Developments in The Banking Sector

by the Banking Policy Department

Preliminary figures indicate that the aggregate pre-tax operating profits of retail banks in respect of their Hong Kong offices increased in 2002, in spite of the continued difficult operating environment. About half the banks experienced an increase in profits, and half a fall.

Credit growth remained subdued. Notwithstanding an increase in the number of negative equity residential mortgage loans and sharply higher write-offs on the credit card portfolio, overall asset quality continued to improve.

Interest Rate Movements

In response to the 50 basis points cut in the US Fed funds target rate, the best lending rate[1] (BLR) was reduced on 8 November by 12.5 basis points to 5.00%. As a result, the average BLR over the quarter dropped by 8 basis points compared with the preceding quarter. Deposit and interbank interest rates fell similarly, with some major banks lowering their savings rates to a historical low of 0.01%. With diminished competition for deposit funds in a time of sluggish economic growth and plentiful liquidity, time deposit rates also fell, by more than interbank rates generally. The average one-month time deposit rate contracted by 10 basis points and the average one-month HIBOR by 5 basis points (Chart 1). This resulted in a divergence in spreads. The average spread between BLR and the one-month time deposit rate widened by 3 basis points while that between BLR and one-month HIBOR narrowed by 3 basis points (Chart 2).

CHART 1
HIBORs and Time Deposit Rates
Quarterly Average

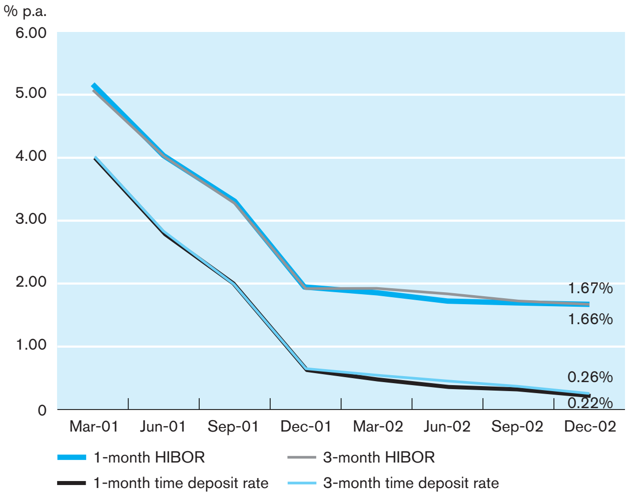
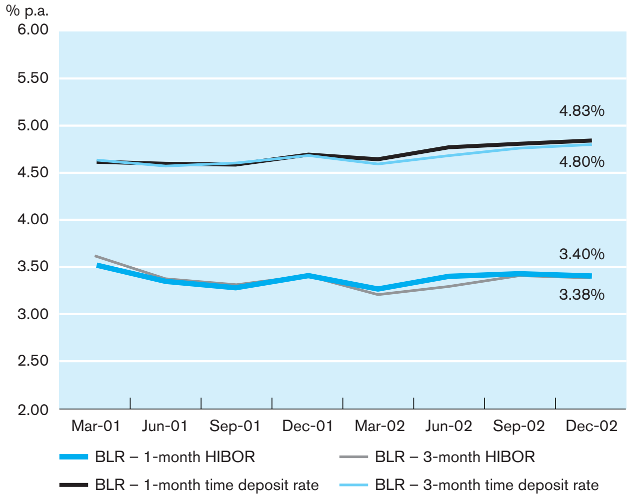


