

Developments in the banking sector

by the Banking Policy Department

Retail banks recorded healthy profit growth in 2005 as the buoyant domestic economy led to an improved operating environment. Increases in both net interest income and non-interest income, which more than offset increased operating expenses, were largely responsible for the profit growth. The continuing net write-back of debt provisions was also a contributing factor, although some banks began to make net new provisions in the third quarter of 2005. Helped by sustained improvements in domestic economic conditions, loan demand increased and overall asset quality improved further.

Interest rate movements

Following the two 25-basis-point increases in the US Fed funds target rate in the fourth quarter of 2005, banks raised their best lending rates (BLR), by 75 basis points to either 7.75% or 8.00%.

Correspondingly both time deposit rates and HIBORs¹ increased (Chart 1). Since time deposit

rates increased by more than the BLR, and HIBORs increased by less than BLR, the average spreads between BLR² and HIBORs widened while those between BLR and time deposit rates narrowed (Chart 2).

CHART 1
HIBORs and time deposit rates
(quarterly average)

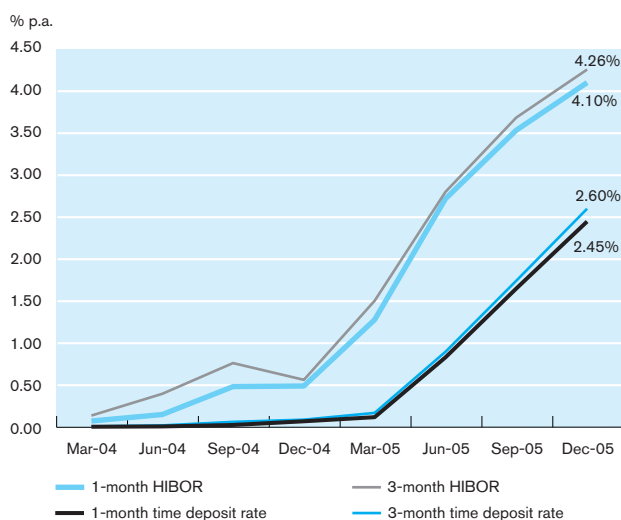
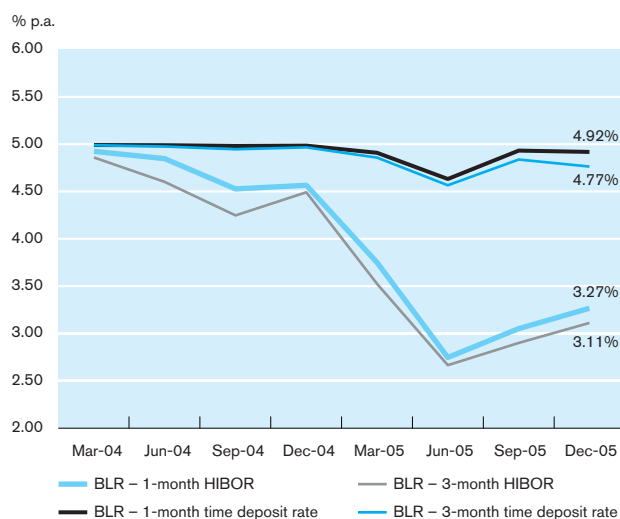


CHART 2
Differentials between best lending rate and
HIBORs/time deposit rates
(quarterly average)



¹ With reference to the Hong Kong Dollar Interest Settlement Rates released by the Hong Kong Association of Banks.

² With reference to the rate quoted by The Hongkong and Shanghai Banking Corporation Limited.

