

# Developments in the banking sector

by the Banking Policy Department

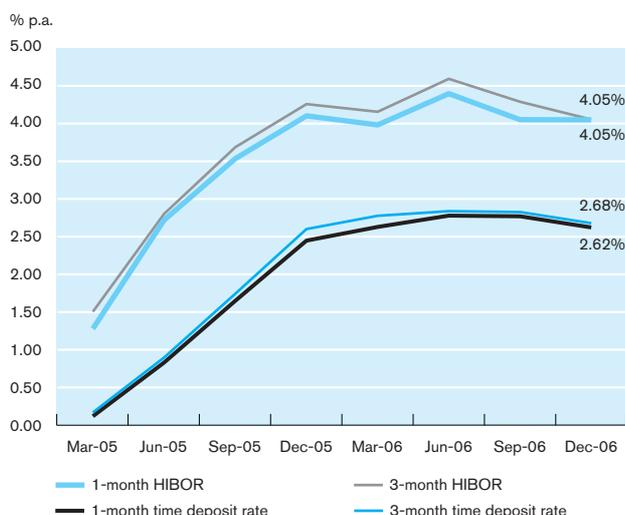
Retail banks recorded another year of solid profit growth in 2006. The key contributing factor was a sharp increase in net interest income, reflecting a recovery in interest margin, which more than offset increased operating expenses and net new provisions. The high level of liquidity in the banking system allowed banks to lower their best lending rates by 25 basis points in early November despite a constant US Fed funds target rate. Although bank lending grew for the year as a whole, the loan portfolio contracted in the fourth quarter after the strong growth in share finance lending for IPOs in the third quarter. Benefiting from the robust domestic economy, overall asset quality improved further.

## Interest rate movements

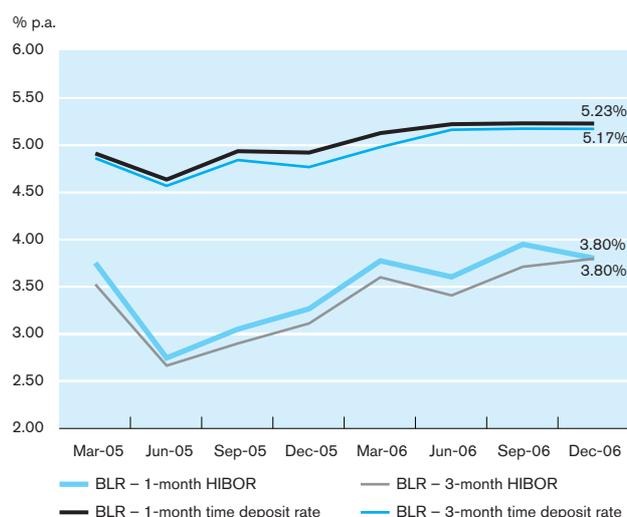
The high level of liquidity in the banking system allowed banks to lower their best lending rates (BLR) by 25 basis points in the fourth quarter to either 7.75% or 8.00% despite no change in the US Fed funds target rate. Correspondingly, average HIBORs<sup>1</sup> and time deposit rates decreased in the

fourth quarter (Chart 1), with average HIBORs decreasing more than time deposits rates. The average spreads between BLR<sup>2</sup> and HIBORs has widened while those between BLR and time deposit rates barely changed (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)



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

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

## Retail banks' profitability

The aggregate pre-tax operating profits of retail banks' Hong Kong offices increased by 10.1% in 2006, on the back of a sharp increase in net interest income which more than offset the increase in operating expenses and net new provisions made.

The increase in net interest income reflected both an expansion of assets and a recovery in interest margin. The net interest margin widened to 1.80% in 2006 from 1.68% in 2005, despite a decline in the fourth quarter (Chart 3). By contrast, non-interest income grew more slowly, affected by declines in treasury income and dividends. As a result, the proportion of non-interest income to total operating income decreased to 38.3% from 41.1%<sup>r</sup> in 2005.

