

# Developments in the banking sector

by the Banking Policy Department

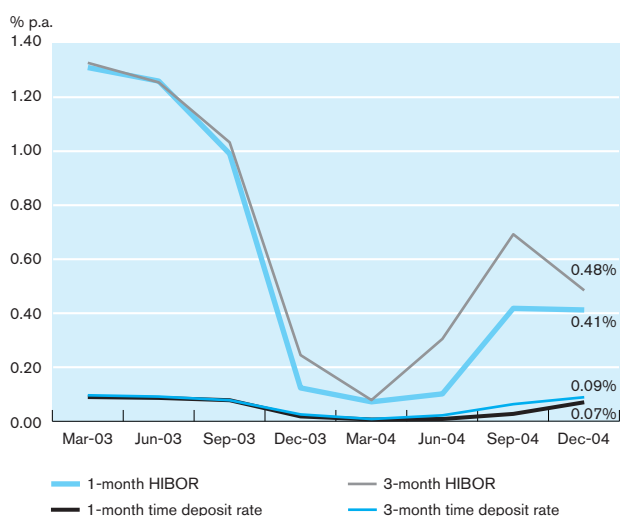
Retail banks reported strong profit growth in 2004 on the back of the economic upturn. The robust results were mainly attributable to a sharp reduction in new bad debt provisions, provision write-backs due to the continuing improvement in asset quality, and increased income from fees and commissions and from treasury operations. However, banks' net interest margins were squeezed in the highly competitive operating environment. Positive developments were seen in banks' balance sheets: domestic loan demand increased; overall asset quality improved further, with the ratios of credit card charge-offs and residential mortgage delinquencies declining; and the number of residential mortgages in negative equity reduced to its lowest level since the start of the HKMA's survey, as a result of recent increases in property prices.

## Interest rate movements

The best lending rate<sup>1</sup> (BLR) remained at 5.0% notwithstanding a 50 basis point increase in the federal funds target rate in the fourth quarter. Given the high level of liquidity in the interbank market, average HIBORs fell from the third quarter while the average time deposit rates remained flat (Chart 1).

CHART 1

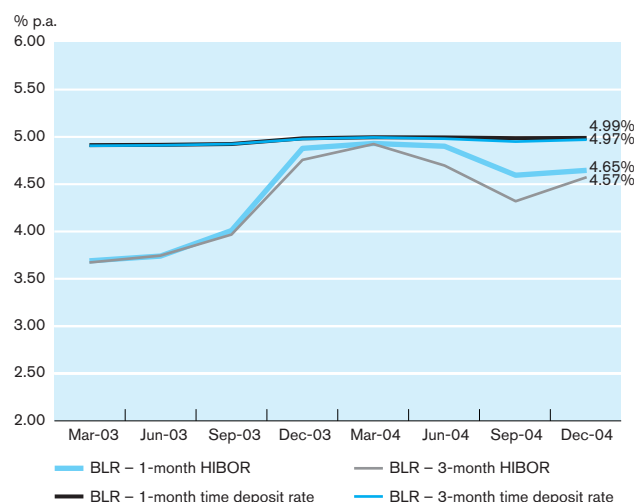
HIBORs and time deposit rates  
quarterly average



As a result, average spreads between BLR and HIBORs widened but those between BLR and time deposit rates remained virtually unchanged (Chart 2).

CHART 2

Best lending rate (BLR) - HIBOR/time deposit rate  
differentials  
quarterly average



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

## Retail banks' profitability

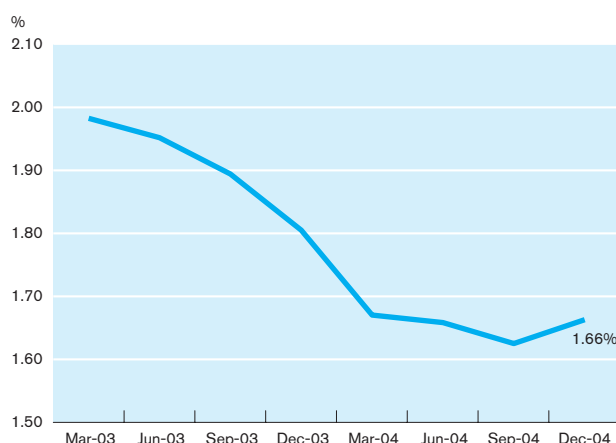
Retail banks' aggregate pre-tax operating profits in respect of their Hong Kong offices increased by 20.3% in 2004 compared to 2003. The increase was mainly attributable to a sharp reduction in bad debt charges as well as provision write-backs following the continuing improvement in asset quality.

