Developments in the banking sector

by the Banking Policy Department

The profits of retail banks continued to grow in the first half of 2006 compared with the same period in 2005. An increase in net interest income due to a recovery in lending margins and expansion in interest bearing assets was the main contributor to profit growth, more than offsetting the increase in operating expenses and the net debt provisions charged in the period. Abundant liquidity meant that banks did not track the increases in the US Fed funds target rate during the quarter. The loan portfolio of retail banks expanded, particularly in lending for trade finance. Asset quality was broadly unchanged with the classified loan ratio edging down and the overdue loan ratio holding constant.

Interest rate movements

Abundant liquidity within the banking system enabled banks to keep their best lending rates (BLR) unchanged at either 8.00% or 8.25% despite the two 25-basis-point increases in the US Fed funds target rate in the second quarter. Nonetheless, both the average time deposit rates and HIBORs[1] increased (Chart 1) to reflect the 25-basis-point increase in the BLR at the end of the first quarter. With HIBORs increasing by more than the BLR, and time deposit rates increasing by a smaller extent than the BLR, the average spreads between the BLR[2] and HIBORs narrowed while those between the BLR and time deposit rates widened (Chart 2).

CHART 1
HIBORs and time deposit rates (quarterly average)

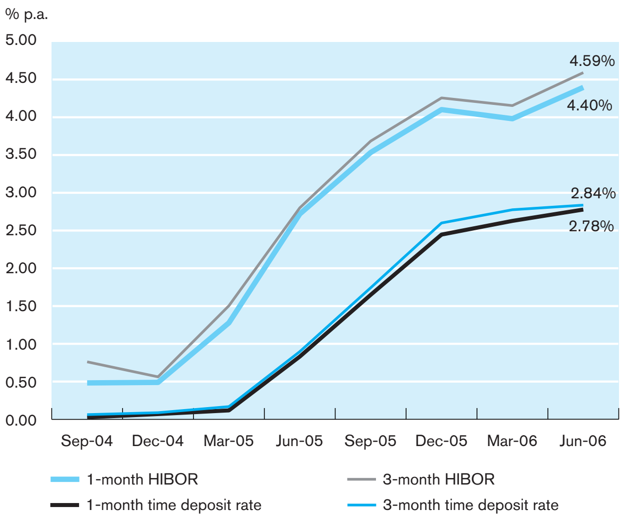
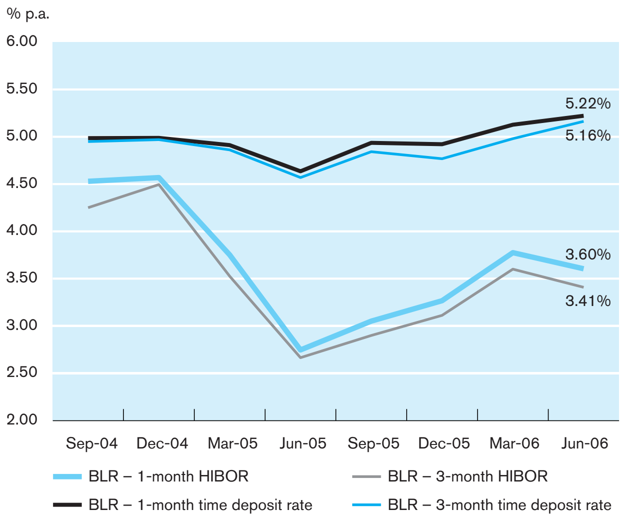


CHART 2
Differentials between best lending rate and HIBORs/time deposit rates (quarterly average)



