

Developments in the banking sector

by the Banking Policy Department

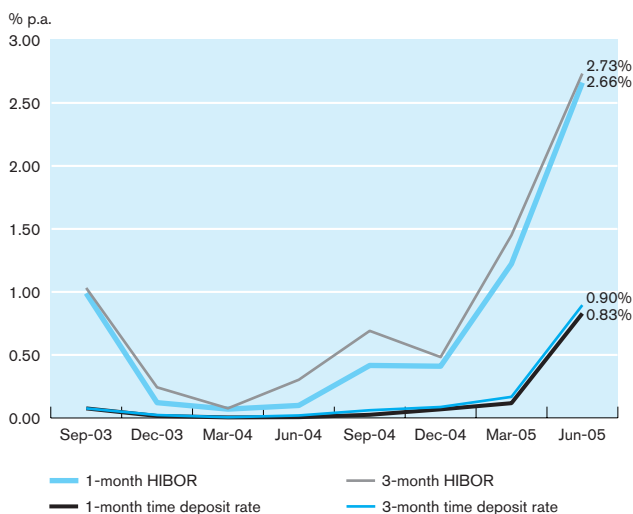
Benefiting from a sustained economic upturn, retail banks recorded solid profit growth in the first half of 2005 compared with the same period of 2004. The improved results were mainly attributable to increases in both net interest income, reflecting strong growth in domestic lending, and non-interest income. Provision write-backs as a result of the continuing improvement in asset quality also contributed to profit growth, although to a lesser extent than in the past. Banks' profits were affected by the introduction of new accounting standards, but not to a significant extent. With improvements in the domestic economy, employment and property values, overall asset quality improved further. The delinquency ratios of credit card lending and residential mortgage lending declined to record lows and the number of residential mortgages in negative equity also reduced.

Interest rate movements

Domestic interest rates increased in the second quarter. Following the introduction of the refinements to the Linked Exchange Rate system on 18 May, excess interbank liquidity largely disappeared and Hong Kong money market rates adjusted accordingly. In line with the move in HIBORs, time deposit rates also increased sharply (Chart 1).

CHART 1

HIBORs and time deposit rates
(quarterly average)

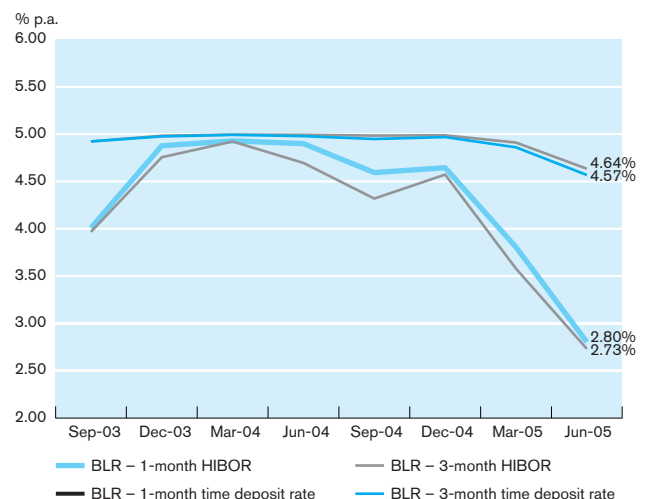


¹ With reference to the rates quoted by the Hongkong and Shanghai Banking Corporation Limited.

An increase of 25 basis points in the US Fed funds target rate in early May was not reflected in Hong Kong banks' best lending rate (BLR) until the rise in HIBORs triggered banks to raise BLR later in the month. At the end of the second quarter BLR ranged from 5.75% to 6.00%. However, the average spreads between BLR and HIBORs and between BLR and time deposit rates narrowed as average HIBORs and time deposit rates increased more rapidly than BLR¹ (Chart 2).

