Developments in The Banking Sector

by the Banking Policy Department

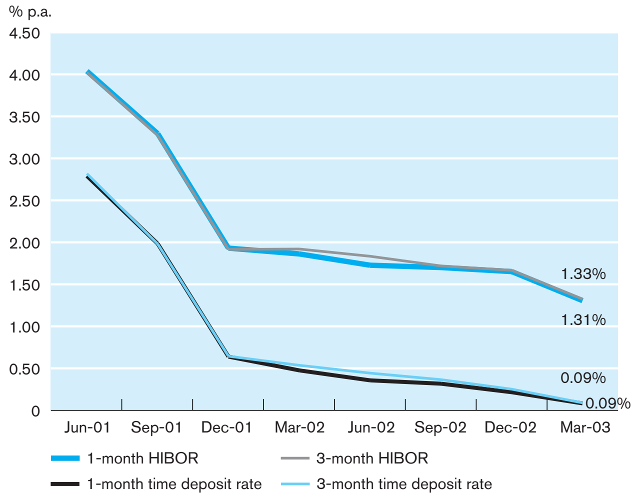
Banks performed well in the first quarter of 2003 despite the difficult economic environment. The outbreak of SARS towards the end of the first quarter did not have much of an impact on the banking sector in the first quarter but may be reflected more in the second quarter's performance. Banks' aggregate pre-tax operating profits in respect of their Hong Kong offices improved over the same period last year although, as usual, the performance of individual banks varied widely. Overall asset quality, however, showed some signs of weakening, while the negative equity problem in the mortgage portfolio increased. Deposit and loan growth remained subdued.

Interest Rate Movements

Reflecting the lack of competition for funds and the weak demand for loans, interbank and deposit rates eased further in the first quarter, with HIBORs dropping by more than the equivalent time deposit rates. The average one-month HIBOR contracted by 35 basis points while the average one-month time deposit rate fell by only 13 basis points (Chart 1).

CHART 1

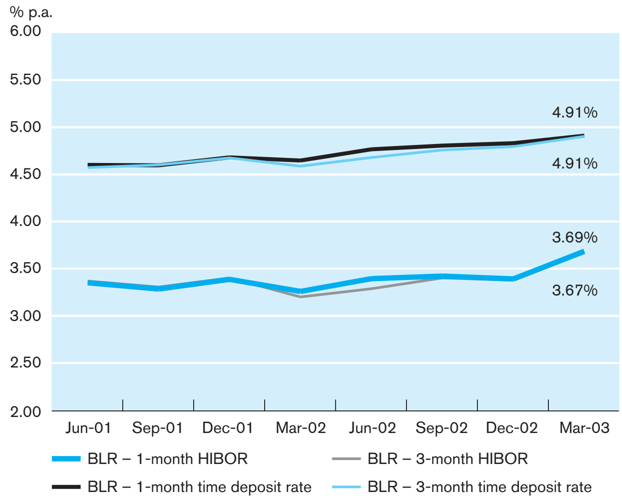
HIBORs and Time Deposit Rates Quarterly Average



With the best lending rate[1] (BLR) remaining unchanged at 5.00%, interest rate spreads widened further. The average spread between BLR and one-month HIBOR widened to 3.69%, and that between BLR and the one-month time deposit rate to 4.91% (Chart 2).

CHART 2

BLR - HIBOR/Time Deposit Rate Differentials Quarterly Average



Retail Banks' Profitability

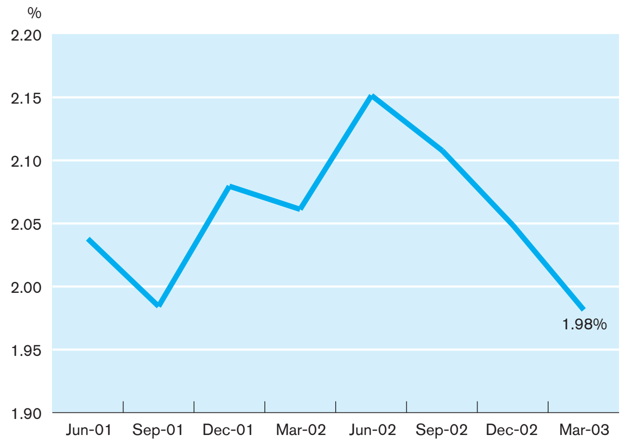
The retail banks' aggregate pre-tax operating profits (Hong Kong offices only) grew in the first quarter, attributable mainly to increased non-interest income, reduced operating costs, and lower bad debt write-offs. Within the aggregate results, however, a

