

Developments in the banking sector

by the Banking Policy Department

Retail banks were highly profitable in 2007. Both their net interest income and non-interest income grew strongly. Owing to a faster increase in net interest income than interest-bearing assets, the net interest margin widened further. The increase in total income more than offset increases in operating expenses and new provisions. Bank lending increased by 12.6% for the year as whole, although share financing, the main driver of the loan growth, contracted by 91.0% in the final quarter. Overall quality of retail banks' assets remained good, although the quality of investment in debt securities worsened mainly due to the sub-prime turmoil. The ratio of provisions to total assets remained low.

Interest rate movements

Retail banks' best lending rates (BLR) were reduced by 75 basis points to 6.75% or 7.00% in the fourth quarter of 2007. Average HIBORs¹ and time deposit rates declined correspondingly (Chart 1). The average spreads between BLR and time deposits remained broadly stable while those between BLR and HIBORs declined as BLR decreased more than HIBOR (Chart 2).

CHART 1
HIBORs and time deposit rates
(quarterly average)

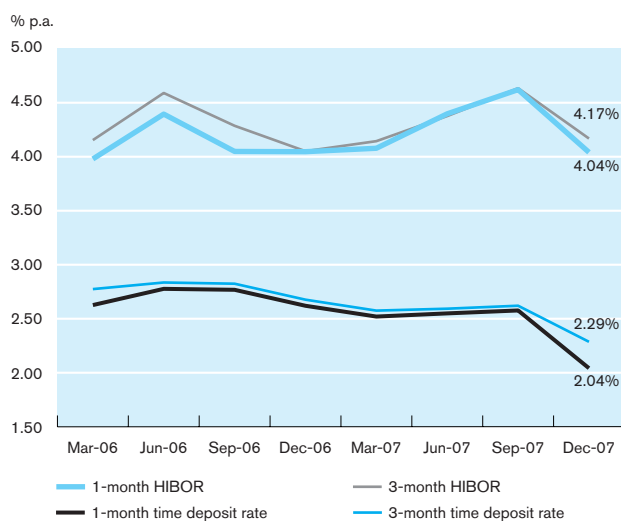
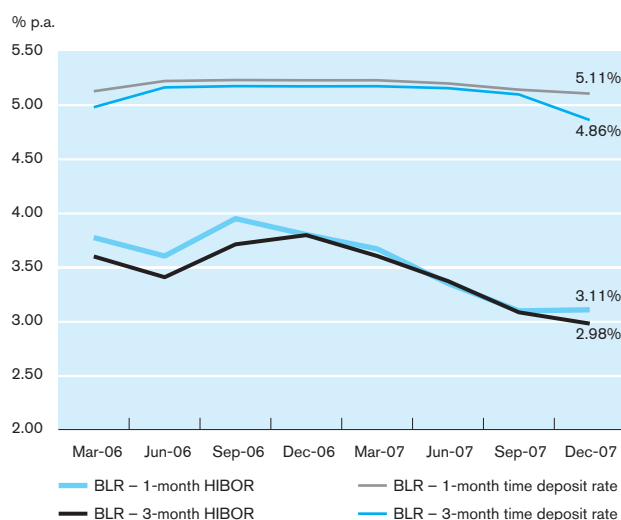


CHART 2
Differentials between best lending rate and
HIBORs/time deposit rates
(quarterly average)



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

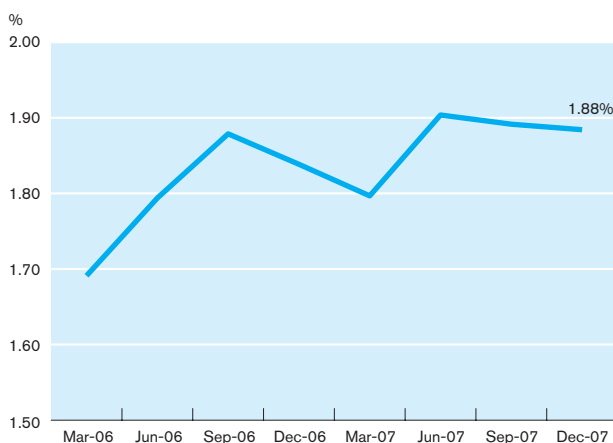
Retail banks' profitability

Retail banks in Hong Kong recorded very strong profit growth in 2007. The aggregate pre-tax operating profits of the banks' Hong Kong offices increased by 31.1% compared with 2006. The profit growth was supported by increases in both net interest income and non-interest income.