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

2 With reference to the rate quoted by the Hong Kong and Shanghai Banking Corporation Limited.

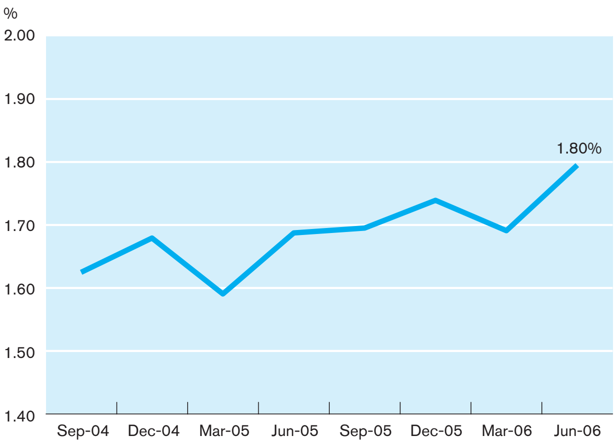
Retail banks' profitability

Retail banks' aggregate pre-tax operating profits for their Hong Kong offices increased by 6.8% in the first half of 2006 compared with the same period in 2005, attributable mainly to an increase in net interest income, which more than offset increased operating expenses and net new provisions.

The annualised net interest margin increased in the second quarter (Chart 3), reflecting an improvement in lending margins. For the first half of 2006 the annualised net interest margin rose to 1.74% from 1.64% in the first half of 2005, as net interest income grew faster than average interest bearing assets.

CHART 3

Retail banks' net interest margin (quarterly annualised)



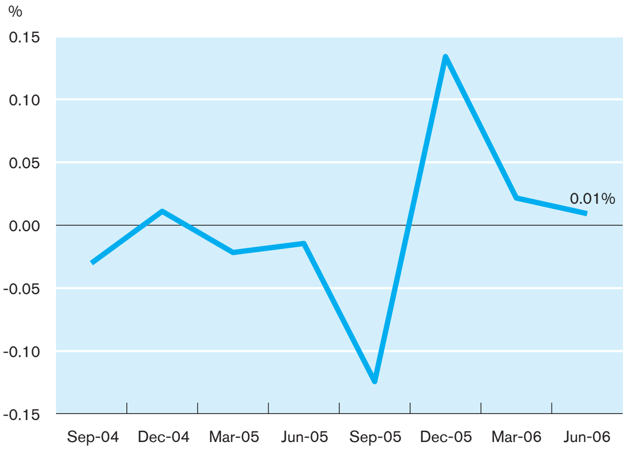
While non-interest income continued to increase, it did so at a slower pace than net interest income due to a decline in income from treasury operations and from investment trading amid volatile foreign exchange and capital markets, as well as a reduction in dividends received. As a result, the proportion of non-interest income to total operating income fell to 39.2% from 41.8%[r] a year ago.

Retail banks' cost-to-income ratio rose to 41.5% from 40.9% a year ago, as growth in operating expenses, largely staff costs caused by pay increases and additional recruitment, outpaced operating income.

Retail banks continued to register net new provisions in the second quarter (Chart 4) notwithstanding a few banks continuing to record net write-backs of provisions. As a result, the ratio of bad debt charge to average total assets for the first half of 2006 stood at 0.02% compared with -0.02% (i.e. a net provision write-back) in the same period of 2005.

CHART 4

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



[r] Figures revised.

CHART 5

Retail banks' asset quality (1)

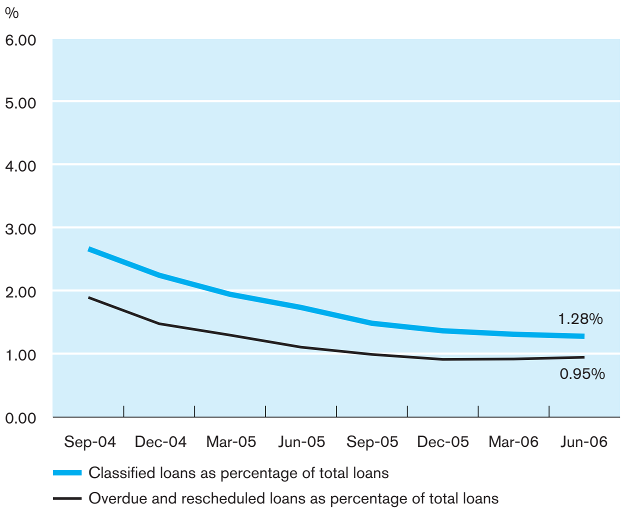


CHART 6

Retail banks' asset quality (2)