CHART 2

Differentials between best lending rate
and HIBORs/time deposit rates
(quarterly average)



Retail banks' profitability

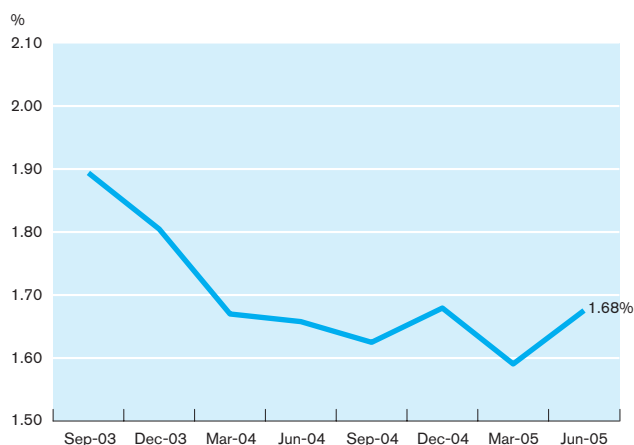
The aggregate pre-tax operating profits of the retail banks' Hong Kong offices increased by 8.0% in the first half of 2005 compared with the same period of 2004, attributable mainly to increases in both net interest income and non-interest income. Provision write-backs due to the continuing improvement in asset quality, although having declined from previous quarters, also contributed to profit growth.

Non-interest income grew faster than net interest income, expanding to 42.0% of retail banks' total operating income from 38.9% in the first half of 2004. A buoyant domestic economy ensured that income growth was broad-based although there were some signs of a contraction in fees and commission income.

Net interest income was higher than that in the first half of 2004, largely because of an expansion in interest bearing assets. Since average interest bearing assets grew faster than net interest income, net interest margin contracted to 1.63% from 1.66% a year ago (Chart 3). However, there was some recovery in the second quarter, particularly in the margin on new mortgage lending. The contraction reflects intense competition for business and the narrowing of average interest rate spreads.

CHART 3

Retail banks' net interest margin (quarterly annualised)

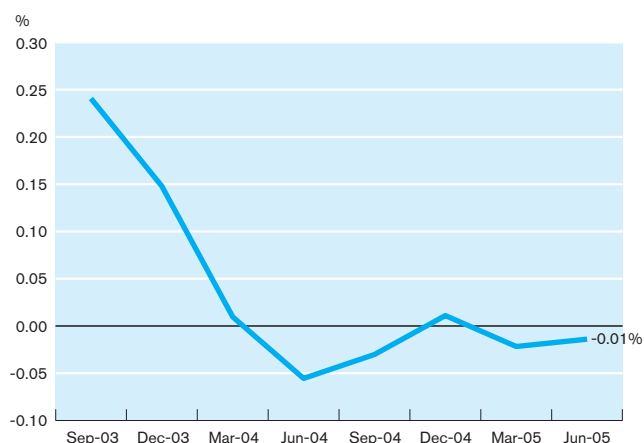


Retail banks' cost-to-income ratio rose to 41.1% from 40.0% in the first half of 2004, as operating expenses outpaced income growth. The deterioration in the ratio was caused by an increase in staff expenses as the result of pay rises and additional recruitment together with higher operating costs arising from business expansion.

On the back of the continued improvement in asset quality, retail banks continued to register net write-back of debt provision. Retail banks' ratio of overall bad debt charge to average total assets remained broadly unchanged at -0.02% (Chart 4).

CHART 4

Retail banks' bad debt charge as percentage of average total assets (quarterly annualised)



Retail banks' asset quality

Overall quality

Overall asset quality of the retail banks continued to improve in the second quarter. All problem loan ratios declined (Table 1). The overdue and rescheduled loan ratio fell to 1.13% and the classified loan ratio to 1.76% (Chart 5). The classified loan ratio, netting off specific provisions, fell to 1.22% (Chart 6). The ratio of specific provisions to total classified loans rose to 31% from 28% at the end of March.

