

DEVELOPMENTS IN THE BANKING SECTOR

Retail banks' lending growth remained subdued in the second quarter. Overall asset quality continued to improve, despite continued deterioration in the quality of credit card receivables. Capital adequacy and liquidity ratios remained high.

Aggregate pre-tax operating profits of the retail banks in respect of their Hong Kong offices fell by around 3% in the first half, compared to the first half of 2001, largely due to increased provisions for bad and doubtful debts.

Interest Rate Movements

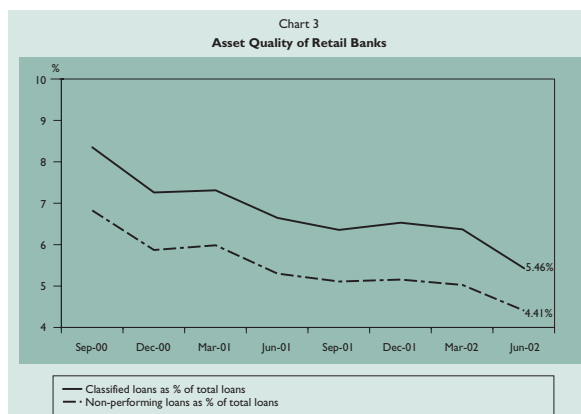
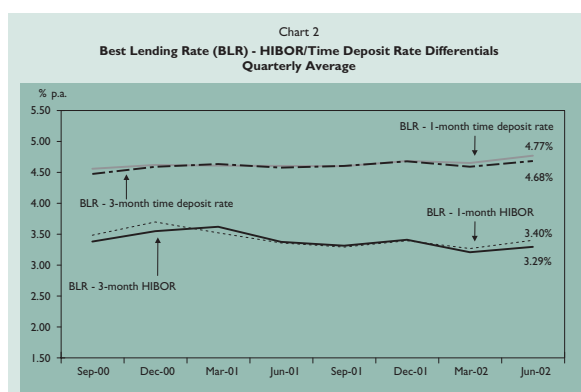
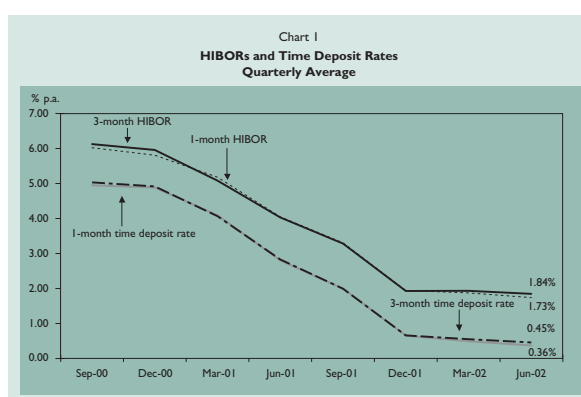
Reflecting high liquidity in the banking system and continued sluggishness in demand for borrowing, deposit and interbank interest rates dropped further in the second quarter although the best lending rate¹ (BLR) remained unchanged. The average one-month time deposit rate contracted by 12 basis points and one-month HIBOR by 14 basis points (Chart 1).

The reduction in deposit and interbank interest rates while BLR remained unchanged resulted in widened interest spreads. The average spread between BLR and one-month HIBOR widened by 14 basis points to 3.40% and that between BLR and the one-month time deposit rate by 12 basis points to 4.77% (Chart 2).

Asset Quality

Retail banks' asset quality continued to improve in the second quarter, influenced by write-offs made by the banks at the half-year and the disposal of problem loans by some banks (Table 1 and Chart 3). The ratios of classified loans and non-performing loans improved to 5.46% and 4.41% at end-June from 6.37% and 5.03% at end-March respectively. The combined ratio of overdue and rescheduled loans also improved to 3.98% at end-June from 4.69% at end-March.

