Edited transcript of DBS third-quarter 2022 results conference call for buy and sell sides, 3 November 2022

Michael Sia Welcome to the conference call for the buy and sell sides.

Nicholas Teh (Credit Suisse) Just a few questions from me. First, you said NIM could reach 2.25% in mid-2023. Does it mean you expect NIM to come off in the second half because funding costs catch up? Second, on credit costs, you said specific allowances would get to through-cycle averages next year. Given that things are volatile, how willing are you to use the significant GP overlay you have to stabilise overall credit costs? Third, on dividends, with ROE over 15%, loan growth slowing and CET-1 above your target range, does it imply you could pay a much higher dividend and still be building capital?

Piyush Gupta On NIM, it is hard to definitively figure out what the backend of next year might be. What you said is correct. Deposit costs will continue to go up, but even so they will start moderating at some point. Our deposit beta is currently around 25%. I think they will get to 35% by end-2022 and 45% by mid-2023 and probably start levelling off then. Also, like other banks, we have a real drag from the treasury book, whose funding is based on market interest rates. But we have tailwinds from $180 billion of interest-bearing assets that have yet to reprice and will do so over the next two years. If the Fed funds rate peaks at 4.75% – although Jerome Powell said last night it would be higher – our NIM would plateau at 2.20-2.25%.

On credit costs, all we are trying to do is make sure we have what Jamie Dimon calls a fortress balance sheet. Our specific allowances for the nine months were only eight basis points. On a bottoms-up view, I do not see them increasing because I am not seeing stress in our book. But when I take a top-down view, you have to expect some impact from a jump in debt servicing with interest rates at 5% together with a likely recession. And so, in our planning for next year, we are assuming through-cycle specific allowances of 17-20 basis points.

You are correct that we have a lot of cushion in the $3.9 billion of general allowances. The GP required by the models fell around $350 million in the first nine months because the quality of the portfolio continued to improve. So we added $350 million to the GP overlay this quarter to offset the model effects, bringing the overlay to $2.1 billion. The overlay is exactly intended to do what you are asking – to moderate provisioning when needed. Frankly, if the world had looked much better, we would already have released some of it.

On the dividend, I have been quite clear that we recognise we have a lot of capital and have the capacity to pay more, but it is something that we will evaluate at year-end. It was not something we were ever planning to do in the third quarter. If you look at our history, we have always done our dividend changes at year-end. All the things you mentioned are correct. Our capital ratios are high and above the target range. And under Basel 4, the capital ratios would even be higher. So we do have the capacity to return more money to shareholders. It is a timing question.

Jayden Vantarakis (Macquarie) My questions are on the same topics as Nick’s. Previously, you helpfully provided a NIM sensitivity of $18 million-20 million for each basis point of Fed funds rate. I understand the sensitivity would be non-linear. Could you update us on what it is in the current rate environment? On credit charges, you must have done some scenario analysis. What would a bear case be for credit charges?

Piyush Gupta You are right that the sensitivity is non-linear. Until end-September, the $18 million-20 million held despite the bigger drag from Treasury Markets. From here on as rates go up, the incremental sensitivity drops by half to about $10 million per basis point, but whatever gains we have so far are locked in. In reality, that is not how it works because the existing stock of deposits also reprices, but that is an easy way to model and think about it. A second way to model is by deposit beta, which goes up from around 25% to 35% at year-end and 45% at mid-2023. Both methods will end up with a NIM of around 2.25% by mid-2023.

On credit costs, all the scenario planning we are doing is not showing a material deterioration in credit. And that is one of my big challenges – because we have not seen a 5% interest rate environment for a long time. But look at our book from bottoms-up.

The large corporates, which are a big chunk of our exposures, continue to be solid. My own sense is that even at 5%, we would not see pain. We have talked to a lot of clients across sectors. I am less certain about our SME book, which is around $30 billion, because a 5% interest rate could hurt. Having said that, we stress tested the book at 6-7% and did not see a lot of damage. I think it has already been seasoned by the trade war and Covid in the past few years. Reviewing the SME book on a bottoms-up approach, credit costs are $200 million-400 million, which are not extraordinarily large.

