Edited transcript of DBS second-quarter 2022 results conference call for buy and sell sides, 4 August 2022

Yeoh Hong Nam Good morning everyone, and welcome to the briefing.

Nicholas Teh (Credit Suisse) I have three questions. Firstly, with income expected to grow strongly in the second half while the macro backdrop remains uncertain, would you look to further build up GP buffers? Secondly, did you say you expect the cost-income ratio to go below 40% by year-end? Finally, could you share more details on your exposure to private real estate companies in China?

Piyush Gupta We are unlikely to further build up general allowance reserves. In fact, we have been releasing GP as exposures move to SP, because roughly half of the SP amount is typically built up in GP by the time exposures move to SP. There is also a substantial cushion in our GP because we plan to maintain our $1.8 billion GP overlay, which is still intact. This is unlike a lot of banks who reversed theirs late last year and early this year.

The cost-income ratio is driven by income, so it could reach 40% at the end of the year. Expenses will also increase somewhat to invest in further technology and technology resources, but aided by the large increase in NII, it is likely we will be able to get to a year-end cost-income ratio of 40% or below.

There are just over $2 billion of loans to privately-owned companies in the China real estate book. The exposure is to a half dozen companies, diversified across specific projects and general corporate loans.

Nick Lord (Morgan Stanley) Just to clarify on the cost-income ratio, you are saying that you expect to be below 40% at year-end and that this is not for the second half or the full year.

Piyush Gupta Yes, that is correct.

Nick Lord Given the potential for fees to recover in 2023 and for margins to continue going up, does that imply that the cost-income ratio could be below 40% in 2023, or will you further increase investments?

Piyush Gupta I think we could hold the cost-income ratio below 40% through next year. And if our predictions are right, there will still be room for the investments I want to make. I don't have a specific number on how low the cost-income ratio can go, but sub-40% is achievable next year.

Chng Sok Hui It depends very much on interest rates. If they go up initially and then the Fed cuts rates sooner than expected, we would have to revisit the forecast.

Harsh Mohdi (JP Morgan) On China real estate, could you give a bit more detail on the POE exposure that you said is slightly above $2 billion?

Piyush Gupta Our exposure is to top developers, and so far we're not seeing any problems with their projects. We're also not seeing any stress from a liquidity standpoint – they have enough cash flow and liquidity, and almost no refinancing needs over the next couple of years. But we have pre-emptively put the whole sector at the first level of our watchlist, meaning that we are monitoring it closely. There was also an NPL with some allowances in the second quarter, but it wasn't very big.

Harsh Mohdi The CET-1 ratio is at 14.2%, and with margins expected to expand significantly over the coming quarters, the amount of capital you are accreting is considerable. Are you still targeting a CET-1 ratio between 12.5% and 13.5% or would you prefer to keep a buffer above 13.5% for a period of time?

Piyush Gupta The CET-1 ratio has been between 13.5% and 14% recently, which is an adequate cushion above the guided range. Our assessment of the portfolio is that we don't need a larger capital buffer, as portfolio quality is benign and general allowance reserves are high enough that we're unlikely to have to dip into capital. So you're right – we'll be sitting on a lot of capital and we will have to think how to return it in an efficient way. It's something we will look at, perhaps towards the end of the year.

Harsh Mohdi Given the macro environment, do you think that regulators would be comfortable approving buybacks?

Piyush Gupta It's not just the capital accretion we discussed. The Basel IV rules that will take effect in early 2024 are advantageous to a bank like us. We expect the CET-1 ratio to rise between one and two percentage points during the transition period from 2024 to 2029. So while we have not discussed returning capital to investors with the regulators, I don't see them having concerns about allowing us to find efficient ways to do it.

Harsh Mohdi My final question is how we should think about allowances in 2023 and 2024. Will they be closer to the long-term rate, or would you keep adding GP simply because of the tougher operating environment even if you're not seeing much SP?

Piyush Gupta We have revised our SP guidance to 18-20 basis points of loans from 20-25 basis points. That reflects a substantial improvement in our credit processes. This year, SP were 8 basis points in the second quarter and 11 basis points in the first half, and I don't see them going up materially in 2022. In 2023, SP could get back to the guided 18-20 basis points. The GP overlay that we have amounts to 42 basis points of loans, so we would only start adding buffers if we were expecting another episode with SP much higher than at present, which is not the case.

Akash Rawat (UBS) My first question is on credit costs. Did you say that they should be 10-11 basis points of loans this year, and that they could return to the new normalised level of 18-20 basis points next year?

Piyush Gupta Yes.

Akash Rawat Under your base case, would you expect the majority of NIM increases to be done by the fourth quarter of this year?

