

Developments in the banking sector

by the Banking Policy Department

As a result of the global financial crisis, the profitability of banks in 2008 was significantly lower than in 2007. The net interest margin of retail banks narrowed to 1.84% in 2008 from 1.90% a year ago. Income from fees and commissions declined as demand for investment products decreased. The failure of Lehman Brothers in September 2008 resulted in further decline in the value of securities. Retail banks generally had to make additional impairment charges for their securities investments. Loan loss provisions also rose as the economic and business environment worsened. Despite the difficult operating environment, banks generally remained financially sound and well capitalised. The capital adequacy ratio of locally incorporated authorized institutions (AIs) remained well above the international standard of 8% at the end of 2008.

Profitability was affected by the financial crisis

Retail banks' overall performance in 2008 was adversely affected by the global financial crisis. Many retail banks registered a significant reduction in profits in 2008. The aggregate pre-tax operating profits of retail banks' Hong Kong offices fell by 35.7% in 2008 compared with 2007.

For 2008 as a whole, the net interest margin (NIM) of retail banks fell to 1.84% compared with 1.90% in 2007. Measured on a quarterly annualised basis, however, the NIM of retail banks rebounded from 1.75% in the third quarter of 2008 to 1.78% in the final quarter of 2008 (Chart 1). The improvement in NIM was partly a result of the lower interest-rate environment since November 2008 (Chart 2).

CHART 1

Retail banks' net interest margin (quarterly annualised)

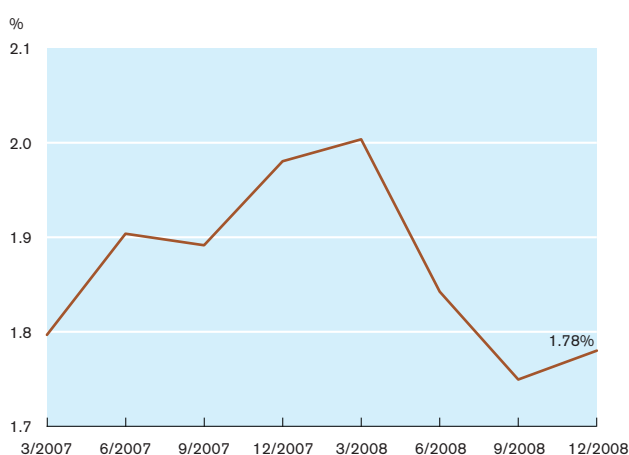
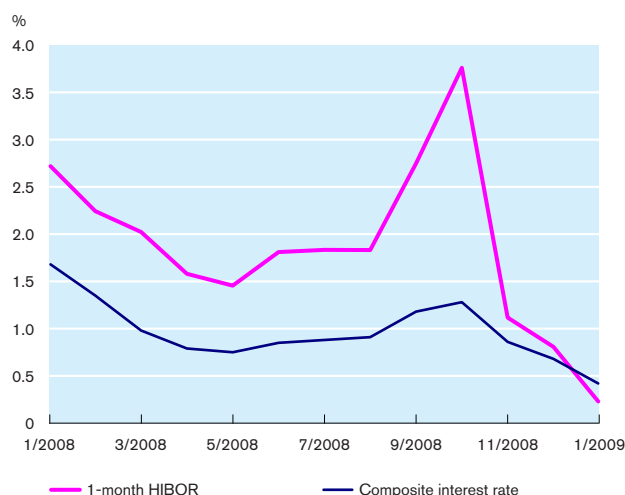


CHART 2

HIBOR and composite interest rate



Note: HIBORs are monthly average figures.

Non-interest income of retail banks fell because of trading investment losses and lower income from fees and commissions. The cost-to-income ratio of retail banks climbed to 45.1% in 2008 from 40.5% in 2007.

Impairment charges increased significantly in 2008 as the economic and financial environment deteriorated. Net charges for debt provisions surged to HK\$10.7 billion in 2008 from HK\$2.1 billion a year ago. Net charges for other provisions, mostly related to impairment allowances for securities holdings, more than tripled to HK\$14.6 billion from HK\$4.4 billion in 2007.

