Developments in the banking sector

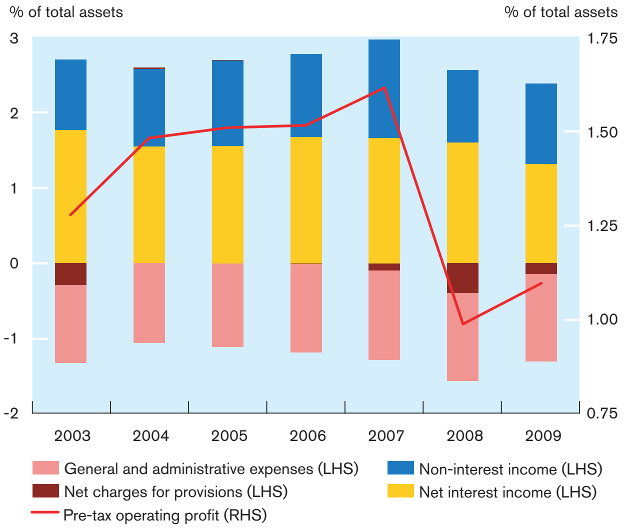
by the Research Department

The profitability of retail banks improved because of higher non-interest income and lower provisions, despite narrowed net interest margins exerting downward pressure on net interest income. Capitalisation strengthened further and asset quality remained sound. Despite the expiry of various temporary liquidity assistance measures provided by the HKMA at the end of March 2009, liquidity conditions remained structurally robust in the assessment period. Amid a slow recovery in demand for loans, limited investment opportunities, and with abnormally low funding costs due to strong capital inflows, price competition has intensified, particularly in the mortgage market. Against this background, banks should closely monitor the interest-rate risk arising from a possible reversal of capital flows and maintain prudent credit underwriting standards.

Profitability improved despite net interest income being under pressure

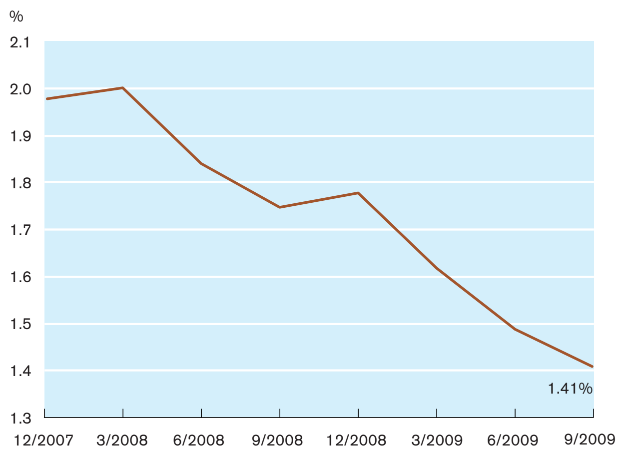
The profitability of retail banks, measured by the aggregate pre-tax operating profit as a percentage of total assets, improved in the assessment period[1] mainly due to rises in non-interest income[2] and lower net charges for provisions[3] (Chart 1). However, retail banks' net interest income remained under pressure as the net interest margin (NIM) continued to narrow and reached a record low in 2009 Q3 (Chart 2).

CHART 1
Profitability of retail banks



Note: Figures for 2009 are annualised figures up to the third quarter.
Source: HKMA.

CHART 2
Net interest margin of retail banks (quarterly annualised)



Source: HKMA.

1 Unless otherwise stated, the assessment period refers to the six-month period from the end of March 2009 to the end of September 2009.

2 Partly attributable to gains from investment holdings, and trading in foreign exchange operations and derivatives.

3 In particular, there was a modest net write-back of provisions in 2009 Q3.

Various factors contributed to the reduction in the NIM. First, banks in Hong Kong sought to utilise their surplus funding by increasing their holding of debt securities issued by governments, which in general offer low yields due to aggressive monetary easing by central banks.