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

number of banks experienced a fall in profits, particularly those with a relatively higher concentration in residential mortgage lending, the margins on which continued to contract. Banks which performed well in treasury business and those that were able to cut costs through integration or rationalisation were able to achieve more favourable results, thus contributing to the overall growth in the aggregate results.

Net interest income decreased moderately, due in part to narrowed margins on residential mortgage lending and in part to the lower yield on free funds. But non-interest income increased markedly on the back of gains in foreign exchange and interest rate derivatives activities, lower mark-to-market losses in investments held for trading, and increased income from fees and commissions. As a result, the proportion of non-interest income to total operating income increased to 30% in the first quarter from 26% a year earlier. Reflecting the decrease in net interest income, the annualised net interest margin declined to 1.98% from 2.06% a year earlier (Chart 3).

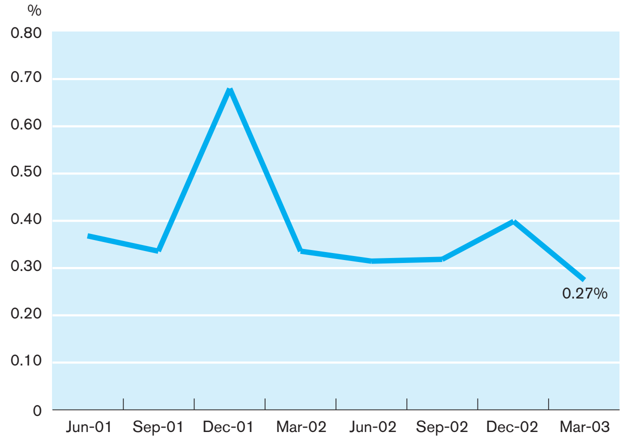
CHART 3
Net Interest Margin (Quarterly Annualised) (Retail Banks)



The banks' operating costs fell compared with the same period last year, with lower staff expenses as a result of further rationalisation in branch networks and lower rental charges. This contraction in total operating costs coupled with growth in total operating income, resulted in the cost-income ratio dropping to 37.5% from 40.1% a year earlier.

The ratio of the overall bad debt charge to average total assets fell to 0.27% from 0.34% a year previously (Chart 4), largely because significant one-off charges last year arising from bank consolidation were not repeated this year.

CHART 4
Bad Debt Charge as Percentage of Average Total Assets (Quarterly Annualised) (Retail Banks)



Retail Banks' Asset Quality

Overall quality

Retail banks' overall asset quality showed some signs of weakening in the first quarter (Table 1). While the classified loans ratio was more or less unchanged at 5.03% at end-March, the special mention loans ratio (a leading indicator of weakening credit quality) increased to 6.47% from 6.09% at end-December.