Despite the overall improvement in asset quality, there was continued deterioration in the quality of credit card receivables. While the credit card delinquency ratio declined to 1.73% at end-June from



¹ Best lending rate refers to the rate quoted by the Hongkong and Shanghai Banking Corporation Limited.

1.90% at end-March, this was due not to an improvement in the performance of banks' credit card portfolios, but rather a sharply higher level of charge-offs. The amount charged off in the second quarter was HK\$2.06 billion or 3.41% of average receivables. If this rate of charge-off were to be maintained for the next three quarters, the "annualised" amount of charge-offs would be HK\$8.22 billion or 13.63% of average receivables (Chart 4). This compares with 9.04% in the previous quarter. The sharp increase came against a backdrop of high unemployment and a growing number of personal bankruptcies. The annualised ratio was however somewhat distorted by the effects of a change in the charge-off policies of some institutions, which have begun to write off accounts earlier (when a bankruptcy petition is presented). Adjusted for this, the quarterly annualised charge-off ratio for the second quarter would have been 12.68%.

In contrast to the credit card portfolio, the asset quality of the mortgage portfolio continued to hold up well. Based on the monthly survey on

residential mortgage lending, the mortgage delinquency ratio (measured by the amount overdue for more than three months as a percentage of the total mortgage portfolio) decreased to 1.10% at end-June, the lowest level since March 1999, from 1.18% at end-March (Chart 4). The decrease was in part due to more loan rescheduling and write-offs at the

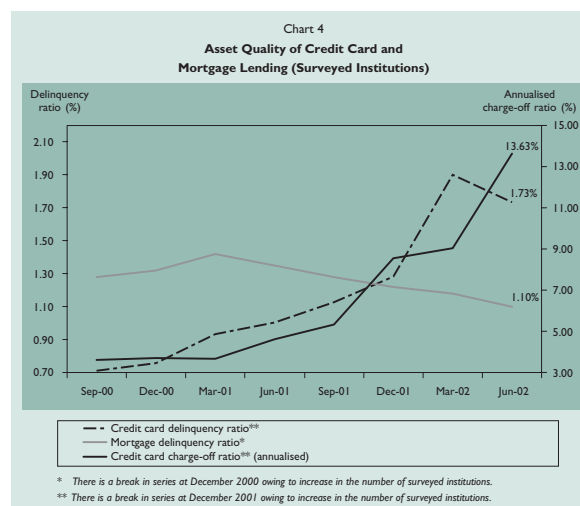


Table I
Asset Quality¹ of Retail Banks

	Jun-01	Sep-01	Dec-01	Mar-02	Jun-02
	as % of total loans				
Pass loans	87.61	88.05	88.02	88.15	88.76
Special mention loans	5.74	5.60	5.45	5.48	5.78
Classified loans (gross)²	6.65	6.36	6.53	6.37	5.46
<i>o/w Substandard</i>	2.32	2.05	2.17	2.06	1.80
<i>Doubtful</i>	3.54	3.34	3.17	2.98	2.42
<i>Loss</i>	0.79	0.97	1.18	1.34	1.24
Classified loans (net)³	4.66	4.37	4.51	4.35	3.75
Overdue > 3 months and rescheduled loans	5.36	5.01	4.57	4.69	3.98
<i>o/w Overdue > 3 months</i>	4.43	4.26	3.95	4.02	3.25
<i>Rescheduled loans</i>	0.93	0.75	0.61	0.66	0.73
Non-performing loans⁴	5.30	5.11	5.16	5.03	4.41

Notes:

1. Period-end figures relate to Hong Kong 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.

half year. The rescheduled loan ratio (measured by the ratio of rescheduled mortgage loans to total outstanding mortgage loans) rose to 0.46% from 0.38%, reflecting banks' responsiveness to assist borrowers in financial difficulties.