Housing loans, most of which are in Singapore, are quite solid. As you know, we had until recently assumed an interest rate of 3.5% in evaluating repayment affordability, which has now been raised to 4%. In addition, the loan-to-value on that portfolio is very low. Historically over the decades, delinquencies have been very low. For the unsecured consumer book of about $10 billion, half is in Singapore, which is very well controlled because rates and borrowing limits are capped. But keeping in mind consumers' disposable income will be affected in a 5% environment, a delinquency pick-up in that book should be expected.

The reason I have gone into detail is to show the difficulty of getting a normalised credit scenario using a bottoms-up approach. But I am cautious because there are a lot of unknown unknowns in a 5% world. I would rather be cautious and be prepared for things that we have not foreseen.

Nick Lord (Morgan Stanley) I have a couple of questions. On the impact on NIM from the trading book, some banks have said that it is offset through higher trading income, so the net income impact is zero. Would that be true for you as well?

Piyush Gupta We saw some of that so far. Total Treasury Markets income was stable at around $270 million in both the second and third quarters, so the drag from funding costs was made up for in trading income. Going forward, it is not clear to me it will be a one-to-one offset because obviously there is volatility. We should be able to stick to the guidance of $275 million a quarter for Treasury Markets income, but there would be choppiness from quarter to quarter.

Nick Lord On credit costs, there could be two potential risks as rates go up – interest cover begins to fall and property prices start to come down. Could you give us any metrics on the interest cover of your customers? And if we did see commercial property prices fall materially, how much of a decline would cause problems for you?

Piyush Gupta I do not have data on interest cover on hand, though we obviously have stress tested it. We have a watchlist that is 4-5% of our portfolio we pay close attention to. When I said our large corporate book is quite pristine, it is because we are not seeing companies under interest-cover stress. In addition to rates, we have also stressed tested using a $200 oil price and currency weakness. Only a handful of names come up. On commercial property, our loan-to-values are low. Our stress tests show that with up to a 30% decline in prices in both Singapore and Hong Kong, where a large part of our collateral is, we would still be in the money.

Nick Lord In terms of mechanisms for returning capital, your share price is quite high, so I do not know if share buybacks work. Then there is the issue of the sustainability of a higher ordinary dividend. At the same time, there are other banks that have not got fortress balance sheets after a year of downturn. You might be in a good position to do M&A. Could you talk about mechanisms of returning capital and how you might use a strong balance sheet to add longer-term value to the group?

Piyush Gupta On M&A, we are still absorbing the transactions done in recent years. Lakshmi Vilas Bank is integrating well but we still have yet to fully extract value from it. The Citi Taiwan integration will only be completed in August next year. So we already have a handful to deal with. Our long-standing approach has been to avoid large-scale M&A and the deals we have done are in the vicinity of $1 billion. If we do get further opportunities, they are not going to drain capital.

We have three choices to return capital – increasing the regular dividend, paying a special dividend or doing a share buyback. Everything is on the table. While a share buyback at current valuations might not be the most attractive path, I hasten to add that the issue is not something the board has reviewed. We will do it at year-end.

Yafei Tian (Citi) I have a couple of questions. Could you give us an indication of the October or September NIM? Also, could you repeat what was said at the media call regarding the portfolio that has yet to reprice.

Chng Sok Hui I previously said NIM would be at 2% sometime between the third and fourth quarters, and we are currently close to 2%. Of the $180 billion of assets yet to reprice, about $60 billion reprices next year, $40 billion in 2024 and the remainder after that. In terms of composition, $80 billion is fixed-rate loans, $20 billion in fixed-deposit-rate-linked housing loans, and $80 billion in loans linked to interest rate swaps as well as a corporate treasury portfolio.

Yafei Tian On operating expenses, with inflation running high in Singapore, what level of cost inflation are you thinking about for next year and beyond?

Piyush Gupta You should be expecting a 9-10% increase for full-year 2023 over full-year 2022. With a higher CPI, wage growth would continue to be somewhat high. Wage costs are also a function of headcount, and we have kept driving efficiency under a strategic cost management agenda. We have added people in technology, for example, at LVB and for integrating Citi Taiwan, some on contract basis who will eventually run off. We have levers to bring cost down. We have said when we have the opportunity or income tailwinds, we would be willing to invest more, and when things get tighter, we would have the discipline to bring our costs back down.

