REGULAR ARTICLE

Developments in the Banking Sector

by the Banking Policy Department

As expected, the impact of the outbreak of SARS was more apparent in the second quarter although the adverse impact eased by mid-May. Accordingly, retail banks' aggregate pre-tax operating profits in respect of their Hong Kong offices declined in the first half of 2003 compared with the same period last year. The effect on profitability, however, was not too severe, helped by profits from treasury operations (both in foreign exchange and investments held for trading). The negative equity problem worsened, affected by the further decline in property prices in the second quarter. However, overall asset quality (in terms of problem loan ratios) improved, influenced largely by interim write-offs and loan repayments. Property lending and credit card advances were also affected to some extent.

Interest Rate Movements

Despite the 25 basis point cut in the US Fed funds target rate in the second quarter, the best lending rate[1] (BLR) remained unchanged at 5.00%. Funding costs, however, dropped further, reflecting diminished competition for funds at a time when loan demand was sluggish and liquidity within the banking sector was plentiful. HIBORs continued to drop by more than time deposit rates. The average HIBOR contracted by 5 basis points to 1.26% while the average one-month time deposit rate barely changed from 0.08% (Chart 1). As a result, interest rate spreads widened further. The average spread between BLR and the one-month HIBOR widened to 3.74% and that between BLR and the one-month time deposit rate to 4.92% (Chart 2).

CHART 1

HIBORs and Time Deposit Rates Quarterly Average

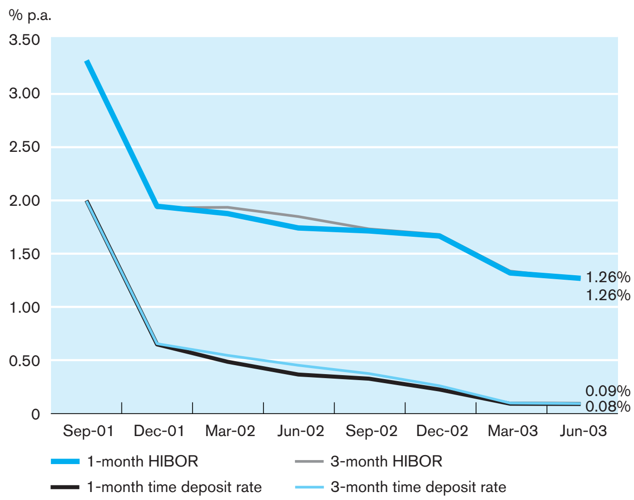
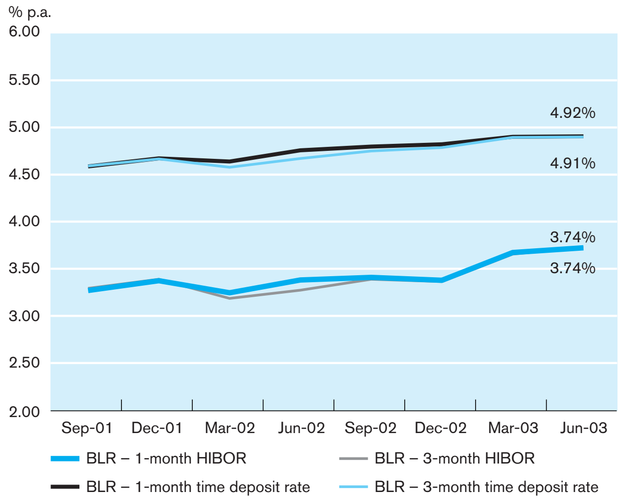


CHART 2

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.