CHART 5
Asset Quality of Retail Banks

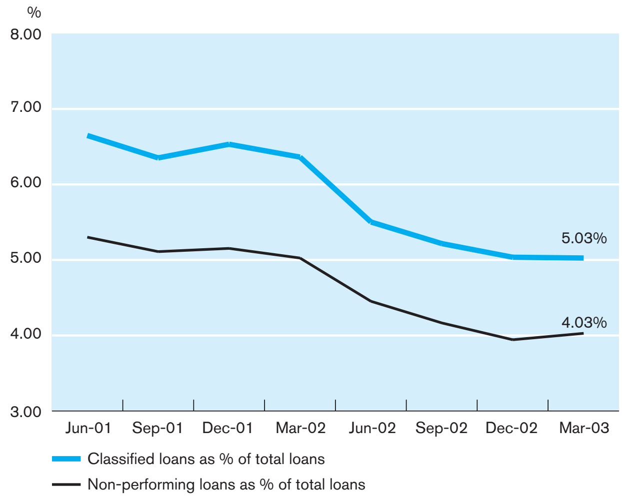


TABLE 1

Asset Quality[1] of Retail Banks

	Mar-02	Jun-02	Sep-02	Dec-02	Mar-03
			as % of total loans		
Pass loans	**88.15**	**88.69**	**89.02**	**88.87 r**	**88.49**
Special mention loans	**5.48**	**5.81**	**5.76**	**6.09**	**6.47**
Classified loans (gross)[2]	**6.37**	**5.50**	**5.22**	**5.04 r**	**5.03**
o/w Substandard	*2.06*	*1.80*	*1.73*	*1.86 r*	*1.83*
Doubtful	*2.98*	*2.44*	*2.24*	*1.97 r*	*2.02*
Loss	*1.34*	*1.26*	*1.24*	*1.21*	*1.18*
Classified loans (net)[3]	**4.35**	**3.78**	**3.52**	**3.53 r**	**3.52**
Overdue > 3 months and rescheduled loans	**4.69**	**4.00**	**4.03**	**3.59 r**	**3.64**
o/w Overdue > 3 months	*4.02*	*3.29*	*3.13*	*2.77 r*	*2.79*
Rescheduled loans	*0.66*	*0.71*	*0.90*	*0.82*	*0.85*
Non-performing loans[4]	**5.03**	**4.45**	**4.17**	**3.94 r**	**4.03**

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.

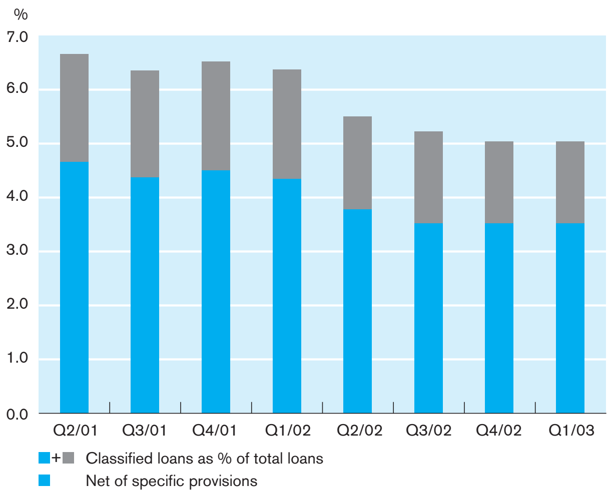
Because of rounding, the figures set out in this table may not add up.

The non-performing loans ratio and overdue and rescheduled loans ratio edged up to 4.03% and 3.64% from 3.94% and 3.53% respectively (Chart 5). The moderate increase in these ratios is not surprising in view of the difficult market conditions.

The ratio of specific provisions to total classified loans stood at around 30% at end-March (Chart 6).

CHART 6

Asset Quality (Retail Banks)

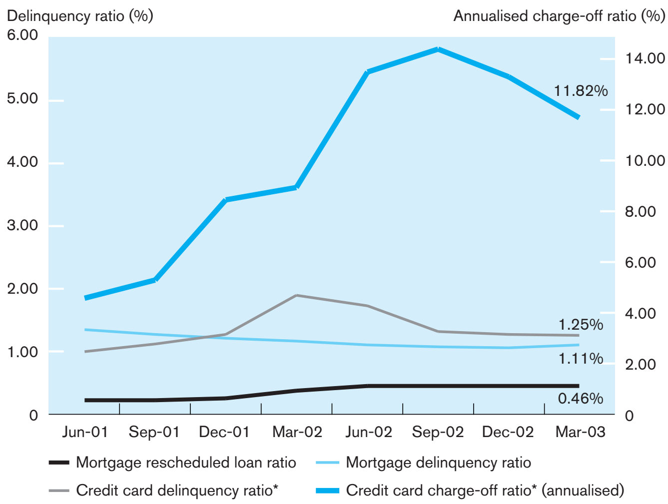


Quality of residential mortgage portfolio

The quality of the overall residential mortgage portfolio weakened marginally in the first quarter. The mortgage delinquency ratio rose to 1.11% from 1.06% at end-December, although this is still low. The restructured mortgage loan ratio remained stable at 0.46% at end-March (Chart 7). How SARS will affect this portfolio is yet to be seen.