The proportion of non-interest income expanded to 39.3% of total operating income from 33.8% in 2003. This was a direct result of banks' expansion of fee-based business to reduce their reliance on interest income, and increased income from treasury operations. The increasing importance of non-interest income also reflected the decline in net interest income during the year, although an increase in the latter occurred in the fourth quarter.

Reflecting the squeeze in residential mortgage margins, and the lower yield on free funds given the exceptionally high levels of liquidity, net interest margin contracted from 1.91% in 2003 to 1.65% despite an expansion in interest bearing assets (Chart 3).

CHART 3

Net interest margin (quarterly annualised)  
(retail banks)

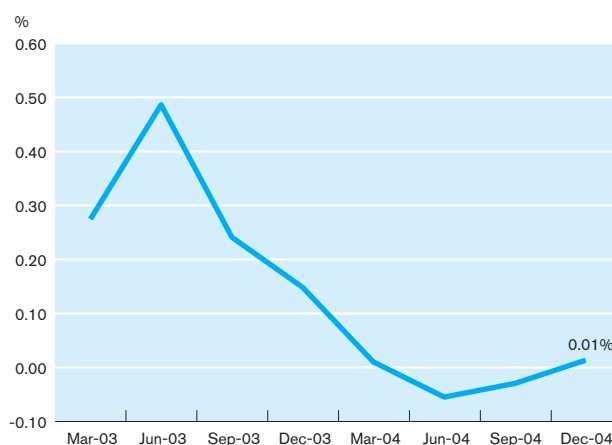


The cost-to-income ratio increased to 41.6% from 38.6%<sup>r</sup> in 2003 as staff costs and expenses for business expansion outpaced revenue growth.

In line with the continuing improvement in asset quality, the bad debt charge declined markedly compared with that of 2003. Retail banks' ratio of overall bad debt charge to average total assets improved to -0.02% (representing a net write-back of provisions) from 0.29% in 2003 (Chart 4).

CHART 4

Bad debt charge as percentage of average  
total assets (quarterly annualised)  
(retail banks)



## Retail banks' asset quality

### Overall quality

As expected, improvement in the overall asset quality of the retail banks continued in the fourth quarter. All problem loan ratios declined to the 1997 levels (Table 1). The overdue and rescheduled loan ratio fell to 1.48%, the classified loans ratio to 2.24% and the non-performing loans ratio to 1.62% (Chart 5). The classified loans ratio, netting off specific provisions, stood at 1.58% (Chart 6). The ratio of specific provisions to total classified loans rose to 30% from 27% at end-September.

<sup>r</sup> Figure revised

TABLE 1

Asset quality<sup>1</sup> of retail banks

	Dec-03	Mar-04	Jun-04 as % of total loans	Sep-04	Dec-04
Pass loans	89.53	90.07	91.41	92.35	93.76
Special mention loans	6.53	6.26	5.59	4.98	4.00
Classified loans (gross) <sup>2</sup>	3.94	3.66	3.00	2.67	2.24
o/w Substandard	1.42	1.36	1.19	1.08	0.98
Doubtful	1.74	1.56	1.26	1.12	0.87
Loss	0.77	0.74	0.55	0.47	0.40
Classified loans (net) <sup>3</sup>	2.78	2.62	2.16	1.95	1.58
Overdue > 3 months and rescheduled loans	2.87	2.61	2.09	1.90	1.48
o/w Overdue > 3 months	2.04	1.83	1.43	1.27	1.04
Rescheduled loans	0.83	0.78	0.66	0.63	0.45
Non-performing loans <sup>4</sup>	3.17	2.92	2.28	2.02	1.62

Notes:

<sup>1</sup> Period-end figures relate to Hong Kong offices and overseas branches.<sup>2</sup> Classified loans are those loans graded as "substandard", "doubtful" or "loss".<sup>3</sup> Net of specific provisions.<sup>4</sup> 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.