CHART 2
BLR – HIBOR/Time Deposit Rate Differentials
Quarterly Average



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

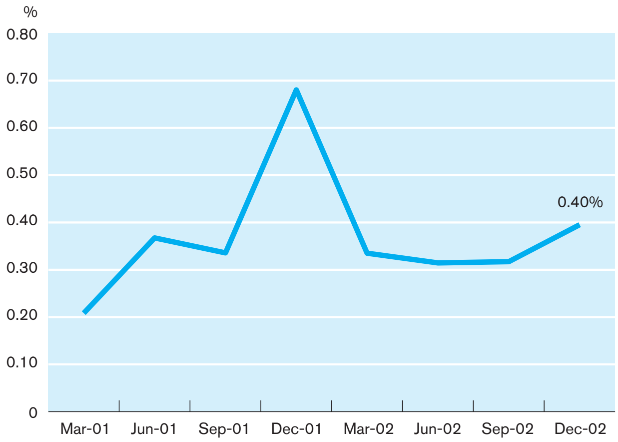
Profitability

The retail banks as a whole posted a rise of 11.6% in their aggregate pre-tax operating profits (in respect of their Hong Kong offices only) in 2002, a turnaround from the decline of 9.3%[r] in 2001, notwithstanding the weak economic environment. The industry-wide results however masked wide variations in the performance of individual banks. Profit growth was registered by half the total number of retail banks, particularly those that performed well in the treasury area and some of those that underwent some form of merger or consolidation in the past year or so, having integrated their operations and achieved synergies from integration. At the other end of the scale, the remaining half of the retail banks recorded a decline in profit for the year of 2002, the decline being particularly apparent in those banks that suffered higher provisions as a result of credit card write-offs.

Notwithstanding that some banks experienced sharply higher write-offs on their credit card portfolio, the overall bad debt charge fell in 2002 to 0.34% of average total assets, down from 0.40%[r] for the retail banks as a whole in 2001 (Chart 3). This reflects continuing improvement in overall asset quality, particularly the commercial lending portfolio, although the ratio is still relatively high compared with before the Asian financial crisis.

CHART 3

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

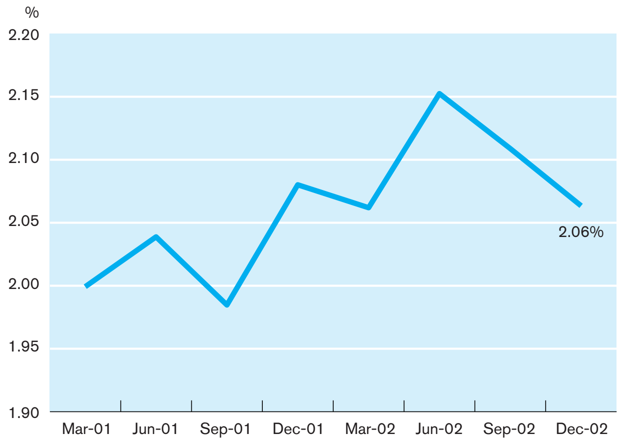


[r] Revised figures.

Retail banks' annualised net interest margin increased to 2.10% in 2002 from 2.03% in 2001 (Chart 4). The increase was helped by the widening of deposit margins and interest derived from treasury business and higher-yielding securities, against a decline in average interest bearing assets. Other operating income declined, attributable largely to losses in investments held for trading arising from unrealised mark-to-market losses which outweighed an increase in dividends received. Non-interest income continued to account for about 30% of retail banks' total income.

CHART 4

Net Interest Margin (Quarterly Annualised) (Retail Banks)



In terms of expenses, better cost control, lower IT costs and branch rationalisation in some banks in 2002 resulted in a reduction in both staff and other operating costs. The absence of group restructuring costs arising from various mergers in the past year also contributed to the decline. As a result, the cost-to-income ratio dropped to 40.6% in 2002 from 43.2% in 2001.

Capital Adequacy Ratio

Preliminary figures indicate that the average consolidated capital adequacy ratio of the locally incorporated AIs declined to 15.8% from 16.3% at end-September (Table 1). This is largely explained by dividend payouts made towards the end of the year, revaluation deficits booked by some banks and increased risk-weighted assets arising from increased holdings of higher yield securities.

Asset Quality

Despite the sluggish domestic economy, problem loan ratios improved in the fourth quarter (Table 2 and Chart 5). Reduced debt servicing burden in a low interest rate environment and increased write-offs were the main driving forces behind the improvement in the ratios. The ratio of classified loans declined to 5.03% from 5.22%[r] at end-September and the ratio of non-performing loans to 3.92% from 4.17%.[r] Similarly, the combined ratio of overdue and rescheduled loans decreased to 3.60% from 4.03%.[r]