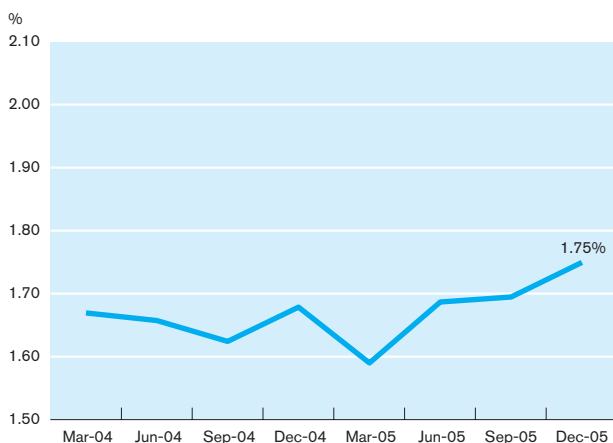
Retail banks' profitability

The aggregate pre-tax operating profits of the retail banks' Hong Kong offices increased by 8.2% in 2005 from 2004, attributable mainly to increases in both net interest income and non-interest income. Release of surplus debt provisions as a result of the continuing improvement in asset quality also contributed to profit growth, although to a lesser extent than in 2004.

Helped by the buoyant economy, banks enjoyed broad-based income growth. As non-interest income increased faster than net interest income, the proportion of non-interest income to total operating income increased to 40.9% from 39.3% a year ago.

Reflecting the continued improvement in lending margins, the annualised net interest margin rose further in the fourth quarter (Chart 3). For 2005 as a whole net interest margin rose for the first time in

CHART 3
Retail banks' net interest margin
(quarterly annualised)

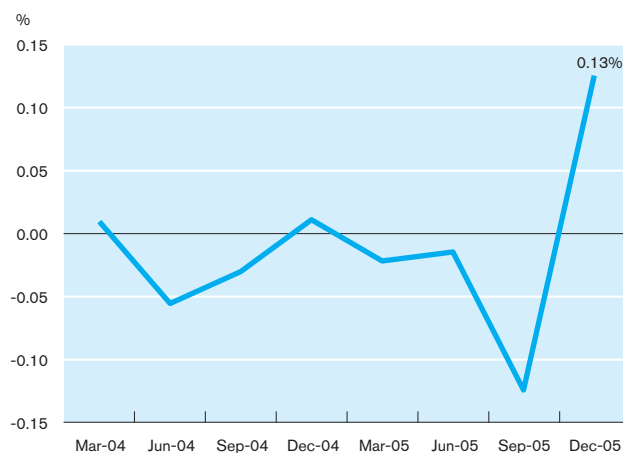


three years to 1.68% in 2005 from 1.66%^r in 2004, as net interest income expanded faster than average interest bearing assets.

Retail banks' cost-to-income ratio rose to 41.9% from 41.4%^r in 2004, as operating expenses (largely staff costs due to additional recruitment for business expansion and pay rises) outpaced income growth.

Although some banks began to make net new provisions in the second half of the year, particularly in the fourth quarter (Chart 4), retail banks as a whole continued to register a net write-back of debt provisions in 2005. As a result, retail banks' ratio of bad debt charge to average total assets stood at -0.01% compared with -0.02% in 2004.

CHART 4
Retail banks' bad debt charge as percentage
of average total assets
(quarterly annualised)



^r Revised figure.

CHART 5

Retail banks' asset quality (1)

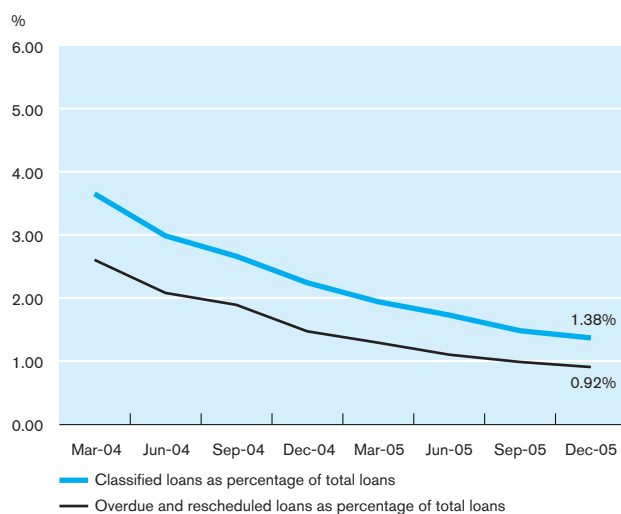


CHART 6

Retail banks' asset quality (2)