At the same time, ample interbank liquidity due to strong capital inflows led the interest margin of HIBOR-based lending to narrow. Reflecting this, the three-month HIBOR decreased by 58 basis points from the end of April 2009 to the end of October 2009, while the composite interest rate, which reflects the average cost of funds of retail banks, fell by 14 basis points (Chart 3), narrowing the interest margin by 44 basis points.[4]

CHART 3

Interest rates

Note: End of period figures.

Source: HKMA.

Finally, notwithstanding the widened gap between the best lending rate (BLR) and the composite interest rate over the assessment period, the intensifying price competition in recent months, particularly in the mortgage markets, may reduce the effective interest margin of BLR-priced lending significantly. Some mortgage loans in recent months were offered with a mortgage interest rate as low as the BLR minus 3.25% for the entire term of the mortgage, translating in effective mortgage rates to around 2.00%. Such thin interest margins raise concerns that intense market competition might have driven some banks to price their mortgages too aggressively without due regard to the attendant interest-rate risk and credit risk.[5]

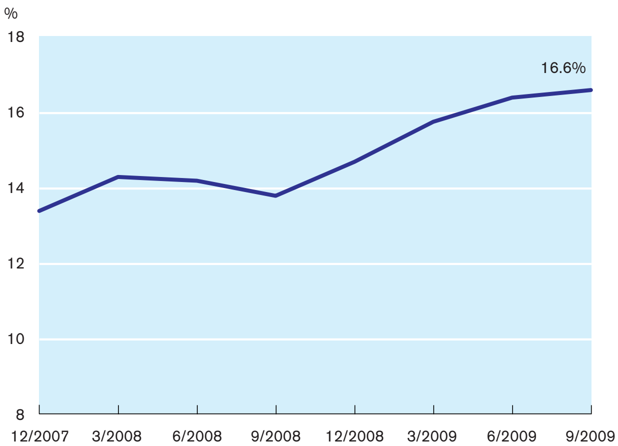
On the whole, although abundant liquidity in the banking sector lowered the funding costs of banks, it also exerted significant downward pressure on banks' net interest income amid limited lending and investment opportunities.

Capitalisation of local AIs improved

Improved profitability, lower provisions and the fundraising activities of some AIs underpinned an improvement in the capitalisation of the banking sector. As a result, the aggregate consolidated capital adequacy ratio of locally incorporated AIs increased further to 16.6% at the end of September 2009, from 15.8% at the end of March 2009 (Chart 4). This level remained well above the minimum international standard of 8%.

CHART 4

Capital adequacy ratio of locally incorporated AIs



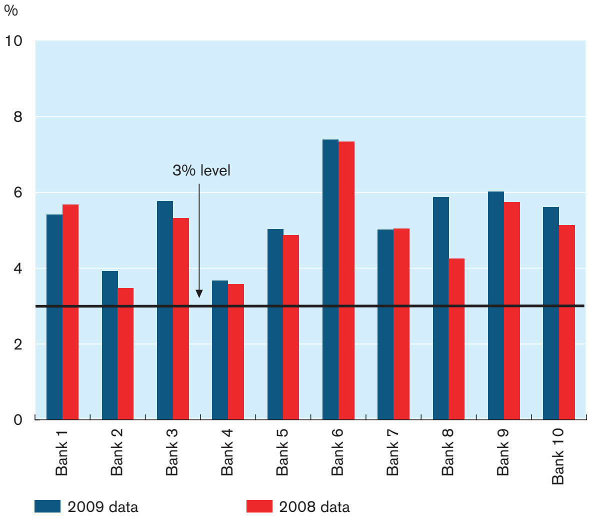
Source: HKMA.

[4] As more mortgages were underwritten using HIBOR-based pricing in the assessment period, banks' NIMs became more sensitive to the movements of HIBORs. According to the Residential Mortgage Survey for September 2009 by the HKMA, the proportion of new mortgage loans priced with reference to rates other than the best lending rate (mostly HIBOR) was 54.5%.