Profitability

While the performance of individual banks varied, at the aggregate level the retail banks' pre-tax operating profits in respect of their Hong Kong offices fell by around 3% in the first half of 2002 compared with the first half of 2001. The fall was largely due to increased provisions and a decline in other operating income. The impact was however reduced by lower operating costs as a result of the tight cost controls initiated by the banks. Provisions for bad and doubtful debts increased in the first half, compared with the first half of 2001, reflecting largely the deterioration in the quality of credit card portfolios. As a result, retail banks' annualised ratio of bad debt charge to average total assets increased to 0.32% in the first half of the year from 0.29% in the first half of 2001 (Chart 5). The decline in operating income was attributable mainly to losses in investments held for trading arising from unrealised mark-to-market losses, fewer dividends received and a fall in other income. The cost-income ratio fell to 38.7% in the first half from 39.7% in the first half of 2001.

The widening in interest spread and decline in average interest bearing assets resulted in retail banks' annualised net interest margin rising to

2.11% in the first half from 2.02% in the first half of 2001 (Chart 6).

Capital Adequacy Ratio

The capital position of the locally incorporated authorized institutions remained strong, with the average consolidated ratio standing at 16.2% at end-June (Table 2).

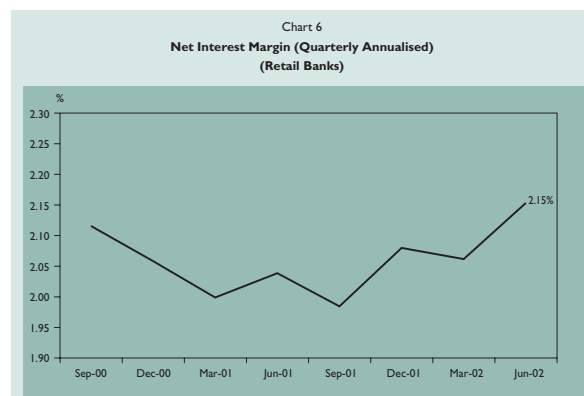
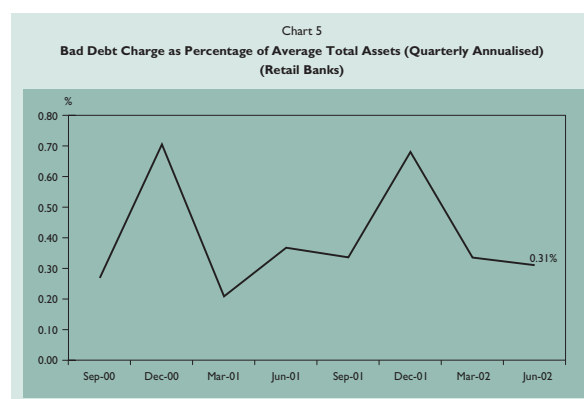


Table 2
Consolidated Capital Adequacy Ratio (All locally incorporated AIs)

(HK\$ mn)

	Jun-01	Sep-01	Dec-01 ^{2,3}	Mar-02 ²	Jun-02
Total capital base after deductions ¹	267,292	278,215	304,855	307,290	306,076
of which core capital	222,333	228,263	252,756	255,276	251,690
Total risk-weighted exposures	1,488,726	1,518,837	1,842,226	1,845,518	1,887,521
Capital adequacy ratio	18.0%	18.3%	16.5%	16.7%	16.2%

Notes:

- Total capital base after deductions refers to total core and supplementary capital after deductions as specified under the Third Schedule to the Banking Ordinance.
- Revised figures due to late adjustments.
- There is a break in series at end-December 2001 owing to a change in the reporting population.

Lending

Retail banks' total loans grew by 0.2% in the second quarter following an increase of 0.5% in the first quarter (Chart 7). The rise was underpinned by the 0.4% growth in loans to customers inside Hong Kong which had increased by 0.5% in the previous quarter. Within this, trade financing loans recorded a strong growth of 9.2% against a drop of 1.5% in the first quarter, while growth trends in other loans for use in Hong Kong were reasonably flat. Retail banks' loans to customers outside Hong Kong declined for the fourth consecutive quarter, largely due to the disposal of some offshore loans by some banks.