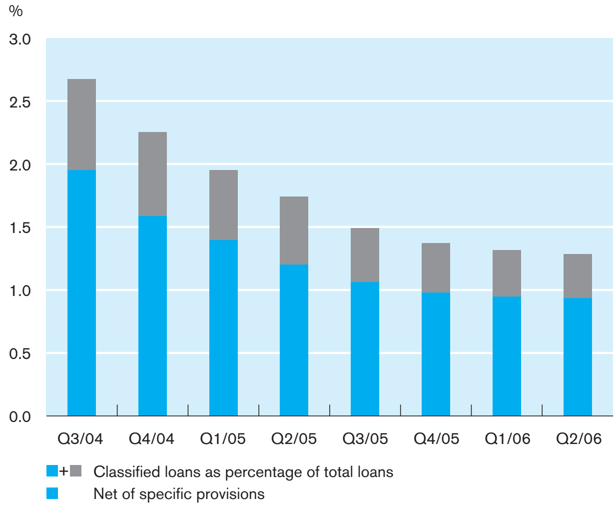


TABLE 1

Asset quality[1] of retail banks

	Jun-05	Sep-05	Dec-05	Mar-06	Jun-06
			as % of total loans		
Pass loans	**95.05**	**95.26**	**95.97 r**	**95.97**	**96.33**
Special mention loans	**3.21**	**3.25**	**2.66**	**2.71**	**2.39**
Classified loans (gross)[2]	**1.74**	**1.49**	**1.37 r**	**1.32**	**1.28**
o/w Substandard	*0.66*	*0.61*	*0.58*	*0.56*	*0.50*
Doubtful	*0.76*	*0.60*	*0.55*	*0.53*	*0.58*
Loss	*0.32*	*0.28*	*0.25*	*0.23*	*0.21*
Classified loans (net)[3]	**1.20**	**1.06**	**0.98**	**0.95**	**0.94**
Overdue > 3 months and rescheduled loans	**1.11**	**1.00**	**0.92**	**0.92 r**	**0.95**
o/w Overdue > 3 months	*0.83*	*0.74*	*0.68 r*	*0.69*	*0.69*
Rescheduled loans	*0.28*	*0.26*	*0.23*	*0.23*	*0.26*

Notes:
1 Period-end figures related to Hong Kong offices and overseas branches.
2 Classified loans are those loans graded as "substandard", "doubtful" or "loss".
3 Net of specific provisions
r Revised figures due to late adjustments.

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

Retail banks' asset quality

Overall quality

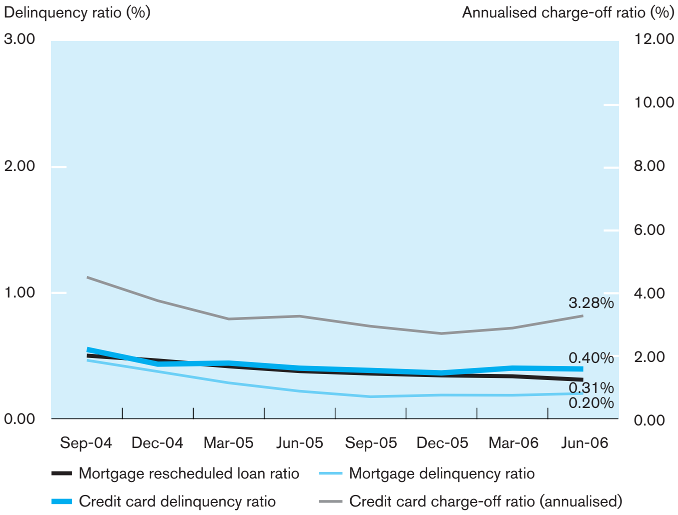
The overall asset quality of the retail banks was broadly unchanged in the second quarter with the classified loan ratio edging down to 1.28% and the overdue loan ratio holding constant. While major problem loan ratios registered a decline (Table 1), the rescheduled loan ratio increased to 0.26%, resulting in an increase in the overdue and rescheduled loan ratio to 0.95% (Chart 5). The classified loan ratio, net of specific provisions, fell to 0.94% (Chart 6). The ratio of specific provisions to total classified loans fell to 27%.