The increase in net interest income by 17.4% in 2007 reflected both an expansion of assets and an improvement in the interest margin. The net interest margin widened to 1.87% in 2007 from 1.80% in 2006 (Chart 3). Non-interest income also increased sharply, by 48.0%, mainly because of a robust increase in fees and commission income on the back of a very active stock market. As non-interest income grew faster than net interest income, the proportion of non-interest income to total operating income increased to 44.0% from 38.4% in 2006.

CHART 3

Retail banks' net interest margin (quarterly annualised)

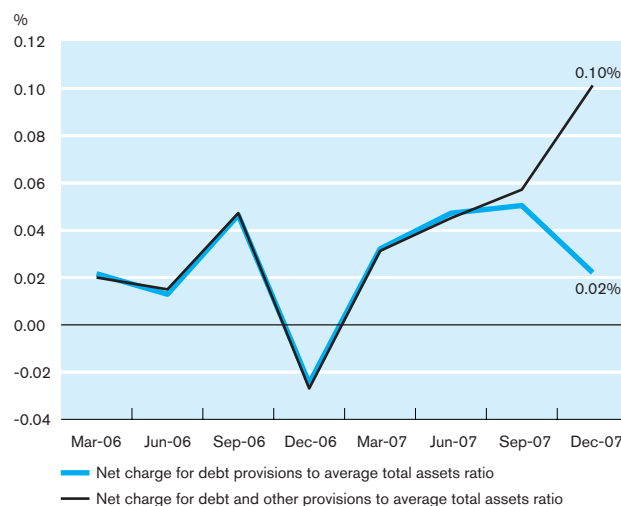


Retail banks' cost-to-income ratio decreased to 40.4% for 2007 from 42.8% in 2006, even though banks' operating costs grew faster in 2007. The higher operating costs reflected the favourable economic conditions and the consequent business expansion and increased demand for staff.

Retail banks' net charge for debt provisions more than tripled compared with 2006, as the amount of provision write-back decreased and new provisions increased in the year. Because of the deterioration in the quality of investment portfolios in relation to banks' exposure to sub-prime related products, the banks' net charge for other provisions also grew sharply to HK\$1.3 billion from a nearly zero-base in 2006. However, the ratio of retail banks' net charge for debt and other provisions to average total assets remained relatively low, at 0.06% at the end of 2007 (Chart 4).

CHART 4

Retail banks' provisions to average total assets ratio (quarterly annualised)



Retail banks' asset quality

Overall quality of loans

The quality of retail banks' loans and advances remained very sound, as the classified loan ratio and the ratio of loans overdue for more than three months dropped to new lows at the end of last year (Table 1). The classified loan ratio fell to 0.86% and the overdue and rescheduled loan ratio to 0.57% (Chart 5). The classified loan ratio, netting off specific provisions, also fell to 0.66% (Chart 6). The ratio of specific provisions to total classified loans declined to around 23%.

CHART 5

Retail banks' loans quality (1)

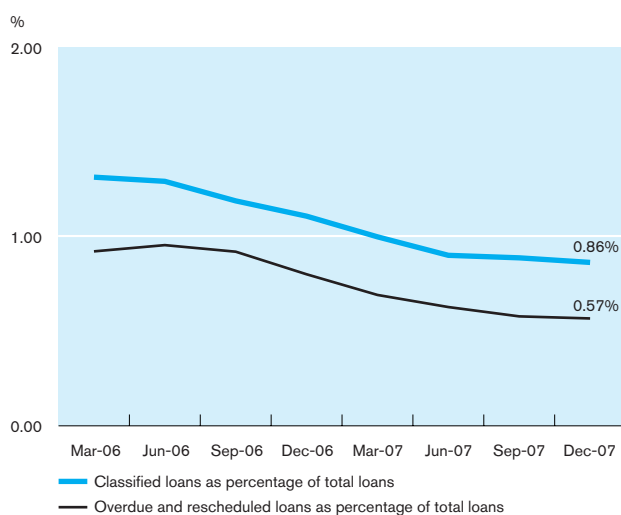


CHART 6

Retail banks' loans quality (2)