Piyush Gupta The pace of NIM increases has exceeded our expectations because the pass-through from USD rates to SGD rates has been on the high end. My general rule of thumb is that the pass-through from USD to SGD rates is about 60% through the cycle, but that it is a barbell. So when the SGD is weakening, the pass-through rises to 80-85% and when it strengthens it comes down to around 40%. So far, we've been around 80-85%, which is high. However the SGD has started to strengthen now, so I expect that while rates continue to go up, the pass-through will come off a bit. Also, as rates continue to increase, deposit costs will also start increasing. So net net, we will continue to see improvement in NIM, but not at the same pace that we were seeing. In other words, NIM will still increase but NIM growth will moderate.

The flip to the moderating NIM growth is that while the sensitivity we have given refers to the first-year impact, in reality there is a meaningful impact in the second and third year as well. We have $40 billion to $50 billion of fixed rate loans and floating rate loans swapped to fixed rate repricing in years two and three, so NIM increases will continue to flow through as these loans reprice. In our FHR mortgage book, we have $20 billion to $25 billion pricing off our deposit rate. The rate has already been adjusted already this year, with a further adjustment due in August. That rate tends to lag market benchmarks by three to six months, so changes there will also flow through eventually.

There will also be some offset to moderating NIM growth from Hibor as the pass-through normalises. The pass-through to HKD rates from USD rates has been unusually low in the first half, around 30-40% instead of the more typical 80-90%. Overall, there are a lot of moving parts, but while the pace of NIM increase will slow down, we will continue to see a pickup in NIM into next year.

Akash Rawat Have you seen any early signs of weakness in Hong Kong and Singapore SME?

Piyush Gupta No. Thirty day and 90-day delinquencies haven't moved, and as I've said before, the SME sector is coming off two to three years of belt tightening. During this time, cash flows were impacted, revenues were constrained, and customer activity was curtailed. So the portfolio has already been stressed and found to be quite resilient. Going forward, the rising cost of goods could pressure SME margins and our borrowers may not be able to pass the higher costs on to their customers. This could lead to a pick-up in delinquencies, although we haven't seen that so far.

Akash Rawat Finally, the market is not giving any valuation benefit to DBS, or other banks, from the higher NIM and benign asset quality. The disconnect appears to be on credit cost. What do you think the market is getting wrong?

Piyush Gupta The general view is that credit costs will go up. There is a lot of concern around consumer books in the west, particularly in the US, where mortgage financing doesn't take cash flows into account. The concern is how consumer books there will be impacted if rates rise, and what knock-on effect this will have on the banking sector. My view is that the doom and gloom is overdone and that long deposit banks will benefit enough from higher NIM to more than outweigh any asset quality concerns. So the sector is mis-priced, even in the West.

In our housing book in Singapore, borrowers' ability to service their mortgages are tested with interest rates of 3.5%. So some upward move in interest rates has already been taken into account. Loan to value is also very low, at 49%, so I'm quite confident that the book will be secure. In our large corporate book, customers have been tested over the last years, so we know they have enough liquidity and financial strength to withstand considerable stress. That leaves the SME portfolio, where we could see some pain, but the book is not large.

Markets could be pricing a Paul Volker scenario a year from now. That would be a deep recession, considerably higher interest rates and large-scale unemployment. This could cause other stresses in our portfolios, but that's not something we are forecasting at this stage.

Yafei Tian (Citi) Firstly, what proportion of loans are linked to the different benchmark interest rates? Secondly, should we expect to see HKD to become a meaningful contributor to NIM growth in the second half given the recent increase in Hibor, and what is the HKD CASA ratio? Finally, your $6 billion of net new money growth is strong compared to many other wealth managers in the region. How did DBS attract more new money compared to your peers?

Chng Sok Hui We run a complex model that takes a whole host of factors into account. Amongst others, it considers the proportion of fixed rate loans, the repricing profile, as well as the proportion of low-cost deposits that could switch to fixed deposits and the proportion could flow out. We have tested the model extensively, which is why we are quite confident that taking all these factors into account, the interest rate sensitivity is between $18 million and $20 million per basis point of Fed Fund Rate. The sensitivity will work up to a Fed Funds Rate of around 3.5% but it might come down a little bit beyond that.

Piyush Gupta Our HKD Casa ratio is 65%, so there will be a positive impact on NIM if Hibor increases in the second half of the year.

The majority of private banking net new money is from North Asia. Anecdotally, we are benefitting from flows into Singapore from Taiwan, Hong Kong, and the mainland. Our ability to provide digital solutions has helped, as has our reputation as a strong and safe bank. We have been able to present what everybody calls 'one bank', where the investment bank and the private bank combine to provide solutions for entrepreneurs who are relocating or rebasing themselves. These factors have all played a part in attracting strong net new money flow.