The breakdown of retail banks' loans to customers inside Hong Kong by major economic sectors² in Chart 8 shows that property lending continued to grow, albeit slightly by 0.9% following an increase of 0.3% in the first quarter. Residential mortgage lending, which has been rising for five consecutive quarters, grew by 1.6% in the second quarter and lending for property development grew by 3.0% following a decline of 4.2% in the first quarter. By contrast, loans for property investment contracted by 1.4%, having risen by 0.9% in the previous quarter.

Retail banks' lending to the telecommunications sector amounted to HK\$14.4 billion at end-June, representing 1.0% of their total domestic lending. The comparable figure for the banking sector as a whole was HK\$31.5 billion, representing 1.7% of total domestic lending.

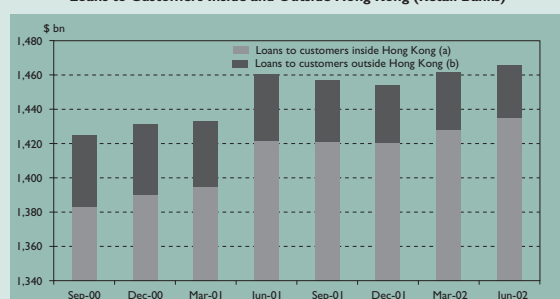
Total outstanding exposure to non-bank Chinese entities continued to fall at end-March, with the exposure of the retail banks declining to HK\$108.2 billion (2.7% of total assets) and that of the banking sector as a whole declining to HK\$153.9 billion (2.4% of total assets). This fall was partly due to loan repayments.

According to the survey of institutions active in credit card business, credit card receivables fell

by 0.1% in the second quarter. This reflects a number of factors including charge-offs by institutions and efforts by some to tighten up on credit card financing and by others to help customers restructure card receivables.

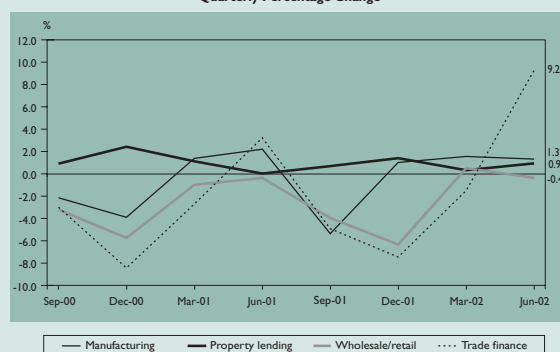
In contrast to the retail bank group, total loans to customers of the banking sector as a whole continued to fall in the second quarter, but at a slower rate of 0.5% compared with 1.2% in the first quarter (Chart 9).

Chart 7
Loans to Customers Inside and Outside Hong Kong (Retail Banks)



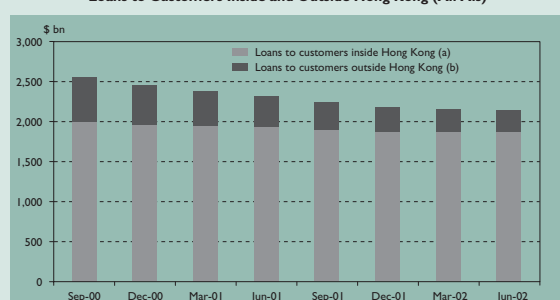
Notes:
(a) Defined as loans for use in Hong Kong plus trade financing loans.
(b) Includes "others" (i.e. unallocated).

Chart 8
Loans for Use in Hong Kong by Selected Sectors (Retail Banks)
Quarterly Percentage Change



N.B. Property lending denotes lending for property development & investment and residential mortgage loans (excluding lending under the Home Ownership Scheme, the Private Sector Participation Scheme & the Tenants Purchase Scheme).