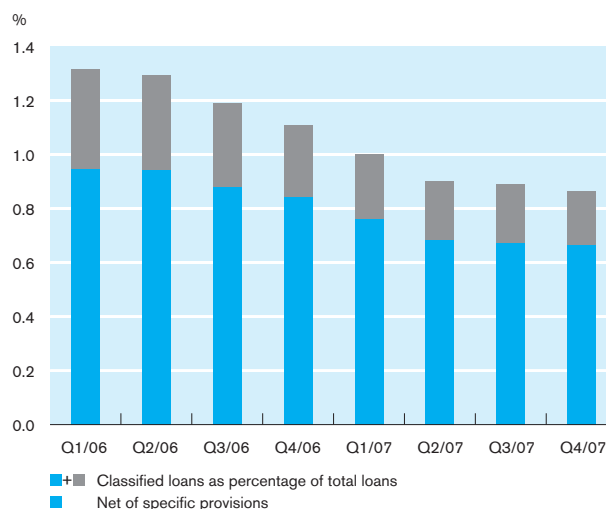


TABLE 1

Loans quality of retail banks¹

	Dec-06	Mar-07	Jun-07	Sep-07	Dec-07
	as % of total loans				
Pass loans	96.65	97.11	97.37	97.47	97.57
Special mention loans	2.24	1.89	1.73	1.64	1.56
Classified loans² (gross)	1.11	1.00	0.90	0.89	0.86
o/w Substandard	0.44	0.40	0.36	0.36	0.36
Doubtful	0.55	0.51	0.48	0.45	0.45
Loss	0.12	0.09	0.07	0.07	0.06
Classified loans (net)³	0.85	0.76	0.68	0.67	0.66
Overdue > 3 months and rescheduled loans	0.80	0.69	0.63^r	0.58	0.57
o/w Overdue > 3 months	0.54	0.46	0.41 ^r	0.39	0.36
Rescheduled loans	0.26	0.23	0.22	0.19	0.20

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.

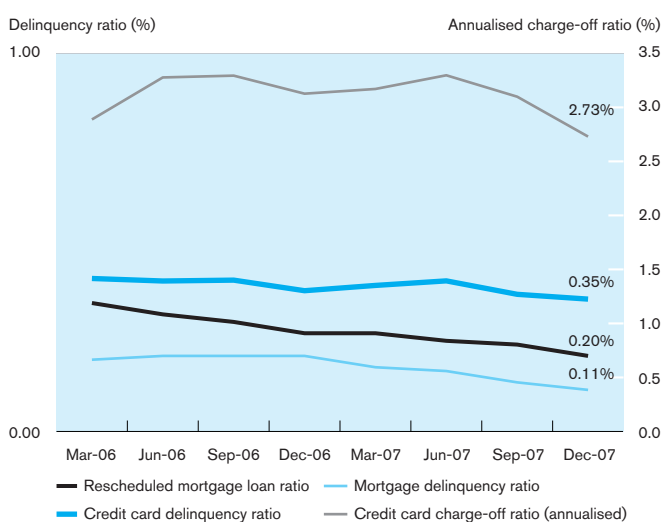
Because of rounding, the figures set out in this table may not add up.

Quality of residential mortgage lending portfolio

The quality of banks' residential mortgage lending portfolio remained sound, with both the mortgage delinquency ratio and the rescheduled ratio declining, to 0.11% and 0.20% respectively at the end of December 2007 (Chart 7). The combined ratio of delinquent and rescheduled loans also fell to a new low of 0.31% from 0.35% at the end of September 2007.

CHART 7

Quality of credit card receivables and mortgage lending of surveyed institutions



In line with the increase in property values, the outstanding number of residential mortgage loans in negative equity decreased from about 3,500 cases (valued at HK\$6 billion) at the end of September to some 1,900 cases with an aggregate value of HK\$3 billion at the end of December. The delinquency ratio of negative-equity residential-mortgage loans rose to 1.75% from 1.57% at the end of September due to the contraction of the portfolio.