TABLE 1
Asset quality¹ of retail banks

| | Jun-04 | Sep-04 | Dec-04 | Mar-05 | Jun-05 |
|--|------------------------------|--------------|--------------|--------------|--------------|
| | as percentage of total loans | | | | |
| Pass loans | 91.41 | 92.35 | 93.76 | 94.30 | 95.03 |
| Special mention loans | 5.59 | 4.98 | 3.99 | 3.75 | 3.21 |
| Classified loans (gross)² | 3.00 | 2.67 | 2.25 | 1.95 | 1.76 |
| <i>of which Substandard</i> | 1.19 | 1.08 | 0.98 | 0.80 | 0.66 |
| <i>Doubtful</i> | 1.26 | 1.12 | 0.88 | 0.79 | 0.77 |
| <i>Loss</i> | 0.55 | 0.47 | 0.40 | 0.36 | 0.33 |
| Classified loans (net)³ | 2.16 | 1.95 | 1.59 | 1.40 | 1.22 |
| Overdue > 3 months and rescheduled loans | 2.09 | 1.90 | 1.48 | 1.30 | 1.13 |
| <i>of which Overdue > 3 months</i> | 1.43 | 1.27 | 1.05 | 0.95 | 0.85 |
| <i>Rescheduled loans</i> | 0.66 | 0.63 | 0.44 | 0.35 | 0.28 |
| Non-performing loans⁴ | 2.28 | 2.02 | 1.63 | N.A. | N.A. |

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 Information of loans on which interest has been placed in suspense or on which interest accrual has ceased are not available from January 2005 following adoption of the new Hong Kong Accounting Standard 39. Because of rounding, the figures set out in this table may not add up.

CHART 5

Retail banks' asset quality (1)

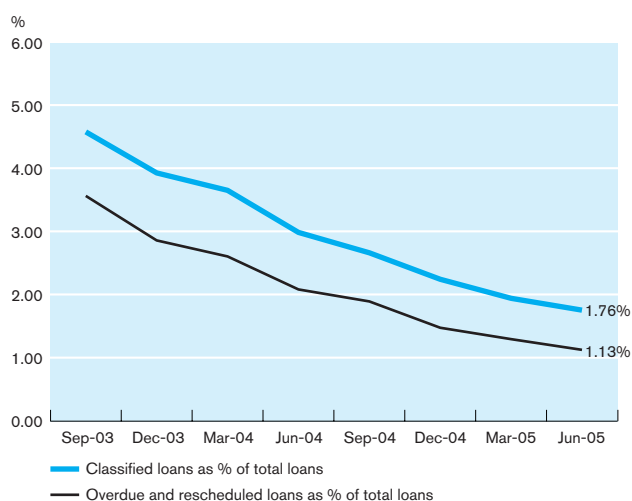
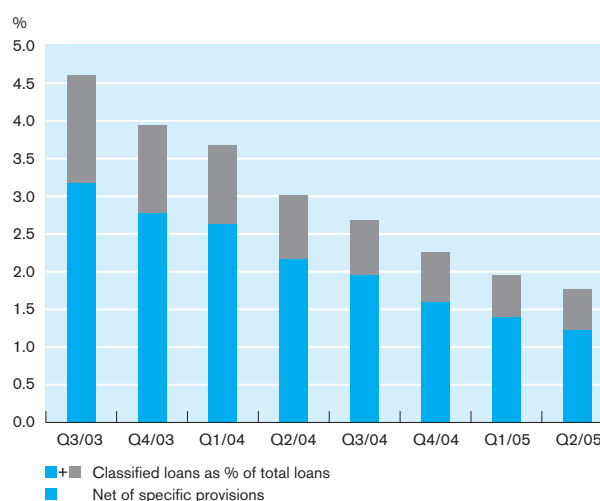


CHART 6

Retail banks' asset quality (2)

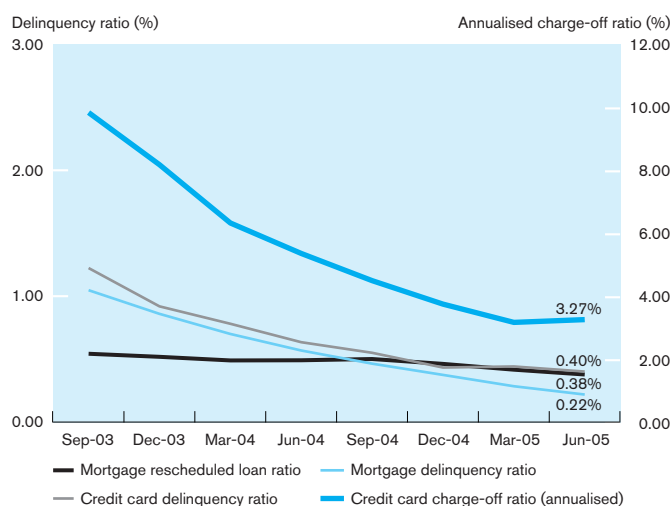


Quality of residential mortgage lending portfolio

The quality of banks' residential mortgage lending portfolios continued to improve in the second quarter with the mortgage delinquency ratio falling to 0.22% at the end of June from 0.29% at the end of March (Chart 7). The combined ratio of delinquent and rescheduled loans decreased to 0.60% from 0.71% at the end of March.