CHART 3

### Retail banks' net interest margin (quarterly annualised)



Retail banks' cost-to-income ratio rose further to 42.7% from 41.8%<sup>r</sup> in 2005, as operating expenses outpaced income growth. The steady increase in operating costs is a result of increases in staff expenses because of additional recruitment and pay rises, and an increase in other expenses relating to business expansion and system enhancements.

Retail banks' bad debt charge increased compared with 2005 despite a net debt provision write-back in the fourth quarter (Chart 4), but amounted to only a small proportion of average total assets: 0.02% in 2006 compared with -0.01% (a net debt provision write-back) in 2005.

CHART 4

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



<sup>r</sup> Figures revised.

CHART 5

## Retail banks' asset quality (1)

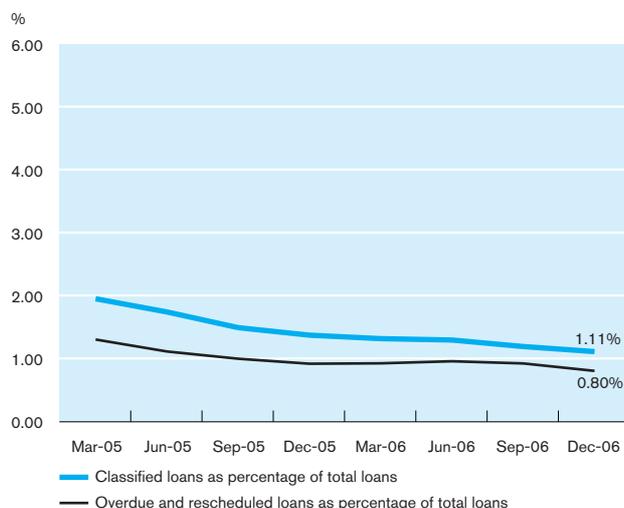


CHART 6

## Retail banks' asset quality (2)

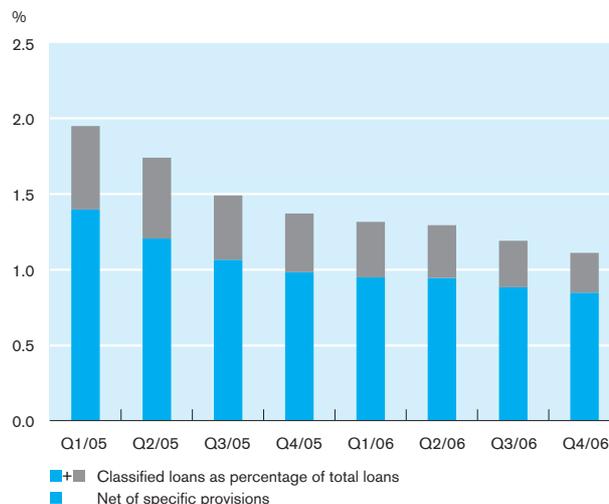


TABLE 1

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

	Dec-05	Mar-06	Jun-06	Sep-06	Dec-06
	as % of total loans				
<b>Pass loans</b>	<b>95.97</b>	<b>95.97</b>	<b>96.15</b>	<b>96.44</b>	<b>96.65</b>
<b>Special mention loans</b>	<b>2.66</b>	<b>2.71</b>	<b>2.55</b>	<b>2.37</b>	<b>2.24</b>
<b>Classified loans (gross)<sup>2</sup></b>	<b>1.37</b>	<b>1.32</b>	<b>1.29</b>	<b>1.19</b>	<b>1.11</b>
o/w <i>Substandard</i>	0.58	0.56	0.50	0.45	0.44
o/w <i>Doubtful</i>	0.55	0.53	0.58	0.57	0.55
o/w <i>Loss</i>	0.25	0.23	0.21	0.17	0.12
<b>Classified loans (net)<sup>3</sup></b>	<b>0.98</b>	<b>0.95</b>	<b>0.94</b>	<b>0.88</b>	<b>0.85</b>
<b>Overdue &gt; 3 months and rescheduled loans</b>	<b>0.92</b>	<b>0.92</b>	<b>0.96</b>	<b>0.92</b>	<b>0.80</b>
o/w <i>Overdue &gt; 3 months</i>	0.68	0.69	0.69	0.65	0.54
o/w <i>Rescheduled loans</i>	0.23	0.23	0.27 <sup>r</sup>	0.27	0.26