Chart 9
Loans to Customers Inside and Outside Hong Kong (All AIs)



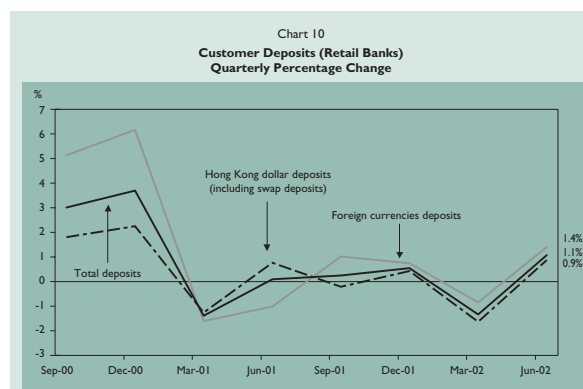
Notes:
(a) Defined as loans for use in Hong Kong plus trade financing loans.
(b) Includes "others" (i.e. unallocated).

2 The trends by economic sectors for the retail banks largely reflect the trends of the banking sector given that the retail banks contribute to about 75% of loans to customers inside Hong Kong. With effect from this issue therefore, the breakdown of loans to customers inside Hong Kong by major economic sectors for the banking sector will no longer be given but will be replaced by the breakdown in respect of the retail banks.

Customer Deposits

Retail banks' customer deposits rose by 1.1% in the second quarter after a decline of 1.3%³ in the preceding quarter (Chart 10). Within this, Hong Kong dollar deposits and foreign currency deposits rose by 0.9% and 1.4% respectively, against declines of 1.6% and 0.9% in the first quarter. At end-June, Hong Kong dollar deposits represented 62.0% of total deposits for retail banks and 55.5% for the banking sector as a whole.

The rise in Hong Kong dollar deposits was largely attributable to the increase in demand and savings deposits, with time deposits continuing to decline. Demand deposits rose by 4.0%, against a drop of 4.5% in the first quarter. Savings deposits rose for the seventh consecutive quarter, by 3.9% in the second quarter. It represented 37.9% of total Hong Kong dollar deposits, up from 31.8% a year ago. Time deposits, on the other hand,



declined for the seventh consecutive quarter, by 1.4%. The proportion of time deposits to total Hong Kong dollar deposits fell to 55.2% at end-June from 62.5% a year ago. The shift from time deposits to savings deposits is likely to be related primarily to the low interest rate environment. Quarterly changes in Hong Kong dollar deposits by type are shown in Table 3.

Table 3
Hong Kong Dollar Deposit Mix

	All AIs			Retail banks		
	Demand	Savings	Time*	Demand	Savings	Time*
Jun-01	106.3	540.8	1,202.9	96.6	535.3	1,052.7
% growth	0.9	8.3	(2.9)	1.6	8.4	(2.8)
Sep-01	112.6	564.8	1,174.1	102.4	558.6	1,019.9
% growth	5.9	4.4	(2.4)	6.0	4.4	(3.1)
Dec-01	128.2	613.9	1,112.5	117.1	608.0	963.0
% growth	13.9	8.7	(5.2)	14.3	8.8	(5.6)
Mar-02	121.9	616.7	1,091.9	111.8	611.2	937.2
% growth	(4.9)	0.5	(1.9)	(4.5)	0.5	(2.7)
Jun-02	126.3	640.7	1,081.4	116.2	634.8	923.7
% growth	3.6	3.9	(1.0)	4.0	3.9	(1.4)

Notes: % growth denotes the quarter-on-quarter growth of the deposits.

* includes swap deposits.

3 The definition of customer deposits has been revised to include short-term Exchange Fund placements. Accordingly, the growth rates of customer deposits of the retail banks and the banking sector for the first quarter have been revised from 1.0% to 1.3% and from 3.3% to 3.5% respectively.

Customer deposits for the banking sector as a whole increased by 1.3% after contracting by 3.5%³ in the first quarter (Chart 11).

