The asset quality and profitability of the banking sector continued to improve in the September quarter. Pre-tax profits of local banks recorded strong growth compared with the same period of 1999, attributable to a significant drop in the bad debt charge and increases in net interest and fee income. Although funding costs eased, the net interest margin narrowed due to a continued decline in lending margins. Domestic loans have increased only modestly in the first three quarters of this year, reflecting the fact that loan demand remains relatively subdued.

Interest Rate Movements

In the light of stable US interest rates and ample liquidity in the banking sector, funding costs eased in the September quarter. For the quarter, average 1-month HIBOR decreased by 42 basis points to 6.02%, against an increase of 88 basis points in the June quarter. The average 3-month HIBOR also decreased, by 44 basis points to 6.12%, as opposed to a rise of 73 basis points in the preceding quarter. Time deposit rates[1] in general moved downward. The average 1-month and 3-month time deposit rates dropped by 27 and 35 basis points to 4.94% and 5.03% respectively, compared with corresponding increases of 104 and 80 basis points in the June quarter.

The best lending rate (BLR) remained unchanged at 9.50%, after rising by 50 basis points in May 2000. Due to the easing in funding costs, the average spread between BLR and 1-month HIBOR widened by 70 basis points to 3.48% and that for 3-month HIBOR by 72 basis points to 3.38%. The average spread between BLR and the 1-month time deposit rate increased by 55 basis points to 4.56% and that for the 3-month time deposit rate by 63 basis points to 4.47%.

Balance Sheet Developments

Customer Deposits

Having risen by 3.3% in the June quarter, customer deposits grew further by 2.6% in the September quarter. Within this, Hong Kong dollar deposits increased by 2.0% after rising by 1.9% in the June quarter. The growth in foreign currency deposits moderated to 3.3% from 4.8% in the preceding quarter. US dollar deposits continued to grow strongly, with growth of 7.9%, following 6.6% in the June quarter. However, non-US dollar deposits declined by 3.5%, reversing growth of 2.4% in the June quarter. Owing to the continued faster growth in foreign currency deposits than Hong Kong dollar deposits, the proportion of Hong Kong dollar deposits to total deposits fell further to 53.64% at end-September from 54.0% at end-June.

Hong Kong dollar demand deposits rose by 1.5% in the September quarter, against a decrease of 4.4% in the June quarter. Savings deposits fell for the second consecutive quarter, by 1.0% following a drop of 2.9% in the preceding quarter, while time deposits increased by 3.1% after rising by 4.4%. Within this, there was a marked switch from the "one to three month" maturity to the "within one month" maturity. The former fell by 23.8% while the latter rose by 22.1%. The growth in time deposits maturing over 3 months moderated to 0.7% from 6.3% in the June quarter. Some banks converted their swap deposits into Hong Kong dollar time deposits, resulting in a marked contraction of 82.6% in total swap deposits (compared with an increase of 1.0% in the June quarter).

According to the survey on the Impact of Deregulation of Time Deposits of 40 licensed banks conducted by the HKMA, Hong Kong dollar notice

1 These are period average figures quoted by 10 major banks for deposit amounts less than HK$100,000 as reported in the HKMA *Monthly Statistical Bulletin*.

Table 1
HK$ Deposit Mix

Amount (HK$ bn)

	Deposits				
	Demand	**Savings**	**Time ***	**Swap**	**Time @**
Jun/99	97.4	430.6	1,150.0	28.8	1,178.8
% growth	1.2	7.7	(0.6)	(4.5)	(0.7)
Sep/99	99.7	413.7	1,170.4	28.8	1,199.1
% growth	2.3	(3.9)	1.8	(0.1)	1.7
Dec/99	105.8	451.7	1,174.8	28.3	1,203.1
% growth	6.2	9.2	0.4	(1.5)	0.3
Mar/00	107.6	456.5	1,152.1	27.4	1,179.6
% growth	1.7	1.1	(1.9)	(3.3)	(2.0)
Jun/00	102.9	443.4	1,203.6	27.7	1,231.3
% growth	(4.4)	(2.9)	4.5	1.0	4.4
Sep/00	104.4	439.0	1,264.8	4.8	1,269.6
% growth	1.5	(1.0)	5.1	(82.6)	3.1