CHART 5

## Asset quality of retail banks

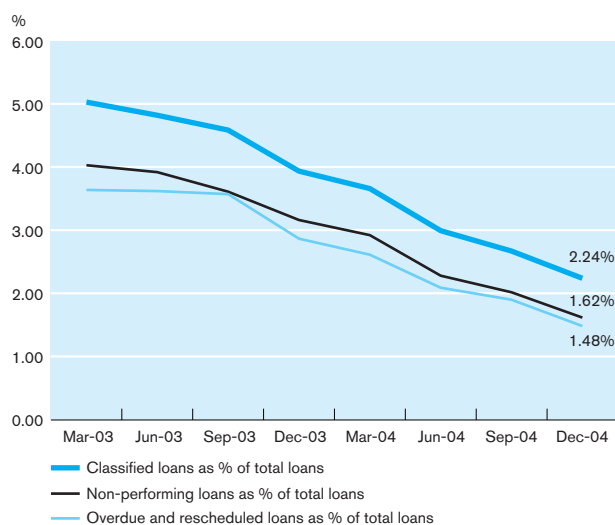
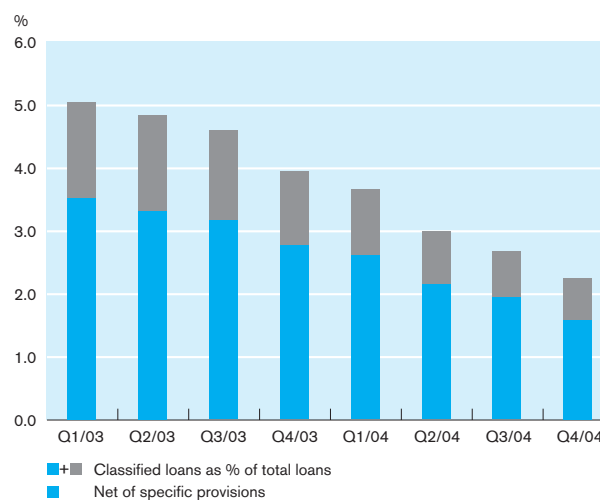


CHART 6

## Asset quality (retail banks)

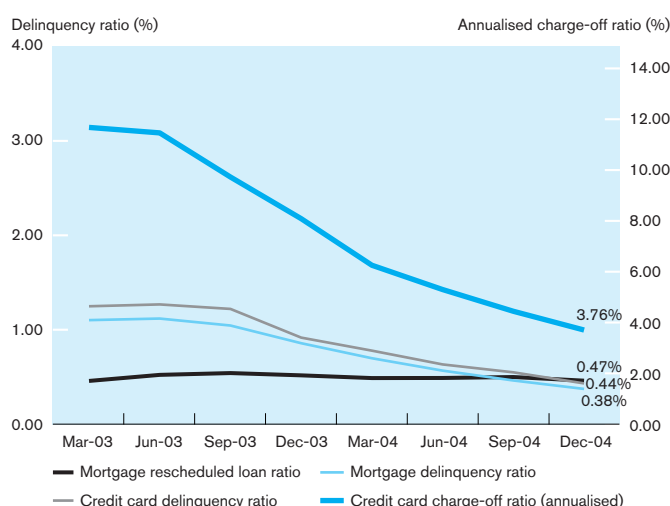


## Quality of residential mortgage lending portfolio

The quality of banks' residential mortgage lending portfolio improved in the fourth quarter, as measured by the decrease in the mortgage delinquency ratio to the 6-year low of 0.38% at end-December from 0.47% at end-September (Chart 7). Combined with the rescheduled loans, the ratio stood at 0.85%, down from 0.97% at end-September.