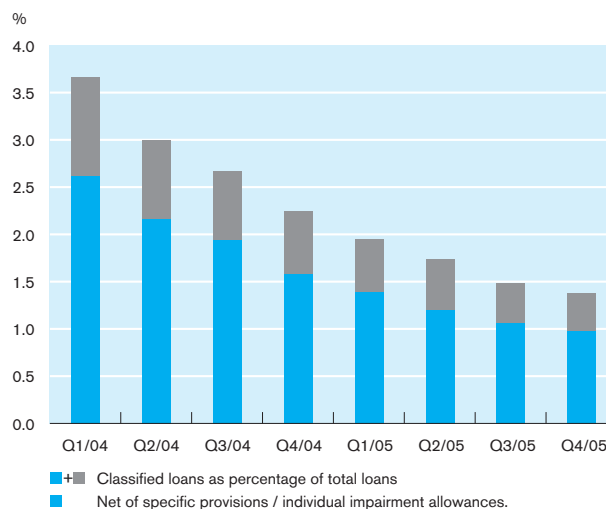


TABLE 1

Asset quality¹ of retail banks

	Dec-04	Mar-05	Jun-05	Sep-05	Dec-05
	as % of total loans				
Pass loans	93.76	94.30	95.05	95.26	95.96
Special mention loans	3.99	3.75	3.21	3.25	2.66
Classified loans (gross)²	2.25	1.95	1.74	1.49	1.38
<i>o/w Substandard</i>	0.98	0.80	0.66	0.61	0.58
<i>Doubtful</i>	0.88	0.79	0.76	0.60	0.55
<i>Loss</i>	0.40	0.36	0.32	0.28	0.25
Classified loans (net)³	1.59	1.40	1.20	1.06	0.98
Overdue > 3 months and rescheduled loans	1.48	1.30	1.11	1.00	0.92
<i>o/w Overdue > 3 months</i>	1.05	0.95	0.83	0.74	0.69
<i>Rescheduled loans</i>	0.44	0.35	0.28	0.26	0.23

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 / individual impairment allowances.

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

Retail banks' asset quality

Overall quality

Alongside the growing domestic economy, overall asset quality of the retail banks continued to improve in the fourth quarter. All problem loan ratios declined

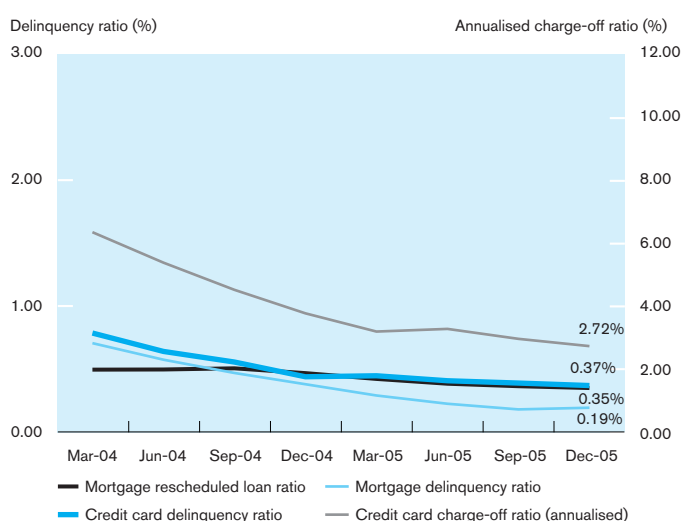
further (Table 1). The overdue and rescheduled loan ratio fell to 0.92% and the classified loan ratio to 1.38% (Chart 5). The classified loan ratio, netting off specific provisions, fell to 0.98% (Chart 6). The ratio of specific provisions to total classified loans was broadly unchanged at 29%.

