IMPLICATIONS OF LOAN PORTFOLIO CONCENTRATION FOR BANKS' CREDIT RISK AND RETURN: EVIDENCE FROM HONG KONG

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Summary

This study investigates the net effects of sectoral loan concentration on banks in Hong Kong. Research in this area remains inconclusive, due to the potential trade-off between concentration risks and specialisation gains. Our empirical results, based on a regulatory panel dataset of licensed banks in Hong Kong, find support for the specialisation gain from higher loan concentration which would more than offset the concentration risk after controlling for the differences in loan composition and common risk factors.

While this finding may, to some extent, alleviate concerns about the rising sectoral concentration in banks' loan portfolios observed after the global financial crisis, it is important to note that the net impact on an individual bank's loan loss provision ratio also

depends on how far the bank allocates its loan portfolio towards riskier sectors. A key implication is that changes in the sectoral concentration and composition of banks' loan portfolios should be monitored jointly to have a more balanced assessment of the risk and return of banks' loan portfolios.