CHART 7

Asset quality of credit card and mortgage lending (surveyed institutions)



Primarily because of the increase in property prices, the number of residential mortgages in negative equity has fallen by more than 80% from the peak of about 106,000 cases (valued at HK\$165 billion) at

end-June 2003. It currently stands at 19,200 cases with an aggregate value of HK\$33 billion, down 24% from end-September. The delinquency ratio fell to 1.58% from 1.63% at end-September.

## Quality of credit card portfolio

The quality of credit card lending of retail banks continued to improve in the fourth quarter. The amount charged off in the fourth quarter declined to HK\$534 million or 0.94% of average receivables during the quarter (Chart 7) compared with HK\$608 million or 1.13% of average receivables in the third quarter. Accordingly, the annualised quarterly charge-off ratio improved to 3.76% from 4.51% in the third quarter, the lowest level since the second quarter of 2001. The credit card delinquency ratio dropped to a new low level of 0.44% at end-December. Together with the HK\$70 million outstanding rescheduled card receivables within the card portfolio, the combined ratio declined to 0.55% from 0.68 at end-September.

## Local authorized institutions' capital strength

With a faster increase in risk-weighted assets than in capital base, the average consolidated capital adequacy ratio of all locally incorporated authorized institutions decreased to 15.4% from 15.9% at end-September (Table 2).

TABLE 2

Consolidated capital adequacy ratio (All locally incorporated AIs)

(HK\$ mn)	Dec-03	Mar-04	Jun-04	Sep-04 <sup>1</sup>	Dec-04
Total capital base after deductions <sup>1</sup> of which core capital	311,646 266,695	330,112 285,314	334,838 290,053	369,972 333,711	377,909 335,051
Total risk-weighted exposures	2,042,768	2,040,148	2,100,572	2,331,521	2,449,202
Capital adequacy ratio	15.3%	16.2%	15.9%	15.9%	15.4%

Notes:

<sup>1</sup> Total capital base after deductions refers to total core and supplementary capital after deductions as specified under the Third Schedule to the Banking Ordinance.

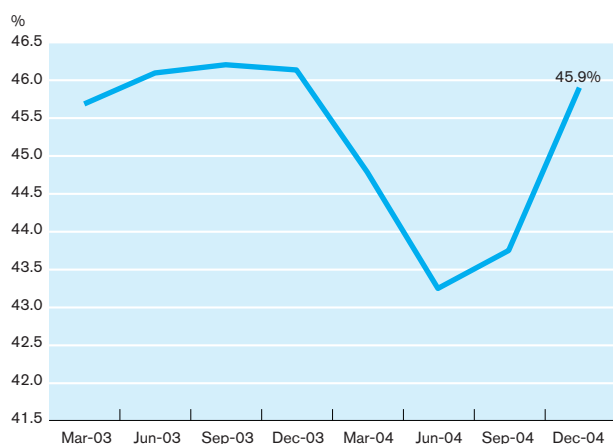
<sup>2</sup> Figures have been revised due to late adjustments.

## Retail banks' liquidity

Retail banks' average liquidity ratio<sup>2</sup> remained very high at about 46% for the fourth quarter, well above the minimum statutory requirement of 25% (Chart 8). The main components of liquifiable assets continued to be marketable debt securities and net interbank claims.

CHART 8

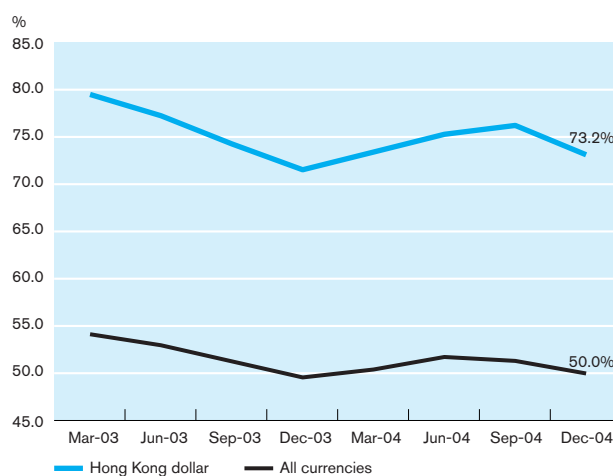
Average liquidity ratio  
(retail banks)



With the growth in deposits outpacing that of loans in the fourth quarter, the overall loan-to-deposit ratio for all currencies and for Hong Kong dollar declined to 50.0% and 73.2% respectively (Chart 9).