Quality of residential mortgage lending portfolio

The quality of banks' residential mortgage lending portfolio was generally stable in the fourth quarter, with the mortgage delinquency ratio staying low at 0.19% at the end of December (Chart 7). With the rescheduled loan ratio remaining unchanged at 0.35%, the combined ratio of delinquent and rescheduled loans was broadly unchanged at 0.54%.

CHART 7

Asset quality of credit card and mortgage lending by surveyed institutions



Reflecting property price adjustment following interest rate increases, the number of residential mortgages in negative equity rose from 9,000 at the end of September to 11,000 with an aggregate value of HK\$19 billion at the end of December. Nonetheless, the number of negative-equity loans was down by 90% compared with the peak of about

106,000 cases (valued at HK\$165 billion) at the end of June 2003. The delinquency ratio of these negative-equity mortgage loans fell to 0.89% from 0.96% at the end of September.

Quality of credit card portfolio

The quality of credit card lending by retail banks was largely unchanged in the fourth quarter. Although the charge-off amount rose slightly to HK\$433 million in the fourth quarter from HK\$429 million in the third quarter, the rapid increase in total card receivables caused the charge-off ratio to fall to 0.68% of average receivables from 0.74% in the third quarter. Accordingly, the annualised quarterly charge-off ratio fell to 2.72% from 2.95% in the third quarter (Chart 7). Similarly, the credit card delinquency ratio dropped to a new low level of 0.37% at the end of December from 0.39% at the end of September despite an increase of 8.8% in the amount delinquent for more than 90 days. Together with a decrease in the outstanding rescheduled card receivables within the card portfolio to HK\$60 million from HK\$66 million, the combined ratio also declined to 0.45% from 0.50% at the end of September.

Local authorized institutions' capital strength

Preliminary statistics show that the average consolidated capital adequacy ratio of all locally incorporated authorized institutions dropped to 14.9% from 15.3% at the end of September (Table 2). The decline was a result of both an increase in risk-weighted assets and a decline in capital base.

TABLE 2

Consolidated capital adequacy ratio (All locally incorporated AIs)

(HK\$ mn)	Dec-04	Mar-05	Jun-05	Sep-05 ¹	Dec-05
Total capital base after deductions ¹ of which core capital	377,208 333,723	382,953 348,176	393,847 351,018	405,196 366,979	402,017 359,781
Total risk-weighted exposures	2,447,873	2,480,419	2,584,554	2,656,969	2,706,920
Capital adequacy ratio	15.4%	15.4%	15.2%	15.3%	14.9%

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.

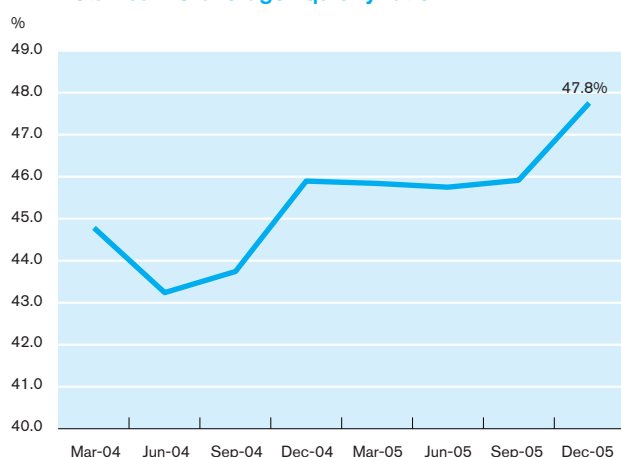
² Figure has been revised due to late adjustments.