[5] As a precautionary measure, the HKMA issued circulars to AIs on 17 September 2009 and 30 October 2009 to draw their attention to the reputation, interest rate and liquidity risks which might arise due to aggressive pricing in the residential mortgage market, and to remind them of the best lending practices for residential mortgage loans. A further circular was issued to AIs on 23 October 2009 to provide guidance on loan-to-value (LTV) ratios for residential mortgages on properties valued at $20 million or more. For residential properties valued at $20 million or more, the LTV ratio will be capped at 60%.

Another important indicator, the ratio of the tier-one capital to total adjusted assets, showed that major listed banks in Hong Kong strengthened their capitalisation generally in the first half of 2009. The average ratio of the banks was well above 3% (Chart 5).[6] More importantly, the increases in the capitalisation, mainly reflected stronger growth in capital than assets, suggesting that banks in Hong Kong did not face significant constraints in accessing fresh capital after the outbreak of the global financial crisis.

CHART 5
The ratio of tier-one capital to total adjusted assets of listed banks in Hong Kong

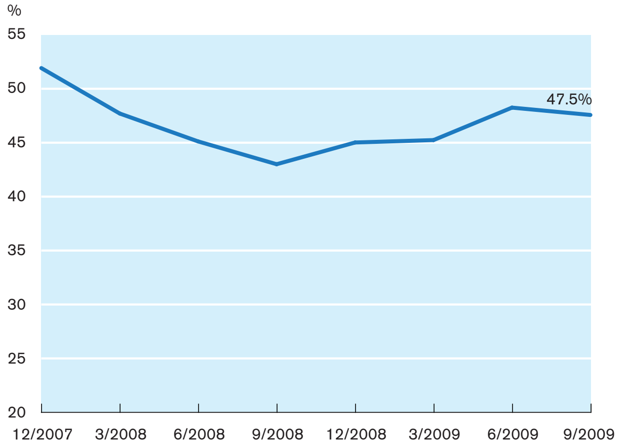


Note: Consolidated positions.
Sources: Banks' annual reports of 2008 and interim reports of 2009, and staff calculations.

Average Liquidity Ratio remained robust

Despite the expiry of some of the HKMA's temporary measures for providing liquidity assistance to licensed banks at the end of March 2009, the liquidity and funding conditions of the banking system remained robust during the assessment period. The average liquidity ratio stood at 47.5% in 2009 Q3, marginally lower than the 48.2% in 2009 Q2 (up from 45.2% in 2009 Q1) but substantially higher than the regulatory minimum of 25% (Chart 6).

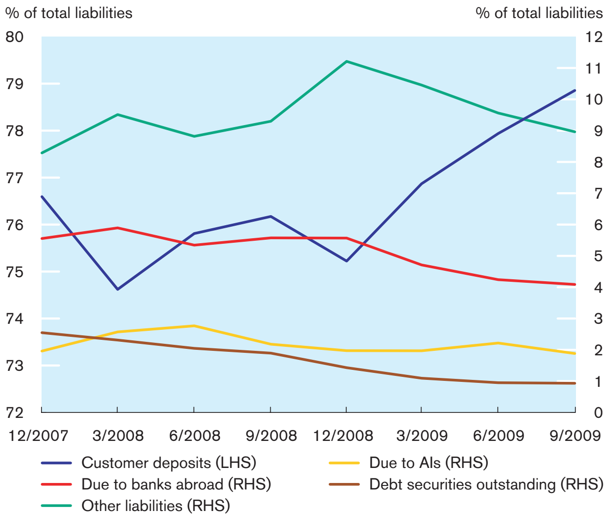
CHART 6
Liquidity ratio of retail banks (quarterly average)



Source: HKMA.

