 85 percentage points, mainly due to that part of the new NPL was collateralised. When making provisions, we will conduct comprehensive assessment of the collateral value pledged under the NPL, and the reliable cash flow support under different scenarios. And for the portion of loans without collateral, we will make full provisions against them, so as to ensure sufficient provision. As of end of June, the impairment allowances of our Chinese CRE loans was 2.3% of the total relevant loans, which was higher than the 0.67% of the Group. In the next stage, we will continue to closely monitor the changes in the Mainland property sector, and assess the changes of asset quality and the operating conditions of our customers, ensuring that their credit rating is adjusted on a real-time basis. We will also reevaluate our provisioning policies and ensure provision charges are enough.

Sam Wong from Jefferies: Based on the current macroeconomic condition, what is the outlook of credit cost? Also, given the current income recovery, how should we think about operating expense growth for this year?

Chief Risk Officer Jiang Xin: As to the credit cost, we can take an integrated view on both the NPL trends and factors that affect provisioning. Regarding the asset quality in the second half, as the banking environment will remain highly complicated, we will uphold our risk bottom line and keep close attention on the changes in customers' financial status and operating conditions. We expect our NPL ratio to remain in a controllable range and at a level that is better than the market average. As to our provisions, we will duly adjust ECL model parameters according to our stringent assessment of the macroeconomic changes, and ensure our provision charge is prudently made and sufficient. For the full year, our credit cost should see some growth year-on-year but overall risk remains manageable.

Chief Financial Officer Liu Chenggang: In the first half, our operating expenses rose by 3.2% year-on-year to HK$7.826 billion, and with faster income growth, our cost-to-income ratio improved by 1.53 percentage points to 28.74%, continuing to lead in the local market. During the period, we continued to promote business flow revamp and low-carbon operations, so as to optimise operational efficiency. Our staff costs increased by 4.9% year-on-year, while premises and equipment expenses, and depreciation and amortisation grew modestly.

For the full year, we will continue to increase investments in key areas of development such as IT, while driving transformation and integration of branch outlets, advancing optimisation projects through the use of e-statements, and development of paperless operations and intelligent operations. We will explore room for cost reduction and optimisation, and enhance the input and output efficiency. We expect to improve our cost-to-income ratio for 2022 compared with the previous year. In the long-run, we will keep our cost-to-income ratio at a better level among the peers, and strive to maintain it below 35% in the long term.