Asset quality remained good by historical standards but signs of deterioration were observed

The credit quality of retail banks' loan portfolios deteriorated further in the last quarter of 2008. The aggregate value of classified loans rose by 25% following an increase of 11% in the third quarter of 2008 and 14% in the second quarter of 2008, and the classified loan ratio increased to 1.24% from 0.96% at the end of September 2008 (Table 1 and Chart 3). The ratio of overdue and rescheduled loans also increased to 0.68% from 0.55% at the end of September 2008.

Retail banks' investments in debt securities which were classified as "substandard", "doubtful" or "loss"

stood at 0.06% of the banks' assets at the end of December 2008. Debt securities investments classified as "special mention" increased to 0.39% of the banks' assets at the end of December 2008, from 0.31% at the end of September 2008.

The HKMA quarterly Credit Card Survey showed that the quality of the surveyed institutions' credit card lending showed some signs of deterioration. The total delinquent amount overdue for more than 90 days rose by 16% from HK\$227 million at the end of September 2008 to HK\$263 million at the end of December 2008. Notwithstanding an increase in total receivables during the quarter, the delinquency ratio rose to 0.34% from 0.31% at the end of September

CHART 3
Asset quality of retail banks

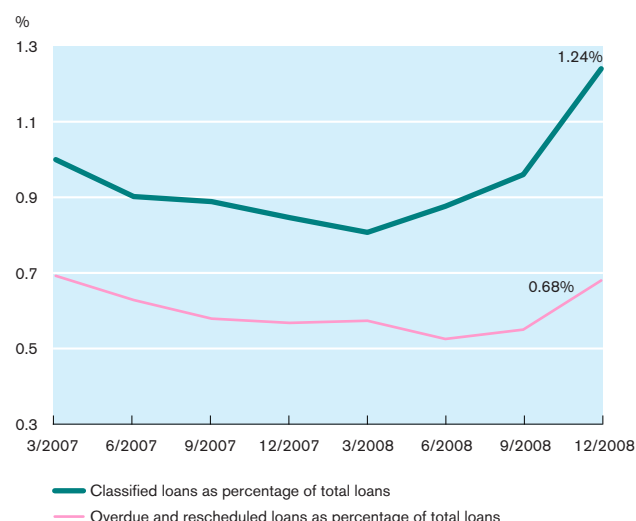


TABLE 1
Quality of loans and advances of retail banks*

	Dec 2007	Mar 2008	Jun 2008 (% of total loans)	Sep 2008	Dec 2008
Special mention loans	1.57	1.47	1.38	1.43	2.19
Classified loans (gross)	0.85	0.81	0.88	0.96	1.24
of which					
Substandard	0.34	0.31	0.38	0.33	0.50
Doubtful	0.45	0.45	0.44	0.56	0.67
Loss	0.06	0.05	0.05	0.07	0.07
Classified loans (net of specific provisions)	0.65	0.62	0.68	0.70	0.84
Overdue > 3 months and rescheduled loans	0.57	0.57	0.53	0.55	0.68
of which					
Overdue > 3 months	0.36	0.39	0.36	0.40	0.49
Rescheduled loans	0.20	0.18	0.16	0.15	0.19

* Period-end figures covering the Hong Kong offices and overseas branches of the banks.

Figures may not add up to total due to rounding.

2008 (Chart 4). The quarterly annualised charge-off ratio also rose to 3.09% in the final quarter of 2008 from 2.74% in the previous quarter. This is however considered a low ratio when compared with the peak of 14.55% in the third quarter of 2002.