CHART 5

Asset Quality of Retail Banks

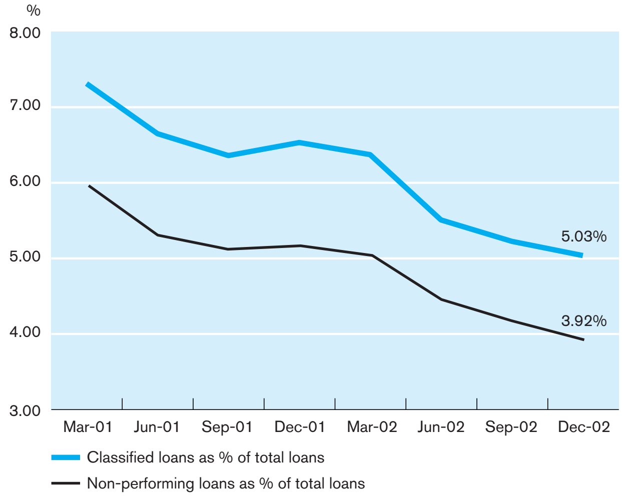


TABLE 1

Consolidated Capital Adequacy Ratio (All locally incorporated AIs)

(HK$ mn)	Dec-01[2]	Mar-02	Jun-02	Sep-02[r]	Dec-02[3]
Total capital base after deductions[1] *of which core capital*	304,855 *252,756*	307,290 *255,276*	305,679 *251,281*	309,993 *256,555*	305,656 *253,552*
Total risk-weighted exposures	1,842,226	1,845,518	1,887,566	1,906,646	1,932,127
Capital adequacy ratio	16.5%	16.7%	16.2%	16.3%	15.8%

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] Preliminary figures.
[r] Revised figures due to late adjustments.

TABLE 2

Asset Quality[1] of Retail Banks

	Dec-01	Mar-02	Jun-02 as % of total loans	Sep-02	Dec-02
Pass loans	**88.02**	**88.15**	**88.69** [r]	**89.02** [r]	**88.88**
Special mention loans	**5.45**	**5.48**	**5.81**	**5.76** [r]	**6.09**
Classified loans (gross)[2]	**6.53**	**6.37**	**5.50** [r]	**5.22** [r]	**5.03**
o/w Substandard	*2.17*	*2.06*	*1.80*	*1.73*	*1.87*
Doubtful	*3.17*	*2.98*	*2.44* [r]	*2.24* [r]	*1.95*
Loss	*1.18*	*1.34*	*1.26* [r]	*1.24* [r]	*1.21*
Classified loans (net)[3]	**4.51**	**4.35**	**3.78**[r]	**3.52** [r]	**3.50**
Overdue > 3 months and rescheduled loans	**4.57**	**4.69**	**4.00** [r]	**4.03** [r]	**3.60**
o/w Overdue > 3 months	*3.95*	*4.02*	*3.29* [r]	*3.13* [r]	*2.78*
Rescheduled loans	*0.61*	*0.66*	*0.71*	*0.90*	*0.82*
Non-performing loans[4]	**5.16**	**5.03**	**4.45** [r]	**4.17** [r]	**3.92**

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.
[r] Revised figures due to late adjustments.

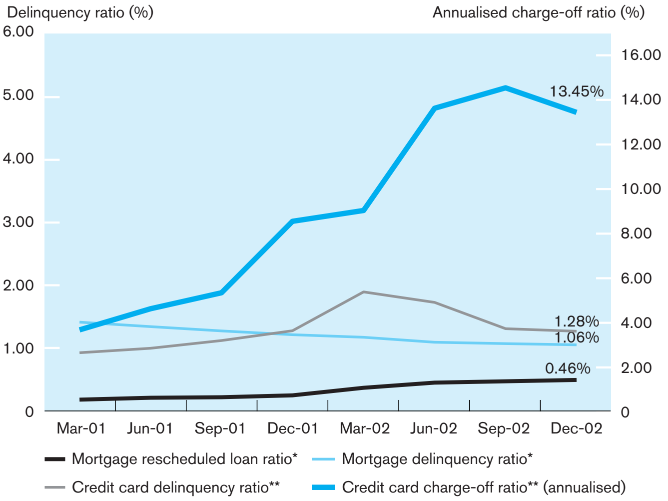
Because of rounding, the figures set out in this table may not add up.