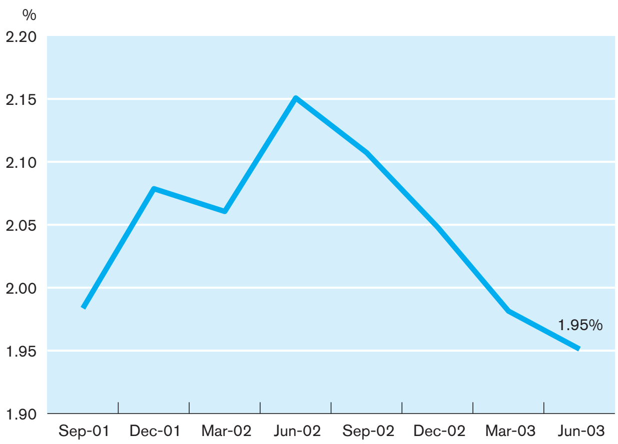
Retail Banks' Profitability

Reflecting the difficult operating conditions, aggravated by the SARS outbreak towards the end of the first quarter, most retail banks registered a decline in profit in the first half of the year compared with the same period last year. For the retail banks as a whole, aggregate profits fell by 8.7% compared with the first half of last year. The fall was particularly evident in the second quarter. However, taking out the effects of property revaluation deficits charged to the profit and loss accounts by some banks in the first half of the year, retail banks' aggregate pre-tax operating profit declined by a more modest 2.5%. The effect of SARS on the profitability of the retail banking sector, thus, appeared to be relatively mild, but this was helped to some extent by good treasury performance (including both foreign exchange and securities trading), which partly offset the effects of higher bad debt provisions and lower net interest income.

Net interest income declined on the back of narrowed margins on residential lending and lower yield on free funds. As a result, the annualised net interest margin fell to 1.97% in the first half of the year from 2.11% for the same period last year (Chart 3).

CHART 3

Net Interest Margin (Quarterly Annualised) (Retail Banks)



Non-interest income for the first half of the year increased, and accounted for 31% of total operating income, up from 28% a year ago. Apart from gains in treasury activities, income from fees and commissions also contributed to the increase.

The cost-income ratio dropped to 37.7% from 38.7% a year ago. Reduction in staff expenses and rental charges contributed to the decline in retail banks' operating costs compared with the same period last year.

As expected, the bad debt charge increased in the second quarter. The increase was largely attributable to increased provisions for personal lending including credit card lending. As a result, retail banks' annualised ratio of the overall bad debt charge to average total assets rose to 0.35% from 0.33% a year earlier (Chart 4).

CHART 4

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

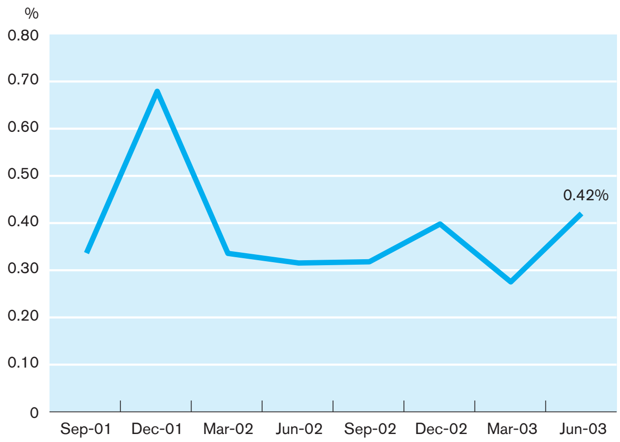


TABLE 1

Asset Quality[1] of Retail Banks

	Jun-02	Sep-02	Dec-02	Mar-03	Jun-03
			as % of total loans		
Pass loans	**88.69**	**89.02**	**88.87**	**88.49**	**88.66**
Special mention loans	**5.81**	**5.76**	**6.09**	**6.47**	**6.57**
Classified loans (gross)[2]	**5.50**	**5.22**	**5.04**	**5.03**	**4.76**
o/w Substandard	*1.80*	*1.73*	*1.86*	*1.83*	*1.67*
Doubtful	*2.44*	*2.24*	*1.97*	*2.02*	*1.99*
Loss	*1.26*	*1.24*	*1.21*	*1.18*	*1.09*
Classified loans (net)[3]	**3.78**	**3.52**	**3.53**	**3.52**	**3.28**
Overdue > 3 months and rescheduled loans	**4.00**	**4.03**	**3.59**	**3.64**	**3.61**
o/w Overdue > 3 months	*3.29*	*3.13*	*2.77*	*2.79*	*2.70*
Rescheduled loans	*0.71*	*0.90*	*0.82*	*0.85*	*0.91*
Non-performing loans[4]	**4.45**	**4.17**	**3.94**	**4.03**	**3.83**

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.