CHART 7

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



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

Reflecting the further decline in property prices, banks' residential mortgage loans in negative equity increased to about 83,000 cases[2] (17% of the total number) with a value of HK$135 billion at end-March. The unsecured portion of these loans was about HK$29 billion, representing 5.4% of total residential mortgage lending. The delinquency ratio for negative equity loans remained higher than that of the overall mortgage portfolio, but improved marginally to 2.56% from 2.62% at end-December. The average interest rate on negative equity loans continued to decline, to 0.88% below BLR from 0.83% below BLR at end-December, reflecting authorized institutions' efforts to help negative equity homeowners by lowering interest rates.

Quality of credit card portfolio

The quality of the credit card portfolio improved in the first quarter but remained weak. The delinquency ratio fell for the fourth consecutive quarter to 1.25% from 1.28% at end-December, attributable in part to charge-offs and in part to the restructuring of problem card receivables by institutions. Over the 12 months to end-March 2003, about HK$1.6 billion of credit card receivables was restructured, representing about 2.8% of total receivables, reflecting banks' proactive measures in the mutual interest of both their customers and themselves. In line with the slight improvement in the bankruptcy situation, the amount charged off in the first quarter also decreased, to HK$1.76 billion or 3.09% of average receivables during the quarter. Assuming the rate of charge-off is maintained for the next three quarters[3], the "annualised" ratio fell to 11.82% compared with 13.45% in the preceding quarter (Chart 7).

[2] 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 some 62,000 RMLs associated with government-funded co-financing schemes and another about 24,000 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.

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

Impact of SARS on the Performance of Retail Banks

The effect of the outbreak of severe acute respiratory syndrome (SARS) on the banks' first quarter results was minimal. It may be more evident in the second quarter results, although the negative impact on the banks appears to have eased by mid-May.

Based on information gathered from the banks, the main effects have been as follows:

- Loan demand reduced further. This was especially so for residential mortgage loans due in part to the lack of new projects since the outbreak and in part to the lack of interest in viewing and buying flats during the period;
- The volume of credit card business diminished as people cut back on retail spending, food and beverage, entertainment and travel. At the height of the SARS problem in Hong Kong, the impact on credit card spending was reportedly quite significant (down by some 30% to 50%). Recent indications are that there has been an improvement in spending following the fall in the number of new SARS cases;
- Customer traffic in branches was also affected and this has made cross-selling opportunities for wealth management products difficult given the lack of face-to-face contact with the customers. However, as for the credit cards business, the situation with branch traffic has also now improved;
- Asset quality has not been badly affected, although there have been some signs of weakening as suggested by the increase in the mortgage delinquency ratio in April to 1.14%. The taxi loan portfolio has also seen a rise in overdue and rescheduled loans. There are concerns about impact of increasing unemployment on the quality of consumer loans.

Lower business volumes and a weakening of asset quality would affect banks' revenue, provisioning levels and profitability to some degree. However, at present the general expectation among banks is that the impact will not be too severe, provided that the SARS problem remains under control.

TABLE 2

Consolidated Capital Adequacy Ratio (All locally incorporated AIs)

(HK$ mn)	Mar-02	Jun-02	Sep-02	Dec-02[r]	Mar-03
Total capital base after deductions[1]	307,290	305,679	309,993	304,032	308,212
of which core capital	*255,276*	*251,281*	*256,555*	*251,862*	*259,440*
Total risk-weighted exposures	1,845,518	1,887,566	1,906,646	1,931,970	1,932,374
Capital adequacy ratio	16.7%	16.2%	16.3%	15.7%	15.9%

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.

[r] Revised figures due to late adjustments.

Local Authorized Institutions' Capital Strength

The capital strength of banks remained robust. The average consolidated capital adequacy ratio of all locally incorporated authorized institutions edged up to 15.9% from 15.7%, mainly due to an increase in banks' reserves (Table 2).

Retail Banks' Liquidity

Retail banks remained highly liquid. Their average liquidity ratio[4] for the first quarter was about 45%, well above the minimum statutory requirement of 25% (Chart 8). The main components of liquifiable assets were marketable debt securities and net interbank claims.

The overall loan-to-deposit ratio rose slightly to 54.1% from 53.5% and the Hong Kong dollar ratio to 79.6% from 78.6% (Chart 9). This reflected the slight increase in lending noted below and a decline in deposits.