Weldon Sng (HSBC) Could I ask about the NIM sensitivity? Based on your previous guidance, it is about six basis points of NIM per 25 basis points of rate increases. If we take current guidance of 2.20-2.25% by mid-2023, it implies 3.5 basis points at the upper bound.

Piyush Gupta I have just given two prisms on how I think of sensitivity. I do not use the prism of six basis points per 25 basis points that you mentioned and cannot relate to it. You can use the two prisms I provided and work back to see what it means from your lens.

Weldon Sng Are you assuming interest rates stay at 4.75% for the rest of 2023?

Piyush Gupta We are assuming it will stay at 4.75%. After yesterday's Fed meeting, I would bet that Powell will get to 5%. I do not see Fed cutting rates next year even with a slowdown or recession. My base case is you will see cuts only in 2024.

Weldon Sng So if the Fed holds rates, would it be correct that there is still repricing in the second half, and the 2.25% is only a mid-year guidance and there is upside in the second half?

Piyush Gupta I think there would be some tailwind from repricing in the second half, but there be might further deposit repricing at the margin when rates are at 5%. So my current estimate is we could wind up plateauing around 2.25%.

Harsh Modi (JP Morgan) A couple of questions. First, could you elaborate on the changes you made in underwriting over the past few years that gives you comfort that, even in a reasonably tough environment, we will only hit 20 basis points of allowances rather than say 50 basis points?

Piyush Gupta You have asked me this question before, and I have given a detailed response. I can redo it for you if you like.

First, we tightened our target market across the board, including our risk acceptance criteria at industry and customer segment level. We reduced our obligor concentration limits. This would enable us to avoid what happened in 2015-16, when we took some large hits in oil and gas. That is a material change.

Second, we dialled up our industry focus. We built much stronger industry expertise all the way down. Our expertise had previously been focused on top-tier companies. Now our midcap and even SME segments are aligned by industry. The industry specialists play a far more active role in both credit underwriting and portfolio monitoring.

Third, we have benefited a lot from data and analytics – not just for underwriting but also early warning and portfolio management. Today, we can tell companies three months before they realise it they are going to have a problem, because our data analytics enable us to stay ahead of the curve in understanding potential weaknesses and what needs to be done. We have used technology end-to-end, giving us a much better measure of the issues.

Fourth, we have been churning our portfolio more actively. We sell down parts of our exposure instead of keeping all of it.

We are increasingly confident that the sum of these changes is showing up in the way our business operates. It is why our guidance for through-cycle credit costs has changed from 22-25 to 17-20 basis points.

Harsh Modi Thanks, Piyush. I know we had that conversation two years ago, but a follow up. For the watchlist, have you had any discussions with the companies that may be at risk? And are you at a point where you have started talking about restructuring some of the higher-risk borrowers?

Piyush Gupta The number of higher-risk companies is very small. Yes, of course we talk to them. The biggest part of the watchlist, close to 4% of the portfolio, is in the lowest category of just monitoring the exposures because of macroeconomic conditions. We put them into the watchlist to monitor.

Harsh Modi Is it fair to say we should see your stage two loans move up over next quarter or two?

Chng Sok Hui We are not seeing that kind of migration. In fact, if you look at our modelled general allowances, they have been coming down – for the nine months, they fell by $350 million. That is why we increased our overlay by $350 million. The underlying portfolio has been improving because we have been seeing upgrades. It is hard to say for next year, but so far our experience has been good.

Harsh Modi The second question is on Hong Kong property exposure. I know you just said that even the commercial property exposure in Hong Kong looks okay. And I remember you had stopped doing housing loans in any large size in Hong Kong a decade ago. But given whatever is your current exposure to Hong Kong property, how do you think about it? How much of that worries you? And it is not the median exposure but the 90th percentile exposure I am referring to.