Strong capital inflows affected the funding structure of banks' liabilities significantly. During the assessment period, customer deposits expanded considerably by 6.6% from March 2009 to September 2009. This was mainly driven by strong growth in savings and demand deposits. As a result, the share of customer deposits in total liabilities increased from 77% in March 2009 to 79% in September 2009 (Chart 7). Generally speaking, this can be taken as a positive development given that customer deposits are perceived to be more stable than other funding sources. However, it should be noted that the increase in customer deposits was mostly in the form of demand and savings deposits, and an abrupt change in market dynamics could cause these deposits to be withdrawn from the banking sector quickly.

CHART 7
Liabilities structure of retail banks



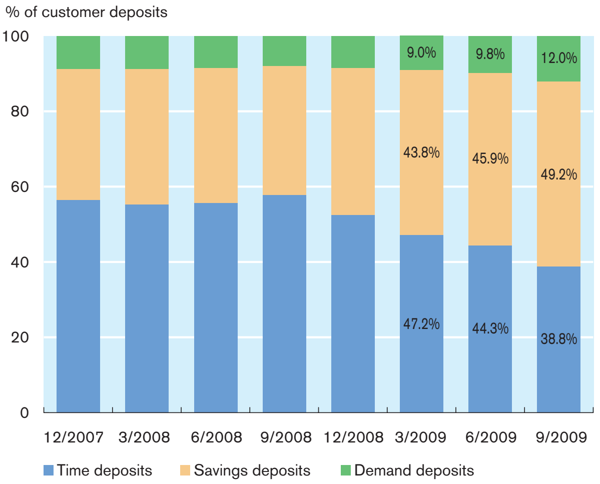
Note: Debt securities comprise negotiable certificates of deposits and all other negotiable debt instruments.
Source: HKMA.

[6] The US regulatory minimum ratio of the tier-one capital to total adjusted assets is 3%.

In the assessment period, the shift from time deposits to demand and savings deposits continued as time-deposit interest rates remained near zero. As a result, time deposits fell by 2.5% in 2009 Q2 and a further 10.2% in 2009 Q3, resulting in a sharp shrinkage of their share of total deposits to 38.8% in September 2009, from 47.2% in March 2009 (Chart 8). In parallel, the share of savings deposits rose to 49.2% from 43.8% and that of demand deposits increased to 12% from 9%, suggesting an increased maturity mismatch between assets and liabilities in some banks.

CHART 8

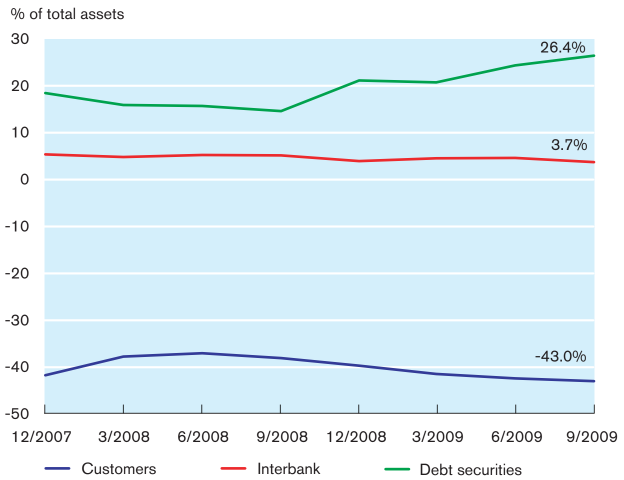
Structure of customer deposits of retail banks



Source: HKMA.