CHART 4

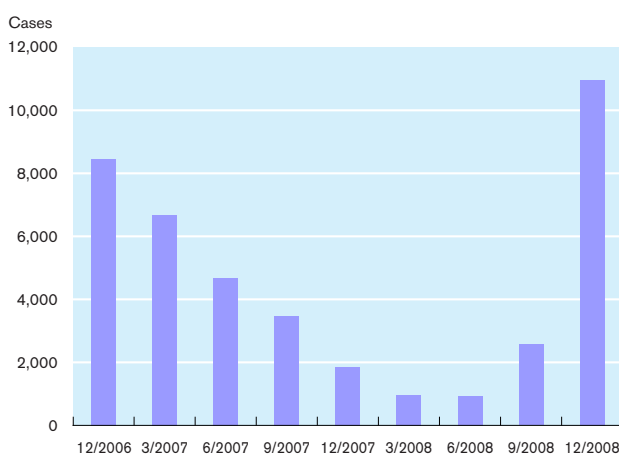
Delinquency ratios of residential mortgages and credit card lending of surveyed institutions



The quality of retail banks' residential mortgage lending remained good, with the delinquency ratio standing at 0.05% and rescheduled loan ratio at 0.14% at the end of December 2008 (Chart 4). However, the outstanding number of residential mortgage loans in negative equity rose to around 11,000 cases at the end of December 2008 from around 2,600 cases at the end of September 2008 as property prices fell during the period (Chart 5).

CHART 5

Residential mortgage loans in negative equity



Loan-to-deposit ratios declined

As the financial crisis intensified after the collapse of Lehman Brothers, banks generally became more cautious in lending. Total loans and advances of retail banks fell by 3.1% in the final quarter of 2008. On the other hand, total customer deposits increased by 2.7% during the same period. The overall loan-to-deposit ratio of retail banks fell to 47.2% at the end of December 2008 from 50.1% at the end of September 2008 (Chart 6). The Hong Kong-dollar loan-to-deposit ratio also fell to 69.4% from 72.9% at the end of September 2008 (Chart 7).

CHART 6

Retail banks' total loans and customer deposits

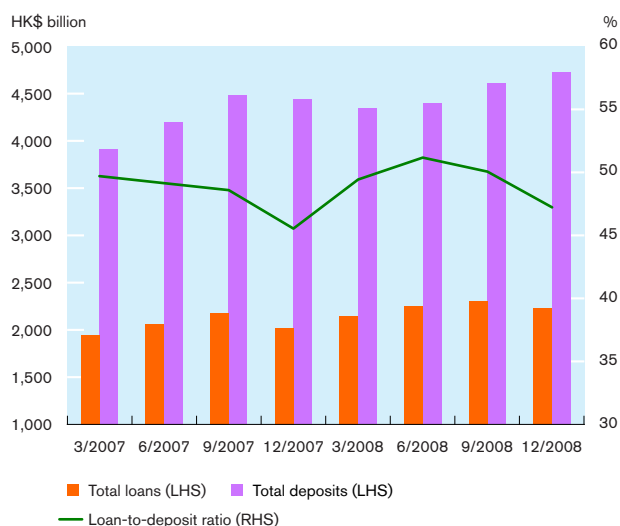
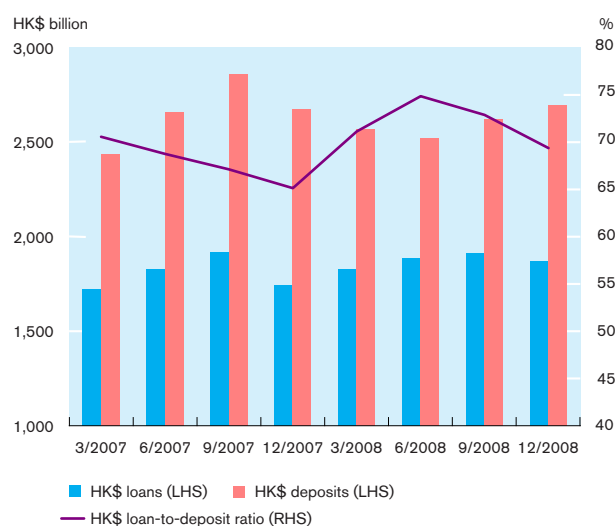


