# DEVELOPMENTS IN THE BANKING SECTOR

*Reflecting the weak state of the economy, the aggregate balance sheet of the banking sector contracted, with both customer deposits and loans to customers declining. Overall asset quality continued to improve despite credit card write-offs and the negative equity problem in the residential mortgage portfolio.*

*Aggregate pre-tax operating profits of the retail banks in respect of their Hong Kong offices was broadly unchanged in the first three quarters of the year compared with the same period last year, although provisions increased modestly, particularly in relation to credit cards.*

## Interest Rate Movements

In light of the high liquidity in the banking system and lacklustre demand for loans, deposit and interbank interest rates continued to drop in the third quarter. The average one-month time deposit rate contracted by 4 basis points and one-month HIBOR by 3 basis points (Chart 1). The maturity profile shows that deposit and interbank interest rates for longer maturities declined more, suggesting anticipation of lower interest rates.

While the best lending rate[1] (BLR) remained unchanged at 5.125% from mid-December 2001 (until the reduction of 12.5 basis points on 8 November), deposit and interbank interest rates have been on a declining trend. This resulted in a widening in the interest rate spread in the third quarter. The average spread between BLR and the one-month time deposit rate widened by 4 basis points to 4.81% points and that between BLR and one-month HIBOR by 3 basis points to 3.43% (Chart 2).

Chart 1
HIBORs and Time Deposit Rates
Quarterly Average

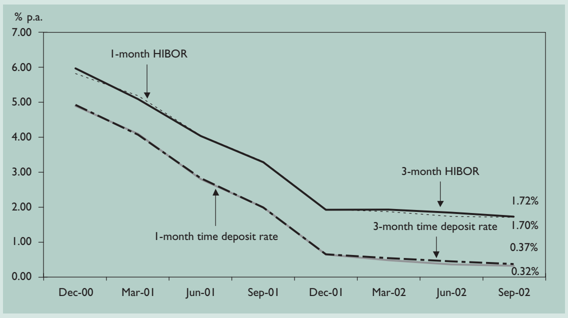
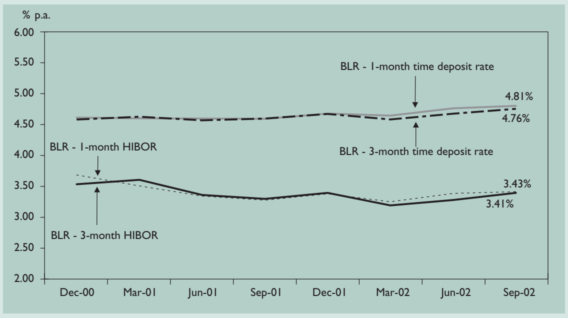



Chart 2
Best Lending Rate (BLR) - HIBOR/Time Deposit Rate Differentials
Quarterly Average




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

## Asset Quality

The overall asset quality of the retail banks continued to improve despite the unfavorable economic environment (Table 1 and Chart 3). Apart from an increase in the ratio of rescheduled loans, the other problem loan ratios improved. The ratios of classified loans, non-performing loans and overdue loans improved to 5.18%, 4.13% and 3.09% from 5.46%, 4.41% and 3.25% respectively at end-June. This improvement was attributable to a number of factors: the low level of interest rates, which helped to reduce borrowers' debt servicing burden; and actions taken by banks to deal with their problem loans, either by helping borrowers to reschedule their loans or to write off those bad loans that were deemed irrecoverable. The combined ratio of overdue and rescheduled loans was stable at 3.99% at end-September.