CHART 8

Average Liquidity Ratio (Retail Banks)

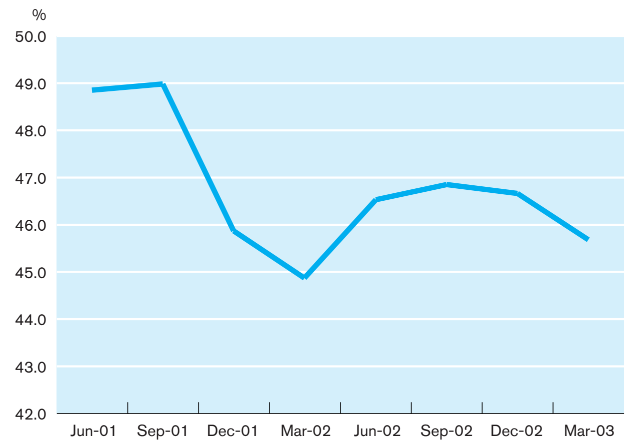
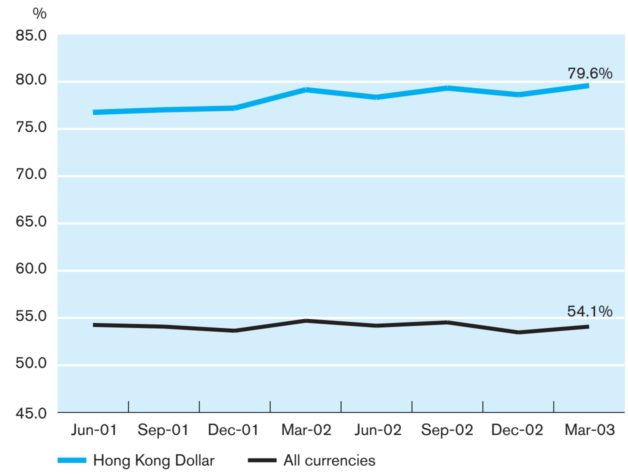


CHART 9

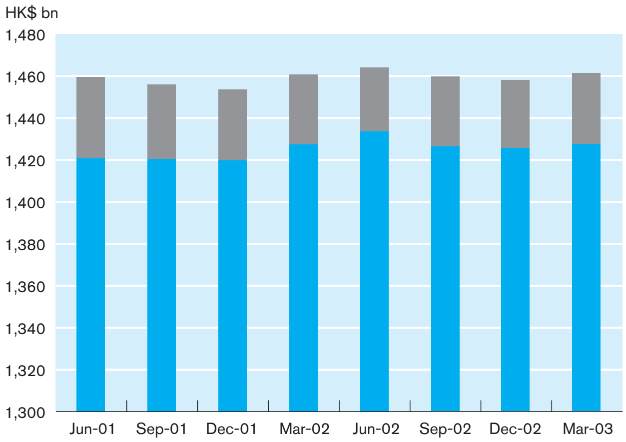
Loan-to-Deposit Ratio (Retail Banks)



[4] All authorized institutions in Hong Kong are required to meet a minimum monthly average liquidity ratio of 25%. This is calculated as the ratio of liquefiable assets (e.g. marketable debt securities and loan repayment within one month subject to their respective liquidity conversion factors) to qualifying liabilities (basically all liabilities due within one month). The method of calculation and its component are specified in the Fourth Schedule to the Banking Ordinance.

CHART 10

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

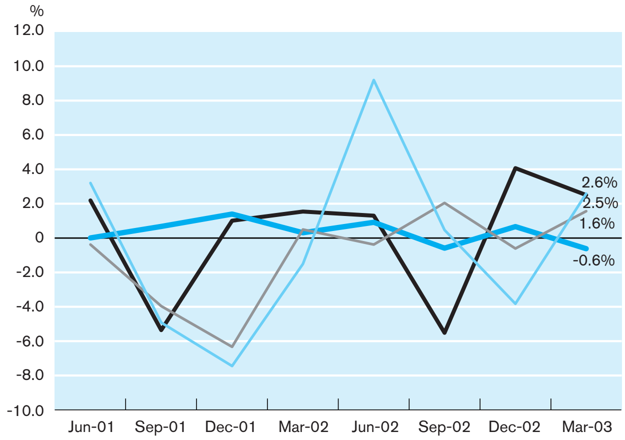


Loans to customers inside Hong Kong (a)
Loans to customers outside Hong Kong (b)

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

CHART 11

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



Manufacturing
Property lending
Wholesale/retail
Trade finance

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).