Retail bank's liquidity

Retail banks' average liquidity ratio³ rose from 46% to almost 48% in 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

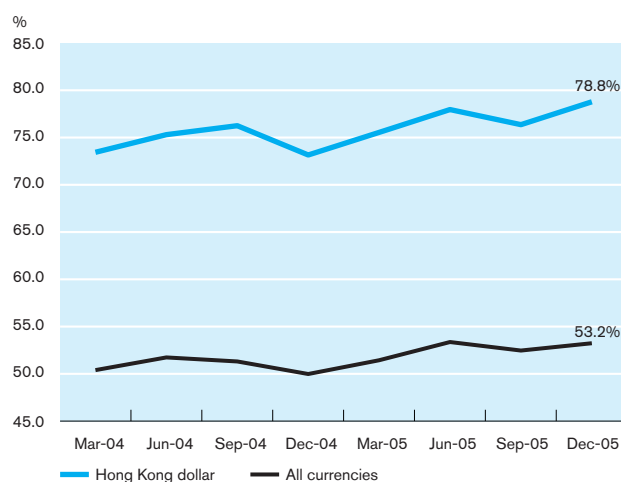
Retail banks' average liquidity ratio



Because loans increased faster than deposits in the fourth quarter, the overall loan-to-deposit ratio for all currencies rose to 53.2% from 52.4% at the end of September, and to 78.8% from 76.4% for Hong Kong dollar (Chart 9).

CHART 9

Retail banks' loan-to-deposit ratio

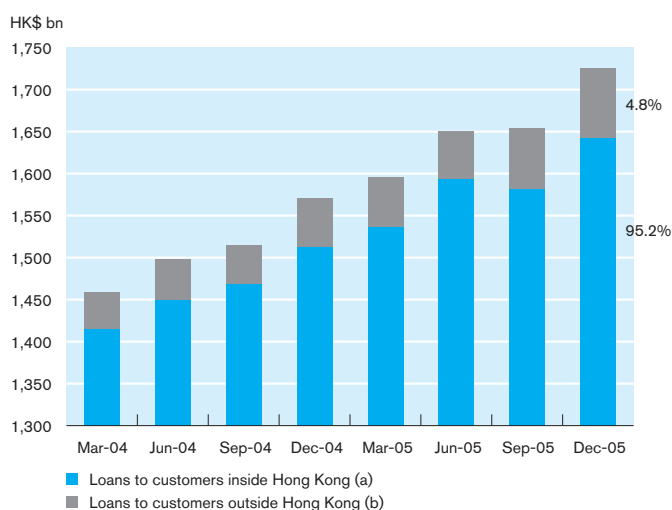


Retail banks' lending

Domestic lending by retail banks reversed a decline of 0.5% in the third quarter to record an increase of 4.1% in the fourth quarter. The increase was also partly due to a bank's intra-group reallocation of finance business. Together with an increase of 8.3% in loans for use outside Hong Kong, retail banks' total loans increased by 4.3% after growing 0.2% in the third quarter (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).

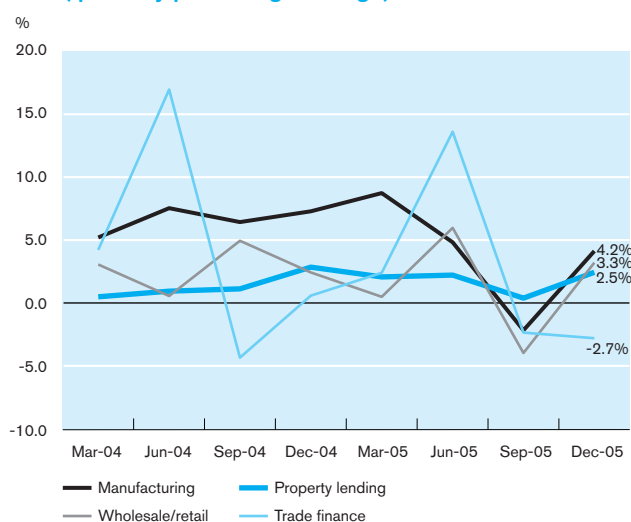
³ All authorized institutions in Hong Kong are required to meet a minimum monthly average liquidity of 25%. This is calculated as the ratio of liquifiable assets (e.g. marketable debt securities and loan repayment within one month subject to their respective liquidity conversion factors) to qualifying 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

Benefiting from the continued domestic economic expansion, domestic lending increased in the fourth quarter. Lending to all major economic sectors, except trade financing, increased (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).