Quality of residential mortgage lending portfolio

The quality of banks' residential mortgage lending portfolio was largely stable in the second quarter. While the mortgage delinquency ratio edged up to 0.20% at the end of June from 0.19% at the end of March (Chart 7), the rescheduled loan ratio declined to 0.31% from 0.34%. The combined ratio of delinquent and rescheduled loans fell slightly to 0.52% from 0.53%.

CHART 7

Asset quality of credit card and mortgage lending by surveyed institutions



In line with increased property values the number of residential mortgages in negative equity declined from 9,200 cases (valued at HK$16 billion) at the end of March to 8,800 cases with an aggregate value of HK$15 billion at the end of June. The number of negative equity cases was down by 92% 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 edged up to 1.13% from 1.04% at the end of March.

Quality of credit card portfolio

Signs of a modest deterioration in the quality of credit card lending appeared in the second quarter along with an increase in bankruptcy petitions. With the charge-off amount rising to HK$510 million in the second quarter from HK$468 million in the first quarter, the charge-off ratio rose to 0.82% of average receivables from 0.72% in the first quarter. Accordingly, the annualised quarterly charge-off ratio rose to 3.28% compared with 2.89% in the first quarter (Chart 7). Despite an increase of 0.9% in the amount delinquent for more than 90 days, the faster increase in total card receivables resulted in the credit card delinquency ratio remaining unchanged at 0.40% at the end of June. Together with the outstanding rescheduled card receivables within the card portfolio, which was broadly unchanged at HK$56 million, the combined ratio edged down to 0.49% from 0.50% at the end of March.

Local authorized institutions' capital strength

The average consolidated capital adequacy ratio of all locally incorporated authorized institutions rose to 15.2% from 15.0% at the end of March (Table 2) as the capital base expanded faster than risk-weighted assets.

TABLE 2

Consolidated capital adequacy ratio (All locally incorporated AIs)

(HK$ mn)	Jun-05	Sep-05	Dec-05[r]	Mar-06	Jun-06
Total capital base after deductions[1]	393,847	405,172	402,064	415,489	430,171
of which core capital	*351,018*	*366,979*	*359,791*	*379,205*	*382,350*
Total risk-weighted exposures	2,584,582	2,656,969	2,710,191	2,769,998	2,836,538
Capital adequacy ratio	15.2%	15.2%	14.8%	15.0%	15.2%

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.

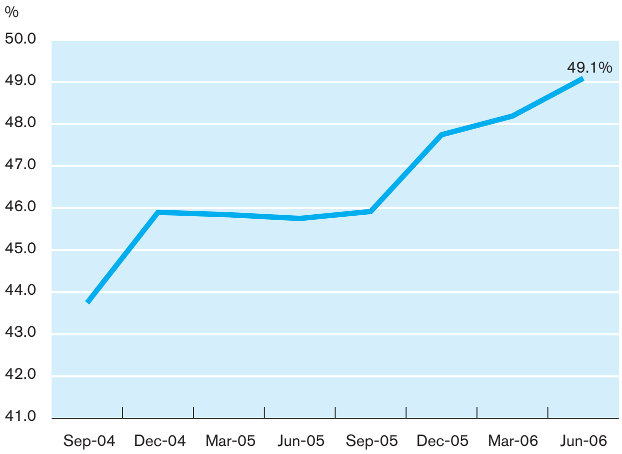
[r] Figures have been revised due to late adjustments.