Notes:

<sup>1</sup> Period-end figures related 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>r</sup> 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

As indicated by the decline in all problem-loan ratios (Table 1), the asset quality of the retail banks continued to improve in the fourth quarter. The

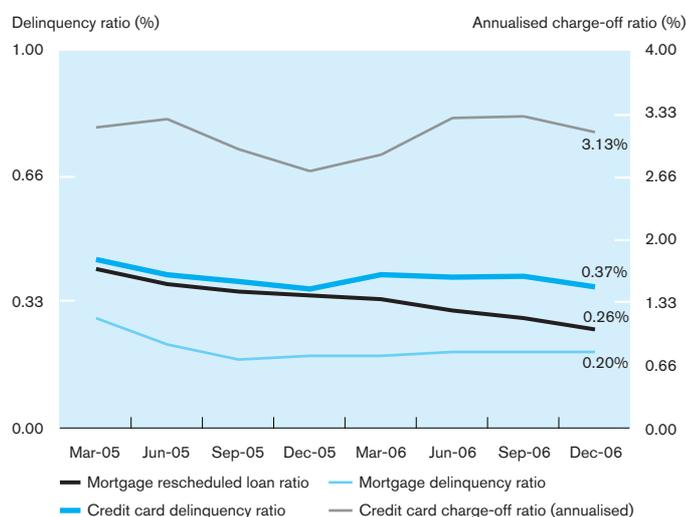
overdue and rescheduled loan ratio fell to 0.80% and the classified loan ratio to 1.11% (Chart 5). The classified loan ratio, netting off specific provisions, also fell to 0.85% (Chart 6). The ratio of specific provisions to total classified loans fell to 24%.

### Quality of residential mortgage lending portfolio

The quality of banks' residential mortgage lending portfolio remained stable in the fourth quarter, with the mortgage delinquency ratio unchanged at 0.20% at the end of December (Chart 7). With the rescheduled loan ratio decreasing to 0.26%, the combined ratio of delinquent and rescheduled loans improved further to 0.46% from 0.49% at the end of September.

CHART 7

#### Asset quality of credit card and mortgage lending by surveyed institutions



The number of residential mortgages in negative equity decreased from about 8,800 cases (valued at HK\$15 billion) at the end of September to about 8,400 cases with an aggregate value of HK\$14 billion at the end of December. The delinquency ratio of negative equity mortgage loans edged up to 1.26% from 1.21% at the end of September due to a smaller denominator.

TABLE 2

#### Consolidated capital adequacy ratio (All locally incorporated AIs)

(HK\$ mn)	Dec-05	Mar-06	Jun-06	Sep-06	Dec-06
Total capital base after deductions <sup>1</sup> <i>of which core capital</i>	402,069 359,788	415,489 379,205	429,572 381,806	451,015 402,674	458,905 400,988
Total risk-weighted exposures	2,710,188	2,769,998	2,836,513	3,002,244	3,069,227
Capital adequacy ratio	14.8%	15.0%	15.1%	15.0%	15.0%
Core ratio	13.3%	13.7%	13.5%	13.4%	13.1%

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.

### Quality of credit card portfolio

The quality of credit card lending declined in the fourth quarter as indicated by the increase in the charge-off amount and the delinquent amount. The charge-off amount rose to HK\$535 million from HK\$525 million in the third quarter. However, the charge-off ratio fell to 0.78% of average receivables from 0.82% in the third quarter due to strong growth in total card receivables. Accordingly, the annualised quarterly charge-off ratio declined to 3.13% from 3.30% in the third quarter (Chart 7). Similarly, the credit card delinquency ratio dropped to 0.37% at the end of December from 0.40% at the end of September despite an increase of 4.0% in the amount delinquent for more than 90 days. Together with a decrease to HK\$51.5 million from HK\$54.6 million in outstanding rescheduled card receivables within the card portfolio, the combined ratio also declined to 0.44% from 0.49% at the end of September.

