

Developments in the banking sector

by the Banking Policy Department

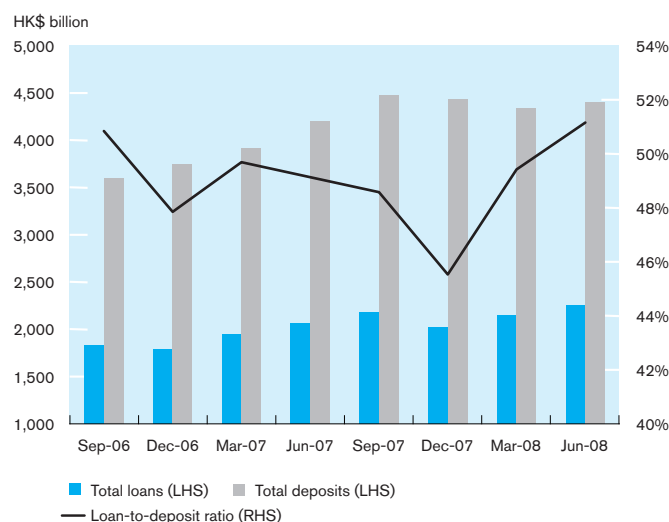
Statistics in the second quarter of 2008 suggest that the operating environment for Als was generally benign during the period, but the outlook for the rest of the year has become less promising. In the second quarter, the loan portfolios of retail banks continued to expand rapidly. However, further expansion of retail banks' portfolios may be limited by sluggish deposit growth. The profitability of retail banks held up reasonably well in the first half of 2008 compared with the same period last year. Growth in net interest income and non-interest income helped to offset increased provisions for securities holdings, and bad and doubtful debts. However, the net interest margins of retail banks contracted conspicuously in the second quarter because of increased funding costs. In addition, there are signs suggesting that the asset quality of retail banks may start to deteriorate. The classified loan ratio increased in the second quarter.

While total loans and advances increased rapidly, growth in customer deposits was sluggish, resulting in higher loan-to-deposit ratios

Following an increase of 6.2% in Q1 2008, total loans and advances of retail banks grew further by 5.0% in Q2 2008 (Chart 1). Total customer deposits, however, increased only by 1.4%, after falling 2.1% in the first quarter. As a result, the overall loan-to-deposit ratio of retail banks climbed to 51.2% in Q2 2008 from 49.4% in the previous quarter.

The increase in the Hong Kong dollar loan-to-deposit ratio is more conspicuous. After falling 3.9% in Q1

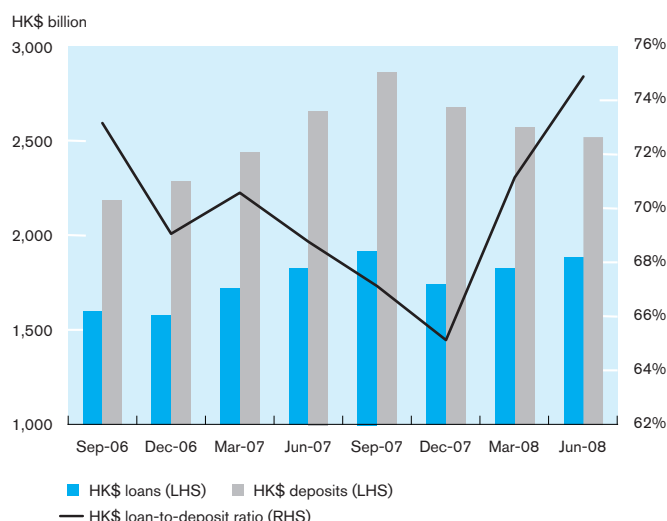
CHART 1
Total loans and customer deposits of retail banks



2008, Hong Kong-dollar deposits declined further by 2.0% in Q2 2008, pushing the Hong Kong-dollar loan-to-deposit ratio to 74.9%, up from 71.1% in Q1 2008 and 65.1% in Q4 2007 (Chart 2).

CHART 2

Hong Kong-dollar loans and customer deposits of retail banks



The increase in loans and advances was broad-based

Loans for use in Hong Kong and outside Hong Kong increased by 4.3% and 13.2% respectively in Q2 2008 (Chart 3).