Retail banks' liquidity

Retail banks' average liquidity ratio[3] rose from 48% to 49% 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

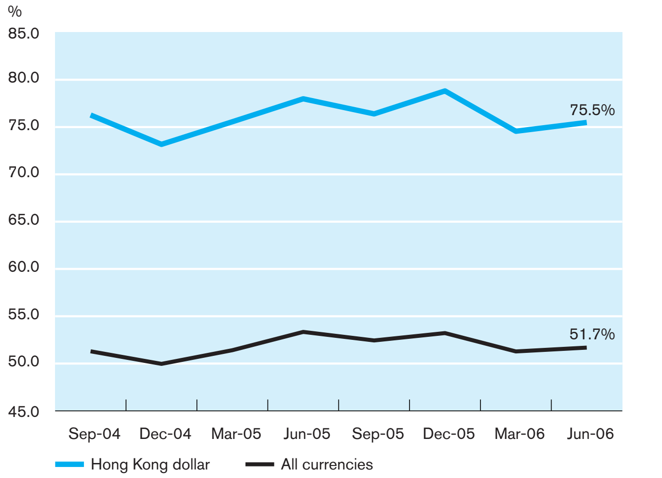
Retail banks' average liquidity ratio



The overall loan-to-deposit ratio for all currencies rose to 51.7% from 51.3% at the end of March, and to 75.5% from 74.6% for Hong Kong dollar over the same period (Chart 9) as loans grew faster than deposits in the second quarter.

CHART 9

Retail banks' loan-to-deposit ratio

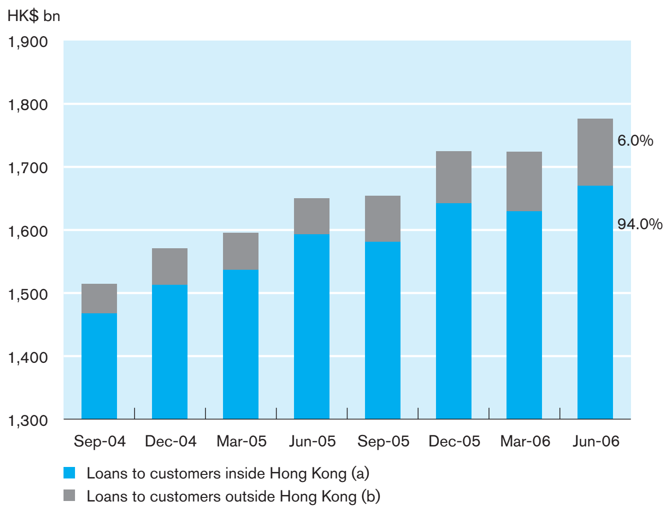


Retail banks' lending

Domestic lending by retail banks reversed a decline of 0.8% in the first quarter to register an increase of 2.5% in the second quarter, driven by the robust domestic economy. Coupled with an increase of 12.3% in loans for use outside Hong Kong, retail banks' total loans increased by 3.0% after being static in the first 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).

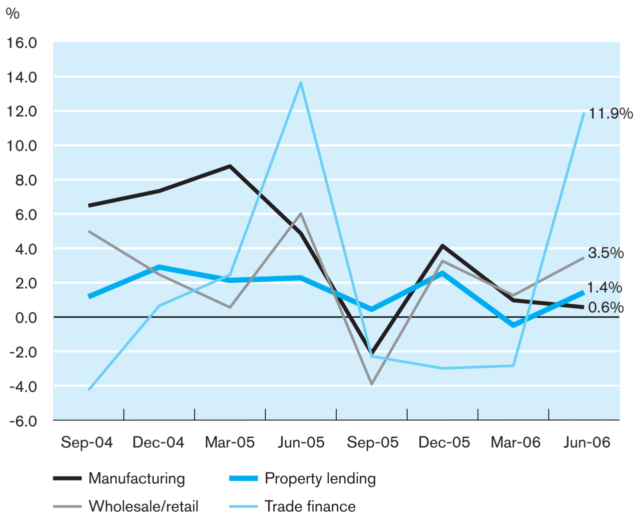
[3] All authorized institutions in Hong Kong are required to meet a minimum monthly average liquidity of 25%. This is calculated as the ratio of liquefiable assets (e.g. marketable debt securities and loan repayment within one month subject to their respective liquidity conversion factors) to qualifying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

Loans to customers inside Hong Kong by various economic sectors

Domestic lending increased in the second quarter on the back of favourable economic conditions. Lending to all major economic sectors, particularly trade financing, increased (Chart 11). Trade financing loans increased by 11.9% in the second quarter after declining for three consecutive quarters. Loans to the manufacturing sector also rose, by 0.6% after rising 1.0% in the first quarter. Following an increase of 1.3% in the first quarter, lending to the wholesale and retail trade sector grew by a further 3.5%.

