Economic and Banking Environment

The Hong Kong economy entered a recovery phase in 2002. Real GDP growth picked up moderately in the latter part of the year, reflecting the strong external trade performance. The banking sector demonstrated its resilience during 2002 despite various negative factors faced by the industry. Overall asset quality of the banking sector improved in spite of a deterioration in the consumer debt portfolio and the growth in negative equity among mortgage borrowers.

THE ECONOMY IN REVIEW

Overview

The economy had a weak start in 2002, but improved in the second half. For the year as a whole, real GDP grew by 2.3%, following a mild increase of 0.6% in 2001. The economic recovery was mainly driven by exports, which rebounded strongly in the second quarter, and recorded double-digit rates of year-on-year growth in the last two quarters. By contrast, domestic demand was constrained by falling asset prices, rising unemployment and an uncertain economic outlook (Table 1).

Broad money declined slightly in 2002, while narrow money increased significantly, largely reflecting low interest rates. Total deposits with authorized institutions fell modestly in 2002 for the second consecutive year, with foreign currency deposits registering a larger decline than Hong Kong dollar deposits. Reflecting weak business activities, domestic loans contracted further and the Hong Kong dollar loan-to-deposit ratio fell slightly during the year.

Dampened domestic demand

Private consumption expenditure declined by 1.6% in 2002, compared with an increase of 1.4% in 2001, as consumer sentiment was affected by the rising unemployment rate, falling income levels and declines in asset prices (Chart 1). Spending on consumer goods declined during the course of the year, while those on services increased.

Having declined for four consecutive quarters, private investment spending rebounded slightly in the final quarter of 2002. For the year as a whole, however, it fell by 4.7%, after increasing by 4% in 2001: a reduction in acquisitions of machinery, equipment and computer software outweighed a moderate increase in building and construction investment. Public investment dropped further from 2001, largely owing to a decline in public housing production and the tapering output of the Priority Railway Projects (Chart 1).

External trade benefited from global recovery

Exports of goods rose significantly in the second half of 2002, as the global economy started to recover and the external trade in the Mainland accelerated. For 2002 as a whole, merchandise exports rose by 8.6% in real terms, as the growth in re-exports more than offset the decline in domestic exports. Exports to most of the markets in East Asia, particularly the Mainland, recorded double-digit growth in 2002, while those to the United States and the European Union also increased in the latter part of the year (Table 2). Imports rose in 2002 by 7.9% from the previous year along with the strong growth in re-exports. As the expansion in exports outpaced that of imports, the value of the merchandise trade deficit narrowed to $40 billion in 2002, from $68.2 billion in 2001 (Chart 2).

Alongside the recovery in external trade and the increase in inbound tourists, exports of services rose by 12.1% in real terms in 2002, compared

TABLE 1 **Contributions to GDP growth by components (%)**

	2001[1]					2002[2]				
	Q1	Q2	Q3	Q4	Overall	Q1	Q2	Q3	Q4	Overall
Private Consumption Expenditure	1.7	1.7	0.7	-0.6	0.8	-0.2	-1.5	-0.8	-1.2	-0.9
Government Consumption Expenditure	0.5	0.4	0.6	0.6	0.6	0.2	0.3	0.3	0.1	0.2
Gross Domestic Fixed Capital Formation	2.7	0.8	0.9	-1.1	0.8	-3.5	-0.2	-1.4	0.1	-1.2
Change in Inventories	-1.1	-0.8	-1.8	-1.6	-1.4	-1.3	-0.1	1.6	1.9	0.6
Net Exports of Goods	-2.7	-2.2	-2.0	0.2	-1.6	2.2	-0.5	0.1	-0.5	0.3
Net Exports of Services	1.2	1.6	1.3	1.7	1.5	2.1	2.8	3.6	4.5	3.3
GDP	**2.3**	**1.6**	**-0.3**	**-0.9**	**0.6**	**-0.5**	**0.8**	**3.3**	**5.0**	**2.3**

[1] Revised figures
[2] Preliminary figures

with growth of 5.9% in the previous year. In contrast, imports of services declined modestly by 0.8% in real terms from 2001, owing to sluggish domestic activity. The overall trade surplus in 2002 amounted to $123.4 billion, or 9.7% of GDP.

Continued decline in consumer prices

Deflationary pressures intensified in 2002. The Composite Consumer Price Index (CCPI) fell by 3% in 2002, compared with a drop of 1.6% in 2001. The larger decline reflected a combination of factors, including sluggish consumer demand, the Government relief measures of rates concessions and waivers of water and sewage charges, and weaker import prices. The Government relief measures were estimated to have contributed around one percentage point to the fall of the CCPI. Import prices dropped by 4.2% in 2002, following a decline of 3.5% in 2001, owing to softened world commodity prices and reduced inflationary pressures in the major economies.

Deterioration in labour market conditions

Labour market conditions deteriorated, with the unemployment rate surging to 7.8% in the three months ending in July, before easing to 7.2% in the final quarter. The average rate of unemployment rose to 7.3% in 2002 from 5.1% in the previous year, reflecting an increase in the labour force (1.8%) and a decline in employment (0.6%) (Chart 3). Labour earnings and household income fell in 2002, following a slight improvement in 2001. The nominal index of payroll per person engaged and median household income dropped by about 1% and 9.5% respectively, in the first three quarters of 2002 from a year earlier.

Continuing corrections in asset markets

Equity prices in Hong Kong closely traced the movements of the US markets. Following a temporary rally in the second quarter, equity prices fell in the middle of the year, as investor sentiment was undermined by concerns over the durability of the US economic recovery and the revelations of corporate malfeasance. Widespread anxieties in global financial markets pushed the Hang Seng Index to a four-year low of 8,859 on 11 October. The index subsequently rose and closed the year at 9,321, 18% lower than its level at the end of 2001.

Residential property prices continued to decline in 2002. The weak economic environment, rising unemployment and fears of further price declines outweighed the positive effect of low mortgage rates. However, following the announcement of a package of measures by the Government in mid-November to address the imbalances in the property market, signs of price stabilisation emerged and transactions increased towards the end of the year. For 2002 as a whole, residential property prices on average fell by 11.1%, and the number of transactions dropped by 2.6%.