CHART 7

Retail banks' Hong Kong-dollar loans and customer deposits

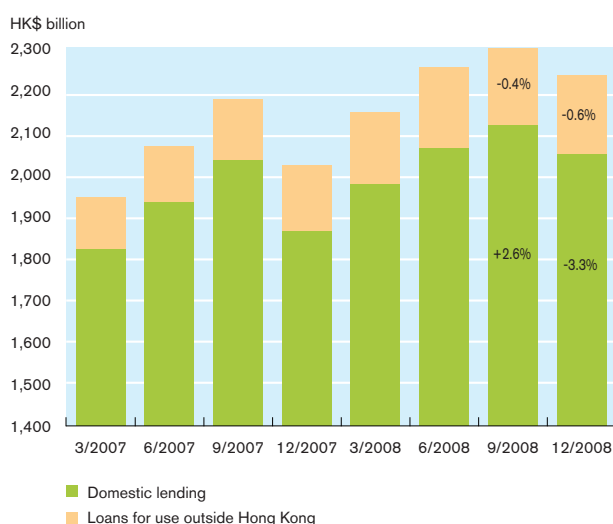


Loans and advances fell in the final quarter of 2008 amid the global economic slowdown

In the final quarter of 2008, domestic lending (loans for use in Hong Kong plus trade finance) declined by 3.3% after growing 2.6% in the previous quarter. Loans for use outside Hong Kong fell by 0.6% in the final quarter of 2008 after falling 0.4% in the previous quarter (Chart 8).

CHART 8

Loans and advances of retail banks



Notes:

- "Domestic lending" is defined as loans for use in Hong Kong plus trade finance.
- "Loans for use outside Hong Kong" include "others" (i.e. unallocated).
- Percentage denotes quarterly growth rate.

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

Wholesale and retail trade	- 2.2%
Manufacturing	- 6.8%
Property lending	- 0.7%
Trade finance	- 14.8%

Trade-finance lending fell significantly by 14.8% in the final quarter following a decline of 2.5% in the previous quarter. This was apparently due to reduced trade activities.

Retail banks' total non-bank China exposures¹ fell to HK\$644 billion (8.4% of total assets) at the end of December 2008 from HK\$696 billion (9.3% of total assets) at the end of September 2008. For the banking sector as a whole, non-bank China exposures decreased to HK\$858 billion (7.1% of total assets) from HK\$949 billion at the end of September 2008 (7.9% of total assets).

The Credit Outlook Survey indicated that AIs have become more pessimistic

AIs remained generally bearish about the credit outlook. According to the HKMA Survey on Credit Outlook in December 2008, 77% of the surveyed AIs expected domestic loan demand to decline in the coming three months (Table 2). The decline in loan demand was expected to be more serious in the

TABLE 2

Expectation of domestic loan demand in the next three months

	Mar 2008	Jun 2008	Sep 2008	Dec 2008
	(% of total respondents)			
Increase considerably	0	0	5	0
Increase somewhat	57	43	5	10
Remain stable	38	48	19	14
Decrease somewhat	5	10	62	67
Decrease considerably	0	0	10	10

Note: Figures may not add up to total due to rounding.

¹ Including exposures booked in the retail banks' banking subsidiaries in Mainland China.

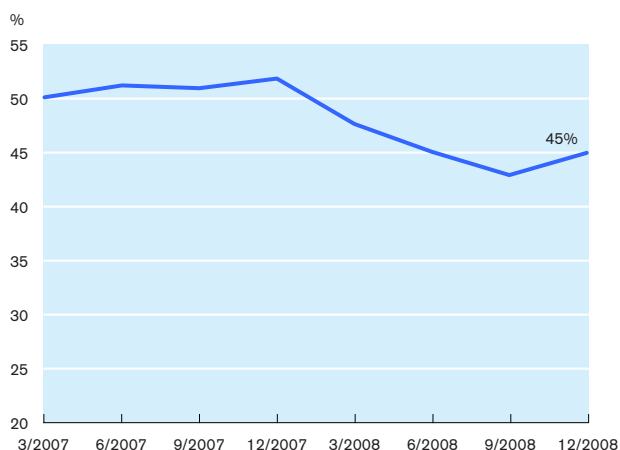
manufacturing, import and export and property sectors. All respondents expected that the quality of their loan portfolios, particularly commercial lending, will deteriorate in the short term.