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).

Reflecting increased property market activities, property lending increased by 1.4% after falling by 0.5% in the first quarter. The increase was due to lending for property investment, which grew by 2.8% after rising by 1.1% in the first quarter, and lending for property development which reversed a decline of 2.6% in the first quarter to register an increase of 7.6%. However, residential mortgage lending declined by 0.3% after falling 1.0% in the first quarter.

With increased initial public offering activities and stock market activities, share finance loans rose by 5.9%, having risen 2.5% in the first quarter. Loans to non-stockbroking companies and individuals to purchase stocks reversed a decline of 4.4% to grow strongly by 22.7%. However, loans to stockbrokers, which had grown strongly by 15.8% in the previous quarter, declined by 20.7%. Loans to financial concerns continued to increase, by 8.7% after increasing 3.5% in the previous quarter.

By contrast, lending to the information technology sector fell by 24.5% after rising 5.6% in the previous quarter, primarily due to a 23.4% decline in telecommunication-related lending.

Credit card receivables

Credit card lending resumed its growth in the second quarter after falling in the first quarter. According to the HKMA's regular survey, total credit card receivables increased by 2.5%. This was despite a transfer of some HK$87 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 4.0%.

Exposure to non-bank Chinese entities

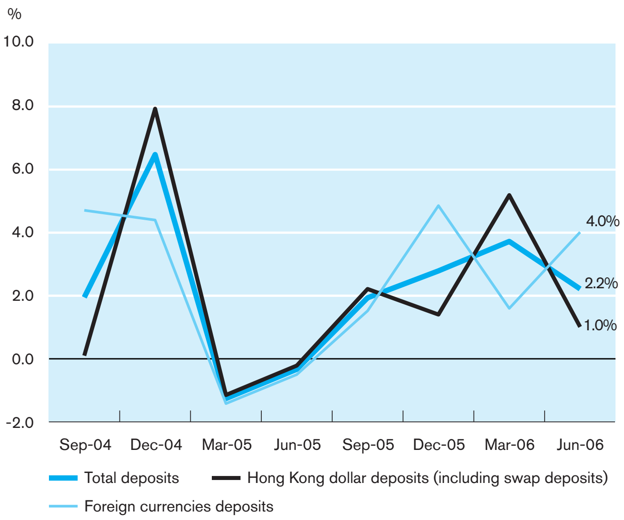
Retail banks' aggregate exposure to non-bank Chinese entities rose to HK$146.2 billion (2.7% of total assets) at the end of June from HK$144.0 billion (2.8% of total assets) at the end of March, largely in the category of exposures to other entities known to be owned or controlled by Chinese interests. The exposure of the banking sector to non-bank Chinese entities also rose to HK$213.0 billion (2.5% of total assets) from HK$210.5 billion (2.6% of total assets).

Retail banks' customer deposits

Retail banks' customer deposits continued to increase, by 2.2% in the second quarter after a 3.7% rise in the first quarter. Both Hong Kong dollar deposits and foreign currency deposits increased, by 1.0% and 4.0% respectively, following increases of 5.2% and 1.6% in the previous quarter (Chart 12). With foreign currency deposits growing faster than Hong Kong dollar deposits, the proportion of Hong Kong dollar deposits to total deposits dropped to 59% from 60% at the end of March. Within foreign currency deposits, US dollar deposits rose by 5.4% and deposits in other foreign currencies rose by 1.2%.

CHART 12

Retail banks' customer deposits (quarterly percentage change)



Hong Kong dollar savings deposits rose for the second consecutive quarter by 1.2% after falling in the previous four quarters. By contrast, Hong Kong dollar demand deposits declined by 2.4% after rising 1.6% in the first quarter. Hong Kong dollar time deposits continued to grow, but by a slower pace of 1.5% compared with 6.0% 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 52.5% from 52.2% at the end of March.