Asset quality problems were, however, still seen in the credit card portfolio, which remained weak although there were signs of stabilisation in charge-offs towards the end of the third quarter. The amount charged off in the third quarter was HK$2.36 billion or 3.95% of average receivables compared to HK$2.06 billion or 3.41% of average

Chart 3
**Asset Quality of Retail Banks**

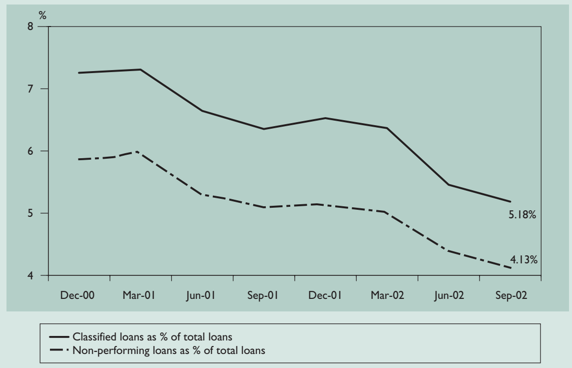



Table 1
**Asset Quality[1] of Retail Banks**

| | Sep-01 | Dec-01 | Mar-02 | Jun-02 | Sep-02 |
|---|---|---|---|---|---|
| | as % of total loans | | | | |
| **Pass loans** | **88.05** | **88.02** | **88.15** | **88.72** | **89.07** |
| **Special mention loans** | **5.60** | **5.45** | **5.48** | **5.81** | **5.75** |
| **Classified loans (gross)[2]** | **6.36** | **6.53** | **6.37** | **5.46** | **5.18** |
| *o/w Substandard* | *2.05* | *2.17* | *2.06* | *1.80* | *1.73* |
| *Doubtful* | *3.34* | *3.17* | *2.98* | *2.42* | *2.22* |
| *Loss* | *0.97* | *1.18* | *1.34* | *1.24* | *1.22* |
| **Classified loans (net)[3]** | **4.37** | **4.51** | **4.35** | **3.75** | **3.48** |
| **Overdue > 3 months and rescheduled loans** | **5.01** | **4.57** | **4.69** | **3.96** | **3.99** |
| *o/w Overdue > 3 months* | *4.26* | *3.95* | *4.02* | *3.25* | *3.09* |
| *Rescheduled loans* | *0.75* | *0.61* | *0.66* | *0.71* | *0.90* |
| **Non-performing loans[4]** | **5.11** | **5.16** | **5.03** | **4.41** | **4.13** |

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.*

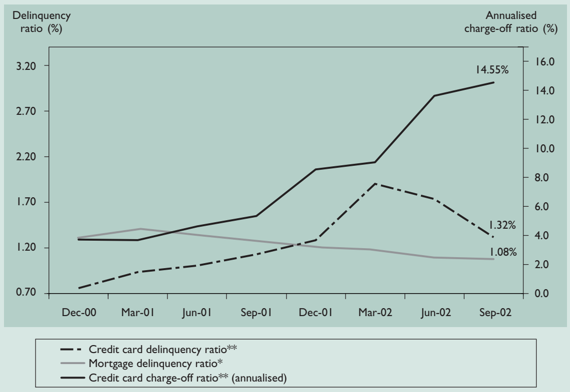
*Because of rounding, the figures set out in this table may not add up.*

receivables in the previous quarter. Assuming a similar rate of charge-off is maintained for the next three quarters, the "annualised" ratio[2] would be 14.55% compared with 13.63% in the previous quarter. However, the rate of charge-off continues to be affected by the impact of accounting policy changes. If the accounting changes had not been made, it is estimated that the "annualised" charge-off ratio would have been 12.4% of average receivables in the third quarter, slightly below the 12.7% in the previous quarter. This suggests that the underlying trend might have stabilised. Reflecting the write-offs made, largely in relation to personal bankruptcies, the delinquency ratio declined to 1.32% at end-September from 1.73% at end-June (Chart 4).

The quality of the residential mortgage loan portfolio continued to hold up well although weighed down by the issue of negative equity in an environment of declining property prices. Survey results showed some 70,000 cases or 15% of total number of residential mortgage loans are in negative equity as at the end of the third quarter. With an average loan-to-value ratio of about 128%, the unsecured portion of these loans is estimated at about $26 billion or 4.8% of the total residential mortgage portfolio for the banking sector. However, how much of this turns into losses for the banks depends on how many borrowers actually default.