Despite strong growth in external trade, trade-financing loans decreased by 2.7% after declining 2.3% in the third quarter.

However, loans to the manufacturing sector rose by 4.2% following a decline of 2.1% in the third quarter.

Partly due to increased numbers of Mainland visitors and growth in consumption demand, lending to the wholesale and retail trade sector also reversed a decline of 3.9% to increase by 3.3%.

Although residential mortgage activities slackened, property lending continued to increase by 2.5% in the fourth quarter. Much of the increase was attributable to lending for property investment, which grew by 7.1% after having risen by 1.8% in the third

quarter. Lending for property development and residential mortgage lending also increased, by 3.0% and 0.1% respectively.

Due to increased initial public offering activities, share-finance loans rose by 16.3% having fallen 9.3% in the third quarter. Loans to non-stockbroking companies and individuals to purchase stocks rose by 17.5% and loans to stockbrokers reversed a decline of 22.9% to increase by 13.9%.

Loans to financial concerns also increased, by 2.8%, as opposed to a decrease of 1.7% in the previous quarter.

On the contrary, lending to the information technology sector fell by 16.1% after rising 20.9% in the previous quarter, primarily due to the 10.2% decline in telecommunication-related lending.

Credit card receivables

Credit card lending increased sharply in the fourth quarter, particularly in December, owing largely to payments of salary taxes by credit card and festive spending. According to the HKMA's regular survey, total credit card receivables increased by 14.6%, despite a transfer of some HK\$72 million rescheduled receivables, representing 0.1% of average receivables, outside the credit card portfolio during the quarter. The total number of credit card accounts grew further by 2.5%.

Exposure to non-bank Chinese entities

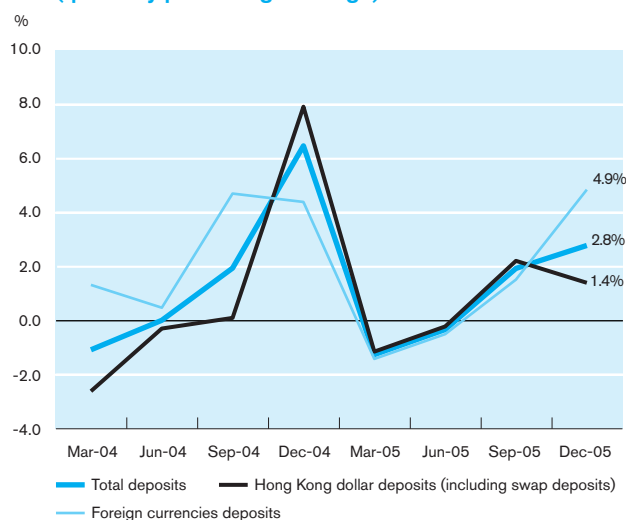
Retail banks' aggregate exposure to non-bank Chinese entities decreased to HK\$141.3 billion (2.8% of total assets) at the end of December from HK\$144.0 billion (2.9% of total assets) at the end of September. The decline was largely in exposures to H-share companies and their subsidiaries. The exposure of the banking sector to non-bank Chinese entities also declined slightly to HK\$206.1 billion (2.6% of total assets) from HK\$206.7 billion (2.7% of total assets).

Retail banks' customer deposits

Retail banks' customer deposits increased by 2.8% after rising by 1.9% in the third quarter. Hong Kong dollar deposits and foreign currency deposits increased by 1.4% and 4.9% respectively following increases of 2.2% and 1.5% in the previous quarter (Chart 12). Due to faster growth in foreign currency deposits than Hong Kong dollar deposits, the proportion of Hong Kong dollar deposits to total deposits dropped to 59% from 60% at the end of September. Within foreign currency deposits, US dollar deposits rose by 3.3% and deposits in other currencies rose by 8.3%.