Retail Banks' Asset Quality

Overall quality

Influenced largely by interim write-offs and loan repayments, retail banks' overall asset quality improved in the second quarter (Table 1). All problem loan ratios fell. Alongside a decrease in the classified loan ratio to 4.76% from 5.03% at end-March, the ratios of non-performing loans and overdue and rescheduled loans improved to 3.83% and 3.61% (Chart 5). The ratio of specific provisions to total classified loans remained stable at about 31% at end-June (Chart 6).

CHART 5

Asset Quality of Retail Banks

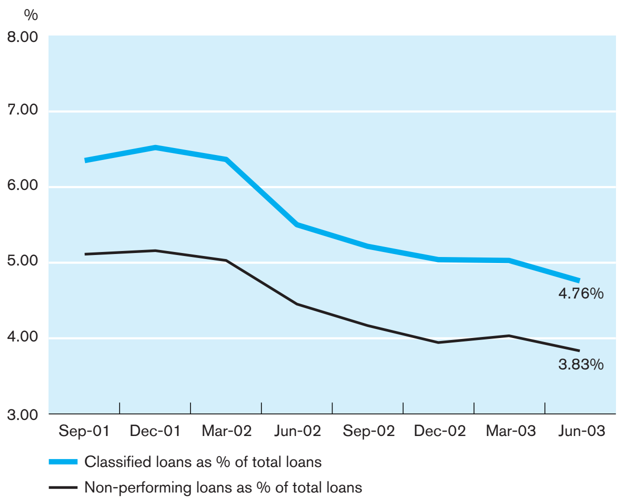
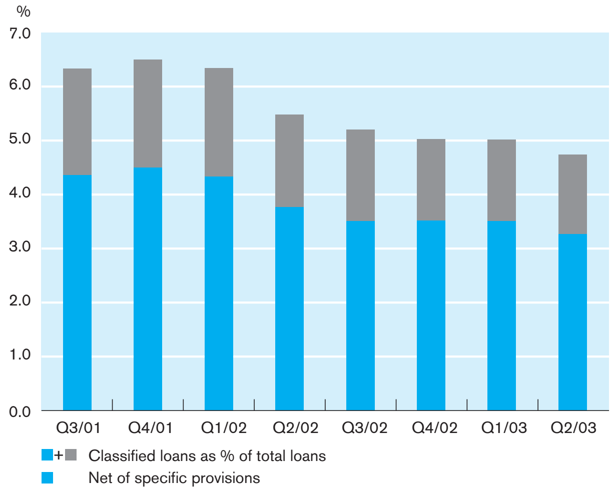


CHART 6

Asset Quality (Retail Banks)



Quality of residential mortgage portfolio

The quality of the overall residential mortgage portfolio was largely maintained in the second quarter. The delinquency ratio, affected by the SARS outbreak, worsened initially to 1.16% at end-May before improving to 1.12% at end-June. This compared with 1.11% at end-March. The rescheduled mortgage loan ratio increased to 0.53% from 0.46% at end-March, reflecting banks'

TABLE 2

Consolidated Capital Adequacy Ratio (All locally incorporated AIs)

(HK$ mn)	Jun-02	Sep-02	Dec-02[r]	Mar-03	Jun-03
Total capital base after deductions[1]	305,679	309,993	303,900	308,212	307,272
of which core capital	*251,281*	*256,555*	*251,745*	*259,440*	*263,375*
Total risk-weighted exposures	1,887,566	1,906,646	1,931,991	1,932,418[r]	1,973,941
Capital adequacy ratio	16.2%	16.3%	15.7%	15.9%	15.6%