Quality of credit card portfolio

The performance of the credit card portfolio during the fourth quarter was somewhat mixed. While the charge-off amount decreased by 7.0% to HK\$504 million, the amount of receivables delinquent for more than 90 days increased by 5.0% to HK\$269 million at the end of December 2007. Notwithstanding the increase in delinquent amount in the fourth quarter, the delinquency ratio edged down to 0.35% due to a strong increase of 8.8% in receivables during the quarter. The combined ratio of delinquent receivables and rescheduled receivables decreased slightly to 0.42% from 0.44% at the end of September. The annualised quarterly charge-off ratio also declined to 2.73% from 3.10% in the third quarter (Chart 7).

Quality of investment

The quality of the retail banks' investment in debt securities worsened in 2007 mainly due to the sub-prime turmoil. At the end of December 2007, retail banks' investments in debt securities classified as "substandard", "doubtful" or "loss" represented about 0.05% of the banks' total assets, and investments under special mention represented about 0.09%. The majority of the special mention and classified investments were sub-prime related instruments.

TABLE 2

Consolidated capital adequacy ratio (All locally incorporated AIs)

(HK\$ million)	Dec-06	Mar-07 ²	Jun-07	Sep-07	Dec-07
Total capital base after deductions ¹ <i>of which core capital</i>	456,839 399,041	471,041 372,590	481,363 372,336	503,337 387,591	498,708 392,391
Total risk-weighted exposures	3,072,618	3,462,521	3,593,506	3,688,217	3,716,074
Capital adequacy ratio	14.9%	13.6%	13.4%	13.6%	13.4%
Core ratio	13.0%	10.8%	10.4%	10.5%	10.6%

Notes:

¹ Before 1 January 2007, total capital base after deductions refers to total core and supplementary capital after deductions as specified under the Third Schedule to the Banking Ordinance. From 1 January 2007, the item is specified under the Banking (Capital) Rules.

² From 1 January 2007, all locally incorporated AIs started to report their capital adequacy positions according to the Banking (Capital) Rules (i.e. the Basel II framework).

Local authorized institutions' capital strength

Preliminary statistics indicated that the average consolidated capital adequacy ratio of all locally incorporated authorized institutions decreased slightly to 13.4% from 13.6% at the end of September (Table 2). This decline was mainly due to an increase in risk-weighted assets during the quarter.

Retail banks' liquidity

Retail banks' average liquidity ratio² remained stable, at a comfortable level of 51.9% in the fourth quarter (Chart 8).

As deposits grew faster than loans, retail banks' loan-to-deposit ratio for all currencies improved to 45.5% from 48.6% at the end of September, and to 65.1% from 67.1% for Hong Kong dollars over the same period (Chart 9).

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 components are specified in the Fourth Schedule of the Banking Ordinance.

CHART 8

Retail banks' average liquidity ratio

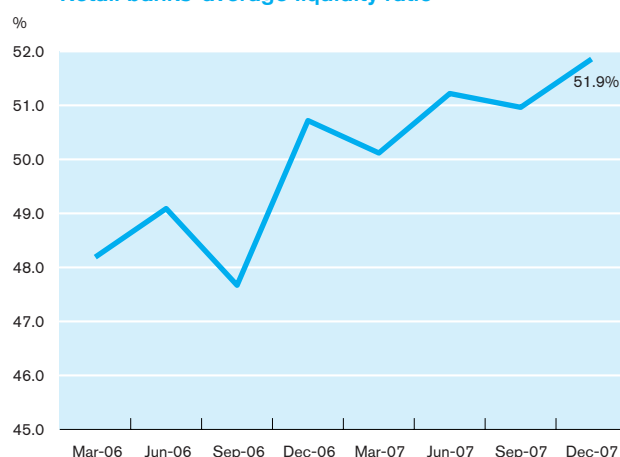
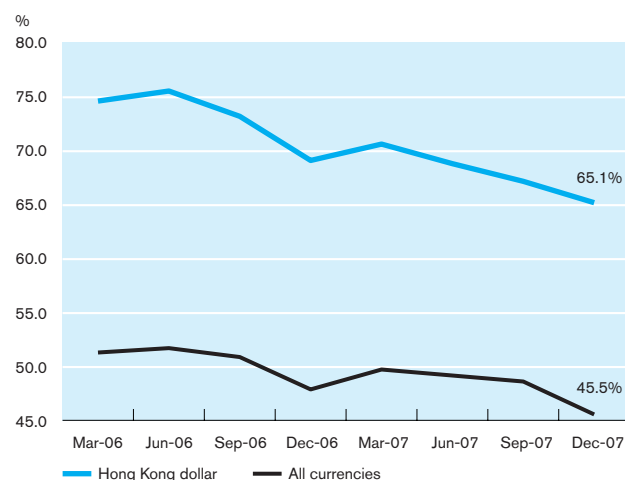