CHART 7

Asset quality of credit card and mortgage lending by surveyed institutions



Owing largely to the continued improvement in property values, the number of residential mortgages in negative equity reduced further by 38% from the end of March to 8,700 cases at the end of June with an aggregate value of HK\$15 billion. This represents

TABLE 2

Consolidated capital adequacy ratio (All locally incorporated AIs)

| (HK\$ mn) | Jun-04 | Sep-04 | Dec-04 [†] | Mar-05 | Jun-05 |
|---|--------------------|--------------------|---------------------|--------------------|--------------------|
| Total capital base after deductions ¹ of which core capital | 334,614 289,829 | 369,974 333,713 | 377,219 333,723 | 382,953 348,176 | 394,442 351,611 |
| Total risk-weighted exposures | 2,100,572 | 2,331,552 | 2,447,883 | 2,480,419 | 2,584,378 |
| Capital adequacy ratio | 15.9% | 15.9% | 15.4% | 15.4% | 15.3% |

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.

[†] Figures have been revised due to late adjustments.

a decline of almost 92% from the peak of about 106,000 cases (valued at HK\$165 billion) at the end of June 2003. The delinquency ratio of these negative mortgage loans fell to 1.38% from 1.51% at the end of March.

Quality of credit card portfolio

The quality of credit card lending of retail banks remained broadly unchanged in the second quarter. The amount charged-off in the second quarter was little changed at HK\$465 million or 0.82% of average receivables during the quarter compared with HK\$461 million or 0.80% in the first quarter. The annualised quarterly charge-off ratio rose slightly to 3.27% from 3.18% in the first quarter (Chart 7). By contrast, the credit card delinquency ratio dropped to a new low level of 0.40% at the end of June. Together with the HK\$65 million outstanding rescheduled card receivables within the card portfolio, the combined ratio declined to 0.52% from 0.57% at the end of March.

Local authorized institutions' capital strength

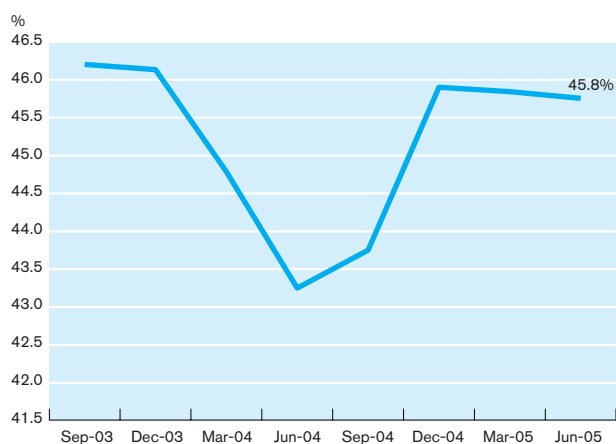
As bank lending increased alongside a growing domestic economy, risk-weighted assets of local authorized institutions grew faster than their capital base. Nonetheless, the average consolidated capital adequacy ratio of all locally incorporated authorized institutions decreased only slightly to 15.3% from 15.4% at the end of March (Table 2).

Retail banks' liquidity

Retail banks' average liquidity ratio² remained high at about 46% for the second quarter, well above the minimum statutory requirement of 25% (Chart 8). The main components of liquefiable assets continued to be marketable debt securities and net interbank claims.