The quality of the credit card portfolio remained weak, although there were some signs that the situation was stabilising in the fourth quarter. The amount charged off in the fourth quarter was HK$2.24 billion or 3.78% of average receivables during the quarter. Assuming the rate of charge-off is maintained for the next three quarters[2], the "annualised" ratio would be 13.45% compared with 14.55% in the third quarter. For the year as a whole, the charge-off ratio was 13.25%, compared with 5.46% in 2001. The delinquency ratio decreased further to 1.28% from 1.32% at the end of the third quarter, as a result of charge-offs made (Chart 6).

Despite a further decline in property values, the quality of the overall residential mortgage portfolio improved in the fourth quarter. The delinquency ratio for the overall mortgage portfolio dropped to 1.06% from 1.08% at end-September while the rescheduled mortgage loan ratio stood at 0.46%. The number of negative equity residential mortgage loans[3] rose to about 78,000 cases or 16% of the total number of residential mortgage loans for the banking sector as a whole at end-December. The unsecured portion of such loans represents 5.1% of total residential mortgage loans. The delinquency ratio for negative equity loans, however, improved to 2.62% from 2.92% at end-September. The average interest rate on negative equity loans fell further to 0.83% below BLR from 0.76% below BLR at end-September and a greater proportion of negative equity loans were being priced below BLR (about 58% at end-December, up from 55% at end-September). The latter figures reflect banks' efforts to help contain problem residential mortgage loans by restructuring or refinancing the loans at lower rates to try to help alleviate borrowers' debt servicing burden.

CHART 6

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



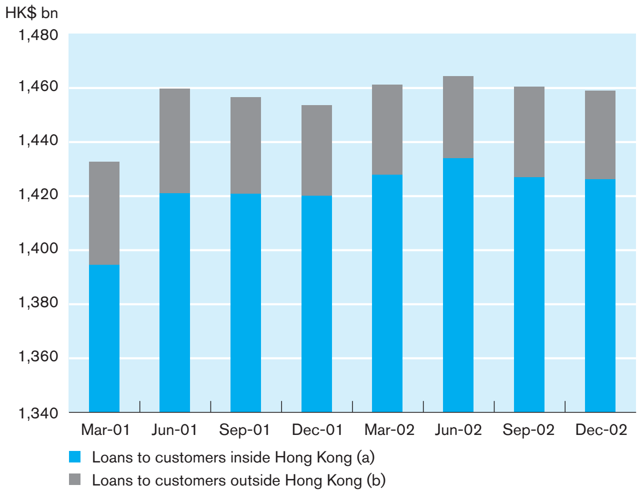
* There ia a break in series at December 2000 owing to increase in the number of surveyed institutions.
** There is a break in series at December 2001 owing to increase in the number of surveyed institutions.

Lending

Domestic lending continued to be lacklustre. Having risen by 1.6% in 2001, retail banks' total loans recorded a marginal increase of 0.4% in 2002. Compared with the previous quarter, total loans declined in the fourth quarter by 0.1% after dropping by 0.3% in the third quarter (Chart 7). Declines were seen in trade financing loans and loans to customers outside Hong Kong. The former contracted by 3.7% against a growth of 0.5% in the preceding quarter, and the latter by 1.9% against a strong increase of 9.9% in the preceding quarter.

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).

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

[3] The figures derived from the survey relate only to RMLs provided by the banks on the basis of first mortgages and which the banks know to be in negative equity. Not included in these figures are 61,876 RMLs associated with Government-funded co-financing schemes and another 22,908 RMLs associated with private sector co-financing schemes. The extent to which such RMLs are in negative equity, taking into account the second mortgage, is not known because banks do not maintain records on the outstanding balances of the second mortgages.

The breakdown of loans to major economic sectors in Chart 8 shows property lending rising by 0.7% against a drop of 0.6% in the preceding quarter. The rise came largely from increases in property development and property investment, which rose by 6.3% and 1.1% respectively, against declines of 4.0% and 0.9% in the preceding quarter. Residential mortgage loans (excluding loans under Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme), in contrast, fell by 0.4%, the first decline since end-March 2001. This is mainly attributable to the weak appetite for property in the light of the decline in property prices.

Retail banks' lending to the telecommunications sector[4] contracted by HK$0.2 billion to HK$14.6 billion at end-December, while the sector's share of total domestic loans remained stable at 1.0%. The telecommunications exposure of the banking sector as a whole was also stable at HK$33.1 billion (1.8% of total domestic lending).