Retail Banks' Lending

Against a 0.1% drop in the previous quarter, banks' total loans increased by 0.3% in the first quarter on the back of growth in trade financing loans and loans to customers outside Hong Kong (Chart 10). Benefiting from a pick up in external trade, trade financing loans rose by 2.6% having fallen by 3.8% in the preceding quarter. After dropping by 0.3% in the preceding quarter, loans to customers outside Hong Kong increased by 4.3%. Due to the weak demand for property loans, overall domestic lending was broadly unchanged.

Loans to customers inside Hong Kong by major economic sectors

Within the aggregate domestic lending, Chart 11 reveals that lending to individual major sectors, except for property, increased in the first quarter. While loans to the manufacturing sector rose by 2.5%, loans to wholesale and retail trade increased by 1.6%. Reflecting the weak market sentiment in light of the further decline in property prices, property lending fell by 0.6% after rising 0.7% in the fourth quarter, with loans for property development falling by 1.5% and residential mortgage loans by 0.8%. However, loans for property investment grew slightly by 0.3%. Loans for the purchase of flats under the Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme also fell by 2.8%, the fifth consecutive quarterly decline. After an increase of 1.8% in the preceding quarter, lending to the electricity, gas and telecommunications sector rose by 9.7%, largely attributable to increased lending to the electricity sector.

Lending to the telecommunications sector

Retail banks' lending to the telecommunications sector[5] rose modestly by HK$0.3 billion to HK$14.9 billion at end-March, representing 1.0% of the sector's total domestic loans. However, the trend for the banking sector as a whole (i.e. adding in the non-retail authorized institutions) was different, with loan disposals and repayments leading to lending to the sector falling by HK$2.3 billion to HK$30.9 billion, accounting for 1.7% of the banking sector's total domestic loans.

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

Exposure to non-bank Chinese entities

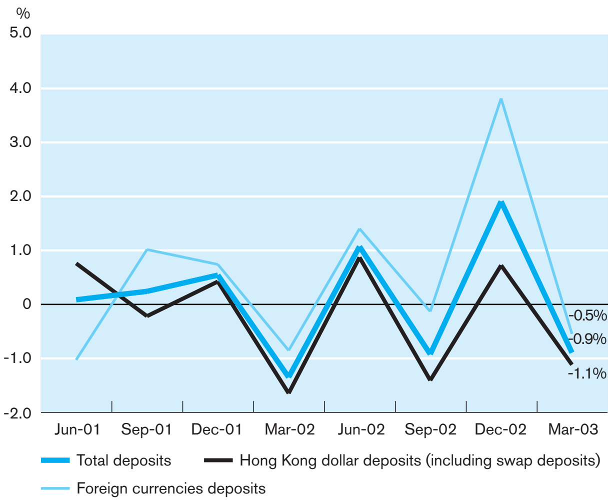
Continuing the declining trend, exposure to non-bank Chinese entities fell in the last quarter of 2002, with the reduction coming mainly in letters of credit, letters of guarantee and write-offs. The retail banks' exposure fell to HK$102 billion (2.5%[r] of total assets) at end-December 2002, and that of the banking sector as a whole to HK$141.3 billion (2.2%[r] of total assets).

Credit card receivables

Consumer lending in the form of card receivables declined by 7.9% in the first quarter following a marginal increase of 0.1% in the previous quarter. The fall reflects a number of factors, including the on-going tightening of lending policies, contraction in consumer spending during the quarter, particularly in March following the outbreak of SARS, and the transfer of restructured card receivables from the card portfolio to other loan accounts (such as personal loan accounts) by some institutions. The total number of credit card accounts continued to decrease by 0.3%.