CHART 8

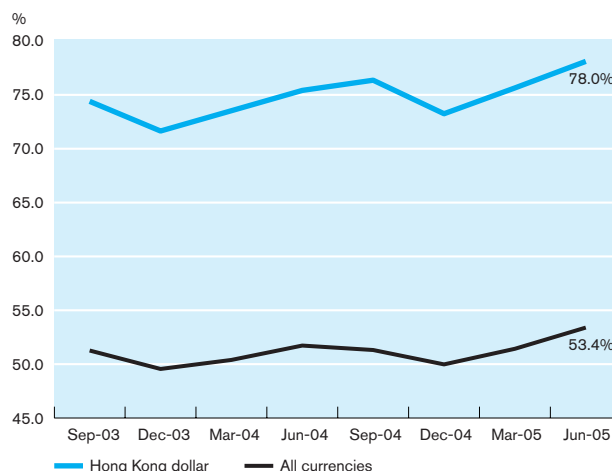
Retail banks' average liquidity ratio



With strong loan growth and a marginal decrease in deposits in the second quarter, the overall loan-to-deposit ratio for all currencies rose to 53.4% from 51.4% at the end of March and to 78.0% from 75.6% for Hong Kong dollar over the same period (Chart 9).

CHART 9

Retail banks' loan-to-deposit ratio

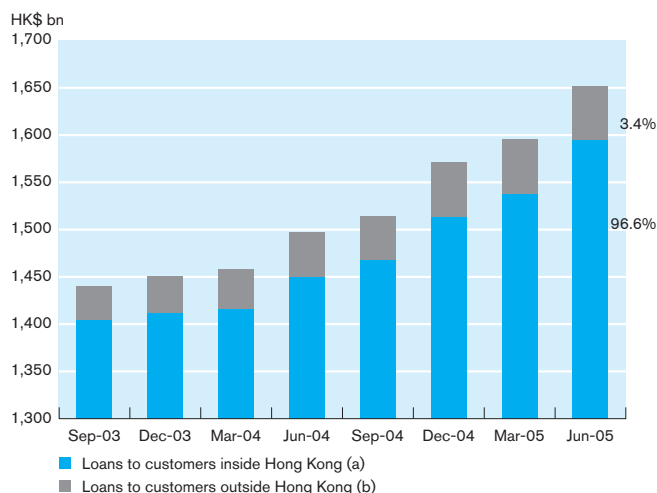


Retail banks' lending

Driven by strong economic growth and a buoyant property market, the domestic lending of retail banks increased by 3.7% in the second quarter, compared with a 1.6% rise in the previous quarter. This was the largest quarterly increase since the fourth quarter of 1997. Retail banks' total loans increased by 3.5% after growing by 1.6% in the first quarter as the increase in domestic lending was partially off-set by a 3.8% decrease in loans for use outside Hong Kong (Chart 10).

CHART 10

Retail banks' loans to customers inside and outside Hong Kong



Notes:

(a) Defined as loans for use in Hong Kong plus trade financing loans.

(b) Includes "others" (i.e. unallocated).

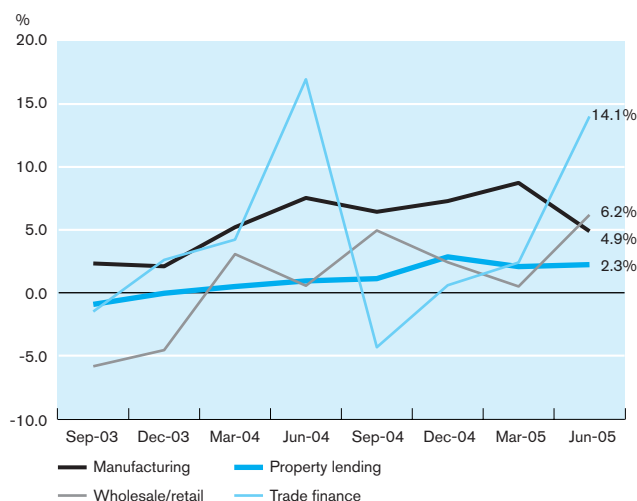
² All authorized institutions in Hong Kong are required to meet a minimum monthly average liquidity of 25%. This is calculated as the ratio of liquefiable assets (e.g. marketable debt securities and loan repayment within one month subject to their respective liquidity conversion factors) to qualifying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

Boosted by the positive economic outlook, improving employment and increased property market activity, domestic loan demand increased strongly in the second quarter. The broad-based increase in lending reflected a more entrenched economic recovery (Chart 11).

CHART 11

Retail banks' loans for use in Hong Kong by selected sectors (quarterly percentage change)



Note: 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).