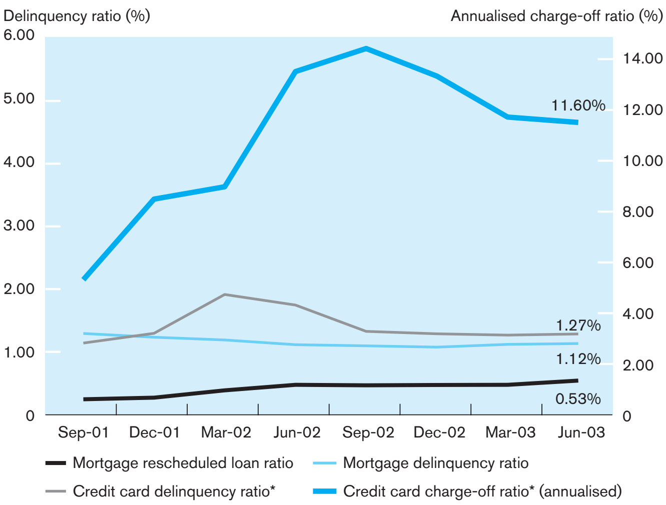
Notes:
1 Total capital base after deductions refers to total core and supplementary capital after deductions as specified under the Third Schedule to the Banking Ordinance.
r Revised figures due to late adjustments.

continued efforts to assist borrowers in financial difficulties (Chart 7).

Given the downward movement in property prices, which was aggravated by the SARS outbreak, banks' residential mortgage loans in negative equity increased to about 106,000 with a value of HK$165 billion at end-June 2003 and an unsecured portion of about HK$36 billion. Despite this, the three-month delinquency ratio of negative equity mortgage loans[2] improved further to 2.28% at end-June. Helped by a reduction in outstanding balances due to repayments and the fact that many of the new negative equity loans are only marginally in negative equity, the overall loan-to-value ratio on negative equity mortgage loans remained stable at 128%. The average interest rate charged on negative equity loans fell further to 1.07% below BLR from 0.88% below BLR at end-March. In all, as at end-June, about 62% of negative equity homeowners are paying an interest rate below BLR compared with 52% a year ago. This reflects the impact of the refinancing and restructuring of mortgage loans in negative equity as well as the lower interest rates already carried by the loans that have recently moved into negative equity.

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.

2 Negative equity residential mortgage loans delinquent for more than three months as a percentage of total negative equity residential loans.

Quality of credit card portfolio

The quality of the credit card portfolio appeared to have stabilised in the second quarter, as suggested by the aggregate charge-off amount which fell for the third consecutive quarter to HK$1.57 billion (Chart 7). Accordingly, the annualised quarterly charge-off ratio dropped to 11.60% from 11.82% in the first quarter. The improvement in the charge-off situation partly reflects the precautionary measures taken by the banks, as well as the continuing impact of debt restructuring arrangements. During the quarter, another HK$198 million or 0.4% of total credit card receivables was restructured, of which about 68% was transferred outside the credit card portfolio.

Local Authorized Institutions' Capital Strength

Owing largely to an increase in risk-weighted assets, the average consolidated capital adequacy ratio of all local authorized institutions declined to 15.6% from 15.9% at end-March (Table 2).

CHART 8

Average Liquidity Ratio (Retail Banks)