TABLE 2 **Exports to major trading partners**[1]

	Share	2001					2002				
	%	Q1	Q2	Q3	Q4	Overall	Q1	Q2	Q3	Q4	Overall
Mainland China	39	8	1	3	-8	1	3	8	13	25	12
United States	21	-1	-10	-12	-15	-10	-15	1	6	9	1
European Union	13	-3	-10	-14	-15	-11	-15	-7	1	7	-3
Japan	5	14	4	-3	-10	1	-14	-10	-2	7	-4
ASEAN5[2] + Korea	8	-3	-10	-17	-13	-11	4	10	20	22	14
Taiwan	2	-5	-10	-20	-9	-11	-10	-7	11	-2	-2
Others	11	-1	-7	-10	-17	-9	-7	3	6	13	4
Total	**100**	**2**	**-5**	**-7**	**-12**	**-6**	**-6**	**3**	**8**	**16**	**5**

1 Figures are percentage changes over a year ago except for major export markets' shares in Hong Kong's total exports.
2 ASENA5 includes the Philippines, Malaysia, Indonesia, Singapore and Thailand.

CHART 1 **Domestic demand (percentage change over a year ago in real terms)**

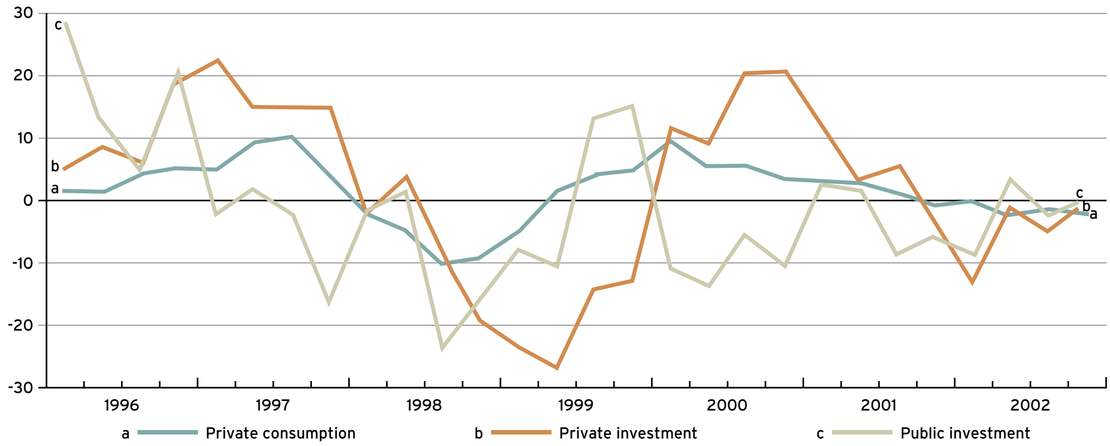


CHART 2 **External merchandise trade**

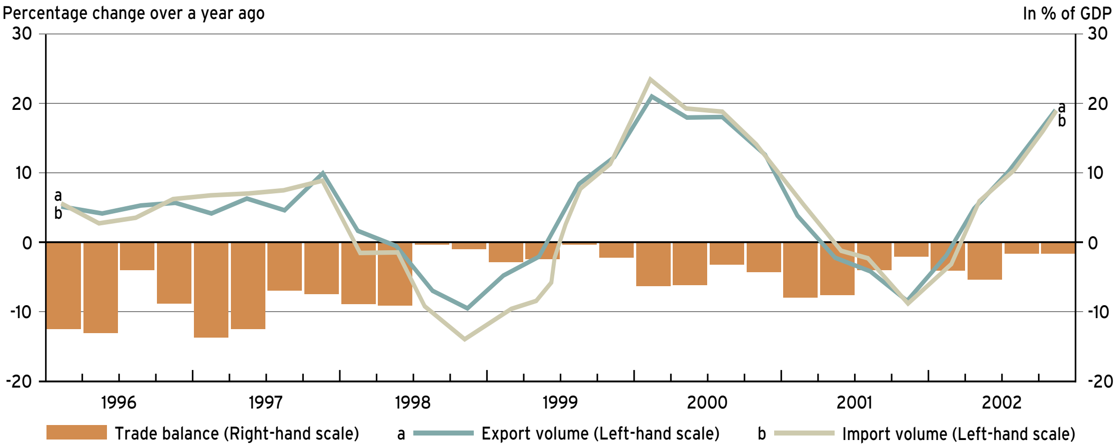
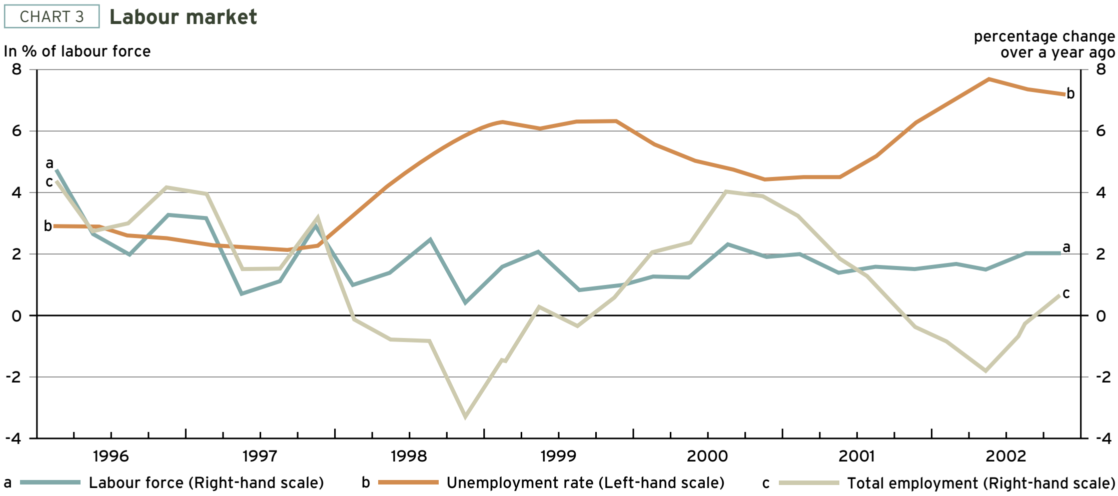


CHART 3 **Labour market**



MONETARY CONDITIONS

Monetary conditions eased during the year as a result of easing interest rates and the lower effective exchange value of the Hong Kong dollar. The trade-weighted real effective exchange rate decreased in 2002, as the Hong Kong dollar weakened against the currencies of its major trading partners, notably the euro zone and Japan, along with the depreciation of the US dollar and the decline in domestic prices.