- On the back of strong growth in external trade, **trade financing loans** increased by 14.1% in the second quarter.
- Loans to the manufacturing sector** rose by 4.9% after rising by 8.8% in the first quarter.
- Reflecting the buoyant property market, **property lending** increased by 2.3% after rising by 2.1% in the first quarter. All types of property lending increased. **Lending for property development** increased by 6.0% following a mild decline of 0.6% in the first quarter, while **lending for property investment** and **residential mortgage lending** increased by 2.1% and 1.8% respectively.

- Loans for the purchase of flats under the Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme** continued to decrease, by 2.5% in the second quarter, as a result of the freeze on sales of the flats under these schemes since the first quarter of 2002.
- Propelled by the continued growth in retail sales and strengthened consumer confidence, **lending to the wholesale and retail trade sector** increased by 6.2%, after rising by 0.6% in the preceding quarter.
- With increased initial public offering activities, particularly in June, **share finance loans** rose by 11.0% after an increase of 6.2% in the previous quarter. Within the total, **loans to non-stockbroking companies and individuals to purchase stocks** rose by 7.6%, and **loans to stockbrokers** reversed a decline of 2.1%, increasing strongly by 16.1%.
- Loans to financial concerns** increased by 3.9% compared with a 0.6% increase in the first quarter.
- Lending to the telecommunications sector** increased by 25.9% after dropping by 4.8% in the first quarter.

Credit card receivables

With improving consumer confidence, credit card lending increased in the second quarter. The HKMA's regular survey indicates that total credit card receivables increased by 0.3%, despite a transfer of some HK\$83 million of rescheduled receivables, representing 0.1% of average receivables, outside the credit card portfolio during the quarter. The total number of credit card accounts increased by 1.7%.

Exposure to non-bank Chinese entities

Retail banks' aggregate exposure to non-bank Chinese entities rose to HK\$147.2 billion (3.0% of total assets) at the end of June from HK\$129.8

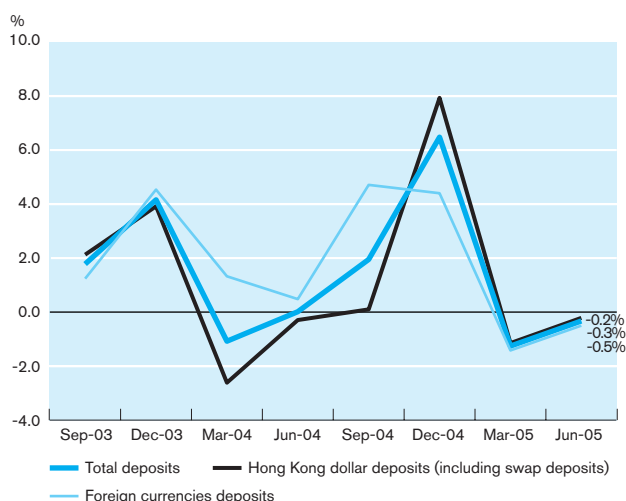
billion (2.7% of total assets) at the end of March, largely relating to exposures to red-chip companies and their subsidiaries. The exposure of the banking sector to non-bank Chinese entities also increased to HK\$208.0 billion (2.7% of total assets) from HK\$183.5 billion (2.4% of total assets).

Retail banks' customer deposits

Retail banks' customer deposits declined for the second consecutive quarter, albeit at a much reduced rate. The 0.3% decrease was partly associated with the outflow of funds following the introduction of the refinements to the Linked Exchange Rate system. Hong Kong dollar deposits decreased by 0.2% after reducing by 1.1% in the first quarter, while foreign currency deposits declined by 0.5% following a decrease of 1.4% in the previous quarter (Chart 12). The proportion of Hong Kong dollar deposits to total deposits remained largely unchanged at 60% at the end of June. Among foreign currency deposits, US dollar deposits decreased by 5.0% but deposits in other currencies rose by 11.7%.

CHART 12

Retail banks' customer deposits (quarterly percentage change)



As interest rates increased, depositors continued to shift their savings and demand deposits back into time deposits. Hong Kong dollar time deposits increased by 18.4% following an increase of 14.3%

in the first quarter (Table 3). As a result, the share of Hong Kong dollar time deposits to Hong Kong dollar total deposits rose to 44.0% from 37.1% at the end of March. Having fallen 11.6% in the first quarter, Hong Kong dollar demand deposits fell further by 9.7%. Similarly, Hong Kong dollar savings deposits fell by 11.6% after a decrease of 7.7% in the first quarter.