Notwithstanding the negative equity problem, the delinquency ratio of the overall residential mortgage portfolio as at end-September was just a little over 1%, at 1.08%. This is helped by the fact that the banks are actively managing their problem mortgage loans (including negative equity loans) by way of restructuring or refinancing the loans to enable borrowers to enjoy a lower debt servicing burden. Accordingly, the mortgage rescheduled ratio rose to 0.46% at end-September, compared to 0.23% a year ago, the average interest rate on negative equity loans fell to the current level of around 0.76% below BLR and there is now a higher proportion (about 55%) of negative equity loans priced at below BLR.

Chart 4
**Asset Quality of Credit Card and Mortgage Lending (Surveyed Institutions)**




* *There is a break in series at December 2000 owing to increase in the number of surveyed institutions.*
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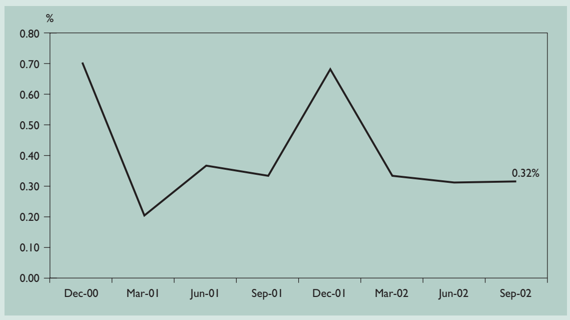
## Profitability

Despite the challenging operating conditions, the aggregate of the retail banks' pre-tax operating profits in respect of their Hong Kong offices was broadly unchanged, helped by the reduction in operating costs, which outweighed the increase in provisions for bad and doubtful debts and a decline in other operating income.

Largely affected by the deterioration in the quality of the credit card portfolio, provisions for bad and doubtful debts increased slightly in the first three quarters of 2002, compared with the same period last year. As a result, retail banks' annualised ratio of bad debt charge to average total assets rose to 0.32% in the first three quarters of the year from 0.30% in the same period last year (Chart 5).

Chart 5
**Bad Debt Charge as Percentage of Average Total Assets (Quarterly Annualised) (Retail Banks)**




2 Excluding certain charge-offs in the third quarter which will not be repeated in subsequent quarters and which it would not therefore be appropriate to annualise.

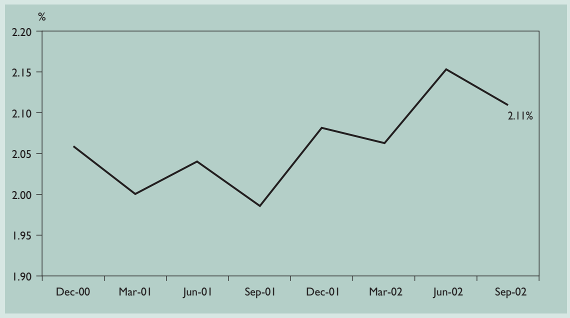
Losses in investments held for trading, arising largely from unrealised mark-to-market losses and a lower level of dividends received, were largely responsible for the decline in operating income. With the banks reining in on costs including lower IT costs after having invested heavily in internet banking over the last few years, operating costs declined and the cost-income ratio fell to 39.2% in the first three quarters of the year from 40.8% in the first three quarters of 2001.

Retail banks' annualised net interest margin increased to 2.11% in the first three quarters of the year from 2.01% in the corresponding period of last year (Chart 6). The increase was attributable to the widening of deposit margins with the shift from time deposits to saving accounts by depositors, investment in higher yielding debt instruments and a decline in average interest bearing assets.

## Capital Adequacy Ratio

The capital position of the locally incorporated institutions continued to be strong as reflected by the average consolidated capital adequacy ratio standing at 16.3% at end-September, well above the international minimum standard (Table 2).