Divergence of narrow money and broad money

Hong Kong dollar narrow money rose by 12.9% during the year, while broad money contracted moderately by 0.6%. The former reflected a low opportunity cost of holding non-interest bearing monetary assets and an increase in cash demand from Mainland tourists. The latter was associated with weak economic activity, as well as a portfolio re-allocation in search of higher returns in the light of record-low deposit rates relative to yields on alternative assets.

Notes and coins

At the end of 2002, the total value of banknotes in circulation was $118,475 million, an increase of 10.2% from a year earlier (Charts 4, 5 and 6). The total value of Government-issued notes and coins in circulation was $5,662 million, including the new $10 note, an increase of 3.6% from a year earlier (Charts 7 and 8). The increase was mainly due to the launch of the $10 note. By the end of the year, its circulation had reached a value of $498 million.

The new $10 note

The new $10 note, which began to circulate on 10 September 2002, was issued in recognition of continuing public demand for a $10 note in addition to the $10 coin. The $10 coin issued by the Government and the $10 notes issued by The Hongkong and Shanghai Banking Corporation Limited and Standard Chartered Bank remain legal tender.


Front


Back

CHART 4 **Banknotes in circulation at end of year**

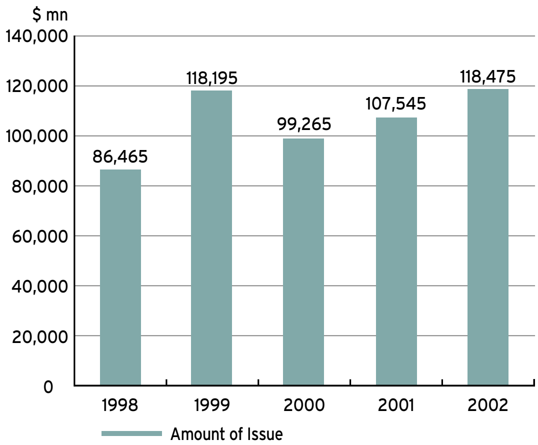


CHART 5 **Distribution of banknotes in circulation at end of 2002**

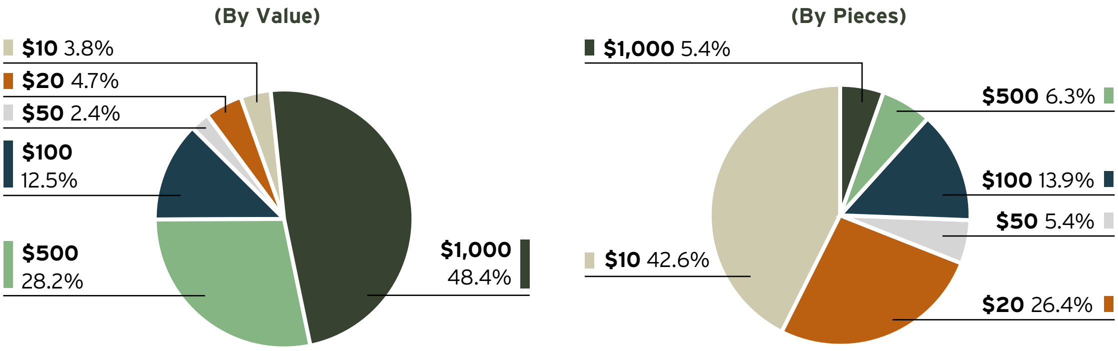


CHART 6 **Banknotes in circulation by note-issuing banks at end of 2002**

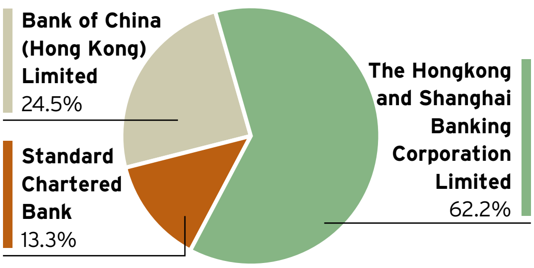


CHART 7 **Government-issued notes and coins in circulation at end of year**

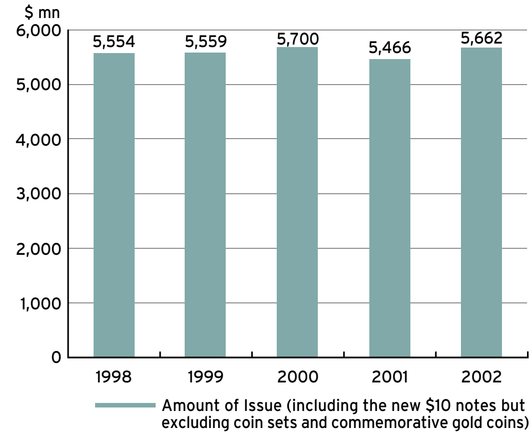
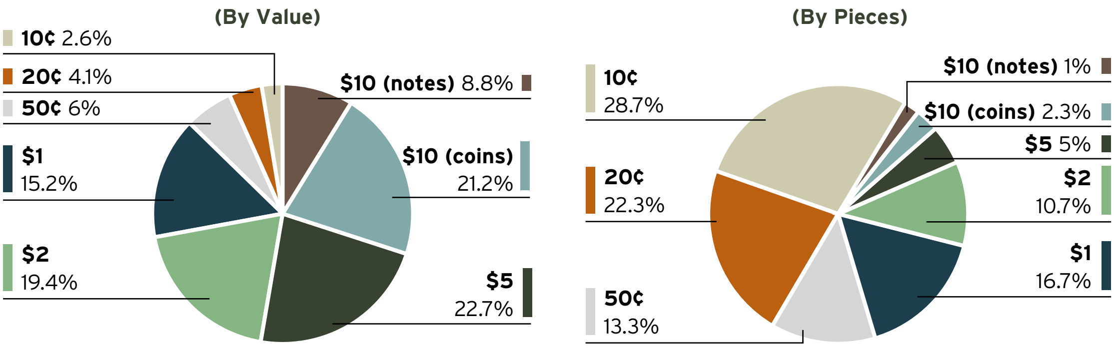


CHART 8 **Distribution of Government-issued notes and coins in circulation at end of 2002**



Review of banknote design

A comprehensive review of the design of Hong Kong dollar banknotes was completed in 2002. Additional security features will be included in the new series. Security features and colour schemes will be standardised among the banknotes issued by the three note-issuing banks (NIB) to facilitate easy recognition by the public. As in the past, the NIBs will design their own banknotes. These will be subject to the final approval of the Financial Secretary, as required by law. Details of the launch of the new series of banknotes will be announced in due course.