CHART 9

Loan-to-deposit ratio  
(retail banks)

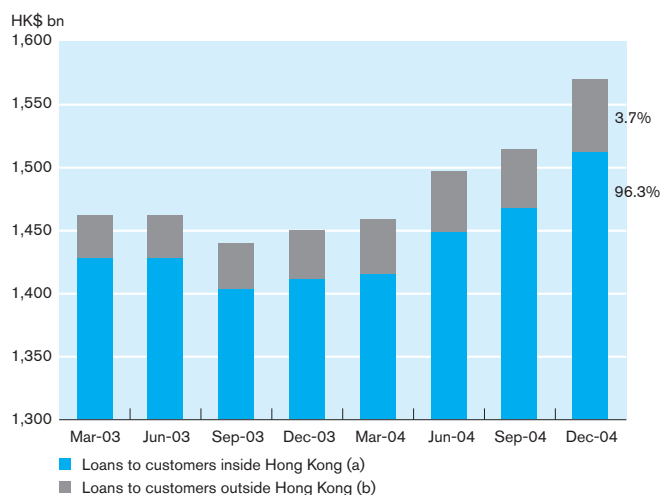


## Retail banks' lending

Stimulated by the improving domestic economy and rebound in property market activity, the domestic lending of retail banks increased by 3.1% in the fourth quarter after rising 1.3% in the third quarter. Together with the 24.3% increase in loans for use outside Hong Kong, retail banks' total loans increased by 3.7% after rising by 1.1% in the third quarter (Chart 10).

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).

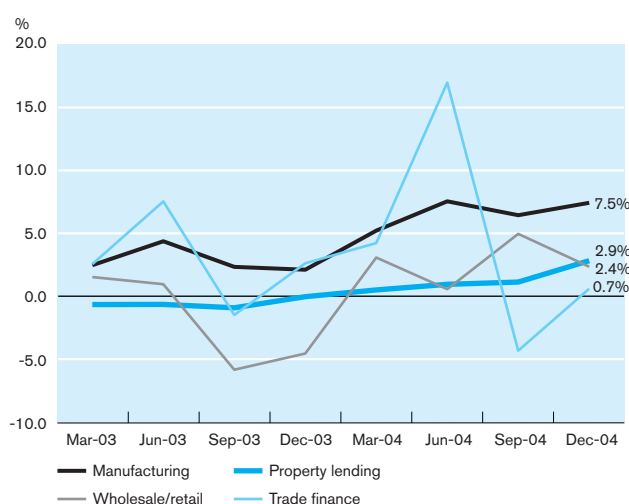
<sup>2</sup> All authorized institutions in Hong Kong are required to meet a minimum monthly average liquidity of 25%. This is calculated as the ratio of liquefiable assets (e.g. marketable debt securities and loan repayment within one month subject to their respective liquidity conversion factors) to 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.

## Loans to customers inside Hong Kong by various economic sectors

With improved business sentiment, improved employment conditions and rising property price, domestic loan demand increased in the fourth quarter. Lending to major economic sectors increased, reflecting a broadened economic recovery (Chart 11).

CHART 11

Loans for use in Hong Kong by selected sectors (retail banks)  
quarterly percentage change



- Amid the continuous robust external trade, **trade financing loans** grew by 0.7% in the fourth quarter.
- Loans to the manufacturing sector** rose by 7.5% after rising by 6.5% in the third quarter.
- In line with the increase in property market activity, **property lending** increased by 2.9% after rising by 1.2% in the third quarter. The increase was across-the-board in property lending. **Lending for property development** increased sharply by 11.6%, after falling since December 2002, while **lending for property investment** and **residential mortgage lending** increased 4.8% and 0.8% respectively.