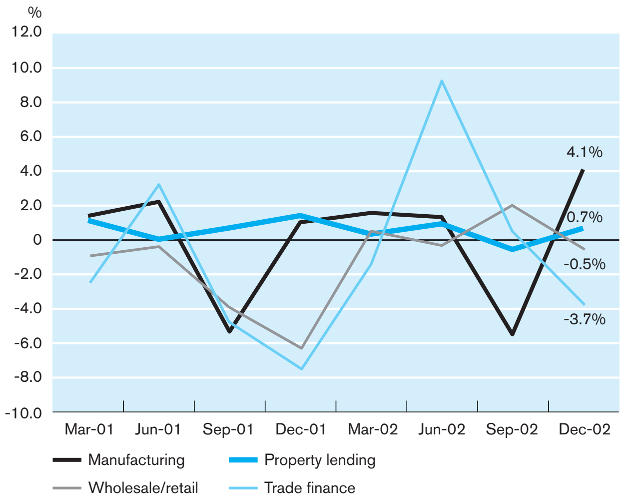
Total outstanding exposure to non-bank Chinese entities continued to fall in the third quarter. The exposure of the retail banks fell to HK$104.0 billion (2.6% of total assets) at end-September, and that of the banking sector as a whole to HK$143.0 billion (2.2% of total assets).

Against a backdrop of record-high personal bankruptcies, banks took a number of actions in relation to their credit card portfolio, including the tightening of credit card issuance and lending policies, termination of dormant accounts, debt restructuring and write-offs. Accordingly, the total number of credit card accounts continued to fall in the fourth quarter, by 3.0%. Total card receivables rose marginally by 0.1% after falling for three straight quarters.

Total loans to customers by the banking sector as a whole continued to exhibit a declining trend, decreasing by 1.0% following a drop of 2.2% in the preceding quarter. A large part of the decline came from the 5.3% drop in loans to customers outside Hong Kong caused mainly by the continued contraction in euroyen loans. Loans to customers inside Hong Kong also declined, by 0.4% (Chart 9). For the year, total loans to customers of the banking sector as a whole contracted by 4.9%, moderating from a drop of 11.2% in the preceding year.

CHART 8

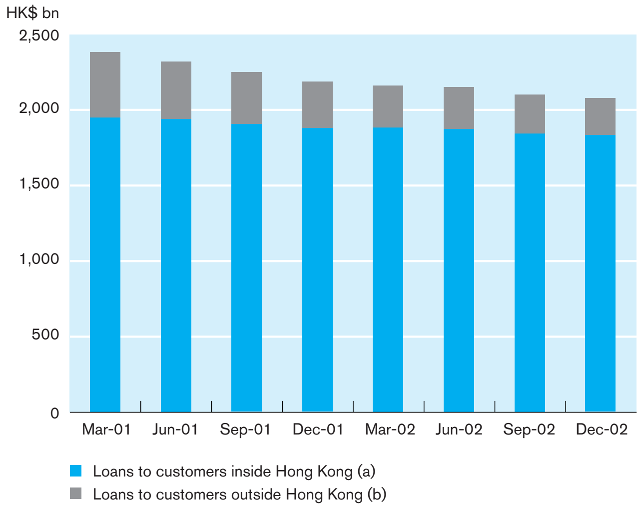
Loans for Use in Hong Kong by Selected Sectors (Retail Banks)
Quarterly Percentage Change



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).

[4] On-balance sheet lending booked in Hong Kong offices only.

Customer Deposits

Against a modest decline of 0.5% in the preceding year, retail banks' customer deposits rose by 0.7% in 2002. This rise came largely from a continued increase in demand and savings deposits, while time deposits contracted further. The historically low interest rate environment has resulted in a preference for the holding of more liquid funds by depositors while awaiting better investment opportunities — thus, a shift from time deposits to demand and savings deposits. In the fourth quarter, retail banks' customer deposits rose by 1.9%, against a drop of 0.9% in the preceding quarter (Chart 10). Within this, both Hong Kong dollar and foreign currency deposits grew, by 0.7% and 3.8% respectively. The proportion of Hong Kong dollar deposits to total deposits for retail banks fell marginally to 61% from 62%.