Negotiable Instruments

Outstanding negotiable certificates of deposit (NCDs) issued by the banking sector increased sharply by 11.0%, compared with a modest increase of 0.5% in the first quarter. Within this, having declined for three consecutive quarters, outstanding NCDs issued by the retail banks increased by 11.4% (Table 4), largely attributable to recent retail issues by some banks. Floating rate instruments dominated the primary NCD market, accounting for 59.1% of new issues by the retail banks in the second quarter. The proportion of the outstanding amount of NCDs held by retail banks declined to 43.6% at end-June from 45.6% at end-March.

The trend of banks switching surplus funds into negotiable debt instruments (NDIs) continued. NDIs held by the banking sector rose by 10.8% after increasing by 4.2% in the first quarter. This

was largely due to the growth of about 12% in NDIs held by retail banks and followed a rise of 2.8% in the first quarter (Table 4). The growth was mainly driven by an increase in the holding of other debt instruments and floating rate notes. The mix of instruments held is shown in Chart 12. About 32% of NDIs held by retail banks were in government bills, notes and bonds. NDIs held by the retail banks have been consistently on the rise over the last few years and reached 20.2% of total assets as at end-June.

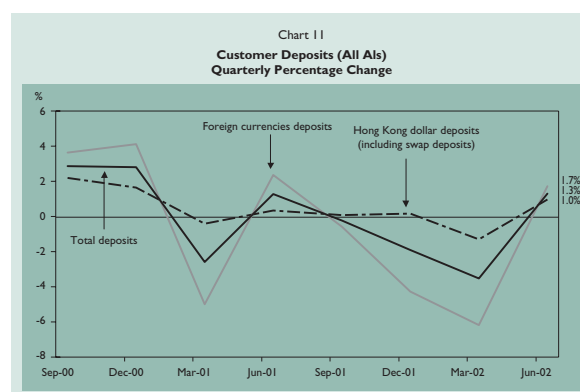
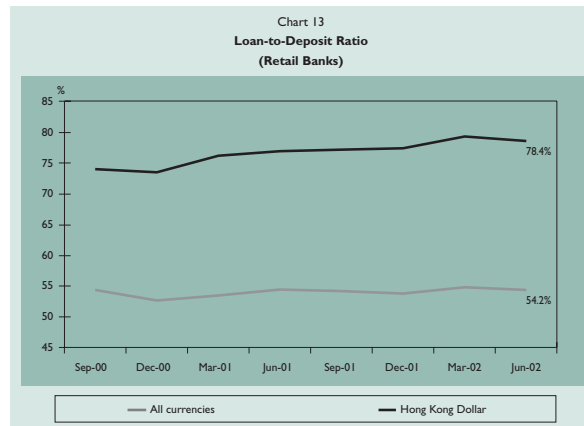
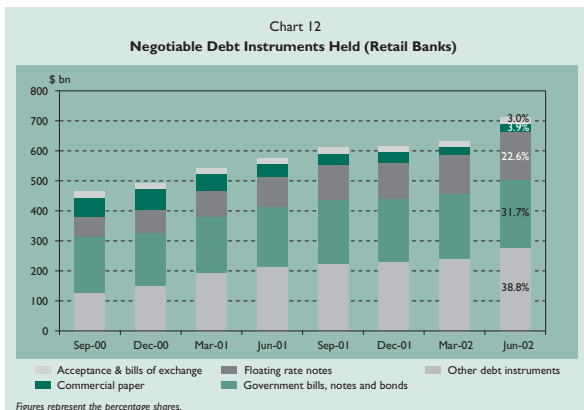


Table 4
NCDs and NDIs

Amount (HK\$ bn)