- Loans for the purchase of flats under the Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme** fell by 2.8% in the fourth quarter due to the continuing freeze on sales of the flats under these schemes.
- Driven by the inflow of Mainland visitors and growth in private consumption, **lending to the wholesale and retail trade sector** grew by 2.4%, after rising 5.0% in the preceding quarter.
- Loans to financial concerns** increased by 2.0% against a decline of 5.4% in the previous quarter.

## Lending to telecommunications sector

Retail banks' lending to the telecommunications sector fell by HK\$1.0 billion to HK\$7.2 billion, accounting for 0.5% of their total domestic loans. Similarly, lending to this sector by the banking sector as a whole also decreased by HK\$0.7 billion to HK\$14.9 billion, which represented 0.8% of the banking sector's total domestic loans.

## Exposure to non-bank Chinese entities

Retail banks' aggregate exposure to non-bank Chinese entities rose to HK\$120.5 billion (2.6% of total assets) at end-September from HK\$115.3 billion (2.5% of total assets) at end-June, largely in exposures to other state, provincial, or municipal government-owned entities and their subsidiaries. The exposure of the banking sector to non-bank Chinese entities also increased to HK\$167.6 billion (2.3% of total assets) from HK\$160.6 billion (2.2% of total assets).

## Credit card receivables

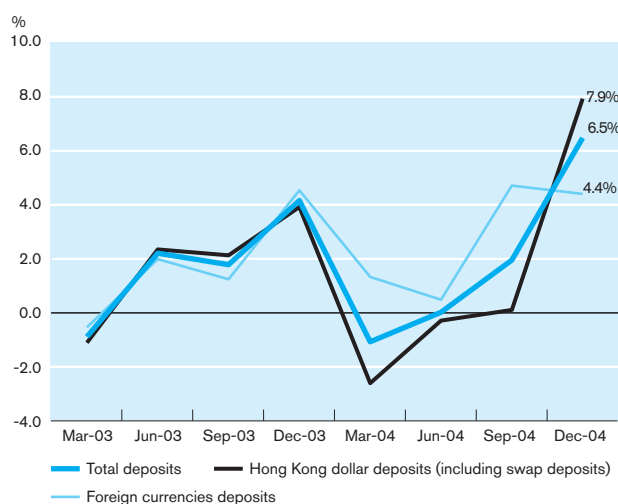
Reflecting the revival in consumer confidence, credit card lending increased in the fourth quarter. According to the regular survey, total credit card receivables rose sharply by 9.2%, despite a transfer of some HK\$96 million rescheduled receivables representing 0.2% of average receivables out of the credit card portfolio during the quarter. The total number of credit card accounts grew further by 1.7%.

## Retail banks' customer deposits

Retail banks' customer deposits increased further by 6.5% in the fourth quarter, partly associated with the strong fund inflow, following a 1.9% in the third quarter. While Hong Kong dollar deposits rose further by 7.9% after increasing by 0.1% in the third quarter, foreign currency deposits rose by 4.4% following an increase of 4.7% (Chart 12). As a result, the proportion of Hong Kong dollar deposits to total deposits increased to 60% from 59% at end-September. Of all foreign currency deposits, US dollar deposits grew by 10.0% while non-US dollar deposits fell by 8.3%.

CHART 12

Customer deposits (retail banks)  
quarterly percentage change



Having risen for two consecutive quarters, Hong Kong dollar time deposits fell by 1.2% after an increase of 7.2% in the third quarter (Table 3). As a result, the share of Hong Kong dollar time deposits to Hong Kong dollar total deposits fell to 32.1% from 35.1% in the third quarter. Reversing a decrease of 5.6% in the third quarter, Hong Kong dollar demand deposits increased by 17.3%. Similarly, Hong Kong dollar savings deposits rose by 11.8% against a decrease of 2.8% in the third quarter.