Notes: % *growth denotes the quarter-on-quarter growth of the deposits*
* *excludes swap deposits*
@ *includes swap deposits*

and time deposits of less than HK$500,000 with a maturity of less than 7 days grew markedly in the September quarter, following the deregulation of such deposits on 3 July 2000[2]. However, the weighted average interest expense quoted in the survey remained virtually unchanged. The impact of this phase of deregulation on banks' profitability should be minimal as this portion of time deposits only represented 0.1% of total HK$ deposits (including swap deposits) at end-September 2000.

Negotiable Instruments

Attributable to sluggish demand and an increase in redemption of negotiable certificate of deposits (NCDs), the outstanding amount of NCDs showed a bigger decline of 5.3% in the September quarter compared with a drop of 2.5% in the June quarter. As in the preceding quarter, most NCDs issued were denominated in Hong Kong dollars and were of short maturity. Floating rate instruments continued to dominate the primary NCD market, as banks expected that interest rates might peak in the near future. As a result, the share of floating rate NCDs increased to 68.7% from 60.0% in the June quarter. Of the total outstanding amount of NCDs issued, 58.2% were held by authorized institutions, up from 56.7% at end-June.

Some banks continued to switch their surplus funds, resulting from the growth in deposits and limited lending opportunities, into negotiable debt instruments (NDIs) in the September quarter. NDIs held by the banking sector as a whole rose by 9.8%, following an increase of 6.8% in the June quarter. Of this total, foreign currency NDIs grew by 11.7% after increasing by 9.6% in the June quarter. Hong Kong dollar NDIs increased by

2 On 3 July 2000, the Interest Rate Rules on time deposits with a maturity of less than 7 days and the prohibition on benefits for deposits (other than Hong Kong dollar savings and current accounts) were uplifted. This completed the remaining phase of deregulation on Hong Kong dollar time deposit rates.

7.4%, compared with a rise of 3.5% in the June quarter.

Continuing with the trend noted in the previous quarter, foreign currency NDIs held by local banks grew markedly in the September quarter, by 21.4% after a notable increase of 29.2% in the preceding quarter. Hong Kong dollar NDIs held by local banks increased by 6.6%, the same growth rate as recorded in the June quarter. Overall, NDIs held by local banks grew by 13.8% after rising by 16.6% in the June quarter.