Coin replacement programme

The programme to replace coins bearing the Queen's Head with those carrying the Bauhinia design continued throughout the year. As a result of the replacement exercise, the number of Queen's Head coins in circulation has declined progressively. In 2002, 30 million pieces of these coins were removed from circulation.

» Consumer Information » Notes and Coins

OUTLOOK FOR THE ECONOMY

Continued recovery

The recovery of the Hong Kong economy is expected to continue in 2003. External trade is likely to remain the driving force behind GDP growth this year, while domestic demand is expected to bottom out. Hong Kong's exports of goods and services should continue to benefit from the buoyant trade performance in the Mainland following China's accession to the World Trade Organisation. A weakening of the US dollar against other major foreign currencies should help improve the competitiveness of the Hong Kong economy. Domestic demand may recover moderately in 2003, as strong export growth in 2002 is expected to filter through to domestic consumption and investment. Nevertheless, high unemployment, sluggish wage growth, weak asset prices and the effects of atypical pneumonia will continue to weigh on consumer spending.

The economic outlook in Hong Kong for 2003 hinges on developments in the global economy. Risks associated with geopolitical tension in the Middle East continue. If the terrorism risk increases, consumer and business confidence could be further undermined. There are also risks associated with the sizable US current account deficit, which raises concerns about the possibility of increased volatility in the US dollar. This could dampen the recovery prospects for Europe and Japan where domestic demand is already weak, and may trigger volatility in global financial markets. Domestically, asset prices are also subject to a high degree of uncertainty.

Reduced deflation and unemployment rates

Consumer prices are expected to continue to decline in 2003, but at a more moderate pace, reflecting an increase in aggregate demand and a weaker US dollar. Labour market conditions should benefit from a sustained and broad-based recovery of the economy. However, the recent shift in the composition of exports towards offshore trade might have affected the responsiveness of domestic employment to export growth, given that offshore trade typically requires less labour than do domestic exports and re-exports.

PERFORMANCE OF THE BANKING SECTOR

The banking sector demonstrated its resilience during 2002 despite various negative factors faced by the industry:

- the prolonged weakness of both the global and domestic economies, which softened lending growth
- increased bad debts in the consumer lending portfolio on the back of an unprecedented level of personal bankruptcies
- weak property prices eroding collateral coverage, particularly in residential mortgage lending, giving rise to negative equity.

Rather than competing aggressively to expand their loan books in a weak economic environment, banks generally shifted their strategies to focus on diversifying revenue sources to treasury business, fee-based financial products and wealth management. In switching their focus, the banks took pre-emptive measures to protect their mortgage loan books, which at the same time helped their borrowers, and tightened lending standards in the area of consumer lending. The banks also took measures to improve asset and liability management, implement cost controls, including the rationalisation of branch networks, and outsource certain activities to improve efficiency and earnings.

Overall asset quality improved in the absence of major corporate failures and despite the deterioration in the consumer debt portfolio and the negative equity issue in respect of the banks' mortgage portfolios.

Interest Rate Trends

Savings deposit rate at historically low levels

Hong Kong dollar interest rates fell to an unprecedented low in 2002. Having remained unchanged for 11 months, the US Fed funds target rate fell in November by 50 basis points. In response, major banks lowered their best lending rate by 12.5 basis points to 5.00% and the savings rate to a new low of 0.01%. One-month HIBOR decreased to an annual average of 1.74% compared to 3.61% in 2001 and one-month time deposit rate to 0.35% from 2.38% (Table 3). Reflecting ample liquidity in the banking system and limited credit expansion, the average one-month time deposit rate declined faster than the average best lending rate and the spread between these rates widened to 477 basis points, compared to 462 basis points in 2001.
The spread between the average best lending rate and average one-month HIBOR was more or less unchanged at 337 basis points.

TABLE 3 **Hong Kong dollar interest rate movements (period average figures)**

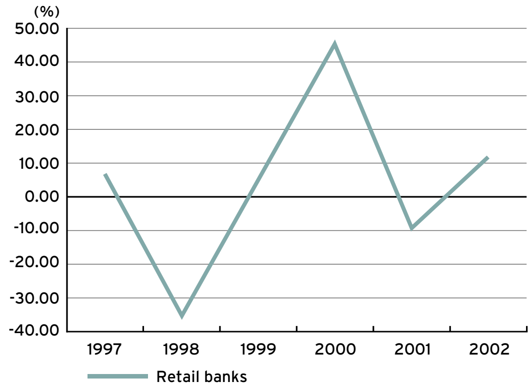
	Time deposits			HIBOR			Saving	Best lending
(% per annum)	1-month	3-month	12-month	1-month	3-month	12-month	deposits	rate
Q4 2001	0.64	0.65	0.96	1.93	1.92	2.36	0.37	5.33
Q1 2002	0.48	0.54	1.13	1.87	1.92	2.58	0.16	5.13
Q2 2002	0.36	0.45	1.06	1.73	1.84	2.56	0.16	5.13
Q3 2002	0.32	0.37	0.48	1.70	1.72	1.88	0.16	5.13
Q4 2002	0.22	0.26	0.34	1.66	1.67	1.82	0.09	5.05
*2001**	*2.38*	*2.38*	*2.55*	*3.61*	*3.57*	*3.75*	*2.17*	*7.00*
*2002**	*0.35*	*0.40*	*0.75*	*1.74*	*1.79*	*2.21*	*0.14*	*5.11*

* annual average figures.

Profitability trends

Despite the economic slowdown, retail banks reported a rise of 11.5% in aggregate pre-tax operating profits (in respect of Hong Kong office operations only) in 2002, against a drop of 9.3%[r] in 2001 (Chart 9). The increase largely reflected the marked improvement in profitability from banks that underwent consolidation or business integration in the previous year or so. The strong performance of some banks in treasury business also contributed to the increase. However, a significant number of the retail banks saw a decline in pre-tax operating profits, primarily because of bad debt write-offs in their credit card portfolios.