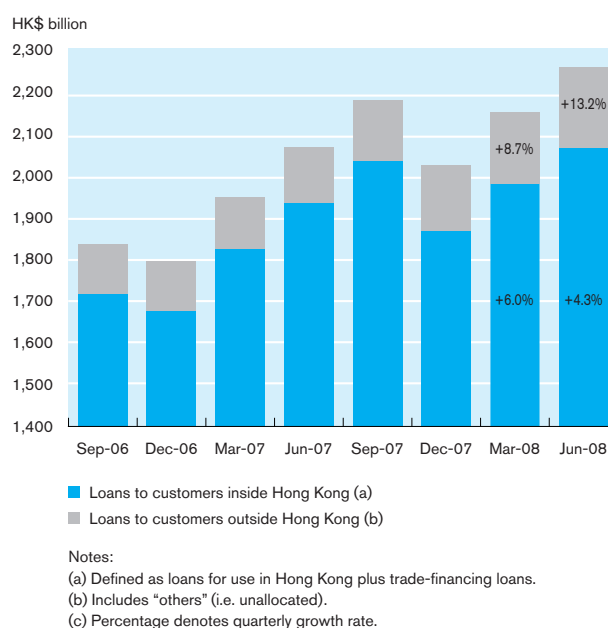
The percentage changes in the amount of credit extended to different economic sectors are shown below:-

Wholesale & retail trade	+ 14.4%
Trade finance	+ 12.9%
Manufacturing	+ 5.7%
Property lending	+ 3.0%

Lending to the wholesale and retail trade sector was particularly strong, recording double-digit growth for two consecutive quarters. The trade finance sector was also solid, growing by 12.9% in Q2 2008 following an increase of 6.5% in Q1 2008.

CHART 3

Loans and advances of retail banks



Share financing¹ declined substantially by 18.4% after rebounding 11.6% in Q1 2008. This is presumably because of the lacklustre performance of the stock market.

Retail banks' total non-bank China exposures² continued to increase, growing by 9.6% to HK\$689 billion (9.5% of total assets) from HK\$628 billion (8.6% of total assets) at the end of March 2008. For the banking sector as a whole, non-bank China exposures increased by 8.7% to HK\$968 billion (8.2% of total assets) from HK\$890 billion (7.4% of total assets).

Asset quality remained high, but signs of deterioration surfaced

The asset quality of retail banks remained high by historical standards. However, signs of deterioration are beginning to be seen. The aggregate value of classified loans increased by 14.3% in the second quarter, following an increase of 1.3% in the first

¹ Share financing includes loans to stockbrokers and loans to non-stockbroking companies and individuals to purchase shares.

² Including exposures booked in the retail banks' banking subsidiaries in Mainland China.

quarter. Consequently, the classified loan ratio increased to 0.88% from 0.81% in Q1 2008 (Table 1 and Chart 4). The ratio of overdue and rescheduled loans, on the other hand, continued to decline to 0.53% in Q2 2008.

The ongoing credit woes continued to undermine the quality of the debt securities held by retail banks. The retail banks' investment in debt securities which were classified as "substandard", "doubtful" or "loss" represented about 0.03% of the banks' assets at end-June, compared with 0.10% at the end of March. Meanwhile, debt securities investment classified as

"special mention" increased to 0.28% of the banks' assets at the end of June from 0.12% at end-March.

The HKMA's quarterly Credit Card Survey indicates that the quality of the surveyed institutions' credit card portfolios was broadly stable in Q2 2008. The delinquency ratio remained unchanged at 0.32% (Chart 5). The combined delinquent and rescheduled ratio edged slightly lower to 0.39% from 0.40% in Q1 2008. However, the total charge-off amount increased by 1.5%, lifting the quarterly annualised charge-off ratio to 2.78% from 2.68% in Q1 2008.

CHART 4

Asset quality of retail banks

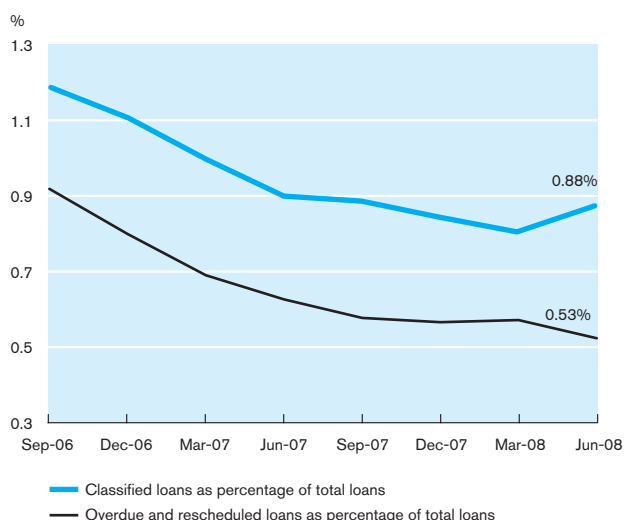


CHART 5

Delinquency ratio of residential mortgages and credit card portfolios by surveyed institutions