CHART 12

Retail banks' customer deposits (quarterly percentage change)



In response to higher interest rates, depositors continued to shift their savings and demand deposits into time deposits. Hong Kong dollar time deposits grew by 7.0% following an increase of 14.0% in the third quarter (Table 3). This resulted in an increase in the share of Hong Kong dollar time deposits to Hong Kong dollar total deposits to 51.8% from 49.1% at the end of September. Meanwhile, both Hong Kong dollar demand deposits and saving deposits fell further, by 0.8% and 4.8% respectively.

TABLE 3

Hong Kong dollar deposit mix

Amount (HK\$ bn)

	Retail banks		
	Demand	Savings	Time*
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
Sep/05	191.3	770.4	927.8
% growth	(4.0)	(7.8)	14.0
Dec/05	189.8	733.8	992.4
% growth	(0.8)	(4.8)	7.0

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

* Includes swap deposits

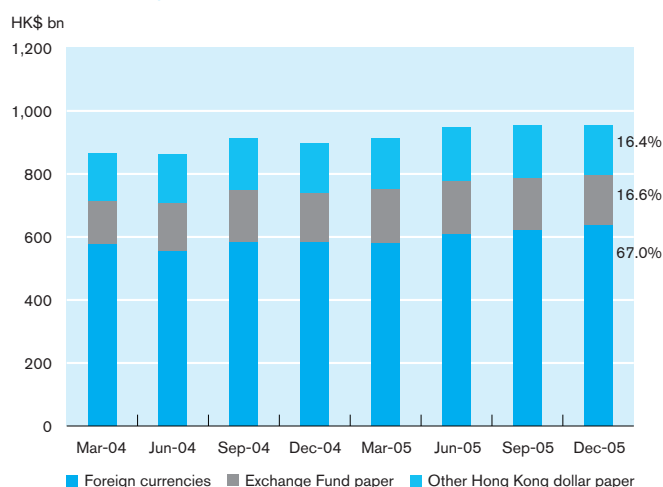
Negotiable instruments

Negotiable debt instruments held

Retail banks' holding of NDIs (excluding negotiable certificates of deposits (NCDs)) edged down by 0.2% from the end of September, but increased by 6.0% from a year ago (Chart 13). The NDIs held by the retail banks accounted for 21.9% of their total assets. The share of foreign currency denominated NDIs held increased to 67.0% from 65.3% at the

CHART 13

Negotiable debt instruments held by retail banks (currency breakdown)



end of September, as holdings of foreign currency denominated NDIs increased but those denominated in Hong Kong dollars decreased. A breakdown of NDIs by instrument types and counterparties is shown in Charts 14 and 15.

CHART 14

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

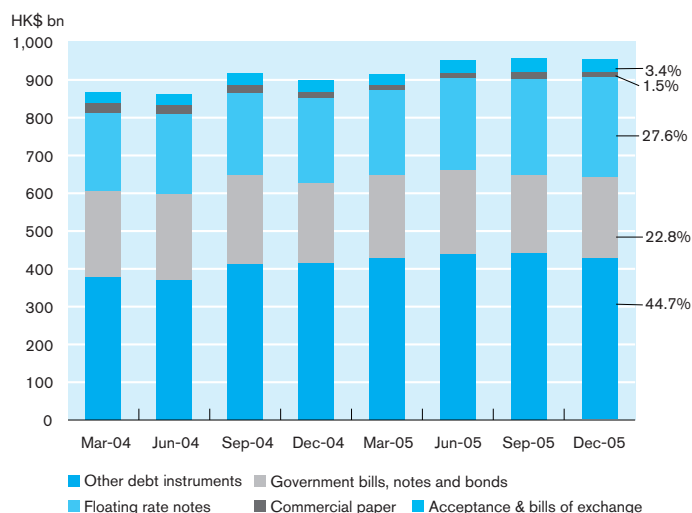
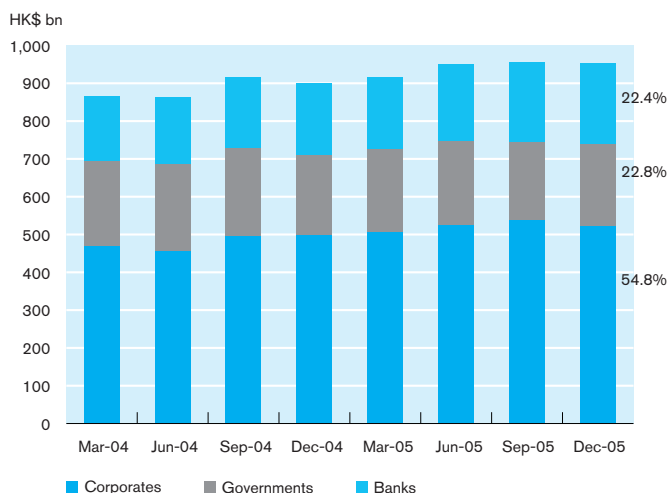