CHART 9

Retail banks' loan-to-deposit ratio

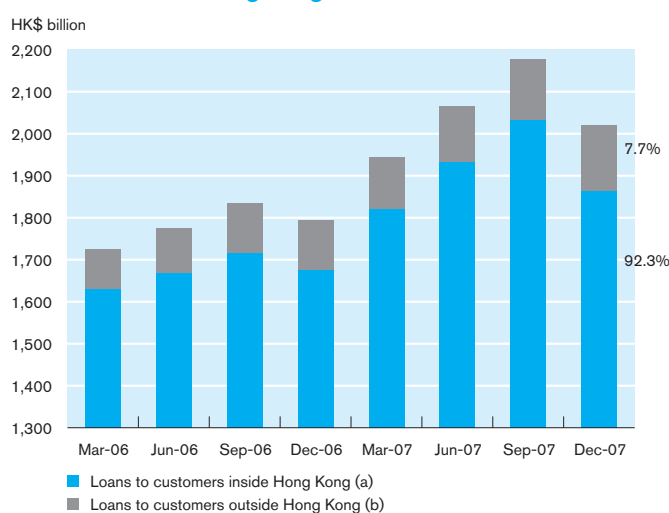


Retail banks' lending

Retail banks' total lending decreased by 7.2% in the fourth quarter, despite an increase of 7.7% in loans for use outside Hong Kong (Chart 10). Domestic lending by retail banks, after rising by 5.2% in the third quarter, declined by 8.2% in the fourth quarter. The decrease was a result of a retraction in share financing, which more than offset the growth in residential mortgage loans and credit card receivables.

CHART 10

Retail banks' loans to customers inside and outside Hong Kong



Notes:

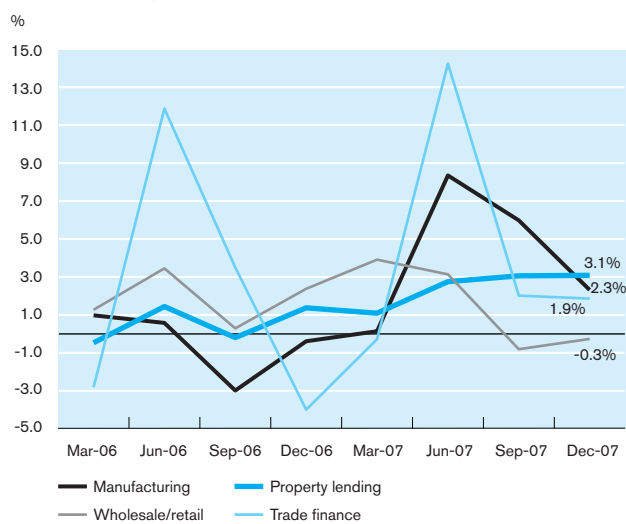
- (a) Defined as loans for use in Hong Kong plus trade-financing loans.
 (b) Includes "others" (i.e. unallocated).

Domestic lending by various economic sectors

Despite the overall decline in domestic lending in the fourth quarter, the picture across major economic sectors was mixed (Chart 11). Trade-financing loans continued to increase by 1.9% after rising by 2.0% in the third quarter. Similarly, loans to the manufacturing sector continued to grow by 2.3% in the fourth quarter, compared with an increase of 6.0% in the previous quarter. Property lending also registered a steady growth of 3.1%, about the same growth rate as in the third quarter, on the back of lower BLR and higher property prices.