TABLE 3

Hong Kong dollar deposit mix

Amount (HK\$ bn)

	Retail banks		
	Demand	Savings	Time*
<b>Dec/03</b>	<b>203.4</b>	<b>927.1</b>	<b>655.8</b>
% growth	24.9	20.7	(16.8)
<b>Mar/04</b>	<b>218.1</b>	<b>958.2</b>	<b>563.3</b>
% growth	7.2	3.4	(14.1)
<b>Jun/04</b>	<b>225.7</b>	<b>941.1</b>	<b>567.7</b>
% growth	3.5	(1.8)	0.8
<b>Sep/04</b>	<b>212.9</b>	<b>914.7</b>	<b>608.7</b>
% growth	(5.6)	(2.8)	7.2
<b>Dec/04</b>	<b>249.8</b>	<b>1,022.9</b>	<b>601.3</b>
% growth	17.3	11.8	(1.2)

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

\* Includes swap deposits

## Negotiable Instruments

### Negotiable debt instruments held

Retail banks' holding of NDIs (excluding negotiable certificates of deposits (NCDs)) declined by 1.7% from end-September but increased by 6.7% from a year before (Chart 13). These NDIs accounted for 21.3% of the total assets, 64.8% of them were denominated in foreign currency. Breakdowns of the NDIs by instrument types and counterparties are shown in Charts 14 and 15 respectively.

CHART 13

Negotiable debt instruments held (retail banks)  
by currency breakdown

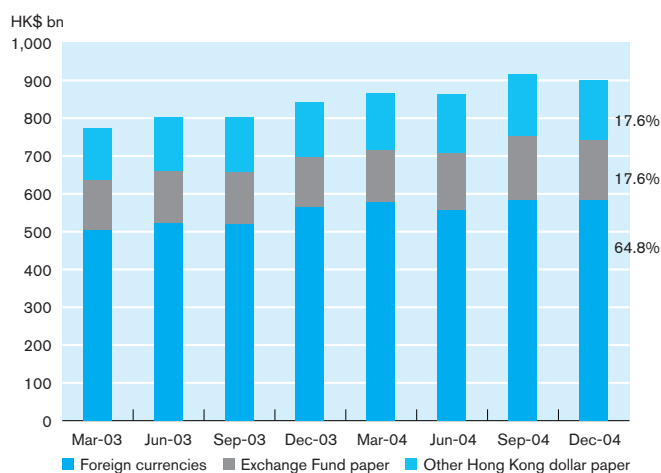
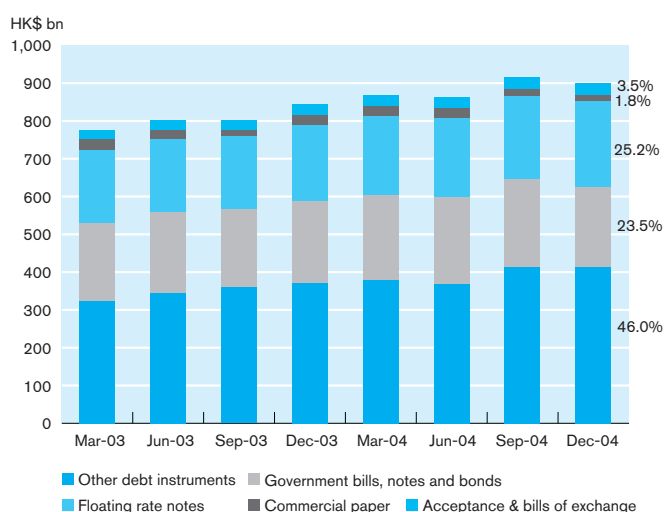


CHART 14

### Negotiable debt instruments held (retail banks) by types of instruments



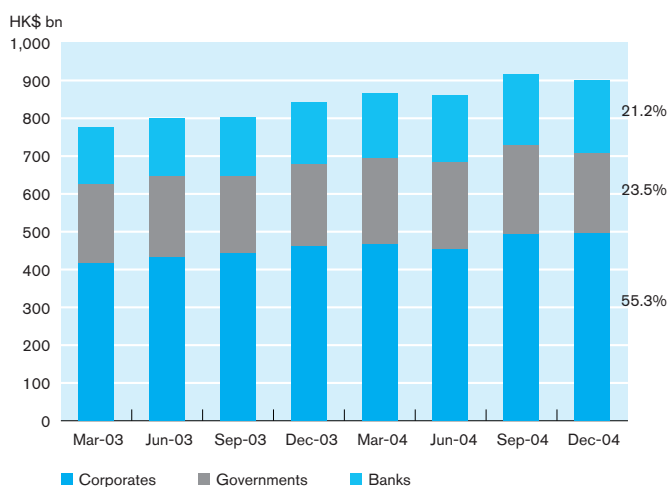
### Negotiable certificates of deposits issued