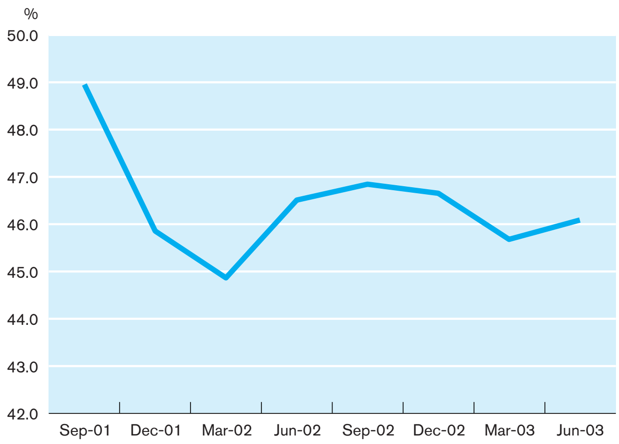
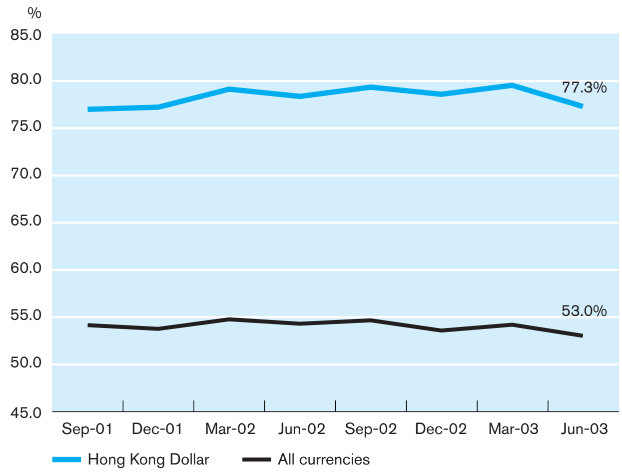


CHART 9

Loan-to-Deposit Ratio (Retail Banks)



Retail Bank's Liquidity

Retail banks' average liquidity ratio[3] increased to 46% for the second quarter, well above the minimum statutory requirement of 25%, indicating that they were highly liquid (Chart 8). The main components of liquifiable assets continued to be marketable debt securities and net interbank claims.

The overall loan-to-deposit ratio dropped to 53.0% from 54.1% and the Hong Kong dollar ratio to 77.3% from 79.6% (Chart 9).

Retail Banks' Lending

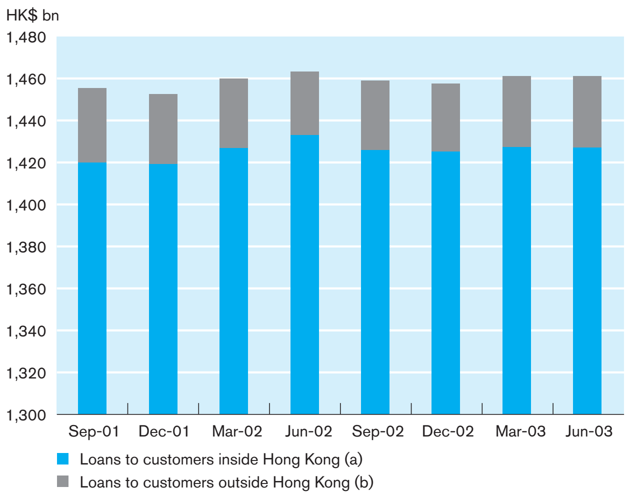
Helped by growth in trade financing loans, which offset the decline in property lending, retail banks' total loans, comprising largely of domestic loans, was virtually unchanged in the second quarter (Chart 10). The growth in trade financing loans of 7.6% following a rise of 2.6% in the previous quarter reflects the strong growth in external trade.

Loans to customers inside Hong Kong by major economic sectors

The effect of the outbreak of SARS on domestic lending was most prominent in lending to private individuals, particularly for the purchase of properties. As shown in Chart 11, only property lending decreased in the second quarter. The weak market sentiment arising from falling property prices and increased unemployment resulted in a further decline of 0.6% in property lending. The decline was attributable to a 1.9% fall in property development

CHART 10

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

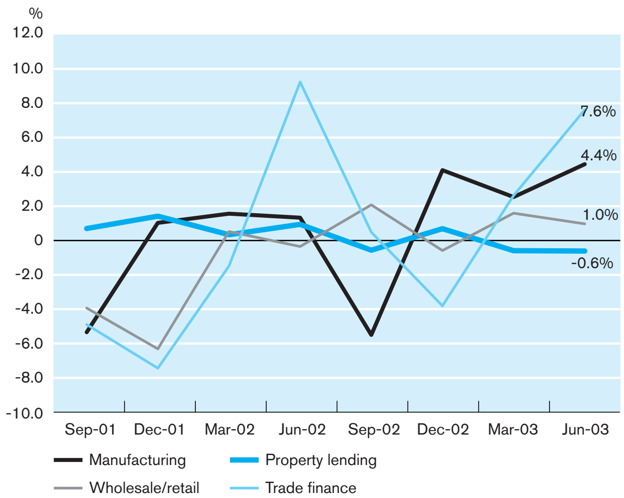


Notes:
(a) Defined as loans for use in Hong Kong plus trade financing loans.
(b) Includes "others" (i.e. unallocated).