Melissa Kuang (Goldman Sachs) What ROE are you expecting by year-end? In 2017, you thought we could reach 15% ROE as the cost-income ratio came down while interest rates were hiked. Do you think you could do better than 15% given the substantial growth in wealth since 2017? Secondly, with some banks' fixed rate mortgages getting closer to the 3.5% Total Debt Servicing Ratio (TDSR) test level, at what interest rate do you expect to see stresses emerge in the housing portfolio?

Piyush Gupta ROE for this year is projected to be well north of 14% under our base scenario. Next year, an ROE between 15.5% and 16.0% is achievable. These numbers are calibrated to where we think the markets are likely to be next year and are based on a NIM over 2% and a cost-income ratio of 40%. We made some assumptions on fee income and non-interest income, but none of them were off the charts.

There are several factors giving us comfort on the housing book. The first is that borrowers' ability to service their loan is checked at inception of the loan by calculating the borrowers' TDSR based on an interest rate of 3.5%. The second is that Singapore mortgages have a major advantage in that a large portion of repayments come from borrowers' CPF accounts instead of relying exclusively on borrowers' cashflows. The third is that more than 80% of our portfolio is owner occupied and borrowers are generally reluctant to renege on mortgage payments for the property they live in. These factors mean that the mortgage book in Singapore has been very stable, with minimal delinquencies and NPL over the last 30 years. Outside of Singapore, we don't really have a mortgage book of any consequence.

Jayden Vantarakis (Macquarie) Your liquidity position is very healthy with LDR at 80%. Would you stop competing for deposits at some point and allow some to flow out to help revenue and profit? My next questions are on the overlay, which you said was unchanged at $1.8 billion. Qualitatively, how do the macro situations at the start of the pandemic and today compare? Why are you leaving the exact same overlay in place?

Piyush Gupta Right now all our deposits make money, so allowing deposits to flow out would worsen revenue and profitability. We actually took in a lot of foreign-currency fixed deposits this quarter for three reasons. First, we replaced some market borrowings with fixed deposits, as we were able to raise the latter more cheaply than commercial paper. Second, to fund the USD book as loans continued to grow. The third reason was the most important. We normally swap from SGD to USD, but as the SGD surpluses were generating very good positive returns from risk-free assets, we were happy to raise fixed deposits that would generate a positive return as well.

Chng Sok Hui Overlays are above and beyond what our baseline model calculates as they are modelled on stress scenarios. At the start of pandemic, we reviewed the worst specific allowances that we had seen and calibrated to those. This resulted in an initial calibration that was very conservative, anticipating between $3 billion and $5 billion of credit costs. At the end of 2020, with the government supporting the economy in the form of grants and moratoriums, we decided that the $1.8 billion of overlay we had built up to bring allowances to $3 billion, was sufficient.

Last year we communicated that we would start releasing some of the overlay as the market opened up. But the Russia-Ukraine crisis has caused us to rethink releasing the overlay. We're in the midst of stress testing to calibrate how much we might need and are unlikely to release the $1.8 billion until we are happy that the buffer is sufficient.

Piyush Gupta Another way to think about it is that there were two 12 to 24 month episodes over the last 20 years when our SP went as high as 80-85 basis points of loans. So while we expect the long-term range to be just below 20 basis points, there have been episodes when it was significantly higher. The amount we have in the overlay provides a cushion against a repeat of those high levels.

Weldon Sng (HSBC) How do you see liquidity in Singapore? Was raising the Multiplier account interest rate a pre-emptive move to protect Casa deposits in Singapore?

Chng Sok Hui Yes. It was a pre-emptive move to protect our Casa balances.

Piyush Gupta SGD liquidity is flush and our local currency loan-deposit ratio at 72% is very low. The LDR on the foreign currency book is much higher than on the SGD book, so what we have done is raise USD fixed deposits. This matches our loan growth and was cheaper than funding through commercial paper.

Weldon Sng: Can you please elaborate on what the floating to fixed hedges are for, how big they are, and how they impact NII? Do they mute your sensitivity interest rates?

Piyush Gupta: The Sora-based loan book is a large part of this. Hedge accounting allows us to convert some floating rate loans to fixed rate loans. Over time this accretes revenue at a higher level, but the hedge is marked-to-market. It also stabilises the loan yield at a higher level and dampens our sensitivity to interest rates. The effect has been factored into our NII sensitivity guidance of $18 million to $20 million per basis point of Fed Funds Rate.

Chng Sok Hui: The guidance we gave was for of NII sensitivity of $18 million to $20 million in the first year, with a portion of fixed rate loans and hedged loans repricing in subsequent years. This is part of the loan book repricing after a year. As we said earlier, hedged loans amount to 8% of our floating rate book, a relatively small number.

Hong Nam Yeoh: Thank you very much. We will speak again next quarter.