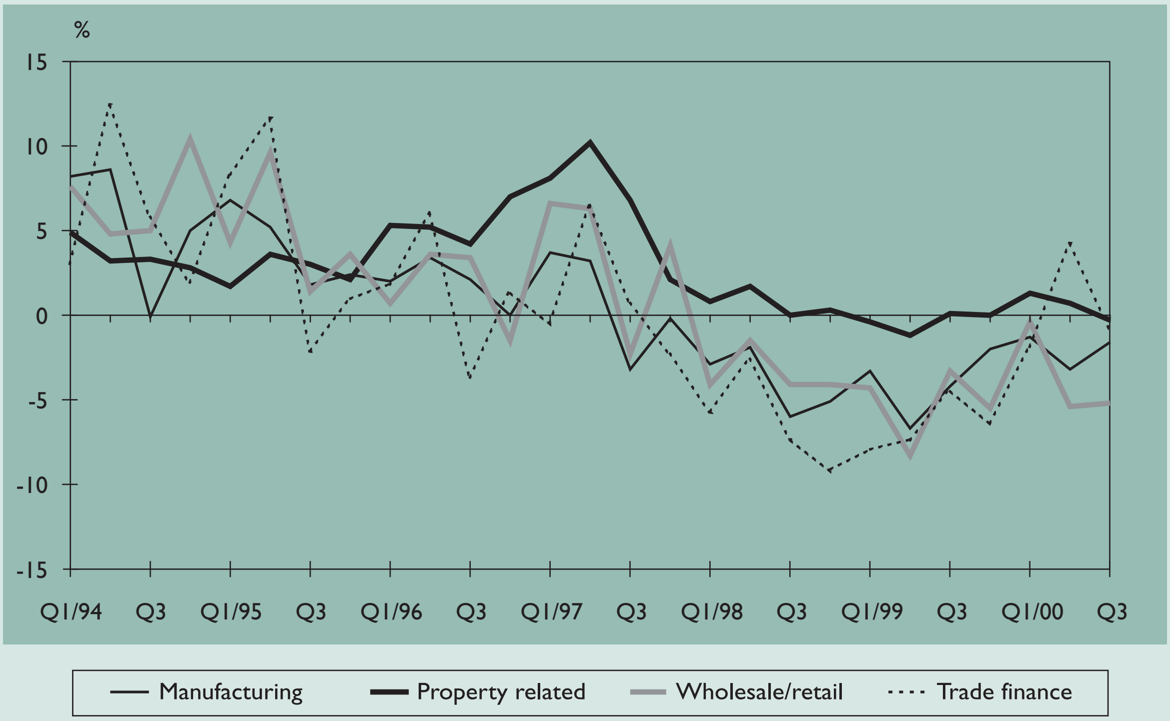
Lending

Loans and advances fell by 1.4% in the September quarter, moderating from a decline of 4.1% in the June quarter. This reflected growth in domestic lending of 3.8% after a drop of 0.2% in the preceding quarter. A large part of the increase in domestic lending, however, was due to loans extended by banks to finance the acquisition of a large corporate, and other than this domestic loan demand remained slow in general. Within domestic lending, foreign currency loans grew at a much faster rate than Hong Kong dollar loans. Foreign currency loans increased strongly by 14.4%, against a decline of 2.3% in the June quarter. The increase was related to the corporate acquisition referred to above. Hong Kong dollar loans rose for the third consecutive quarter, by 1.6% after rising by 0.2% in the previous quarter.

Continued contraction in Japanese banks' Euroyen lending activities led to a further drop of 17.0% in offshore loans, compared with a decline of 14.3% in the June quarter.

Chart 1

Loans for Use in Hong Kong by Selected Sectors
Quarterly Percentage Change



N.B. Property related loans denotes lending for property development & investment (including civil engineering) and private residential loans (including lending under the Home Ownership Scheme, Private Sector Participation Scheme & Tenants Purchase Scheme).

Affected by the sluggish conditions in the property market, property lending recorded a decline of 0.3% in the September quarter, in contrast to an increase of 0.6% in the June quarter. The decline was due mainly to a drop in loans for property development, which fell by 4.1% against an increase of 2.4%[3] in the preceding quarter, while loans for property investment rose further by 0.3% after rising by 0.3% in the June quarter. The growth of residential mortgage loans (excluding loans under Home Ownership Scheme and Private Sector Participation Scheme) remained modest, at 0.3% following a 0.2% increase in the preceding quarter.

Loans to the electricity, gas, and telecommunications sectors surged by 148.4% in the September quarter, compared with a rise of 8.1% in the June quarter. However, the share of such loans in total domestic lending remained low, at 3.5% at end-September. While loans to the wholesale and retail sectors decreased further by 5.3% after dropping by 5.4% in the preceding quarter, the decline in loans to the manufacturing sector moderated to 1.6% from 3.2% in the June quarter. Helped by increased activity in the stock market, loans to stockbroking companies registered a marked growth of 68.7% in the September quarter, compared with a marginal increase of 0.1% in the June quarter. Loans to non-stockbroking companies and individuals for the purchase of shares also rose significantly, by 67.5%, as opposed to a decline of 11.7% in the preceding quarter. However, loans for trade financing shrank by 0.8% after rising by 4.2% in the preceding quarter. Following an increase of 7.7% in the June quarter, credit card receivables expanded further by 6.4%.