Average liquidity ratio remained at a comfortable level

The quarterly average liquidity ratio of retail banks stood at 45% in the final quarter of 2008, well above the statutory minimum of 25% (Chart 9).

CHART 9

Retail banks' liquidity ratio (quarterly average)



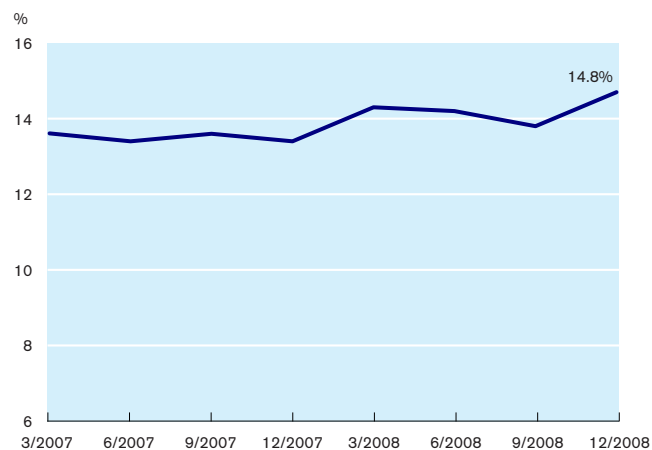
Als were well capitalised

Despite increased provisions for securities investments and bad and doubtful debts, the capital positions of locally incorporated Als remained sound. The consolidated capital adequacy ratio (CAR) of locally incorporated Als stood at 14.8% at the end of December 2008, compared with 13.8% at the end of September 2008 (Chart 10).

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

CHART 10

Capital adequacy ratio of locally incorporated Als



APPENDIX

KEY PERFORMANCE INDICATORS OF THE BANKING SECTOR¹ (%)

	Dec 2007	Sep 2008	Dec 2008
Interest rate			
1-month HIBOR ² (quarterly average)	4.04	2.14	1.89
3-month HIBOR (quarterly average)	4.17	2.42	2.50
BLR ³ and 1-month HIBOR spread (quarterly average)	3.11	3.11	3.22
BLR and 3-month HIBOR spread (quarterly average)	2.98	2.83	2.61
Composite interest rate ⁴	2.29	1.18	0.68
Retail banks			
Balance sheet developments⁵			
Total deposits	-1.0	4.6	2.7
Hong Kong dollar	-6.4	4.2	2.8
Foreign currency	8.6	5.2	2.6
Total loans	-7.2	2.3	-3.1
Domestic lending ⁶	-8.2	2.6	-3.3
Loans for use outside Hong Kong ⁷	7.7	-0.4 ^r	-0.6
Negotiable instruments			
Negotiable certificates of deposit (NCD) issued	-10.7	-0.9	-17.9
Negotiable debt instruments held (excluding NCD)	2.2 ^r	-2.8	43.5
Asset quality⁸			
As percentage of total loans			
Pass loans	97.59	97.61	96.57
Special mention loans	1.57	1.43	2.19
Classified loans ⁹ (gross)	0.85	0.96	1.24
Classified loans (net) ¹⁰	0.65	0.70	0.84
Overdue > 3 months and rescheduled loans	0.57	0.55	0.68
Profitability¹¹			
Bad debt charge as percentage of average total assets	0.04	0.09 ^r	0.18
Net interest margin	1.90	1.86 ^r	1.84
Cost-to-income ratio	40.5 ^r	43.7 ^r	45.1
Liquidity ratio (quarterly average)	51.9	42.9 ^r	45.0
Surveyed institutions			
Asset quality			
Delinquency ratio of residential mortgage loans	0.11	0.05	0.05
Credit card receivables			
Delinquency ratio	0.35	0.31	0.34
Charge-off ratio — quarterly annualised	2.73	2.74	3.09
— year-to-date annualised	2.90	2.67	2.72
All locally incorporated AIs			
Capital adequacy ratio (consolidated)	13.4	13.8	14.8

Notes:

¹ Figures related to Hong Kong office(s) only except where otherwise stated.

² With reference to the Hong Kong-dollar 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 finance.

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.