### Local authorized institutions' capital strength

Preliminary statistics indicate that the average consolidated capital adequacy ratio of all locally incorporated authorized institutions was unchanged at 15.0% at the end of December (Table 2). This level remains well above the statutory requirement and international standards.

## Retail bank's liquidity

Retail banks' average liquidity ratio<sup>3</sup> rose to 50.7% from 47.7% in the third quarter, well above the statutory minimum 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



Owing to an increase in deposits and a decrease in total loans in the fourth quarter, retail banks' overall loan-to-deposit ratio for all currencies fell to 47.9% from 50.9% at the end of September. The ratio for Hong Kong dollar also declined to 69.1% from 73.1% over the same period (Chart 9).

CHART 9

Retail banks' loan-to-deposit ratio

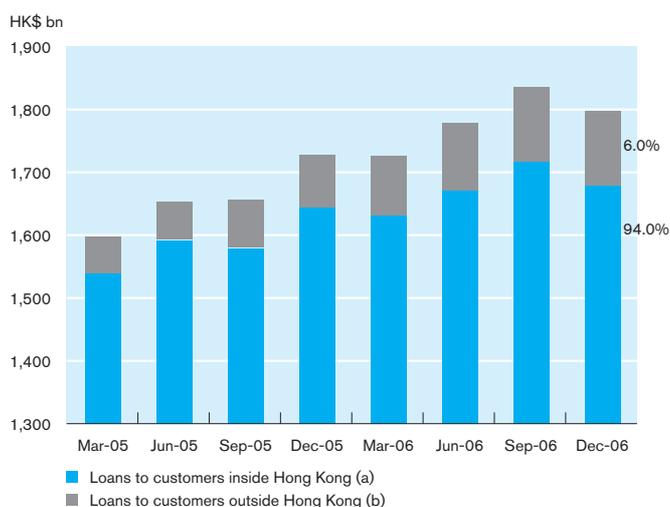


## Retail banks' lending

Domestic lending of retail banks, after increasing 3.2% in the third quarter, fell 2.1% in the fourth quarter. The decrease reflected the decline in share finance lending after strong growth in the third quarter due to active IPO activities and the buoyant domestic stock market. Together with a decrease of 3.8% in loans for use outside Hong Kong, retail banks' total loans decreased by 2.2% after growing 3.2% 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).

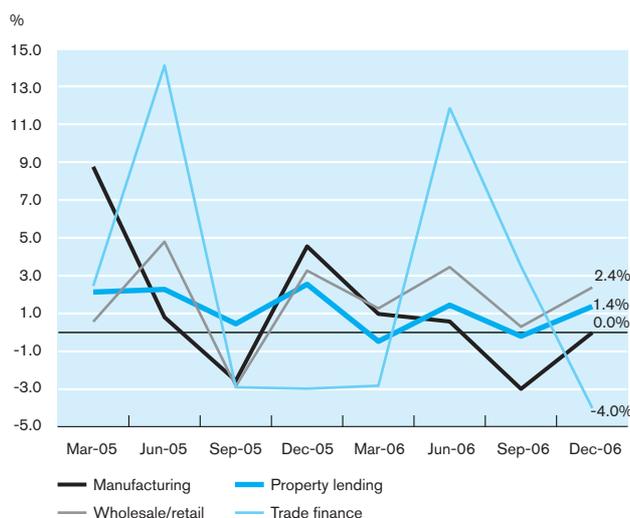
<sup>3</sup> All authorized institutions in Hong Kong are required to meet a minimum monthly average liquidity of 25%. This is calculated as the ratio of liquifiable assets (e.g. marketable debt securities and loan repayment within one month subject to their respective liquidity conversion factors) to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

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

Despite the overall decrease in domestic lending in the fourth quarter, the picture across major economic sectors was mixed (Chart 11). Loans for share financing declined by 76.4%, after having grown more than fourfold in the preceding quarter. Loans to non-stockbroking companies and individuals to purchase stocks also fell by 18.4% after increasing 38.5%. Similarly, loans to stockbrokers recorded a decrease of 90.2% after rising more than ten times in the third quarter. Loans to financial concerns also dropped, by 14.8%, as opposed to an increase of 14.7% in the previous quarter.