	All AIs				Retail banks			
	Total NCDs outstanding	HK\$	FC	Total	Total NCDs outstanding	HK\$	FC	Total
Jun-01	180	369	492	861	124	254	323	578
% growth	4.2	(1.1)	9.0	4.4	7.6	(0.8)	12.5	6.2
Sep-01	180	392	522	915	123	272	342	614
% growth	(0.2)	6.4	6.2	6.3	(0.7)	6.9	5.9	6.3
Dec-01	172	355	553	908	113	256	360	616
% growth	(4.1)	(9.6)	5.9	(0.8)	(7.6)	(5.6)	5.0	0.3
Mar-02	173	392	553	946	112	276	357	633
% growth	0.5	10.7	0.0	4.2	(1.3)	7.6	(0.6)	2.8
Jun-02	192	395	653	1,048	125	273	440	713
% growth	11.0	0.7	18.0	10.8	11.4	(0.9)	23.1	12.6

Notes: % growth denotes the quarter-on-quarter growth of NCDs and NDIs.



Loan-to-Deposit Ratio

Both the overall and the Hong Kong dollar loan-to-deposit ratio of the retail banks declined slightly, to 54.2% and 78.4% at end-June from 54.7%⁴ and 79.1%⁴ at end-March respectively (Chart 13).

A table of key performance indicators of the banking sector is at Annex. 

- Prepared by the Banking Policy Department

⁴ Overall and Hong Kong dollar loan-to-deposit ratios at end-March were revised downwards from 55.3% and 79.2% respectively due to the inclusion of short-term Exchange Fund placements in customer deposits.

Key Performance Indicators of the Banking Sector¹(%)

	Jun-01	Mar-02	Jun-02
Interest rate²			
1-month HIBOR	4.04	1.87	1.73
3-month HIBOR	4.02	1.92	1.84
BLR and 1-month HIBOR spread	3.36	3.26	3.40
BLR and 3-month HIBOR spread	3.37	3.21	3.29
Retail Banks			
Balance sheet developments³			
Total deposits	0.1	-1.3	1.1
Hong Kong Dollar	0.8	-1.6	0.9
Foreign currency	-1.0	-0.9	1.4
Total loans	1.9	0.5	0.2
Loans to customers inside Hong Kong ⁴	1.9	0.5	0.4
Loans to customers outside Hong Kong ⁵	1.5	-0.4	-9.1
Negotiable instruments			
Negotiable debt certificates issued	7.6	-1.3	11.4
Negotiable debt instruments held	6.2	2.8	12.6
Asset quality⁶			
As % of total loans			
Pass loans	87.61	88.15	88.76
Special mention loans	5.74	5.48	5.78
Classified loans (gross) ⁷	6.65	6.37	5.46
Classified loans (net) ⁸	4.66	4.35	3.75
Overdue > 3 months and rescheduled loans	5.36	4.69	3.98
Non-performing loans ⁹	5.30	5.03	4.41
Profitability¹⁰			
Bad debt charge as % of average total assets	0.29	0.34	0.32
Net interest margin	2.02	2.06	2.11
Cost income ratio	39.7	40.1	38.7
Surveyed Institutions			
Asset quality			
Delinquency ratio of residential mortgage loans	1.35	1.18	1.10
Credit card receivables			
Delinquency ratio	1.00	1.90	1.73
Charge-off ratio - quarterly annualised	4.62	9.04	13.63
- year-to-date annualised	4.10	9.04	11.24
All Locally Incorporated AIs			
Capital adequacy ratio (consolidated)¹¹	18.0	16.7 ^r	16.2

1. Figures related to Hong Kong office(s) only except where otherwise stated.

2. Quarterly average.

3. Quarterly change

4. Loans for use in Hong Kong plus trade financing loans.

5. Includes "others" (i.e. unallocated)

6. Figures relate to retail banks' Hong Kong office(s) and overseas branches.

7. Classified loans are those loans graded as "substandard", "doubtful" or "loss".

8. Net of specific provisions.

9. Loans on which interest has been placed in suspense or on which interest accrual has ceased.

10. Year-to-date annualised.

11. There is a break in series at end-December 2001 owing to the change in the reporting population.

r Revised figures due to late adjustments.