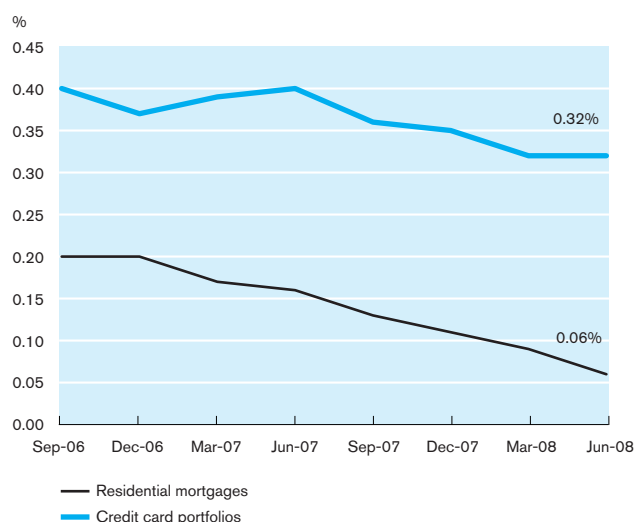


TABLE 1

Loans quality of retail banks¹

	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08
	as % of total loans				
Pass loans	97.37	97.47	97.59 ^r	97.72	97.75
Special mention loans	1.73	1.64	1.57 ^r	1.47	1.38
Classified loans ² (gross)	0.90	0.89	0.85 ^r	0.81	0.88
<i>o/w Substandard</i>	0.36	0.36	0.34 ^r	0.31	0.38
<i>Doubtful</i>	0.48	0.45	0.45	0.45	0.44
<i>Loss</i>	0.07	0.07	0.06	0.05	0.05
Classified loans (net) ³	0.68	0.67	0.65 ^r	0.62	0.68
Overdue > 3 months and rescheduled loans	0.63	0.58	0.57	0.57	0.53
<i>o/w Overdue > 3 months</i>	0.41	0.39	0.36	0.39	0.36
<i>Rescheduled loans</i>	0.22	0.19	0.20	0.18	0.16

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.

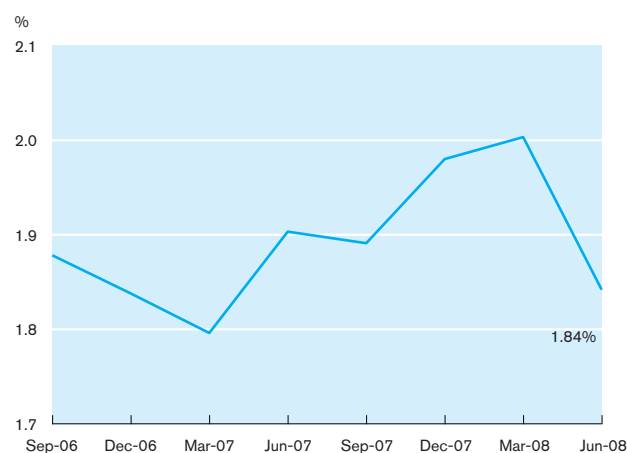
The quality of retail banks' residential mortgage lending remained solid. The delinquency ratio declined to 0.06% from 0.09% in Q1 2008 (Chart 5). The rescheduled loan ratio also declined to 0.15% from 0.17% in Q1 2008. Therefore, the combined ratio of delinquent and rescheduled loans fell to a record low of 0.21% from 0.27% in Q1 2008. The outstanding number of residential mortgage loans in negative equity decreased marginally to 936 cases from 953 cases in the previous quarter.

The profitability of retail banks held up reasonably well in H1 2008, although the performance of individual banks varied depending on the amount of provisions required for their securities holdings

The aggregate pre-tax operating profit of retail banks' Hong Kong offices dropped slightly by 1.9% in H1 2008 compared with the same period last year. Both net interest income and non-interest income increased, which helped to offset the impact of higher operating costs and increased provisions for securities holdings and bad and doubtful debts. The annualised net interest margin in H1 2008 improved to 1.92% from 1.85% in H1 2007. If measured on a quarterly annualised basis, however, the net interest margin declined to 1.84% in the second quarter from 2.00% in the first quarter of 2008 (Chart 6).

CHART 6

Net interest margin of retail banks (Quarterly annualised)



The increase in non-interest income was mainly attributable to increases in fees and commission income and income from foreign exchange operations.