TABLE 3

Hong Kong dollar deposit mix

Amount (HK$ bn)

	Retail banks		
	Demand	Savings	Time*
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
Mar/06	**192.8**	**770.8**	**1,051.8**
% growth	1.6	5.0	6.0
Jun/06	**188.2**	**779.8**	**1,067.8**
% growth	(2.4)	1.2	1.5

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

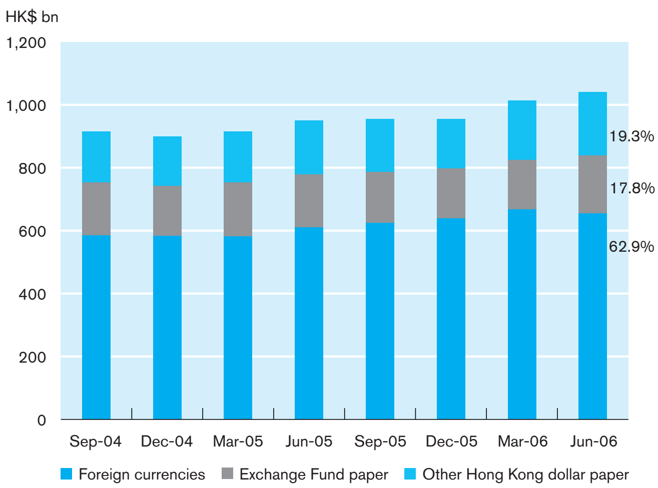
Negotiable instruments

Negotiable debt instruments (NDIs) held

Retail banks' holding of NDIs (excluding negotiable certificates of deposits (NCDs)) increased by 2.6% compared with the position at the end of March and by 9.4% compared with that of a year ago (Chart 13). The NDIs held by the retail banks accounted for 22.6% of their total assets. The share of foreign currency denominated NDIs decreased to 62.9% from 65.8% at the end of March, as holdings

CHART 13

Negotiable debt instruments held by retail banks (currency breakdown)



of foreign currency denominated NDIs declined but those denominated in Hong Kong dollars increased. A breakdown of NDIs by instrument types and counterparties is shown in Charts 14 and 15 respectively.

CHART 14

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

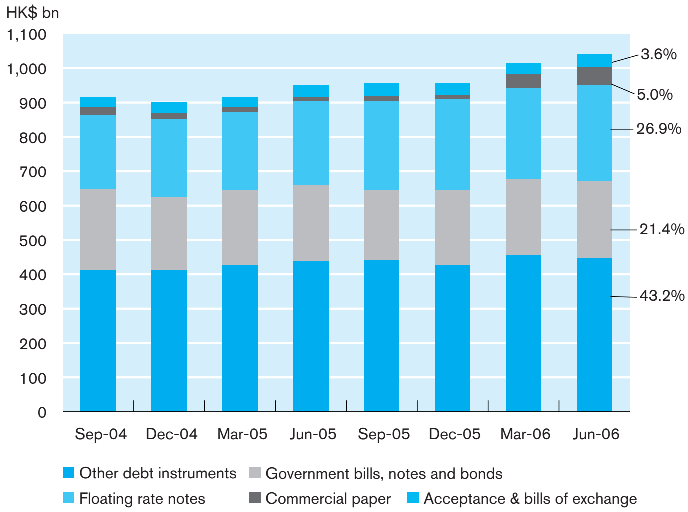
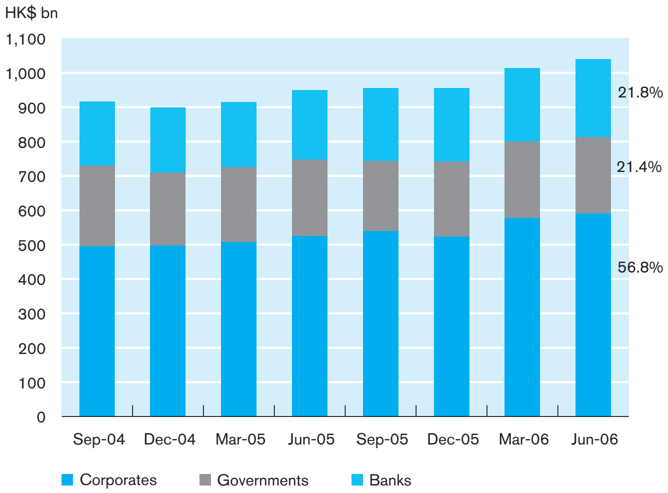