TABLE 3

Hong Kong dollar deposit mix

Amount (HK\$ bn)

| | Retail banks | | |
|---------------|--------------|----------------|--------------|
| | Demand | Savings | Time* |
| Jun/04 | 225.7 | 941.1 | 567.7 |
| % growth | 3.5 | (1.8) | 0.8 |
| Sep/04 | 212.9 | 914.7 | 608.7 |
| % growth | (5.6) | (2.8) | 7.2 |
| Dec/04 | 249.8 | 1,022.9 | 601.3 |
| % growth | 17.3 | 11.8 | (1.2) |
| Mar/05 | 220.7 | 944.4 | 687.3 |
| % growth | (11.6) | (7.7) | 14.3 |
| Jun/05 | 199.2 | 835.2 | 814.0 |
| % growth | (9.7) | (11.6) | 18.4 |

Note: Percentage 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)) increased by 3.8% from the end of March and by 10.2% from a year ago (Chart 13). The NDIs held by the retail banks accounted for 22.4% of their total assets, of which 64.3% were denominated in foreign currencies. A breakdown of NDIs by instrument types and counterparties is shown in Charts 14 and 15 respectively.

NCDs held by retail banks also increased by 3.4%, compared with a decrease of 4.7% in the first quarter. The holding represented 1.9% of the retail banks' total assets. About 62.9% of the NCD holdings were in Hong Kong dollars, compared with 68.4% at the end of March.

Negotiable certificates of deposits issued

With new issues of NCDs more than offsetting the NCDs redeemed during the quarter, retail banks' outstanding NCDs rose by 0.5% in the second quarter. Compared with a year ago, outstanding NCDs rose by 16.6%. The total outstanding NCDs accounted for about 4% of retail banks' total liabilities at the end of June.

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

CHART 13

Negotiable debt instruments held by retail banks (currency breakdown)

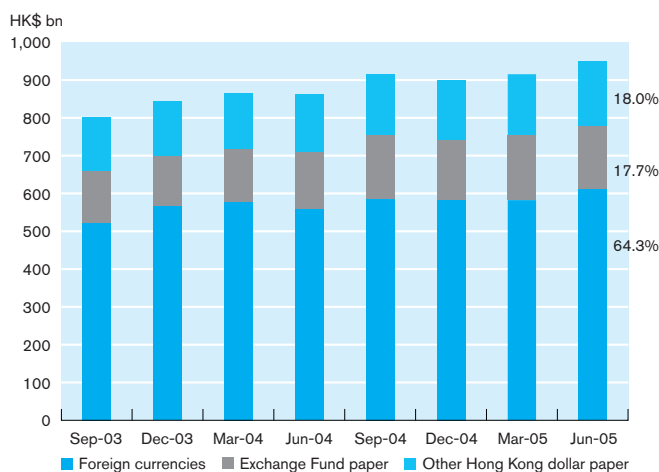


CHART 14

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

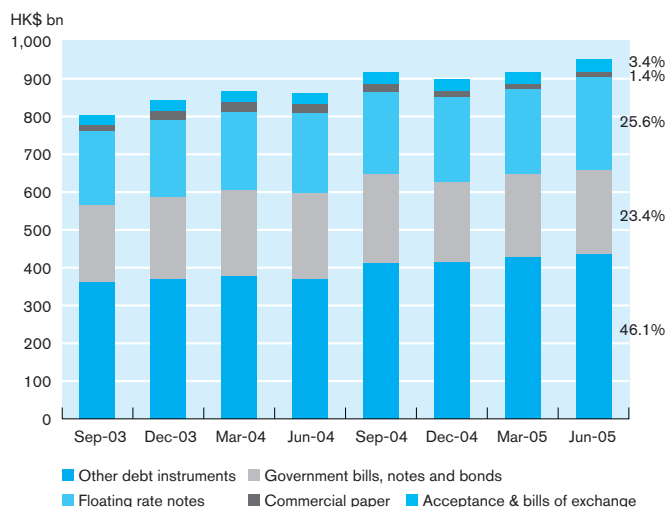
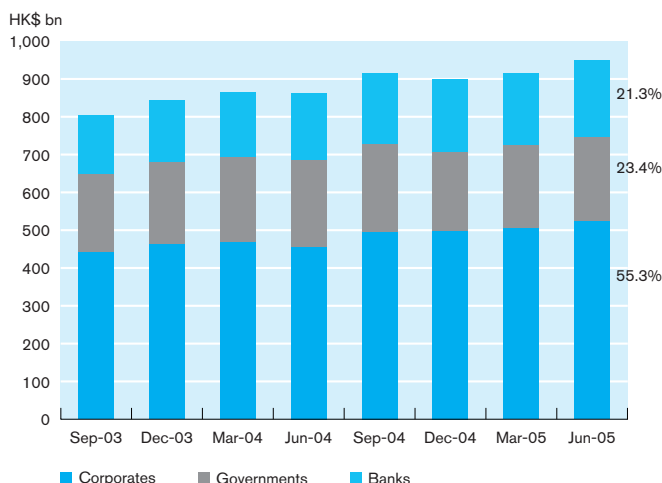