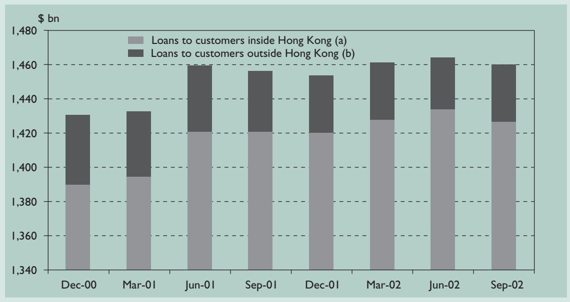
Chart 6
**Net Interest Margin (Quarterly Annualised)**
**(Retail Banks)**




## Lending

Retail banks' total loans declined by 0.3% in the third quarter (Chart 7), with a 0.5% fall in loans to customers inside Hong Kong, which was more than offset by a 9.9% increase in loans to

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).*

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

(HK$ mn)

| | Sep-01 | Dec-01[2] | Mar-02 | Jun-02[3] | Sep-02 |
|---|---|---|---|---|---|
| Total capital base after deductions[1] | 278,215 | 304,855 | 307,290 | 305,679 | 309,993 |
| *of which core capital* | *228,263* | *252,756* | *255,276* | *251,281* | *256,555* |
| Total risk-weighted exposures | 1,518,837 | 1,842,226 | 1,845,518 | 1,887,566 | 1,906,228 |
| Capital adequacy ratio | 18.3% | 16.5% | 16.7% | 16.2% | 16.3% |

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

customers outside Hong Kong, largely taking the form of lending to European companies.

Chart 8 shows the recent pattern of loans to customers inside Hong Kong by major economic sectors. Trade financing loans, the major contributor to loan growth in the second quarter, rose slightly by 0.5% in the third quarter. Property lending, the major component of the retail banks' loan portfolio, declined by 0.6% after an increase of 0.9% in the previous quarter. The decline was mainly in lending for property development and investment, with the former falling by 4.0% after rising by 3.0% in the second quarter and the latter falling by 0.9% following a drop of 1.4% in the previous quarter. Residential mortgage lending was flat, rising by only 0.1%, after an increase of 1.6% in the previous quarter.

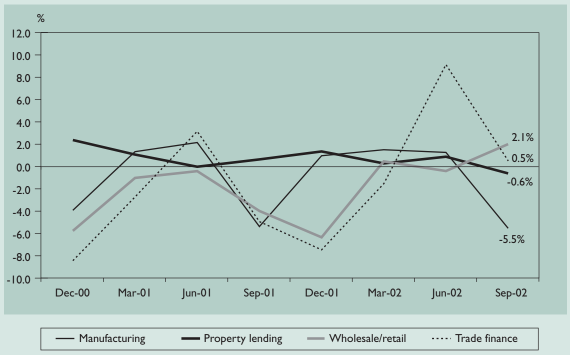
Retail banks' lending to the telecommunications sector rose by HK$0.4 billion to HK$14.8 billion at end-September, but exposure to this sector continues to account for only about 1.0% of their total domestic lending. The telecommunications exposures of the banking sector as a whole also increased, to HK$33.2 billion, to represent 1.8% of total domestic lending.

Due mainly to loan repayments, total outstanding exposure to non-bank Chinese entities continued to fall at end-June. The exposure of the retail banks fell to HK$104.2 billion (2.6% of total assets), and that of the banking sector as a whole, to HK$145.4 billion (2.2% of total assets) at end-June.

According to the survey of institutions active in credit card business, total card receivables fell for the third consecutive quarter, by 1.8%, in the third quarter. The total number of credit card accounts also fell, by 1.2%. This reflects the impact of charge-offs, tightening of credit card issuance and lending policies as well as restructuring of card receivables (i.e. into personal loans) by some institutions. Aggregate credit card lending constitutes about 3% of retail banks' domestic lending.