CHART 15

Negotiable debt instruments held by retail banks (counterparty breakdown)



NCDs held by retail banks decreased by 8.5%, representing 1.5% of their total assets, against an increase of 4.1% in the first quarter. The share of Hong Kong dollar denominated NCD holdings rose to 72.2% compared with 66.1% at the end of March as holdings of foreign currency NCDs decreased while those denominated in Hong Kong dollars remained unchanged.

Negotiable certificates of deposits issued

As the amount of NCDs redeemed during the quarter more than offset those newly issued, retail banks' outstanding NCDs fell by 3.2% in the second quarter. The amount of outstanding NCDs also fell by 5.8% compared with a year ago. The total amount of NCDs outstanding remained largely unchanged at about 4% of retail banks' total liabilities at the end of June.

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

APPENDIX

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

	Jun-05	Mar-06	Jun-06
Interest rate[2]			
1-month HIBOR[3]	2.72	3.98	4.40
3-month HIBOR[3]	2.80	4.15	4.59
BLR and 1-month HIBOR spread	2.75	3.77	3.60
BLR and 3-month HIBOR spread	2.66	3.60	3.41
Composite interest rate	1.58	3.00	3.16
		Retail banks	
Balance sheet developments[4]			
Total deposits	-0.3	3.7	2.2
Hong Kong Dollar	-0.2	5.2	1.0
Foreign currency	-0.5	1.6	4.0
Total loans	3.4	-0.1	3.0
Loans to customers inside Hong Kong[5]	3.7	-0.8	2.5
Loans to customers outside Hong Kong[6]	-3.8	14.3	12.3
Negotiable instruments			
Negotiable certificates of deposit issued	0.4	-0.5	-3.2
Negotiable debt instruments held	3.8	6.1[r]	2.6
Asset quality[7]			
As percentage of total loans			
Pass loans	95.05	95.97	96.33
Special mention loans	3.21	2.71	2.39
Classified loans (gross)[8]	1.74	1.32	1.28
Classified loans (net)[9]	1.20	0.95	0.94
Overdue > 3 months and rescheduled loans	1.11	0.92[r]	0.95
Profitability[10]			
Bad debt charge as percentage of average total assets	-0.02	0.02[r]	0.02
Net interest margin	1.64	1.69	1.74
Cost-income ratio	40.9	41.1[r]	41.5
Liquidity ratio[11]	45.8	48.2	49.1
		Surveyed institutions	
Asset quality			
Delinquency ratio of residential mortgage loans	0.22	0.19	0.20
Credit card receivables			
Delinquency ratio	0.40	0.40	0.40
Charge-off ratio — quarterly annualised (adjusted)	3.27	2.89	3.28
— year-to-date annualised	3.19	2.89	2.98
		All locally incorporated AIs	
Capital adequacy ratio (consolidated)	15.2	15.0	15.2

Notes:
1 Figures related to Hong Kong office(s) only except where otherwise stated.
2 All figures are quarterly averages except the composite interest rates, which are end-period figures.
3 With reference to the HKD Interest Settlement Rates released by the Hong Kong Association of Banks.
4 Quarterly change.
5 Loans for use in Hong Kong plus trade-financing loans.
6 Includes "others" (i.e. unallocated).
7 Figures related to retail banks' Hong Kong office(s) and overseas branches.
8 Classified loans are those loans graded as "substandard", "doubtful" or "loss".
9 Net of specific provisions / individual impairment allowances.
10 Year-to-date annualised.
11 Quarterly average.
r Revised figure.