CHART 11

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



N.B. 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).

By contrast, loans for share-financing reversed the sharp increase of 23% in the third quarter to a reduction of 91.0% in the final quarter. Within this portfolio, loans to non-stockbroking companies and individuals to purchase stocks fell by 87.4% following an increase of 42.2% in the third quarter. Similarly, loans to stockbrokers decreased by 93.9% having risen 10.6% in the previous quarter. Modest decline was also seen in the wholesale and retail trade sector, by 0.3% in the fourth quarter. Lending to the information technology sector continued to fluctuate sharply, declining by 29.0% in the fourth quarter after rising 31.3% in the third quarter.

Credit card receivables

Credit card lending increased strongly in the fourth quarter, owing largely to festive spending and the payment of salaries tax using credit cards. According to the HKMA's regular survey, total credit card receivables increased by 8.8% in the fourth quarter after growing by 2.2% in the third quarter. This was despite a transfer of some HK\$126 million of rescheduled receivables outside the credit card portfolio during the quarter. The total number of credit card accounts also increased by 1.6% after a 0.5% growth in the third quarter.

Exposures to non-bank Chinese entities

Retail banks' aggregate exposure to non-bank Chinese entities increased to HK\$550.4 billion (7.8% of total assets) at the end of December from HK\$377.5 billion (5.3% of total assets) at the end of September. Total exposure of the banking sector to non-bank Chinese entities also increased to HK\$756.1 billion (6.5% of total assets) from HK\$561.0 billion (5.0% of total assets). These increases were mainly driven by the amendment in the reporting requirement to include exposures to non-bank Chinese entities incurred by the retail banks' banking subsidiaries in Mainland China starting December 2007³. Exposures to companies and individuals for purchasing properties in Mainland China increased to HK\$10.4 billion at the end of December from HK\$9.9 billion at the end of September.

Retail banks' customer deposits

Retail banks' customer deposits decreased by 1.0% in the fourth quarter after rising 6.7% in the previous quarter. The decline was mainly due to the repatriation of IPO funds by issuers and was seen in Hong Kong-dollar deposits, which fell by 6.4% in the quarter. The reduction of Hong Kong-dollar deposits was mainly in demand and time deposits, which fell by 11.6% and 17.6% respectively (Table 3). Foreign-currency deposits increased by 8.6% (Chart 12). The increase in foreign-currency deposits was partially due to a revaluation effect as the exchange value of a number of foreign currencies appreciated significantly in the last quarter of 2007. In addition, the anticipation of stronger foreign currencies also attracted depositors to shift their Hong Kong-dollar deposits into foreign-currency deposits. As a result, the proportion of Hong Kong-dollar deposits to total deposits decreased to 60%.

³ Previously, only exposures incurred by the banks (i.e. including branches but excluding subsidiaries) were reported. Many banks converted their Mainland China branches into banking subsidiaries during the first half of 2007. Therefore, exposures previously booked in the banks' branches were taken out from the data stream until the latest amendment in the reporting requirement.

TABLE 3

Hong Kong dollar deposit mix

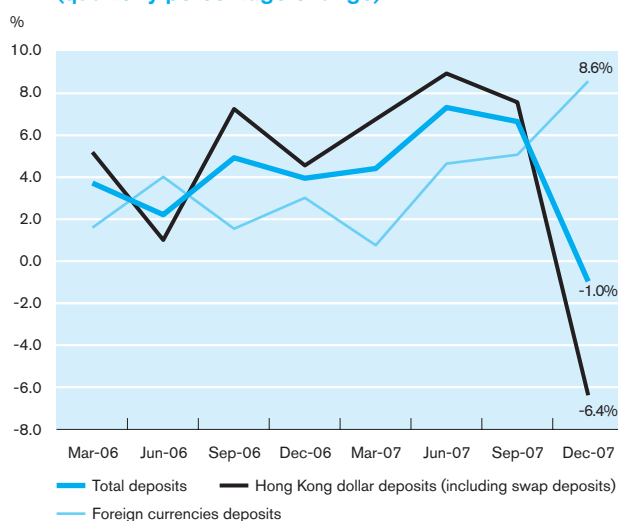
Amount (HK\$ billion)			
	Retail banks		
	Demand	Savings	Time*
Dec-06	219.0	924.2	1,139.8
% growth	9.1	12.8	(2.0)
Mar-07	246.7	893.1	1,297.6
% growth	12.6	(3.4)	13.8
Jun-07	333.0	943.3	1,379.0
% growth	35.0	5.6	6.3
Sep-07	308.4	964.6	1,583.4
% growth	(7.4)	2.3	14.8
Dec-07	272.7	1,095.9	1,305.4
% growth	(11.6)	13.6	(17.6)