CHART 9 **Growth of operating profit before tax (year-on-year)**



Net interest margin increased to 2.09% in 2002 from 2.03% in 2001 (Chart 10), reflecting in part the shift of excess liquid funds into higher-yielding securities. The net margin was also helped by the interest generated from treasury business and the widening of deposit margins arising from the shift from time to savings deposits.

Other operating or non-interest income continued to account for about 30% of total operating income. Income from fees and commissions and from foreign exchange operations continued to make up the majority of non-interest income at 62.0% and 15.4% respectively, up marginally from 61.2% and 15.3% a year before.

The average cost-to-income ratio dropped to 40.6% in 2002 from 43.2% in 2001 (Chart 11). Tight cost controls, lower IT costs and the restructuring of branch networks by some banks resulted in declines in both staff and other operating costs. Restructuring costs arising from consolidation and business integration in 2001, which were not repeated in 2002, also contributed to the decline in operating costs.

CHART 10 **Net interest margin**

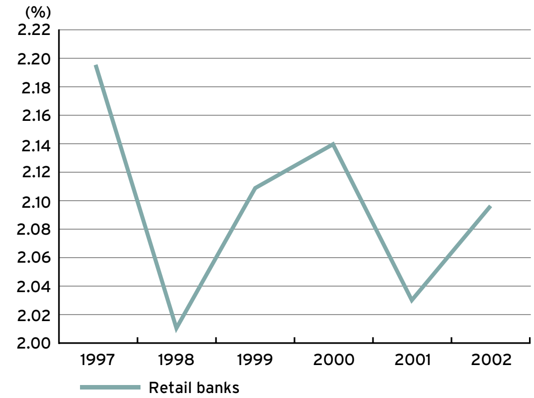
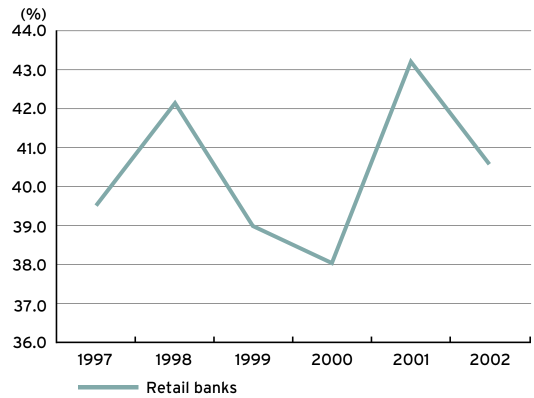


CHART 11 **Cost-income ratio**



[r] Figure revised.

Despite increased provisions by those banks active in the credit card business, the total bad debt charge of banks fell to 0.34% of average total assets from 0.40%[r] in 2001 (Chart 12). This reflected the improvement in overall asset quality, although the ratio was still higher than the level before the Asian financial crisis.

Reflecting the above, the industry-wide post-tax return on assets rose to 1.18% from 1.05% in 2001 (Chart 13).

Balance sheet trends

Total retail banks' assets grew modestly by 0.3% in 2002 after falling by 2.3% in 2001.
The modest growth was primarily driven by the continued shift towards higher yielding securities, while loan growth was restrained by the lack of demand for bank credit.

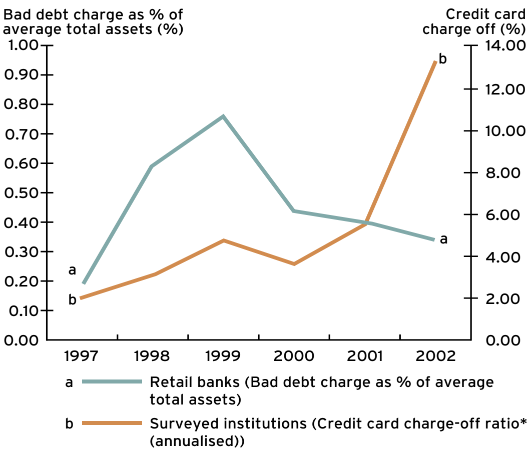
Retail banks' deposit liabilities also picked up, but growth was modest at 0.7%. This partly reflected the lack of deposit creation through domestic credit expansion and the diversion of funds into higher-yielding forms of investment.

The balance sheet of the banking sector as a whole contracted for the fifth consecutive year, down by 2.5% in 2002. This was largely attributable to the diminished booking of euroyen loans in Hong Kong by the Japanese banks.

Constrained domestic loan growth

A cautious appetite among home purchasers in a weak property market, coupled with an ebbing demand for leverage by the corporate sector in the wake of the economic slowdown, constrained loan growth. Retail banks' total lending rose modestly by 0.4% following an increase of 1.6% in 2001. While the contraction of loans to customers outside Hong Kong moderated to 2.3% from a notable drop of 17.7% in 2001, growth in total loans to customers inside Hong Kong slowed to 0.4% from 2.2% in 2001 (Chart 14).

CHART 12 **Charge-off ratios**



* There is a break in series in December 2001 owing to an increase in the number of surveyed institutions.

CHART 13 **Return on assets (post-tax profit)**

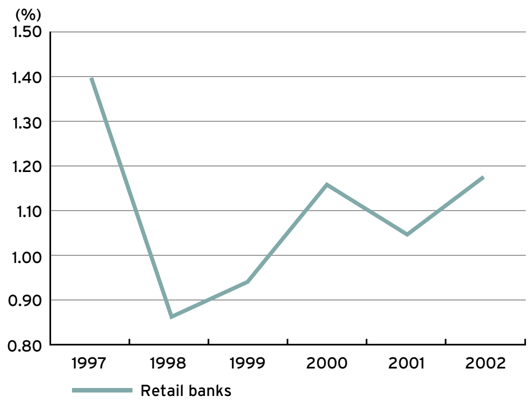
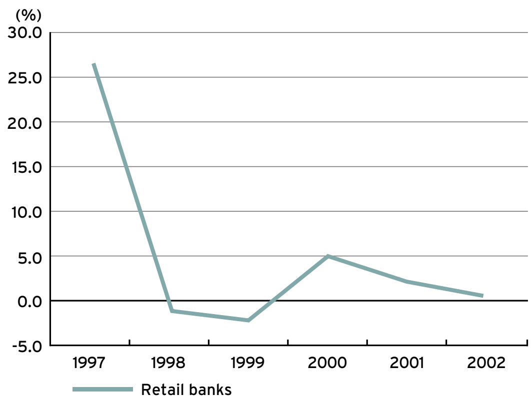


CHART 14 **Growth of loans to customers inside Hong Kong* (year-on-year)**



* Defined as loans for use in Hong Kong plus trade financing loans.