CHART 9

Funding gaps of retail banks, by type of fund



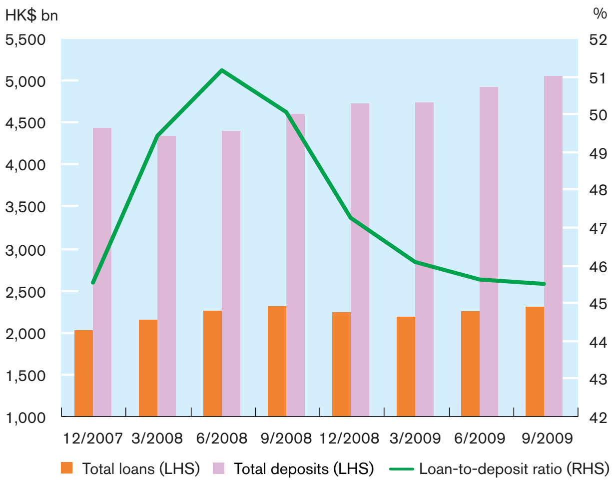
Notes:
1. Measured as assets less liabilities in the balance-sheet categories shown, as a percentage of total assets.
2. "Customers" comprises all non-AI borrowers and depositors.
3. Debt securities comprise negotiable certificates of deposits and all other negotiable debt instruments.

Source: HKMA.

Nevertheless, the ample funding from retail deposits continued to contribute to a negative "customer funding gap" in retail banks, with the amount of customer loans being smaller than that of customer deposits. The gap widened from -41.4% in March 2009 to -43.0% in September 2009 (Chart 9) due to a stronger growth in deposits than loans in the assessment period. As a result, the all-currency loan-to-deposit ratio for retail banks dropped from 46.1% in March 2009 to 45.5% in September 2009 (Chart 10) and the ratio for the banking sector edged down from 52.6% to 51.0%. Likewise, the Hong Kong-dollar loan-to-deposit ratio dropped from 67.6% to 63.7% for retail banks (Chart 11), and from 75.5% to 70.2% for the banking sector.

CHART 10

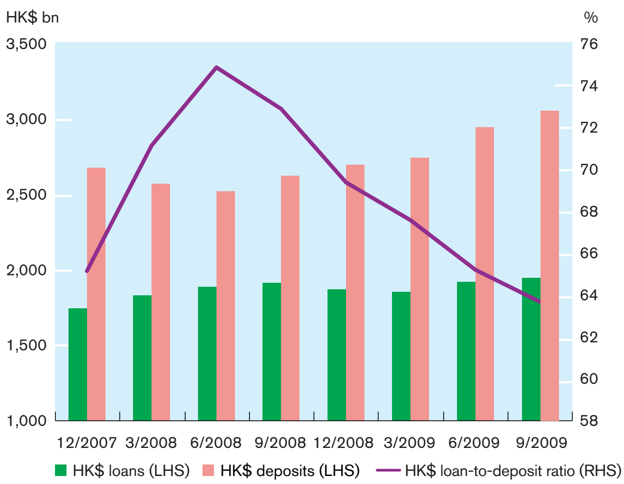
Total loans and customer deposits of retail banks



Source: HKMA.

CHART 11

Hong Kong-dollar loans and customer deposits of retail banks



Source: HKMA.

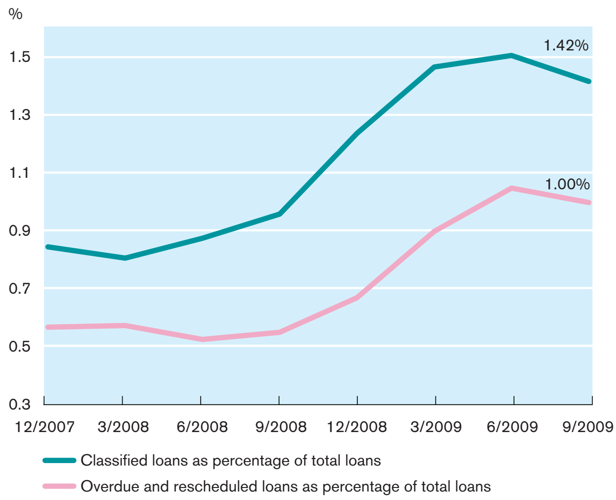
Asset quality showed modest improvement in 2009 Q3

The classified loan ratio fell to 1.42% in September 2009, after increasing to 1.51% in June 2009 from 1.47% in March 2009. Meanwhile, the ratio of overdue and rescheduled loans dropped to 1.00%, after rising to 1.05% from 0.90% (Chart 12 and Table 1).