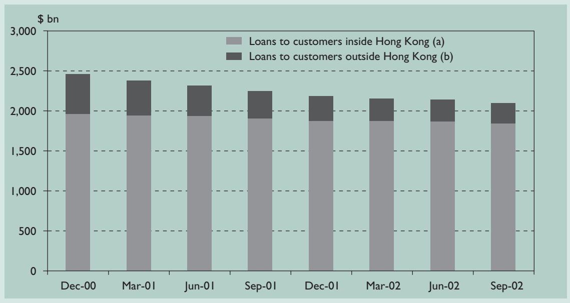
The declining trend of total loans to customers of the banking sector as a whole continued in the third quarter, with total loans to customers falling by 2.2% after falling by 0.5% in the second quarter (Chart 9).

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)**

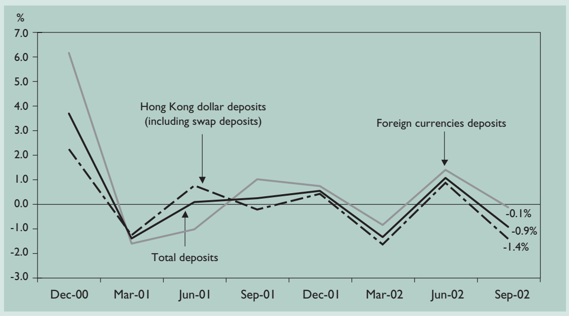



Notes:
*(a) Defined as loans for use in Hong Kong plus trade financing loans.*
*(b) Includes "others" (i.e. unallocated).*

## Customer Deposits

Retail banks' customer deposits contracted by 0.9% in the third quarter against an increase of 1.1% in the second quarter (Chart 10). This is not surprising in light of low deposit interest rates and

Chart 10
**Customer Deposits (Retail Banks)**
**Quarterly Percentage Change**



the increasing popularity of guaranteed funds. Hong Kong dollar deposits declined by 1.4% following a rise of 0.9% in the second quarter and foreign currency deposits fell by 0.1%, having increased by 1.4% in the previous quarter. Despite this decline, the proportion of Hong Kong dollar deposits to total deposits for retail banks and for the banking sector as a whole remained stable at around 62% and 55% respectively.

The decline in retail banks' Hong Kong dollar deposits was in both time and savings deposits. Time deposits, continuing their declining trend, fell by 2.5%. This resulted in a decline in the proportion of time deposits to total Hong Kong dollar deposits to 54.5% from 60.7% a year ago. Savings deposits also declined, by 0.9%, after rising for seven consecutive quarters. They represent 38.1% of total Hong Kong deposits, up from 33.2% a year ago. However, demand deposits increased further by 4.7% having risen by 4.0% in the second quarter. Quarterly changes in Hong Kong dollar deposits by type are shown in Table 3.

Customer deposits for the banking sector as a whole fell by 1.2%, against an increase of 1.3% in the second quarter (Chart 11).

## Negotiable Instruments

Negotiable certificates of deposit (NCDs) issued continued to increase in the third quarter, largely attributable to retail issues by some banks. Outstanding NCDs issued by retail banks grew by 6.4% after rising strongly by 11.4% in the second

Chart 11
**Customer Deposits (All AIs)**
**Quarterly Percentage Change**

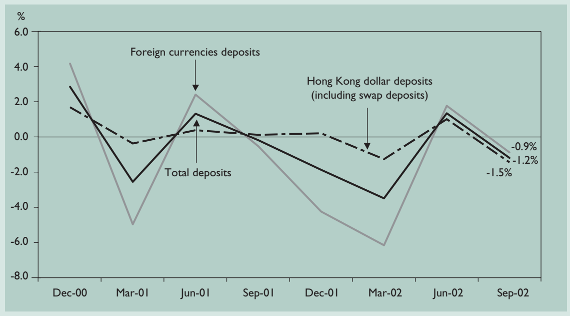



Table 3
**Hong Kong Dollar Deposit Mix**

Amount (HK$ bn)

| | All AIs | | | Retail banks | | |
|---|---|---|---|---|---|---|
| | **Demand** | **Savings** | **Time*** | **Demand** | **Savings** | **Time*** |
| 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) |
| Sep-02 | 132.2 | 634.8 | 1,054.1 | 121.7 | 629.0 | 900.5 |
| % growth | 4.7 | (0.9) | (2.5) | 4.7 | (0.9) | (2.5) |