With the issue of NCDs more than offset that of the NCDs redeemed, retail banks' outstanding NCDs rose by 4.7% in the fourth quarter. Compared with a year ago, outstanding NCDs rose by 10.4%. The total outstanding NCDs accounted for about 4% of retail banks' total liabilities at the end of the fourth quarter.

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

CHART 15

### Negotiable debt instruments held (retail banks) by counterparty breakdown



NCDs held by retail banks declined by 0.2% to represent 2.0% of total assets, as opposed to an increase of 1.9% in the third quarter. In contrast to NDIs, most (66.5%) of the NCDs were in Hong Kong dollars.



## APPENDIX

KEY PERFORMANCE INDICATORS OF THE BANKING SECTOR<sup>1</sup> (%)

	Dec-03	Sep-04	Dec-04
<b>Interest rate<sup>2</sup></b>			
1-month HIBOR	0.12	0.42	0.41
3-month HIBOR	0.24	0.69	0.48
BLR and 1-month HIBOR spread	4.88	4.59	4.65
BLR and 3-month HIBOR spread	4.76	4.32	4.57
<b>Retail banks</b>			
<b>Balance sheet developments<sup>3</sup></b>			
Total deposits	4.2	1.9	6.5
Hong Kong Dollar	3.9	0.1	7.9
Foreign currency	4.5	4.7	4.4
Total loans	0.7	1.1	3.7
Loans to customers inside Hong Kong <sup>4</sup>	0.5	1.3	3.1
Loans to customers outside Hong Kong <sup>5</sup>	6.5	-3.5	24.3
Negotiable instruments			
Negotiable debt certificates issued	5.1	7.1	4.7
Negotiable debt instruments held	5.0	6.2	-1.7
<b>Asset quality<sup>6</sup></b>			
As % of total loans			
Pass loans	89.53	92.35	93.76
Special mention loans	6.53	4.98	4.00
Classified loans (gross) <sup>7</sup>	3.94	2.67	2.24
Classified loans (net) <sup>8</sup>	2.78	1.95	1.58
Overdue > 3 months and rescheduled loans	2.87	1.90	1.48
Non-performing loans <sup>9</sup>	3.17	2.02	1.62
<b>Profitability<sup>10</sup></b>			
Bad debt charge as % of average total assets	0.29	-0.02	-0.02
Net interest margin	1.91	1.65	1.65
Cost income ratio	38.6	41.6	41.6
<b>Liquidity ratio<sup>11</sup></b>	46.1	43.7	45.9
<b>Surveyed institutions</b>			
<b>Asset quality</b>			
Delinquency ratio of residential mortgage loans	0.86	0.47	0.38
Credit card receivables			
Delinquency ratio	0.92	0.55	0.44
Charge-off ratio — quarterly annualised	8.19	4.51	3.76
— year-to-date annualised	10.02	5.31	4.73
<b>All locally incorporated AIs</b>			
<b>Capital adequacy ratio (consolidated)</b>	15.3	15.9	15.4

## Notes:

<sup>1</sup> Figures related to Hong Kong office(s) only except where otherwise stated.<sup>2</sup> Quarterly average.<sup>3</sup> Quarterly change.<sup>4</sup> Loans for use in Hong Kong plus trade financing loans.<sup>5</sup> Includes "others" (i.e. unallocated).<sup>6</sup> Figures relate to retail banks' Hong Kong office(s) and overseas branches.<sup>7</sup> Classified loans are those loans graded as "substandard", "doubtful" or "loss".<sup>8</sup> Net of specific provisions.<sup>9</sup> Loans on which interest has been placed in suspense or on which interest accrual has ceased.<sup>10</sup> Year-to-date annualised.<sup>11</sup> Quarterly average.