CHART 12

Customer Deposits (Retail Banks) Quarterly Percentage Change



Retail Banks' Customer Deposits

Retail banks' customer deposits shrank by 0.9% in the first quarter, against an increase of 1.9% in the preceding quarter. Both Hong Kong dollar and foreign currency deposits dropped, by 1.1% and 0.5% respectively (Chart 12). While US dollar deposits fell by 3.0%, non-US dollar foreign currency deposits grew by 5.2%, reflecting the depreciation of US dollar against other major currencies. The share of Hong Kong dollar deposits to total deposits remained stable at 61%.

As indicated in Table 3, time deposits fell for the tenth consecutive quarter, by 3.6%, to represent 50.5% of total deposits, down from 56.5% a year ago. Demand deposits also declined, by 2.3%. Savings deposits, however, rose further by 2.3%, reflecting the continued shift of time deposits to savings deposits while depositors await better investment opportunities.

Negotiable Instruments

Negotiable debt instruments held

In the light of plentiful liquidity and limited lending opportunities, banks continued to invest surplus

TABLE 3

Hong Kong Dollar Deposit Mix (Retail Banks)

Amount (HK$ bn)

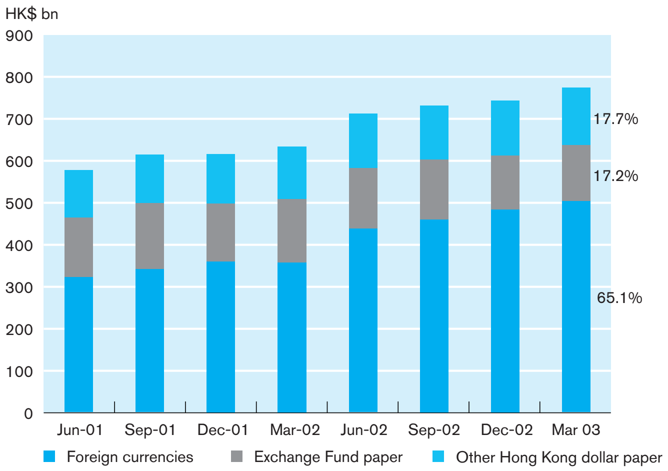
	Demand	Savings	Time*
Mar/02	**111.8**	**611.2**	**937.2**
% growth	(4.5)	0.5	(2.7)
Jun/02	**116.2**	**634.8**	**923.7**
% growth	4.0	3.9	(1.4)
Sep/02	**121.7**	**629.0**	**900.5**
% growth	4.7	(0.9)	(2.5)
Dec/02	**133.8**	**668.1**	**861.3**
% growth	9.9	6.2	(4.3)
Mar/03	**130.7**	**683.3**	**830.6**
% growth	(2.3)	2.3	(3.6)

Note: % growth denotes the quarter-on-quarter change in deposits.
* includes swap deposits

[r] Revised figures.

CHART 13

Negotiable Debt Instruments Held (Retail Banks) By Currency Breakdown



funds in negotiable debt instruments (NDIs) in the first quarter. Holdings of other NDIs (excluding negotiable certificates of deposits (NCDs)) — the main conduit for banks' surplus funds in recent years — increased by 4.1%. The share of NDIs denominated in foreign currency to total NDIs remained unchanged at 65.1% (Chart 13). NDIs held by retail banks accounted for 21.6% of their total assets at end-March, up from 20.9% at end-December. The breakdown of NDIs held by types of instruments and counterparties is shown in Chart 14 and Chart 15 respectively.

Retail banks' holdings of NCDs have also risen in the past year, to represent 2.6% of their total assets at end-March compared with 2.2% a year ago.

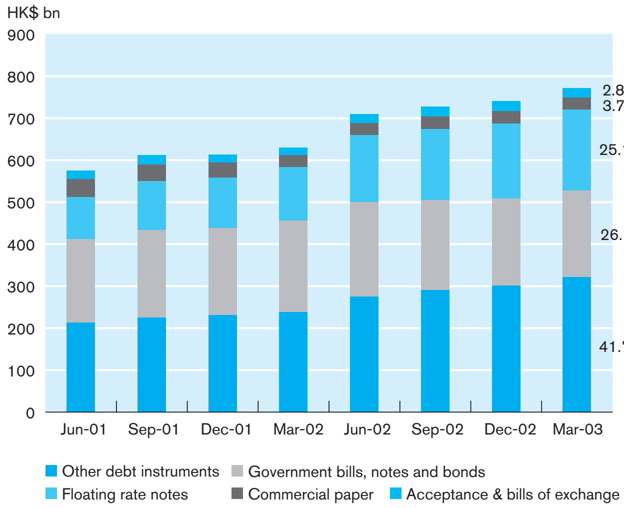
Negotiable certificates of deposits issued