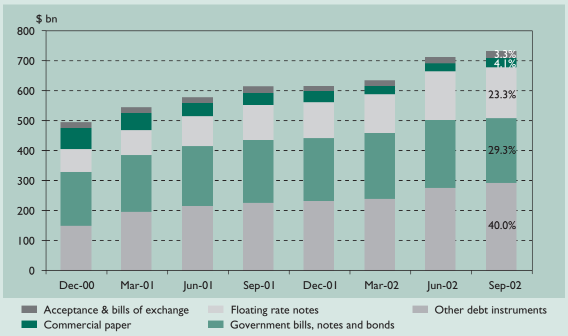
Notes: % *growth denotes the quarter-on-quarter growth of the deposits.*
* *includes swap deposits.*

quarter (Table 4). Unlike in the previous quarter, fixed rate instrument dominated the primary NCD market to represent 63.7% of all NCDs issued by the retail banks, up from 40.9% in the preceding quarter. The proportion of the outstanding amount of NCDs which is held by retail banks fell for the second consecutive quarter, to 39.9% at end-September.

Continuing with the trend noted in previous quarters, banks switched their surplus funds into higher-yielding negotiable debt instruments (NDIs, excluding NCDs). NDIs held by retail banks increased by 2.7% following a rise of 12.5% in the second quarter (Table 4). The increase was driven by the 4.7% growth in holding of foreign currency NDIs (mostly in floating rate notes and other debt instruments) which offsets the 0.6% decrease in Hong Kong dollar NDIs held. The mix of instruments held is shown in Chart 12. Broken down by issuers, 54.5% of NDIs held by retail banks were issued by corporates (up from 52.0% a year ago), 29.3% were issued by governments and the remaining 16.2% by banks (Chart 13).

Chart 12

**Negotiable Debt Instruments Held by Types of Instruments Held (Retail Banks)**




*Figures represent the percentage shares.*

Chart 13

**Negotiable Debt Instruments Held by Counterparties (Retail Banks)**

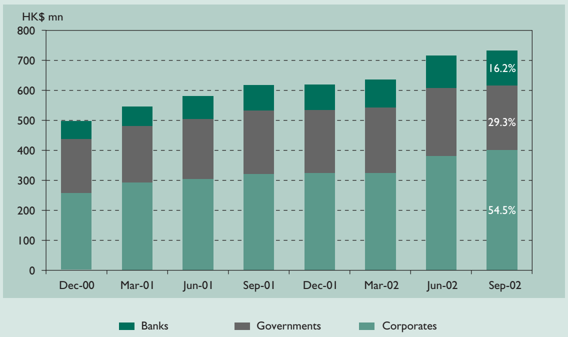



Table 4

**NCDs and NDIs**

Amount (HK$ bn)

| | All AIs | | | | Retail banks | | | |
|---|---|---|---|---|---|---|---|---|
| | Total NCDs outstanding | NDIs held HK$ | NDIs held FC | NDIs held Total | Total NCDs outstanding | NDIs held HK$ | NDIs held FC | NDIs held Total |
| 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 | 651 | 1,046 | 125 | 273 | 439 | 712 |
| % growth | 11.0 | 0.7 | 17.7 | 10.6 | 11.4 | (0.9) | 22.9 | 12.5 |
| Sep-02 | 201 | 414 | 678 | 1,092 | 133 | 272 | 460 | 732 |
| % growth | 4.5 | 4.7 | 4.1 | 4.3 | 6.4 | (0.6) | 4.7 | 2.7 |

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

Reflecting the consistent rise in holdings of NDIs by the retail banks, NDIs held accounted for 20.9% of retail banks' total assets at end-September, up from 16.4% a year ago.