[r] Figure revised.

Property lending – the major form of retail banks' lending – grew at a slower rate of 1.4%, compared with an increase of 3.3% in 2001. Within this, residential mortgage loans (excluding loans under the Home Ownership Scheme, the Private Sector Participation Scheme and the Tenants Purchase Scheme) rose by 2.2%, having increased by 2.8% in 2001. Lending for property development rose by 0.8%, compared with an increase of 13.4% in 2001, while lending for property investment declined by 0.4% following an increase of 0.5% in 2001.

Retail banks' loans to other major economic sectors showed a mixed performance in 2002. Both loans to manufacturing and loans to wholesale and retail trade increased, by 1.2% and 1.6% respectively, against declines of 0.9% and 11.2% in 2001. In line with the subdued stock market and weak investment sentiment, loans to financial concerns contracted by 10.3% after increasing by 1.3% in 2001. However, loans to non-stockbroking companies and individuals to purchase shares rose significantly by 18.4%, although this was from a low base in 2001. Loans to the electricity, gas and telecommunications sector recorded an increase of 12.2%, underpinned by 7.6% growth in loans to the telecommunications sector. Nonetheless, exposure to the telecommunications sector represented only 1.0% of retail banks' loans to customers inside Hong Kong.

Consumer lending contracted, particularly in the credit card business, in the light of the historically high level of personal bankruptcies and the sharp deterioration in the quality of credit card lending. According to the HKMA's regular survey of authorized institutions active in credit card businesses, total credit card receivables declined in 2002 by 4.5% to $59.2 billion. This is the first decline since the survey began in 1996. The number of credit card accounts also dropped, to 9.1 million at the end of 2002 from 9.2 million at the end of 2001.

» Information Centre » Press Releases » Credit Card Lending Survey Results category

As a result of further loan repayments, total outstanding exposure to non-bank Chinese entities continued to fall in 2002. Retail banks' exposure declined by 8.4% to $102 billion at the end of 2002. This represents 2.8% of their total assets.

Continued shift to higher-yielding securities

Switching into higher-yielding negotiable debt instruments (NDIs), excluding negotiable certificate of deposits (NCDs), was the main conduit for banks' surplus funds in view of the limited lending opportunities. NDIs held by the retail banks have grown at double-digit pace in each of the past five years. The holdings rose by a further 20.8% in 2002, having increased by 24.7% in 2001. As a result, the proportion of NDIs held rose to 20.9% of retail banks' total assets at the end of 2002, up from 17.3% at the end of 2001 and 7.8% at the end of 1997. Much of the rise was in debt instruments and floating rate notes denominated in foreign currencies and issued by corporates. Foreign currency NDIs grew by 34.8%, while Hong Kong dollar denominated NDIs rose by only 1.1% (Chart 15). Broken down by issuers, 54.0% of outstanding NDIs were issued by corporates, 28.0% by governments and 18.0% by banks (Chart 16).

CHART 15 **Negotiable debt instruments held (retail banks) by currency breakdown**

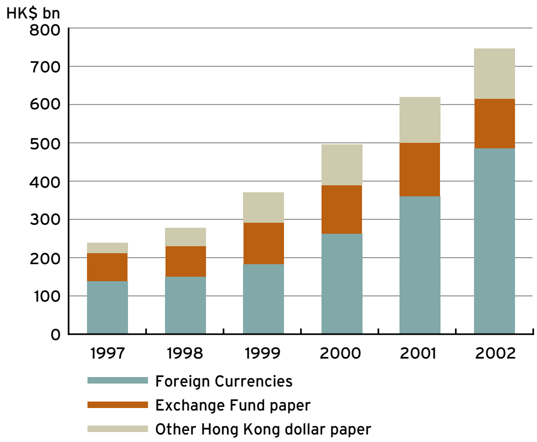
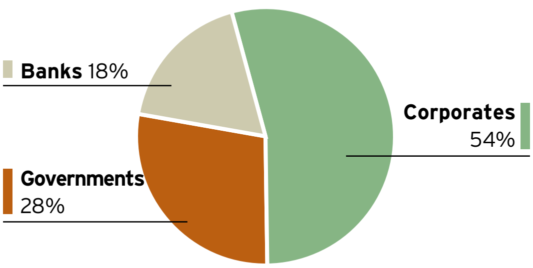


CHART 16 **Negotiable debt instruments (retail banks) by counterparty breakdown**



Outstanding NCDs issued by retail banks increased by 21.7%, against a decline of 3.6% in 2001. This was due largely to increased retail issues, which proved to be successful given the low yield on savings and time deposits. Reflecting the increased holdings of NCDs by retail customers, the proportion of outstanding NCDs held by retail banks dropped to 38.3% at the end of 2002, compared with 44.4% a year ago.

Growth in customer deposits

Retail banks' total customer deposits grew modestly by 0.7%, against a decline of 0.5% in 2001 (Chart 17). This was attributable to the 4.2% increase in foreign currency deposits, which offset the 1.5% decrease in Hong Kong dollar deposits (Chart 18). As a result, the proportion of Hong Kong dollar deposits to total deposits dropped to 61.0% from 62.3% at the end of 2001. Low interest rates and a reduction in the opportunity cost of holding liquid deposits resulted in a preference for savings deposits: hence the increasing shift from time to savings deposits over the past two years. Time deposits fell by 5.3% in 2002, whereas savings deposits increased by 11.1%.

Ample liquidity

Retail banks' liquidity remained high in 2002 although their loan-to-deposit ratios in all currencies and in Hong Kong dollars showed a modestly diverging trend. The former edged down to 53.5% from 53.7% at the end of 2001 and the latter rose to 78.6% from 77.2% because of a slight shift to foreign currency deposits, while Hong Kong dollar lending showed a small increase.