[3] All authorized institutions in Hong Kong are required to meet a minimum monthly average liquidity 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 of the Banking Ordinance.

CHART 11

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).

and a decrease of 0.8% in residential mortgage lending which more than offset the 0.3% increase in loans for property investment. Loans for the purchase of flats under the Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme also fell for the sixth consecutive quarter, by 3.3%. In contrast, loans to the manufacturing sector and to wholesale and retail trade increased by 4.4% and 1.0%, having risen by 2.5% and 1.6% respectively in the first quarter. Lending to the electricity, gas and telecommunications sector grew by 2.0% after an increase of 9.7% in the first quarter. Led by a 10.7% increase in lending to taxi and public light buses, loans to the transport and transport equipment sector increased by 4.2% after falling by 0.5% in the preceding quarter.

Lending to telecommunications sector

Retail banks' lending to the telecommunications sector rose moderately by HK$0.4 billion to HK$15.3 billion, accounting for 1.1% of their total domestic loans. Similarly, the banking sector as a whole also recorded an increase in their lending to this sector by HK$0.6 billion to HK$31.5 billion, which represents 1.7% of the banking sector's total domestic loans.

Exposure to non-bank Chinese entities

As opposed to a decline in the last quarter of 2002, exposure to non-bank Chinese entities rose in the first quarter, with the increase mainly attributable to loan drawdowns and issuance of letters of credit. The retail banks' aggregate exposure rose marginally to HK$102.2 billion (2.5% of total assets) at end-March 2003, and that of the banking sector as a whole to HK$143.3 billion (2.2% of total assets).

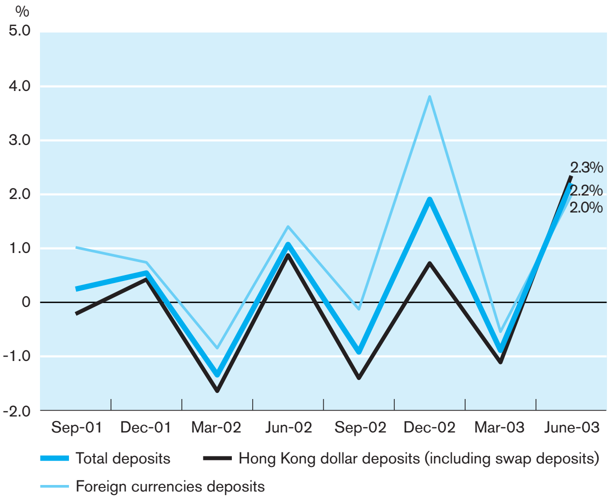
Credit card receivables

Affected by SARS, credit card receivables declined in April and in May but recovered somewhat in June. For the second quarter as a whole, credit card receivables declined, but at a slower pace of 1.07% in the second quarter compared with a decrease of 7.9% in the first quarter. The decline was due to a combination of factors including the continuous tightening of lending policies, the transfer of restructured card receivables from the card portfolio to other loan accounts (such as personal loan accounts) by some institutions and weakened consumer spending. The total number of credit card accounts declined slightly by 0.8%.