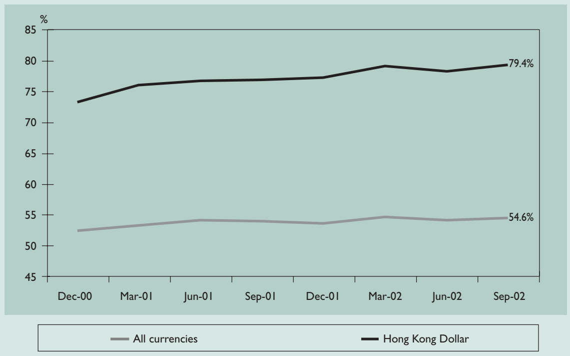
## Loan-to-Deposit Ratio

Both the overall and Hong Kong dollar loan-to-deposit ratios of the retail banks rose, the former to 54.6% from 54.2% at end-June and the latter to 79.4% from 78.4% (Chart 14).

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

- Prepared by the Banking Policy Department

Chart 14
**Loan-to-Deposit Ratio**
**(Retail Banks)**



## Key Performance Indicators of the Banking Sector[1] (%)

| | Sep-01 | Jun-02 | Sep-02 |
|---|---|---|---|
| **Interest rate[2]** | | | |
| 1-month HIBOR | 3.30 | 1.73 | 1.70 |
| 3-month HIBOR | 3.28 | 1.84 | 1.72 |
| BLR and 1-month HIBOR spread | 3.29 | 3.40 | 3.43 |
| BLR and 3-month HIBOR spread | 3.31 | 3.29 | 3.41 |
| | | **Retail Banks** | |
| **Balance sheet developments[3]** | | | |
| Total deposits | 0.2 | 1.1 | -0.9 |
| Hong Kong Dollar | -0.2 | 0.9 | -1.4 |
| Foreign currency | 1.0 | 1.4 | -0.1 |
| Total loans | -0.2 | 0.2 | -0.3 |
| Loans to customers inside Hong Kong[4] | 0.0 | 0.4 | -0.5 |
| Loans to customers outside Hong Kong[5] | -7.9 | -9.0 | 9.9 |
| Negotiable instruments | | | |
| Negotiable debt certificates issued | -0.7 | 11.4 | 6.4 |
| Negotiable debt instruments held | 6.3 | 12.5 | 2.7 |
| **Asset quality[6]** | | | |
| As % of total loans | | | |
| Pass loans | 88.05 | 88.72 | 89.07 |
| Special mention loans | 5.60 | 5.81 | 5.75 |
| Classified loans (gross)[7] | 6.36 | 5.46 | 5.18 |
| Classified loans (net)[8] | 4.37 | 3.75 | 3.48 |
| Overdue > 3 months and rescheduled loans | 5.01 | 3.96 | 3.99 |
| Non-performing loans[9] | 5.11 | 4.41 | 4.13 |
| **Profitability[10]** | | | |
| Bad debt charge as % of average total assets | 0.30 | 0.32 | 0.32 |
| Net interest margin | 2.01 | 2.11 | 2.11 |
| Cost income ratio | 40.8 | 38.7 | 39.2 |
| | | **Surveyed Institutions** | |
| **Asset quality** | | | |
| Delinquency ratio of residential mortgage loans | 1.28 | 1.10 | 1.08 |
| Credit card receivables | | | |
| Delinquency ratio | 1.13 | 1.73 | 1.32 |
| Charge-off ratio - quarterly annualised | 5.34 | 13.63 | 14.55 |
| - year-to-date annualised | 4.52 | 11.24 | 12.75 |
| | | **All Locally Incorporated AIs** | |
| **Capital adequacy ratio (consolidated)[11]** | 18.3 | 16.2 | 16.3 |

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.*