Piyush Gupta You have correctly said our housing loan book is quite small, and which has an LTV of around 30%. On the commercial book, I do not have the number with me, but the bulk of it is in high-end names such as Cheung Kong. We did a complete review of the commercial property exposure just last month and we really are not seeing any problems. We have some exposure to second-tier developers but they are well secured with low LTV.

Harsh Modi The last question is on capital generation and distribution. Assuming some RWA increases down the line and a very impressive 15% ROE, what kind of capital can you generate? In terms of distribution, how sacrosanct is the upper-end 13.5% CET-1 target when we think about dividend payout?

Piyush Gupta Our target CET-1 range has always been guided at 12.5-13.5%, so 13.5% is not sacrosanct in itself. Another thing to factor in is the impact of Basel 4, which is very material. Our CET-1 jumps to 16% because of it. Between now and the end of the decade, we are looking at capital cushion buffers of two to three percentage points, not decimals of a percent.

Harsh Modi But will MAS allow you to pay out 200 basis points of capital?

Piyush Gupta Why are you assuming I want to pay out 200 basis points of capital. I think it is inappropriate to address the question of dividends because, as I have said, the board has not deliberated on it.

Harsh Modi That is fair, but I am just trying to understand if you are going to stay with the guidance of 12.5-13.5%. Is the board willing to stay with that guidance, or do you think that since we are going into a downturn it would be fair to assume a buffer above 13.5%?

Piyush Gupta Harsh, let me just say what I just said. For some reason, you assumed there would be a dividend increase in the third quarter. I do not know where that idea came from. I have nothing more to add to what I have told you. I will tell you at year-end after we have deliberated it with the board what we are prepared to do and what we think is appropriate.

Aakash Rawat (UBS) My first question is on the NIM sensitivity. You mentioned about the deposit beta. You suggested savings rates would go up which is why the sensitivity would be lower. But the other variable is Casa outflows. If they accelerate from here, could that sensitivity go down further?

Piyush Gupta The sensitivity we provided has factored in Casa outflows and FD inflows, not just Casa repricing. If we need funding, we can always pay up for FD, and the sensitivity takes it into account.

Aakash Rawat My second question is on the ROE guidance of “comfortably above 15%”, which I think looks conservative. Even with your base assumptions, I think ROE could be a lot higher. I believe you would have baked in some best-case, worst-case scenarios. Could you help us understand some of the ROE drivers in your mind, such as credit costs in a worst-case scenario, or what wealth management income would be like to get to 15%?

Piyush Gupta The “comfortably above 15%” ROE guidance has credit costs going back to SP of 20 basis points and some GP. I think it is a fairly conservative assumption because we might not need that level of credit costs, so there could be upside to ROE. In terms of growth, we have baked in a mid-single-digit loan growth and low-double-digit fee income growth. Our wealth income has dropped by 20% this year. So, if the environment turns around, there is no reason we would not get back to previous wealth income levels. And we got an annualised $20 billion of net new money inflows so far this year. So wealth management could be even stronger, but it would have to depend on a far more helpful environment. It could also get worse, but we have been conservative.

Aakash Rawat On the mechanism of capital payout, you said all options were on the table, including a special dividend. If I look back, DBS has rarely done a special dividend. So is such a special dividend linked to Basel 4, or even if Basel 4 implementation were to get delayed, would you still consider a special dividend?

Piyush Gupta I think we would have enough capital without Basel 4. By the way, we did do a special dividend of 50 cents per share five years ago, but you are correct it is not something we normally do.

Aakash Rawat How would you go about thinking between a core dividend increase and a special dividend? I am just trying to understand which way you would lean and why.

Piyush Gupta Our philosophy is we do not want to wind up with a core dividend level that needed to be backtracked on. Other than when the regulators have asked us to cut the dividend, our policy has been to keep it consistent. Therefore, we would like to leave some cushion for the core dividend.

Aakash Rawat Finally, could you give some colour on trading income this quarter?

Chng Sok Hui There were a few components. Treasury Markets had strong trading gains, which were the offset to its higher funding costs in net interest income. We also had higher customer flow income than the previous quarter, both from corporate and wealth management customers.

Michael Sia Thank you for joining us.