Improvement in overall asset quality

Influenced by the low interest rates, which helped reduce the debt servicing burden, together with write-offs and the disposal of problem loans by some banks, the overall asset quality of banks continued to improve in 2002. The problem loan ratios of retail banks declined,

CHART 17 **Growth of total customer deposits (year-on-year)**

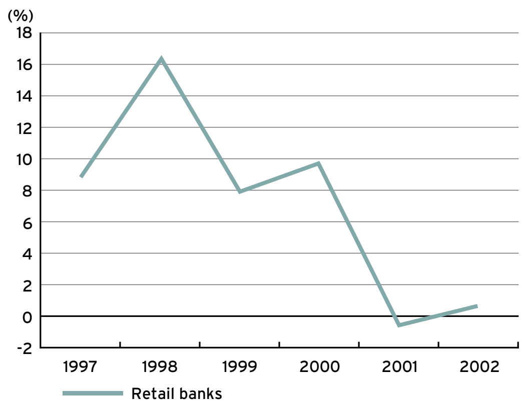
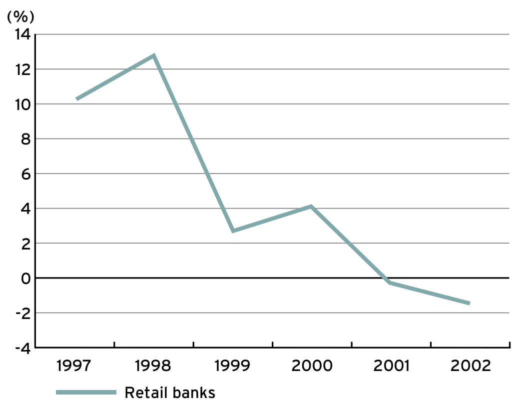


CHART 18 **Growth of Hong Kong dollar deposits* (year-on-year)**



* Including swap deposits.

with the classified and non-performing loan ratios dropping to 5.05% and 3.95% from 6.53% and 5.16% at the end of 2001 respectively. The combined ratio of overdue and rescheduled loans also improved, to 3.60% from 4.57% (Chart 19). Within the latter, loans overdue for more than three months and rescheduled loans dropped to 2.78% and 0.82% respectively.

The quality of the residential mortgage loan portfolio continued to hold up well, although weighed down by the negative equity problem as a result of declining property prices. Survey results from banks active in mortgage financing revealed that some 78,000 cases within the banking sector (or 16% of total mortgage borrowers) were in negative equity at the end of 2002. With an average loan-to-value ratio of 127%, the unsecured portion of these loans was estimated at about $28 billion or about 5% of the total residential mortgage portfolio.

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Notwithstanding the negative equity problem, the delinquency ratio of the residential mortgage portfolio dropped from 1.22% at the end of 2001 to 1.06% at the end of 2002 (Chart 20). The improvement was helped by the pre-emptive actions taken by banks to assist borrowers in financial difficulties to restructure their problem mortgage loans. Accordingly, the rescheduled loan ratio rose from 0.26% at the end of 2001 to 0.46% at the end of 2002. While the delinquency ratio of the negative equity loans was higher, at 2.62% of total residential mortgage loans, it was still at a manageable level.

The main focus of asset quality in 2002 was the worsening quality of the credit card portfolio arising from a doubling in the number of personal bankruptcies in the year. For 2002, the charge-off ratio recorded a record high of 13.25%, compared with 5.46% for 2001 (Chart 12). The credit card delinquency ratio ended the year unchanged at 1.28% after reaching a high of 1.90% at the end of March (Chart 20). Although the credit card portfolio remained weak, signs of stabilisation emerged towards the end of the year.

CHART 19 **Gross classified loans and combined overdue and rescheduled loans as a percentage of total loans**

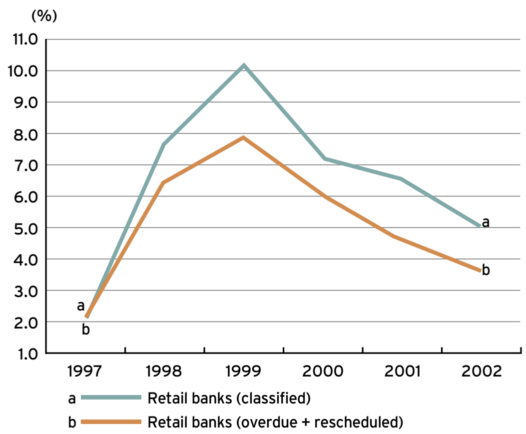
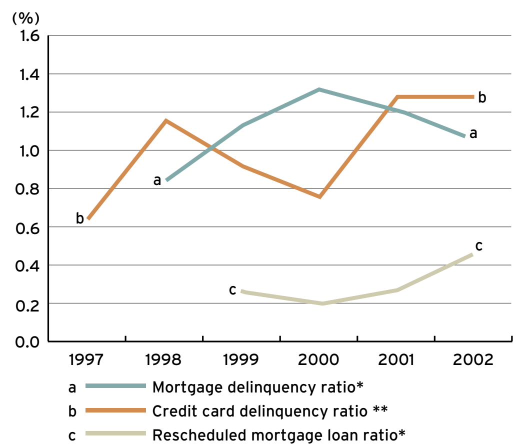


CHART 20 **Asset quality of credit card and mortgage lending (surveyed institutions)**



* There is break in series in December 2000 owing to an increase in the number of surveyed institutions

** There is a break in series in December 2001 owing to an increase in the number of surveyed institutions

Recent developments in the credit card business

In the aftermath of the Asian financial crisis the operating environment for banks became more difficult. Loan growth turned negative, while deposits continued to grow. This resulted in an accumulation of surplus deposits. With ample liquidity, keen competition reducing the margins on residential mortgage lending, and little corporate loan demand, banks turned to other types of consumer lending, especially credit card business, to broaden their income sources. In the past few years, credit card lending by the retail banks has risen considerably. Although its share in the banks' loan portfolio is small, credit card lending has more than doubled to 2.9% at end-2002 from 1.3% at end-June 1997 (Chart A).