The operating costs of retail banks rose by more than 14% in H1 2008 as compared with H1 2007, owing to increases in salary and commission, rental and IT-related expenses. Consequently, the cost-to-income ratio climbed to 41.6% from 39.8% in the same period last year.

Corresponding to the global credit deterioration, the net charge for other provisions, most of which related to provisions for securities holdings, surged to HK\$3.1 billion in H1 2008, compared with a small write-back in H1 2007.

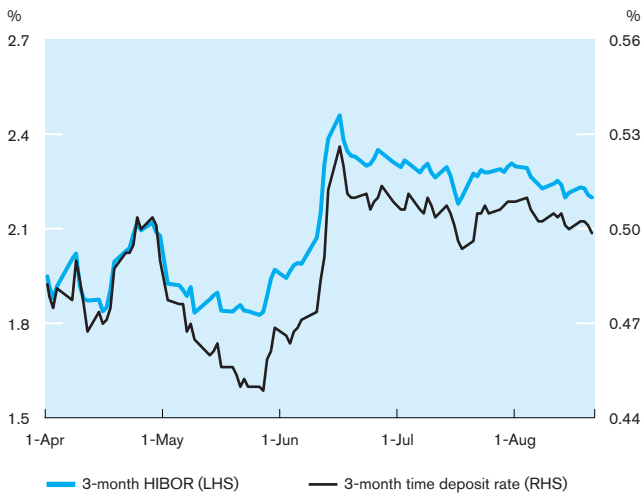
The net charge for debt provisions also increased in H1 2008. This seems to be in line with the increase in the aggregate value of classified loans during the period. However, the ratio of retail banks' net charge for debt provisions to average total assets remained relatively low at 0.05% in the first half of 2008.

Funding costs have increased and retail banks are offering higher rates for time deposits

The monthly average one-month and three-month HIBORs in July 2008 were 1.83% and 2.28% respectively, compared with 1.81% and 2.23% in June, and 1.58% and 1.98% in April (Charts 7 and 8). Statistics collected from retail banks suggest that competition for customer deposits is intensifying, and the spreads between best lending rates (BLR) and time deposit rates have narrowed.

CHART 7

HIBOR and deposit rate

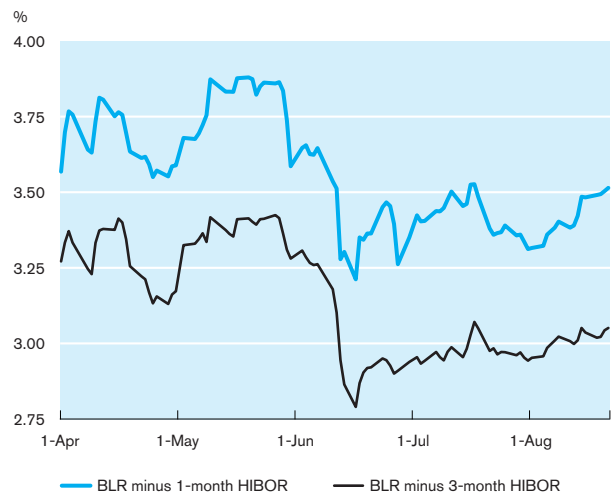


Note:

Deposit rates on deposits of less than HK\$100,000. The average interest rates for time deposits are compiled based on the interest rates quoted by leading licensed banks.

CHART 8

Spread between BLR and HIBOR

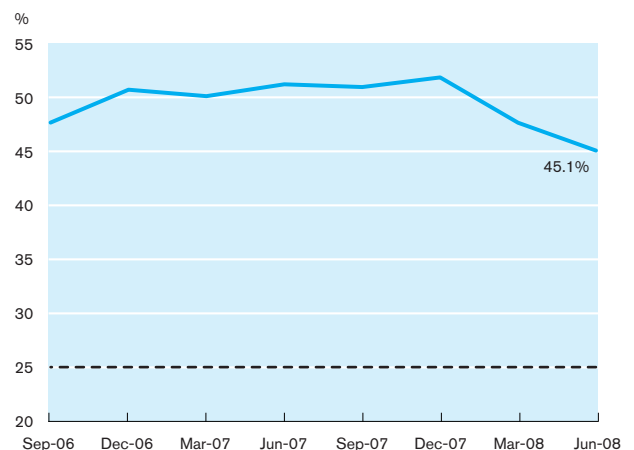


Average liquidity ratio remained at a comfortable level

The average liquidity ratio of retail banks stood at 45.1% at the end of June, well above the statutory minimum of 25% (Chart 9).