Retail Banks' Customer Deposits

Retail banks' customer deposits rose by 2.2%, compared with a decrease of 0.9% in the preceding quarter. Both Hong Kong dollar and foreign currency deposits rose, by 2.3% and 2.0% respectively, against a decrease of 1.1% and 0.5% in the

CHART 12
Customer Deposits (Retail Banks)
Quarterly Percentage Change



preceding quarter (Chart 12). Within foreign currency deposits, US dollar deposits increased by 4.2% and non-US dollar foreign currency deposits decreased by 2.9% as opposed to a decrease of 3.0% and an increase of 4.2% respectively in the first quarter. The proportion of Hong Kong dollar deposits to total deposits remained unchanged at 61%.

Hong Kong dollar time deposits dropped for the eleventh consecutive quarter, at a slower pace of 2.4% compared with 3.6% in the first quarter (Table 3). As a result, the share of time deposits to total deposits fell to 48.2% from 50.5% in the previous quarter. On the other hand, demand deposits increased sharply by 9.7% as opposed to a drop of 2.3% in the first quarter. Savings deposits also rose, by 6.7%, having increased by 2.3% in the preceding quarter. The shift from time deposits to demand and savings deposits suggested that the historical low interest rate environment has driven depositors to holding more liquid funds while awaiting better investment opportunities.

TABLE 3
Hong Kong Dollar Deposit Mix

Amount (HK$ bn)

	Retail banks		
	Demand	Savings	Time*
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)
Jun/03	**143.4**	**728.9**	**810.9**
% growth	9.7	6.7	(2.4)

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

Negotiable Instruments

Negotiable debt instruments held

Banks continued to divert their surplus funds to negotiable debt instruments (NDIs) for higher yield. Retail banks' holding of NDIs (excluding negotiable certificates of deposits (NCDs)) increased further by 3.4%. At end-June, total holdings of NDIs by retail banks accounted for 21.9% of their total assets, compared to 20.2% a year ago. The share of NDIs denominated in foreign currency to total NDIs increased slightly to 65.2% (Chart 13). The

CHART 13
Negotiable Debt Instruments Held (Retail Banks)
By Currency Breakdown

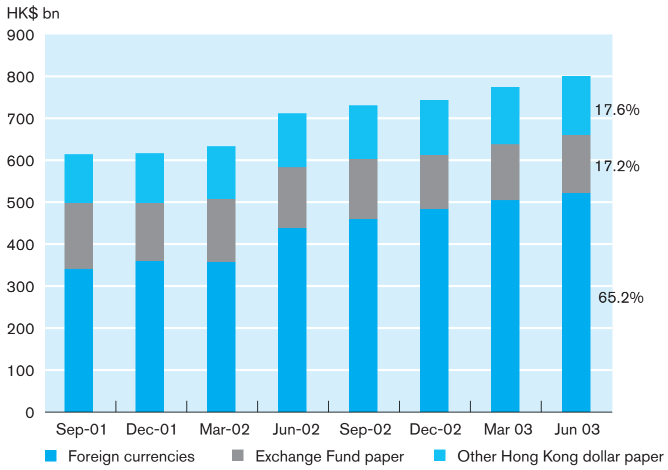
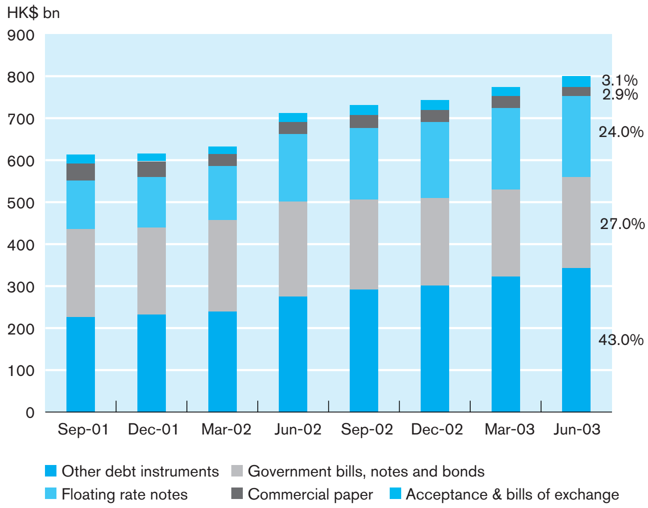