The asset quality of banks' overall mortgage portfolios remained sound by historical standards. The delinquency and rescheduled-loan ratios of banks' overall mortgage portfolios stayed low at 0.05% and 0.11% at the end of September 2009 respectively (Chart 13). The continued rise in property prices resulted in the significant fall in the number of negative equity cases from around 3,767 at the end of June 2009 to 835 at the end of September 2009,

CHART 12

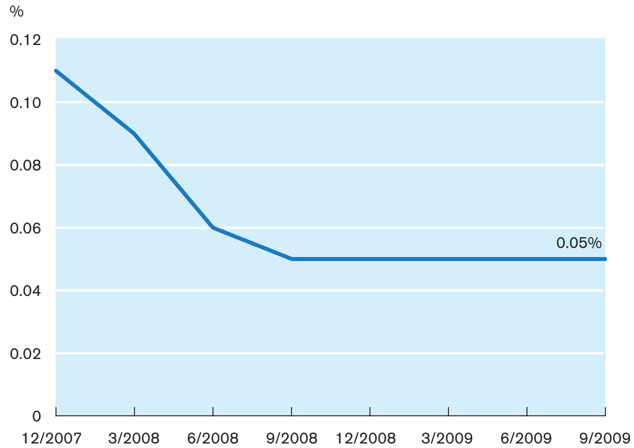
Asset quality of retail banks



Source: HKMA.

CHART 13

Delinquency ratio of residential mortgages



Source: HKMA.

TABLE 1

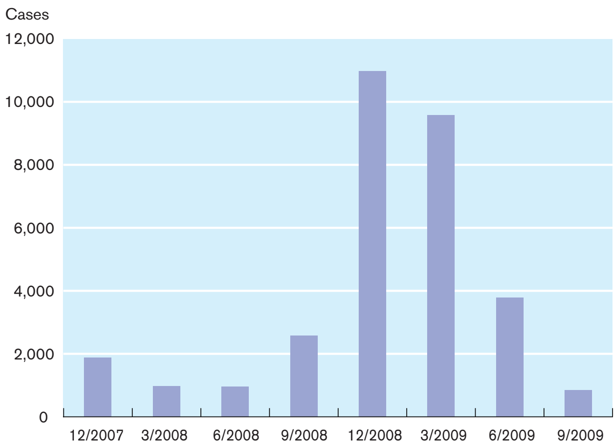
Quality of loans and advances of retail banks*

	Sep 2008	Dec 2008	Mar 2009 (% of total loans)	Jun 2009	Sep 2009
Special mention loans	**1.43**	**2.20**	**2.44**	**2.35**	**2.12**
Classified loans (gross)	**0.96**	**1.24**	**1.47**	**1.51 ****	**1.42**
of which					
Substandard	0.33	0.50	0.64	0.60	0.59
Doubtful	0.56	0.67	0.76	0.79	0.71
Loss	0.07	0.07	0.07	0.11	0.12
Classified loans (net of specific provisions)	**0.70**	**0.84**	**1.00**	**1.01**	**0.95**
Overdue > 3 months and rescheduled loans	**0.55**	**0.67**	**0.90**	**1.05**	**1.00**
of which					
Overdue > 3 months	0.40	0.48	0.69	0.75	0.71
Rescheduled loans	0.15	0.19	0.21	0.30	0.29

* Period-end figures covering the HK offices and overseas branches of the banks.
** Figures may not add up to total due to rounding.
Source: HKMA.

representing a share of less than 1% in banks' overall mortgage portfolios (Chart 14). The delinquency ratio of negative-equity mortgage loans rose to 0.82% from 0.17% at the end of June 2009. However, this mainly reflected a larger decline in the total amount of mortgages in negative equity compared with the decline in the delinquent amount.