Table 3 shows quarterly changes in Hong Kong dollar deposits by types. Time deposits fell by 4.3% in the fourth quarter while demand deposits rose strongly by 9.9% and savings deposits by 6.2%. The share of time deposits to total Hong Kong deposits fell to 51.8%, down from 57.0% a year ago.

Customer deposits of the banking sector as a whole dropped by 2.6% in 2002 after a decline of 3.4% in the preceding year. (Chart 11).

CHART 10

Customer Deposits (Retail Banks) Quarterly Percentage Change

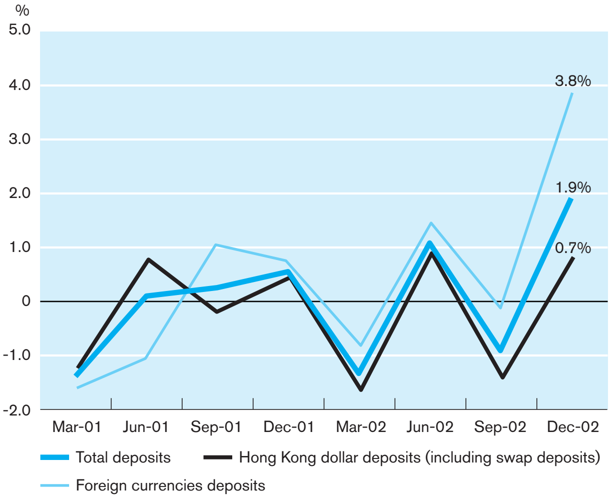


CHART 11

Customer Deposits (All AIs) Quarterly Percentage Change

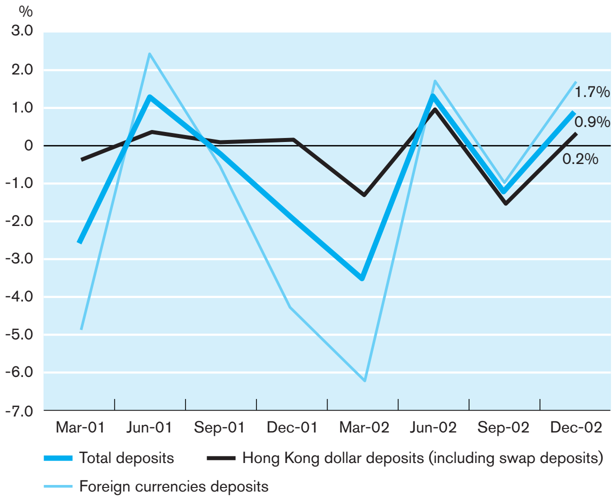


TABLE 3

Hong Kong Dollar Deposit Mix

Amount (HK$ bn)

	All AIs			Retail banks		
	Demand	Savings	Time*	Demand	Savings	Time*
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)
Dec/02	**146.2**	**674.3**	**1,004.4**	**133.8**	**668.1**	**861.3**
% growth	10.5	6.2	(4.7)	9.9	6.2	(4.3)

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

Negotiable Instruments

Retail banks' holdings of negotiable debt instruments (NDIs) (excluding negotiable certificates of deposits (NCDs)) rose markedly in 2002 to account for 20.9% of total assets, up from 17.3% at the end of 2001, as banks continued to switch their surplus funds into higher-yielding instruments. Compared with the preceding quarter, holdings of NDIs grew by 1.7% in the fourth quarter. Within this, holdings of Hong Kong dollar NDIs fell by 4.5%. In contrast, underpinned mainly by growth in government bills, notes and bonds and other debt instruments, holdings of NDIs denominated in foreign currencies increased by 5.3%. Reflecting this, the portion of NDIs denominated in foreign currencies to total NDIs held by retail banks rose to 65.1%, up from 62.9% at end-September (Chart 12).

The breakdown of NDIs held by retail banks by types of issuers shows that 54.0% were issued by corporates (up from 52.4% a year ago), 28.0% by governments and the remaining 18.0% by banks (Chart 13). The mix of instruments held is shown in Chart 12. Major types of instruments held by retail banks are "other debt instruments" followed by "government bills, notes and bonds" with shares of total NDIs held of 40.7% and 28.0% respectively at end-December, compared with 37.7% and 33.8% a year ago (Chart 14).