CHART 15

Negotiable debt instruments held by retail banks (counterparty breakdown)



NCDs held by retail banks also decreased by 3.1%, representing 1.6% of their total assets, following a decrease of 11.1% in the third quarter. The share of NCD holdings in Hong Kong dollar rose to 71.1% compared with 69.0% at the end of September as holdings of foreign currency NCDs decreased faster than those denominated in Hong Kong dollar.

Negotiable certificates of deposits issued

Given the amount of NCDs redeemed outweighed the newly issued NCDs during the quarter, retail banks' outstanding NCDs fell by 2.6% in the fourth quarter. Compared with a year ago, the amount of outstanding NCDs increased by 1.6%. The total amount of outstanding NCDs remained steady at about 4% of retail banks' total liabilities at the end of December.

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

APPENDIX

KEY PERFORMANCE INDICATORS OF THE BANKING SECTOR¹ (%)

	Dec-04	Sep-05	Dec-05
Interest rate²			
1-month HIBOR	0.49	3.53	4.10
3-month HIBOR	0.56	3.68	4.26
BLR and 1-month HIBOR spread	4.57	3.05	3.27
BLR and 3-month HIBOR spread	4.50	2.90	3.11
Retail banks			
Balance sheet developments³			
Total deposits	6.5	1.9	2.8
Hong Kong Dollar	7.9	2.2	1.4
Foreign currency	4.4	1.5	4.9
Total loans	3.7	0.2	4.3
Loans to customers inside Hong Kong ⁴	3.1	-0.5	4.1
Loans to customers outside Hong Kong ⁵	24.5	19.7	8.3
Negotiable instruments			
Negotiable certificates of deposit issued	4.7	0.4	-2.6
Negotiable debt instruments held	-1.8 ^r	0.6	-0.2
Asset quality⁶			
As percentage of total loans			
Pass loans	93.76	95.26	95.96
Special mention loans	3.99	3.25	2.66
Classified loans (gross) ⁷	2.25	1.49	1.38
Classified loans (net) ⁸	1.59	1.06	0.98
Overdue > 3 months and rescheduled loans	1.48	1.00	0.92
Profitability⁹			
Bad debt charge as percentage of average total assets	-0.02	-0.05	-0.01
Net interest margin	1.66 ^r	1.66	1.68
Cost-income ratio	41.4 ^r	41.1	41.9
Liquidity ratio¹⁰	45.9	45.9	47.8
Surveyed institutions			
Asset quality			
Delinquency ratio of residential mortgage loans	0.38	0.18	0.19
Credit card receivables			
Delinquency ratio	0.44	0.39	0.37
Charge-off ratio — quarterly annualised (adjusted)	3.76	2.95	2.72
— year-to-date annualised	4.73	3.05	2.81
All locally incorporated AIs			
Capital adequacy ratio (consolidated)	15.4	15.3	14.9

Notes:

- ¹ Figures related to Hong Kong office(s) only except where otherwise stated.
 - ² With reference to the HKD Interest Settlement Rates released by the Hong Kong Association of Bank.
 - 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 / individual impairment allowances.
 - ⁹ Year-to-date annualised.
 - ¹⁰ Quarterly average.
- ^r Revised figure.