CHART 14

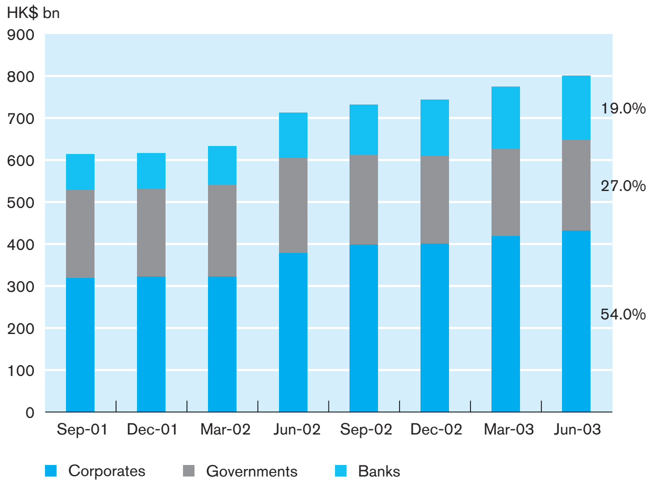
Negotiable Debt Instruments Held (Retail Banks) By Types of Instruments



Figures represent the percentage shares.

CHART 15

Negotiable Debt Instruments Held (Retail Banks) By Counterparty Breakdown



breakdown of NDIs held by types of instruments and counterparties is shown in Chart 14 and Chart 15 respectively.

Growth in retail banks' holdings of NCDs moderated to 3.4% from 11.9% in the first quarter, representing 2.6% of their total assets at end-June compared with 2.3% a year ago.

Negotiable certificates of deposits issued

Issuance of NCDs by retail banks increased modestly in the second quarter after marked growth in the past four quarters. Retail banks' outstanding NCDs rose by 0.4% in the second quarter, compared with an increase of 8.5% in the previous quarter. Compared with a year ago, outstanding NCDs have increased by 20.7%. However, it only accounted for 4.1% of retail banks' total liabilities.

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

APPENDIX

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

	Jun-02	Mar-03	Jun-03
Interest rate[2]			
1-month HIBOR	1.73	1.31	1.26
3-month HIBOR	1.84	1.33	1.26
BLR and 1-month HIBOR spread	3.40	3.69	3.74
BLR and 3-month HIBOR spread	3.29	3.67	3.74
		Retail Banks	
Balance sheet developments[3]			
Total deposits	1.1	-0.9	2.2
Hong Kong Dollar	0.9	-1.1	2.3
Foreign currency	1.4	-0.5	2.0
Total loans	0.2	0.3	0.0
Loans to customers inside Hong Kong[4]	0.4	0.2	0.0
Loans to customers outside Hong Kong[5]	-9.0	4.3	0.6
Negotiable instruments			
Negotiable debt certificates issued	11.4	8.5	0.4
Negotiable debt instruments held	12.5	4.1	3.4
Asset quality[6]			
As % of total loans			
Pass loans	88.69	88.49	88.66
Special mention loans	5.81	6.47	6.57
Classified loans (gross)[7]	5.50	5.03	4.76
Classified loans (net)[8]	3.78	3.52	3.28
Overdue > 3 months and rescheduled loans	4.00	3.64	3.61
Non-performing loans[9]	4.45	4.03	3.83
Profitability[10]			
Bad debt charge as % of average total assets	0.32	0.27	0.35
Net interest margin	2.11	1.98	1.97
Cost income ratio	38.7	37.5	37.7
Liquidity ratio[11]	46.5	45.7	46.1
		Surveyed Institutions	
Asset quality			
Delinquency ratio of residential mortgage loans	1.10	1.11	1.12
Credit card receivables			
Delinquency ratio	1.73	1.25	1.27
Charge-off ratio — quarterly annualised (adjusted)[12]	13.63	11.82	11.60
— year-to-date annualised	11.24	12.35	11.77
		All Locally Incorporated AIs	
Capital adequacy ratio (consolidated)	16.2	15.9	15.6

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.