CHART 9

Average liquidity ratio of retail banks



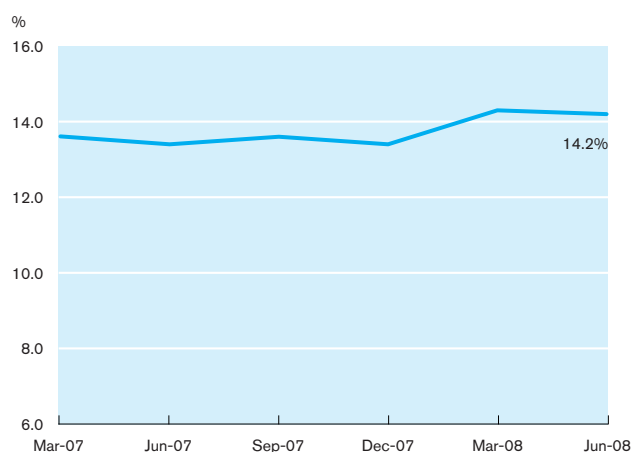
Als remain well capitalised

Starting from January 2007, all locally incorporated Als reported their capital adequacy ratio under the revised capital adequacy framework set out in the Banking (Capital) Rules. Notwithstanding the inclusion of a wider spectrum of risk factors in the revised calculation method, the aggregate capital adequacy ratio of locally incorporated Als has remained at a relatively stable level in the past several quarters.

The average consolidated capital adequacy ratio of locally incorporated Als edged slightly lower to 14.2% from 14.3% at the end of March 2008 (Chart 10).

CHART 10

Capital adequacy ratio of locally incorporated Als



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

APPENDIX

KEY PERFORMANCE INDICATORS OF THE BANKING SECTOR¹ (%)

	Jun-07	Mar-08	Jun-08
Interest rate			
1-month HIBOR ² (Quarterly average)	4.40	2.33	1.62
3-month HIBOR (Quarterly average)	4.38	2.45	2.03
BLR ³ and 1-month HIBOR spread (Quarterly average)	3.35	3.63	3.63
BLR and 3-month HIBOR spread (Quarterly average)	3.37	3.51	3.22
Composite interest rate ⁴	3.09	0.98	0.85
Retail banks			
Balance sheet developments⁵			
Total deposits	7.3	-2.1	1.4
Hong Kong dollar	8.9	-3.9	-2.0
Foreign currency	4.6	0.6	6.3
Total loans	6.1	6.2	5.0
Loans to customers inside Hong Kong ⁶	6.1	6.0	4.3
Loans to customers outside Hong Kong ⁷	6.3	8.7	13.2
Negotiable instruments			
Negotiable certificates of deposit issued	-12.8	-19.1	-22.3
Negotiable debt instruments held	-4.2	-13.0 ^r	-2.1
Asset quality⁸			
As percentage of total loans			
Pass loans	97.37	97.72	97.75
Special mention loans	1.73	1.47	1.38
Classified loans ⁹ (gross)	0.90	0.81	0.88
Classified loans (net) ¹⁰	0.68	0.62	0.68
Overdue > 3 months and rescheduled loans	0.63	0.57	0.53
Profitability			
Bad debt charge as percentage of average total assets ¹¹	0.04	0.05	0.05
Net interest margin ¹¹	1.85	2.00	1.92
Cost-to-income ratio	39.8	39.6	41.6
Liquidity ratio (Quarterly average)	51.2	47.7	45.1
Surveyed institutions			
Asset quality			
Delinquency ratio of residential mortgage loans	0.16	0.09	0.06
Credit card receivables			
Delinquency ratio	0.40	0.32	0.32
Charge-off ratio — quarterly annualised	3.30	2.68	2.78
— year-to-date annualised	3.17	2.68	2.68
All locally incorporated AIs			
Capital adequacy ratio (consolidated)	13.4	14.3	14.2

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 The composite interest rate is a weighted average interest rate of all Hong Kong-dollar interest-bearing liabilities, which include deposits from customers, amounts due to banks, negotiable certificates of deposit and other debt instruments, and Hong Kong-dollar non-interest-bearing demand deposits on the books of banks. Further details can be found in the HKMA website.

⁵ Quarterly change.

⁶ Loans for use in Hong Kong plus trade-financing loans.

⁷ Includes "others" (i.e. unallocated).

⁸ Figures related to retail banks' Hong Kong office(s) and overseas branches.

⁹ Classified loans are those loans graded as "substandard", "doubtful" or "loss".

¹⁰ Net of specific provisions / individual impairment allowances.

¹¹ Year-to-date annualised.

^r Revised figure.