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

* Includes swap deposits.

CHART 12

Retail banks' customer deposits (quarterly percentage change)



Negotiable Instruments

Negotiable debt instruments (NDIs) held

Retail banks' holdings of NDIs (excluding negotiable certificates of deposits (NCDs)) increased by 4.1% in the fourth quarter (Chart 13). The increase, coupled with the decline in total assets in the quarter, led to an increase in the proportion of NDIs held to total assets to 20.3% from 18.7% in the third quarter. The share of foreign-currency-denominated NDIs held also rose to 67.9% from 63.1% at the end of September. A breakdown of NDIs by instrument types and counterparties is shown in Charts 14 and 15 respectively.

CHART 13

Retail banks' holdings of negotiable debt instruments (currency breakdown)

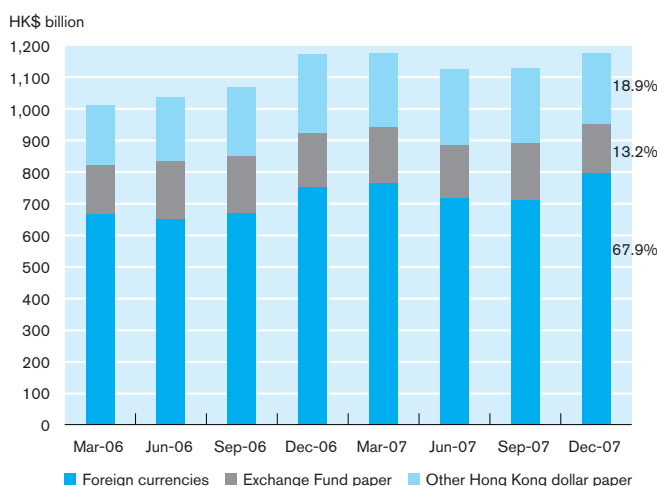


CHART 14

Retail banks' holdings of negotiable debt instruments (types of instrument)

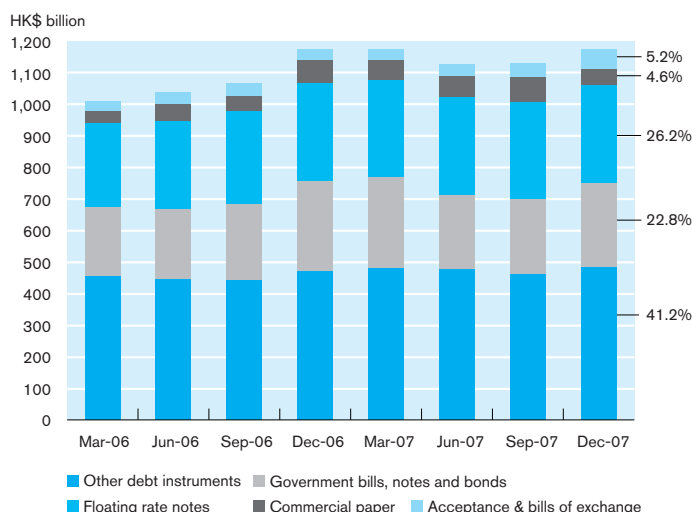
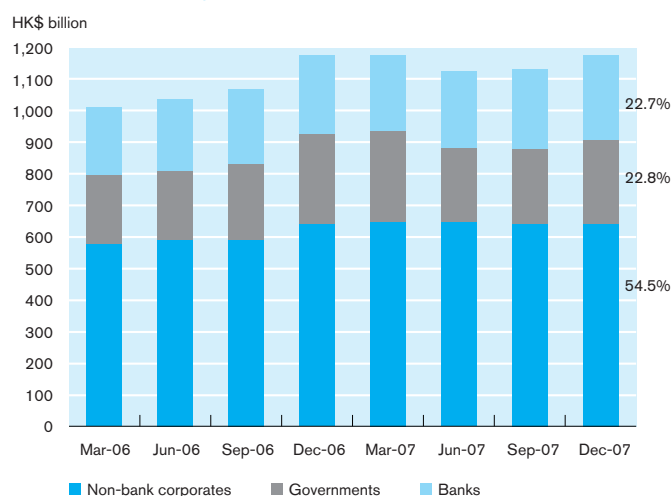