Issuance of NCDs by retail banks increased on the back of increased demand for NCDs by retail customers in the low interest rate environment. Retail banks' outstanding NCDs rose for the fourth consecutive quarter, by 8.5%, in the first quarter. Compared with a year ago, outstanding NCDs have risen by almost 34%.

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

CHART 14

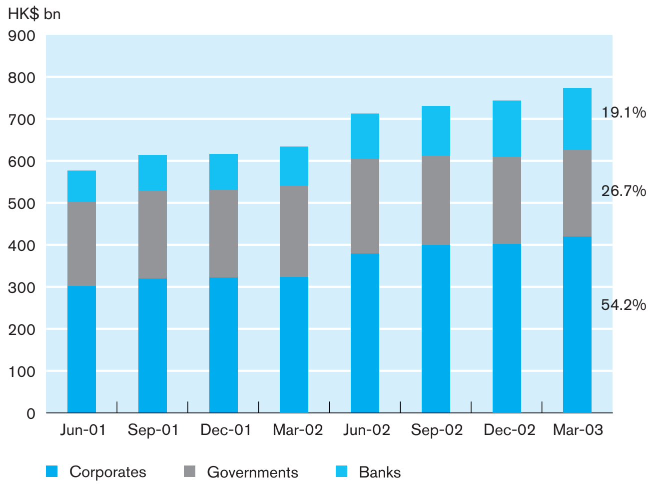
Negotiable Debt Instruments Held (Retail Banks) By Types of Instruments



Figures represent the percentage shares.

CHART 15

Negotiable Debt Instruments Held (Retail Banks) By Counterparty Breakdown



APPENDIX

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

	Mar-02	Dec-02	Mar-03
Interest rate[2]			
1-month HIBOR	1.87	1.66	1.31
3-month HIBOR	1.92	1.67	1.33
BLR and 1-month HIBOR spread	3.26	3.40	3.69
BLR and 3-month HIBOR spread	3.21	3.38	3.67
		Retail Banks	
Balance sheet developments[3]			
Total deposits	-1.3	1.9	-0.9
Hong Kong Dollar	-1.6	0.7	-1.1
Foreign currency	-0.9	3.8	-0.5
Total loans	0.5	-0.1	0.3
Loans to customers inside Hong Kong[4]	0.5	-0.1	0.2
Loans to customers outside Hong Kong[5]	-0.3	-2.3	4.3
Negotiable instruments			
Negotiable debt certificates issued	-1.3	4.0	8.5
Negotiable debt instruments held	2.8	1.7	4.1
Asset quality[6]			
As % of total loans			
Pass loans	88.15	88.87	88.49
Special mention loans	5.48	6.09	6.47
Classified loans (gross)[7]	6.37	5.04	5.03
Classified loans (net)[8]	4.35	3.53	3.52
Overdue > 3 months and rescheduled loans	4.69	3.59	3.64
Non-performing loans[9]	5.03	3.94	4.03
Profitability[10]			
Bad debt charge as % of average total assets	0.34	0.34	0.27
Net interest margin	2.06	2.09	1.98
Cost income ratio	40.1	40.6	37.5
Liquidity ratio[11]	44.9	46.7	45.7
		Surveyed Institutions	
Asset quality			
Delinquency ratio of residential mortgage loans	1.18	1.06	1.11
Credit card receivables			
Delinquency ratio	1.90	1.28	1.25
Charge-off ratio — quarterly annualised (adjusted)[12]	9.04	13.45	11.82
— year-to-date annualised	9.04	13.25	12.35
		All Locally Incorporated AIs	
Capital adequacy ratio (consolidated)	16.7	15.7[r]	15.9

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 Quarterly average.
12 Excluding certain charge-offs which will not be repeated in subsequent quarters and which it would not therefore be appropriate to annualise. The year-to-date figures are not similarly adjusted.

r Revised figures due to late adjustments.