Loan-to-Deposit Ratio

Given the faster growth in customer deposits than in total loans, the overall loan-to-deposit ratio

Table 2
Asset Quality[1] of All Local Banks

	Sep/99	Dec/99	Mar/00	Jun/00	Sep/00
	as % of total loans				
Pass Loans	**81.48**	**82.14**	**82.67**	**84.07**	**85.03**
Special Mention Loans	**8.19**	**8.04**	**8.05**	**7.36**	**7.25**
Classified Loans (Gross)[2]	**10.33**	**9.81**	**9.28**	**8.58**	**7.72**
o/w Substandard	*4.33*	*3.72*	*3.43*	*3.00*	*2.58*
Doubtful	*5.56*	*5.44*	*5.11*	*5.01*	*4.56*
Loss	*0.44*	*0.66*	*0.74*	*0.56*	*0.58*
Classified Loans (Net)[3]	**7.29**	**6.59**	**6.12**	**5.62**	**4.90**
Overdue > 3 Months and Rescheduled Loans	**7.54**	**6.96**	**6.86**	**6.33**	**6.27**
o/w Overdue > 3 months	*6.32*	*5.85*	*5.90*	*5.48*	*5.26*
Rescheduled loans	*1.22*	*1.11*	*0.96*	*0.85*	*1.02*
Non-Performing Loans[4]	**7.22**	**7.14**	**6.81**	**6.44**	**6.00**

1. Period-end figures relate to HK offices and overseas branches.
2. Classified loans are those loans graded as "substandard", "doubtful" or "loss".
3. Net of specific provisions
4. Loans on which interest has been placed in suspense or on which interest accrual has ceased.

Because of rounding, the figures set out in this table may not add up.

3 Revised from an increase of 1.7% due to reporting adjustments.

of local banks fell to 52.2% at end-September from 52.5% at end-June. Conversely, the Hong Kong dollar loan-to-deposit ratio of local banks increased to 71.3% from 70.9% as their Hong Kong loans grew faster than their Hong Kong dollar deposits. For the banking sector as a whole, the overall loan-to-deposit ratio dropped to 75.5% at end-September from 78.6% at end-June due to the continued contraction in total loans and rise in customer deposits. The Hong Kong dollar loan-to-deposit ratio also fell to 91.4% from 91.6% because Hong Kong dollar customer deposits grew faster than Hong Kong dollar loans.

Asset Quality

Owing to the continued decline in the problem loans of local banks and the rise in their total loans, local banks' asset quality improved further in the September quarter. Loans overdue for more than three months dropped to 5.26% of total loans from 5.48% at end-June. Despite an increase in rescheduled loans to 1.02% from 0.85%, the combined ratio of overdue and rescheduled loans stood at 6.27% of total loans at end-September, down from 6.33% at end-June. Non-performing (non-accrual) loans also fell, to 6.00% from 6.44%. Classified loans (a broader measure of problem loans which takes account of both qualitative and quantitative factors) fell for the fourth straight quarter, to 7.72% of total loans at end-September from 8.58% at-end June. Net of specific provisions, classified loans stood at 4.90% at end-September compared with 5.62% at end-June.

The quality of credit card receivables continued to improve. Delinquent accounts (measured as receivables overdue for more than 90 days to total receivables) declined to 0.71% at end-September from 0.73% at end-June. The annualised charge-off ratio also fell for the fourth consecutive quarter, to 3.57% from 3.98% in the June quarter.

According to the monthly residential mortgage survey, residential mortgage loans overdue for more than three months as a percentage of the total mortgage portfolio continued to rise, to 1.28% at end-September from 1.23% at end-June.

Profitability

The profitability of local banks as a whole continued to recover in the September quarter and for the first nine months of the year was sharply higher than in the same period of 1999. This reflected a significant drop in the bad debt charge and increases in net interest and fee income.

For the first nine months of 2000, the annualised net interest margin (NIM) rose to 2.37% from 2.28% for the same period of 1999. However, on a quarterly basis, the annualised NIM dropped for the second consecutive quarter, to 2.33% in the September quarter from 2.40% in the March quarter, reflecting the continued decline in lending margins. Consistent with the improving trend in asset quality, the annualized bad debt charge as a percentage of total average assets declined to 0.23% in the first nine months of 2000 from 0.54% in the same period of 1999.

The average consolidated capital adequacy ratio of all local incorporated institutions remained unchanged at 18.7% at end-September.

- Prepared by the Banking Policy Department