CHART 15

Retail banks' holdings of negotiable debt instruments (counterparty breakdown)



By contrast, NCDs held by retail banks registered a decrease of 1.1% in the fourth quarter, and represented only 1.0% of the banks' total assets at the end of December 2007. The share of NCDs in Hong Kong dollars held by the banks remained stable, at 78.3% at the end of December.

Negotiable certificates of deposits issued

Against the strong growth in customer deposits, retail banks' outstanding NCDs further reduced in the fourth quarter. NCDs issued by the banks, which represented 1.8% of the banks' total liabilities at the end of 2007, decreased by 10.7% in the fourth quarter and by 34.5% compared with a year ago. By currencies, outstanding NCDs issued dropped for both Hong Kong dollars and foreign currencies.

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

APPENDIX

KEY PERFORMANCE INDICATORS OF THE BANKING SECTOR¹ (%)

	Dec-06	Sep-07	Dec-07
Interest rate²			
1-month HIBOR	4.05	4.62	4.04
3-month HIBOR	4.05	4.64	4.17
BLR ³ and 1-month HIBOR spread	3.80	3.10	3.11
BLR ³ and 3-month HIBOR spread	3.80	3.08	2.98
Composite interest rate	2.86	3.34	2.29
Retail banks			
Balance sheet developments⁴			
Total deposits	4.0	6.7	-1.0
Hong Kong dollar	4.6	7.6	-6.4
Foreign currency	3.0	5.1	8.6
Total loans	-2.2	5.4	-7.2
Loans to customers inside Hong Kong ⁵	-2.1	5.2	-8.2
Loans to customers outside Hong Kong ⁶	-3.5 ^r	8.7	7.7
Negotiable instruments			
Negotiable certificates of deposit issued	-7.2	-11.4	-10.7
Negotiable debt instruments held	10.0	0.2	4.1
Asset quality⁷			
As percentage of total loans			
Pass loans	96.65	97.47	97.57
Special mention loans	2.24	1.64	1.56
Classified loans ⁸ (gross)	1.11	0.89	0.86
Classified loans (net) ⁹	0.85	0.67	0.66
Overdue > 3 months and rescheduled loans	0.80	0.58	0.57
Profitability¹⁰			
Bad debt charge as percentage of average total assets	0.01	0.04	0.04
Net interest margin	1.80	1.86	1.87
Cost-income ratio	42.8	39.9	40.4
Liquidity ratio¹¹	50.7	51.0	51.9
Surveyed institutions			
Asset quality			
Delinquency ratio of residential mortgage loans	0.20	0.13	0.11
Credit card receivables			
Delinquency ratio	0.37	0.36	0.35
Charge-off ratio — quarterly annualised (adjusted)	3.13	3.10	2.73
— year-to-date annualised	2.91	3.10	2.90
All locally incorporated AIs			
Capital adequacy ratio (consolidated)¹²	14.9	13.6	13.4

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 Banks.

³ With reference to the rate quoted by The Hongkong and Shanghai Banking Corporation Limited.

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.

¹² From 1 January 2007, all locally incorporated AIs started to report their capital adequacy positions according to the Banking (Capital) Rules (i.e. the Basel II framework).

^r Revised figure.