CHART 15

Negotiable debt instruments held by retail banks (counterparty breakdown)



APPENDIX

KEY PERFORMANCE INDICATORS OF THE BANKING SECTOR¹ (%)

| | Jun-04 | Mar-05 | Jun-05 |
|---|--------|--------------------|--------|
| Interest rate² | | | |
| 1-month HIBOR | 0.10 | 1.22 | 2.66 |
| 3-month HIBOR | 0.30 | 1.45 | 2.73 |
| BLR and 1-month HIBOR spread | 4.90 | 3.81 | 2.80 |
| BLR and 3-month HIBOR spread | 4.70 | 3.58 | 2.73 |
| Retail banks | | | |
| Balance sheet developments³ | | | |
| Total deposits | 0.0 | -1.3 | -0.3 |
| Hong Kong dollar | -0.3 | -1.1 | -0.2 |
| Foreign currency | 0.5 | -1.4 | -0.5 |
| Total loans | 2.7 | 1.6 | 3.5 |
| Loans to customers inside Hong Kong ⁴ | 2.4 | 1.6 | 3.7 |
| Loans to customers outside Hong Kong ⁵ | 10.7 | 1.9 | -3.8 |
| Negotiable instruments | | | |
| Negotiable certificates of deposit issued | 1.9 | 3.5 | 0.5 |
| Negotiable debt instruments held | -0.5 | 1.8 ^r | 3.8 |
| Asset quality⁶ | | | |
| As percentage of total loans | | | |
| Pass loans | 91.41 | 94.30 | 95.03 |
| Special mention loans | 5.59 | 3.75 | 3.21 |
| Classified loans (gross) ⁷ | 3.00 | 1.95 | 1.76 |
| Classified loans (net) ⁸ | 2.16 | 1.40 | 1.22 |
| Overdue > 3 months and rescheduled loans | 2.09 | 1.30 | 1.13 |
| Non-performing loans ⁹ | 2.28 | N.A. | N.A. |
| Profitability¹⁰ | | | |
| Bad debt charge as percentage of average total assets | -0.02 | -0.02 ^r | -0.02 |
| Net interest margin | 1.66 | 1.59 | 1.63 |
| Cost income ratio | 40.0 | 42.6 ^r | 41.1 |
| Liquidity ratio² | 43.2 | 45.8 | 45.8 |
| Surveyed institutions | | | |
| Asset quality | | | |
| Delinquency ratio of residential mortgage loans | 0.57 | 0.29 | 0.22 |
| Credit card receivables | | | |
| Delinquency ratio | 0.64 | 0.45 | 0.40 |
| Charge-off ratio — quarterly annualised (adjusted) | 5.37 | 3.18 | 3.27 |
| — year-to-date annualised | 5.79 | 3.18 | 3.19 |
| All locally incorporated AIs | | | |
| Capital adequacy ratio (consolidated) | 15.9 | 15.4 | 15.3 |

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 Information of loans on which interest has been placed in suspense or on which interest accrual has ceased are not available from January 2005 following adoption of the new Hong Kong Accounting Standard 39.

¹⁰ Year-to-date annualised.

^r Revised figures due to late adjustments.