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).

In other sectors declines were more modest. Trade financing loans fell 4.0% after increasing 3.5% in the third quarter, while loans to the manufacturing sector were largely unchanged after declining 3.0% in the third quarter. Lending to the information technology sector fell by 14.9% after rising 28.2% in the previous quarter, primarily due to a 13.6% decline in telecommunications-related lending.

By contrast, lending to the wholesale and retail trade sector increased by 2.4% following a 0.3% increase in the third quarter. Property lending also increased,

by 1.4%, in the fourth quarter. The increase was largely due to lending for property development, which grew by 6.1% after falling 1.4% in the previous quarter. Property investment lending also increased by 1.2% and residential mortgage lending by 0.7%.

### Credit card receivables

Credit card lending increased strongly in the fourth quarter, particularly in December, owing largely to festive spending and the payment of salary tax using credit cards. According to the HKMA's regular survey, total credit card receivables increased by 11.8%. This was despite a transfer of some HK\$110 million rescheduled receivables, representing 0.2% of average receivables, outside the credit card portfolio during the quarter. The total number of credit card accounts grew further by 0.8%.

### Non-bank China exposures

According to the revised reporting framework for non-bank China exposures, retail banks' aggregate non-bank China exposures increased to HK\$420.2 billion (7.2% of total assets) at the end of December from HK\$418.6 billion (7.4% of total assets) at the end of September. Most of the increase is due to exposures to companies and individuals outside China for credit used in China. Total amount of non-bank China exposures of the banking sector also increased to HK\$545.7 billion (5.9% of total assets) from HK\$535.3 billion (6.0% of total assets). Exposures to companies and individuals for purchasing properties in China increased to HK\$19.3 billion at the end of December from HK\$18.2 billion at the end of September.

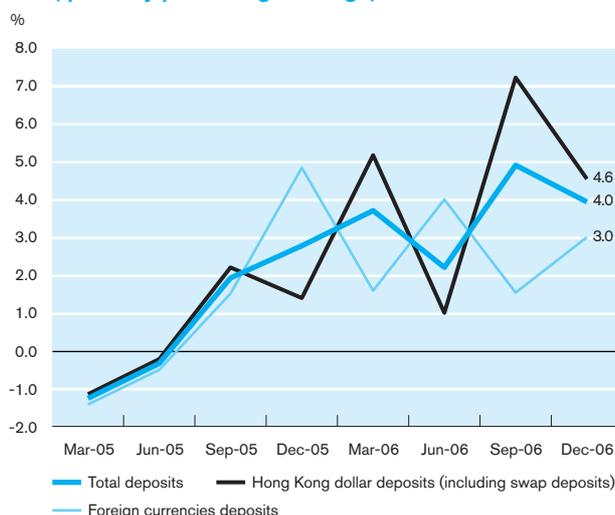
### Retail Banks' Customer Deposits

The 4.0% increase in retail banks' customer deposits represented a slower pace compared with the 4.9% increase recorded in the third quarter. Both Hong Kong dollar and foreign currency deposits increased, by 4.6% and 3.0% respectively, following increases of 7.3% and 1.5% in the previous quarter (Chart 12). The proportion of Hong Kong dollar deposits to total deposits remained at around 60%. Among foreign currency deposits, US dollar deposits rose by 6.5% while deposits in other currencies fell by 5.5%.