However, the quality of the credit card portfolio started to deteriorate in the fourth quarter of 2001 along with the weakening of the domestic economy. This is reflected in the rising delinquency ratio and the escalating charge-off ratio (Chart B). The trend is closely related to the surge in personal bankruptcies, a relatively recent phenomenon, attributable to rising unemployment in recent years and changes in the bankruptcy law in 1998, which allowed for an earlier release of bankrupts. Bankruptcy petitions began to accelerate from the second half of 2001. The number of cases reached an unprecedented high of 26,922 in 2002, double that of 2001 (Chart C). In view of this development, the banks tightened their lending polices to help stem the rise in problem debts. They also moved to restructure these debts and write off the bad debts earlier. This resulted in a sharp increase in the charge-off ratio, which rose significantly in 2002 after being relatively stable for the past few years.

The deterioration in the quality of the credit card portfolio appeared to stabilise in the fourth quarter of 2002. Given the uncertain economic environment, banks are now more cautious about issuing cards and setting credit limits. The quality of the credit card portfolio will continue to be influenced by the number of personal bankruptcies, which in turn depends largely on the economic situation and the trend in unemployment. The recent initiative to allow sharing of positive credit information will provide a means for banks to better manage their credit card business.

CHART A **Credit card receivables as a percentage of total loans for use in Hong Kong**

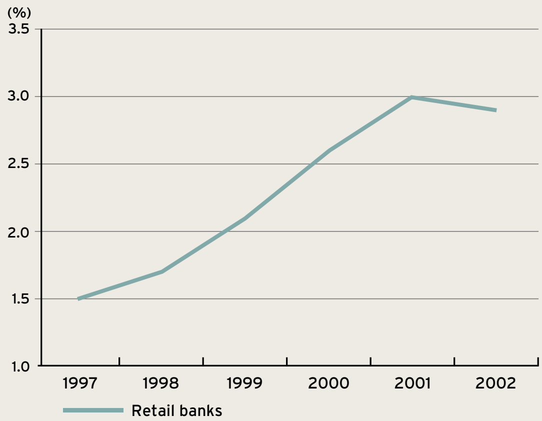
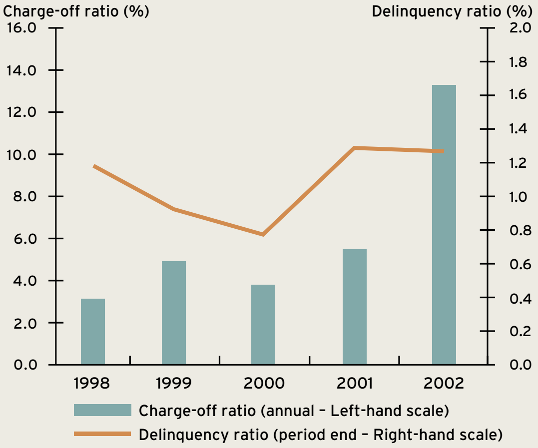
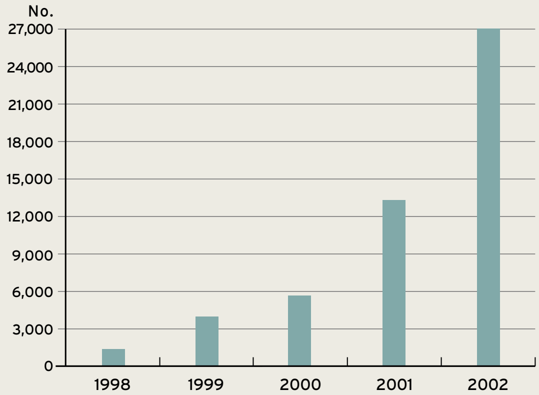


CHART B **Credit card delinquency and charge-off ratios**



Note: There is a break in series in Q4 2001 owing to an increase in the number of surveyed institutions.

CHART C **Personal bankruptcy petitions (Annual total)**



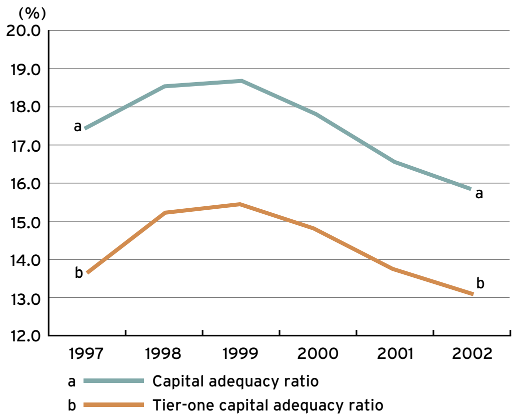
Source: Official Receiver's Office

Capital ratio remained strong

The capital adequacy ratio of all locally incorporated AIs declined to 15.8% at the end of 2002 from 16.5%[r] at the end of 2001 (Chart 21). The decline was due to a combination of factors: higher dividend payouts by a number of AIs, the effects of consolidation and integration during the year, revaluation deficits booked by some banks and an increase in risk-weighted assets, particularly in high-yielding securities.

Nevertheless, capital levels remained strong with a significant portion of the capital base constituted by core capital. The Tier 1 capital ratio stood at 13.1% as at the end of 2002 (Chart 21). While innovative capital instruments are still not widely used among the locally incorporated institutions in Hong Kong, hybrid capital instruments saw a sharp rise of 22.4% in the year and constituted 5% of their total capital base.

CHART 21 **Consolidated capital adequacy ratio (all locally incorporated AIs)**



[r] Figure revised.

PROSPECTS FOR 2003

The outlook for the banking sector remains challenging amid continuing economic uncertainties and geopolitical tensions. A decade of economic prosperity in the 1990s provided growth and strengthened the financial position of the banks to face the challenges ahead. The general expectation is that loan demand will remain subdued and the profit margin from consumer loan products such as mortgage and personal loans will continue to be squeezed due to keen competition. Provisions for the credit card portfolio will depend very much on the bankruptcy and unemployment situations, but are expected to remain high. So far, however, the quality of residential mortgage and corporate loan portfolios seem to be holding up well, although the issue of negative equity continues to be of concerm.

In the coming year, efforts will be further devoted to product innovation and service enhancement, although strengthening revenues remains an uphill battle. Banks will have to look towards deriving benefits from Hong Kong's further integration with the Mainland. They are also likely to continue to keep a close eye on costs. Consolidation within the industry is expected to continue as banks realise that in an increasingly difficult market this may help to achieve revenue synergies and growth, as well as further cost reductions.