CHART 12

Negotiable Debt Instruments Held (Retail Banks) By Currency Breakdown

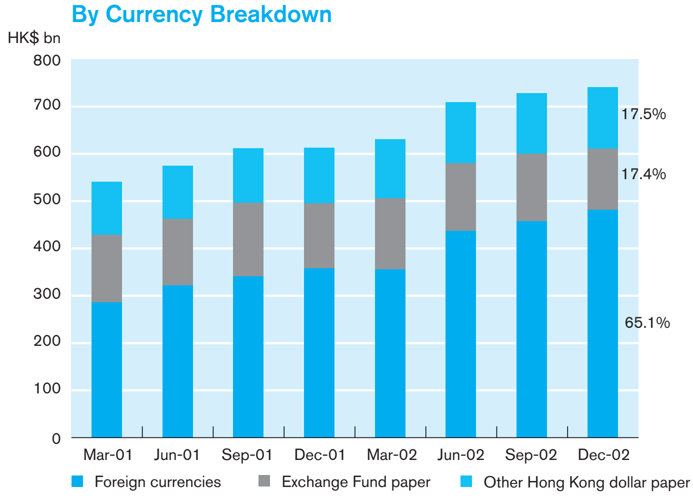


CHART 13

Negotiable Debt Instruments Held (Retail Banks) By Counterparty Breakdown

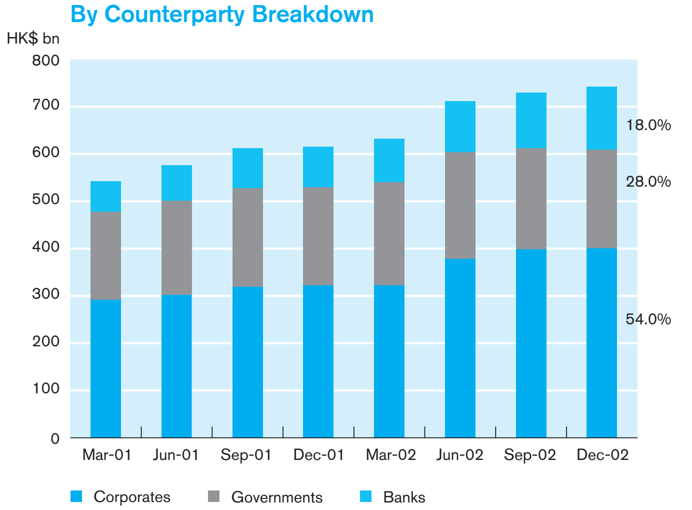
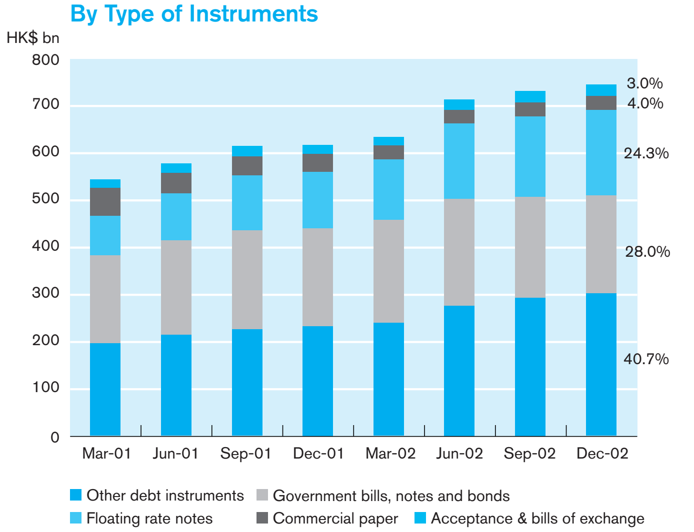


CHART 14

Negotiable Debt Instruments Held (Retail Banks) By Type of Instruments



Figures represent the percentage shares.

Largely attributable to increased retail issues by some banks, outstanding NCDs recorded a notable increase of 21.7% in 2002, against a decline of 3.6% in the preceding year. Retail banks' outstanding NCDs rose for three consecutive quarters, by 4.0% in the fourth quarter following an increase of 6.4% in the preceding quarter. However, the proportion of the outstanding amount of NCDs held by retail banks continued to fall, to 38.3% from 39.9% at end-September (Table 4). Similar to the previous quarter, fixed rate instruments continued to dominate the primary NCD market, accounting for 68.9% of all NCDs issued by the retail banks, compared with 63.7% in the preceding quarter.