The increase in Hong Kong dollar deposits was mainly in savings and demand deposits. Hong Kong dollar demand deposits grew by 9.1% after increasing by 6.6% in the third quarter (Table 3). Hong Kong dollar savings deposits also increased by 12.8% compared to a 5.0% increase in the previous quarter. Consequently, the share of Hong Kong dollar time deposits to Hong Kong dollar total deposits declined to 49.9% from 53.3% at the end of September.

CHART 12

### Retail banks' customer deposits (quarterly percentage change)



## Negotiable Instruments

### Negotiable debt instruments held

Retail banks' holdings of NDIs (excluding negotiable certificates of deposits (NCDs)) increased by 10.0% from the end of September and by 23.2% from a year ago (Chart 13). NDIs held by retail banks accounted for 23.9% of their total assets. The share of foreign currency denominated NDIs held increased to 64.2% from 62.8% at the end of September because foreign currency denominated NDIs increased faster than Hong Kong dollar denominated ones. A breakdown of NDIs by instrument types is shown in Chart 14, and by counterparties in Chart 15.

TABLE 3

### Hong Kong dollar deposit mix

	Retail banks		
	Demand	Savings	Time*
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
Sep/06	200.7	819.2	1,163.6
% growth	6.6	5.0	9.0
Dec/06	219.0	924.2	1,139.8
% growth	9.1	12.8	(2.0)

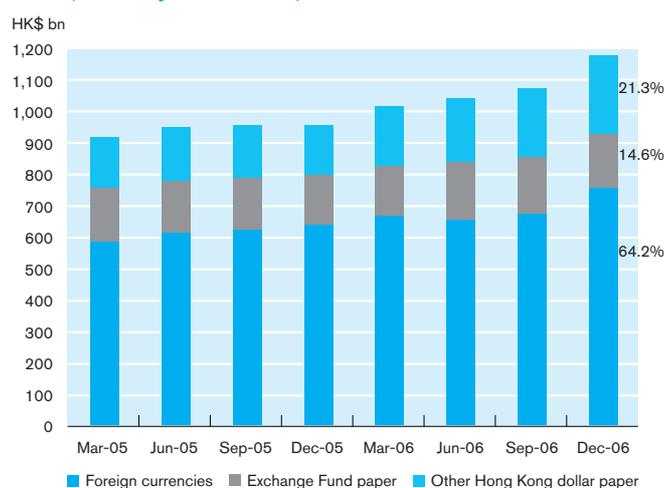
Note: % growth denotes the quarter-on-quarter change in deposits.

\* Includes swap deposits

By contrast, NCDs held by retail banks, representing 1.2% of their total assets, decreased by 12.1% after a 0.5% increase in the previous quarter. The share of NCD holdings in Hong Kong dollar rose to 73.8% compared with 68.6% at the end of September as holdings of foreign currency NCDs decreased faster than holdings of those denominated in Hong Kong dollars.

CHART 13

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



Note: Because of rounding, the figures set out in this chart may not add up.

### Negotiable certificates of deposits issued

Retail banks' outstanding NCDs fell by 7.2% in the fourth quarter as the amount of NCDs redeemed during the quarter more than offset those newly issued, and decreased by 12.7% compared with a year ago. The total NCDs outstanding fell to 3.2% of retail banks' total liabilities at the end of December.

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

CHART 14

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

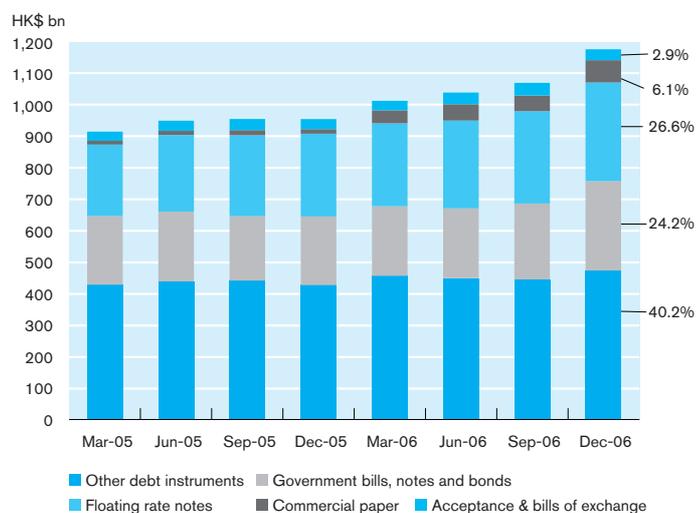
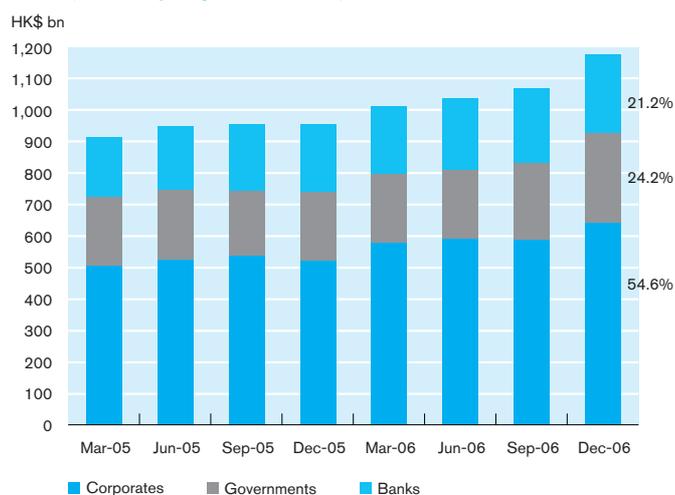


CHART 15

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



## APPENDIX

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

	Dec-05	Sep-06	Dec-06
<b>Interest rate<sup>2</sup></b>			
1-month HIBOR	4.10	4.05	4.05
3-month HIBOR	4.26	4.29	4.05
BLR <sup>3</sup> and 1-month HIBOR spread	3.27	3.95	3.80
BLR <sup>3</sup> and 3-month HIBOR spread	3.11	3.71	3.80
Composite interest rate	2.88	3.06	2.86
<b>Retail banks</b>			
<b>Balance sheet developments<sup>4</sup></b>			
Total deposits	2.8	4.9	4.0
Hong Kong Dollar	1.4	7.3	4.6
Foreign currency	4.9	1.5	3.0
Total loans	4.3	3.2	-2.2
Loans to customers inside Hong Kong <sup>5</sup>	4.2 <sup>r</sup>	3.2	-2.1
Loans to customers outside Hong Kong <sup>6</sup>	7.4 <sup>r</sup>	3.8	-3.8
Negotiable instruments			
Negotiable certificates of deposit issued	-2.6	-2.4	-7.2
Negotiable debt instruments held	0.0 <sup>r</sup>	3.0	10.0
<b>Asset quality<sup>7</sup></b>			
As percentage of total loans			
Pass loans	95.97 <sup>r</sup>	96.44	96.65
Special mention loans	2.66	2.37	2.24
Classified loans (gross) <sup>8</sup>	1.37 <sup>r</sup>	1.19	1.11
Classified loans (net) <sup>9</sup>	0.98	0.88	0.85
Overdue > 3 months and rescheduled loans	0.92	0.92	0.80
<b>Profitability<sup>10</sup></b>			
Bad debt charge as percentage of average total assets	-0.006 <sup>r</sup>	0.03	0.01
Net interest margin	1.68	1.79	1.80
Cost-income ratio	41.8	41.9	42.7
<b>Liquidity ratio<sup>11</sup></b>	47.7	47.7	50.7
<b>Surveyed institutions</b>			
<b>Asset quality</b>			
Delinquency ratio of residential mortgage loans	0.19	0.20	0.20
Credit card receivables			
Delinquency ratio	0.37	0.40	0.37
Charge-off ratio — quarterly annualised (adjusted)	2.72	3.30	3.13
— year-to-date annualised	2.81	3.02	2.91
<b>All locally incorporated AIs</b>			
<b>Capital adequacy ratio (consolidated)</b>	14.8 <sup>r</sup>	15.0	15.0

## Notes:

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