TABLE 4

NCDs

Amount (HK$ bn)

	Total NCDs outstanding	
	All AIs	Retail banks
Dec/01	**172**	**113**
% growth	(4.1)	(7.6)
Mar/02	**173**	**112**
% growth	0.5	(1.3)
Jun/02	**192**	**125**
% growth	11.0	11.4
Sep/02	**201**	**133**
% growth	4.5	6.4
Dec/02	**211**	**138**
% growth	5.1	4.0

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

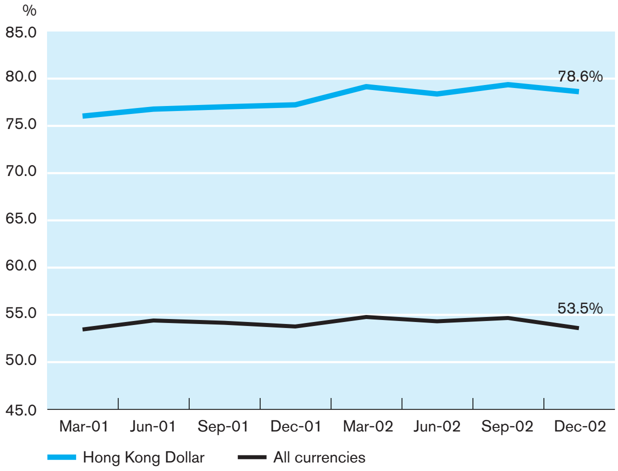
Loan-to-Deposit Ratio

Owing to a decline in total loans and an increase in customer deposits in all currencies including the Hong Kong dollar, retail banks' overall loan-to-deposit ratio fell to 53.5% from 54.6% at end-September and their Hong Kong dollar loan-to-deposit ratio to 78.6% from 79.4% (Chart 15).

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

CHART 15

Loan-to-Deposit Ratio (Retail Banks)



APPENDIX

KEY PERFORMANCE INDICATORS OF THE BANKING SECTOR[1] (%)

	Dec-01	Sep-02	Dec-02
Interest rate[2]			
1-month HIBOR	1.93	1.70	1.66
3-month HIBOR	1.92	1.72	1.67
BLR and 1-month HIBOR spread	3.39	3.43	3.40
BLR and 3-month HIBOR spread	3.41	3.41	3.38
		Retail Banks	
Balance sheet developments[3]			
Total deposits	0.5	-0.9	1.9
Hong Kong Dollar	0.4	-1.4	0.7
Foreign currency	0.7	-0.1	3.8
Total loans	-0.2	-0.3	-0.1
Loans to customers inside Hong Kong[4]	0.0	-0.5	0.0
Loans to customers outside Hong Kong[5]	-5.9	9.9	-1.9
Negotiable instruments			
Negotiable debt certificates issued	-7.6	6.4	4.0
Negotiable debt instruments held	0.3	2.7	1.7
Asset quality[6]			
As % of total loans			
Pass loans	88.02	89.02 r	88.88
Special mention loans	5.45	5.76 r	6.09
Classified loans (gross)[7]	6.53	5.22 r	5.03
Classified loans (net)[8]	4.51	3.52 r	3.50
Overdue > 3 months and rescheduled loans	4.57	4.03 r	3.60
Non-performing loans[9]	5.16	4.17 r	3.92
Profitability[10]			
Bad debt charge as % of average total assets	0.40	0.32	0.34
Net interest margin	2.03	2.11	2.10
Cost income ratio	43.2	39.2	40.6
		Surveyed Institutions	
Asset quality			
Delinquency ratio of residential mortgage loans	1.22	1.08	1.06
Credit card receivables			
Delinquency ratio	1.28	1.32	1.28
Charge-off ratio — quarterly annualised	8.55	14.55	13.45
— year-to-date annualised	5.46	12.75	13.25
		All Locally Incorporated AIs	
Capital adequacy ratio (consolidated)[11]	16.5	16.3	15.8#

Notes:
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.
Preliminary figure.