CHART 14
Residential mortgage loans in negative equity



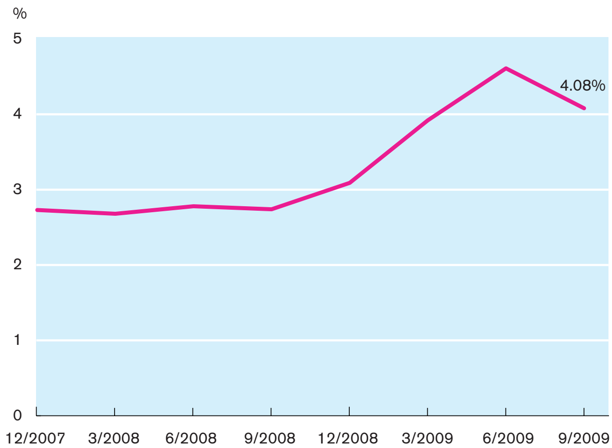
Source: HKMA.

The quarterly annualised credit card charge-off ratio declined to 4.08% in 2009 Q3, after rising to 4.61% in 2009 Q2 from 3.92% in 2009 Q1 (Chart 15).

Demand for loans picked up gradually

Partly reflecting better recovery prospects, domestic lending by AIs grew in 2009 Q2 by 1.6%, and a further 1.6% in 2009 Q3. The distribution of loans to different sectors varied (Table 2). As the property market turned more active with prices returning to pre-crisis levels, mortgage loans increased by 3.5% in 2009 Q3, after rising by 2.0% in 2009 Q2. By contrast, credit for building, construction, property

CHART 15
Charge-off ratio for credit-card lending of surveyed AIs



Note: Quarterly annualised figures.
Source: HKMA.

TABLE 2
Domestic lending by AIs

	Quarter-on-quarter % changes				Share to total (%)
	Dec 2008	Mar 2009	Jun 2009	Sep 2009	Sep 2009
Domestic lending [1]	**-3.5**	**-3.8**	**1.6**	**1.6**	
of which					
Trade financing	-16.2	-15.1	3.3	2.3	6.2
Mortgages [2]	-1.4	-0.3	2.0	3.5	25.4
Manufacturing	-5.3	-1.5	-5.8	1.9	5.1
Transport and transport equipment	-4.0	-0.8	-5.5	2.8	5.6
Electricity and gas	1.0	-9.8	19.3	-5.6	1.1
Information technology	-14.4	26.9	-18.1	2.0	1.3
Building, construction, property development and investment	1.9	-1.0	-0.5	-2.3	24.6
Wholesale and retail trade	-3.3	-5.5	1.9	3.8	5.6
Financial concerns [3]	-5.4	-14.5	-9.0	2.1	8.4
Stockbrokers	-10.4	-10.3	443.6	-17.2	1.6
Credit card advances	3.9	-8.7	-0.9	-1.0	2.4

[1] Loans for use in Hong Kong plus trade finance.
[2] Mortgage loans-include loans for the Home Ownership Scheme, the Private Sector Participation Scheme and the Tenants Purchase Scheme.
[3] Loans for financial concerns include loans to investment and insurance companies, futures brokers and finance companies.

Source: HKMA.

development and investment declined further by 2.3% in 2009 Q3, after edging down by 0.5% in 2009 Q2. As a result, the share of property-related loans in total domestic lending decreased slightly to 50.0% from 51.0% at the end of June 2009.

Owing partly to periodic loan demand for IPO-related activities, lending to stockbrokers increased notably by 443.6% in 2009 Q2, which was followed by a 17.2% decrease in 2009 Q3. Despite the strong growth in the assessment period, lending to stockbrokers represented only approximately 1.6% of total domestic lending, indicating that the banking sector's exposure to stock market activities remained at a low level. Lending to financial concerns, which mainly consists of lending to investment companies, rose by 2.1% in 2009 Q3, after decreasing by 9% in 2009 Q2.

For other sectors, lending to wholesale and retail trade, and trade financing sectors had recorded significant growth since March 2009, while lending to transport and transport equipment, information technology, and manufacturing sectors registered mild growth in 2009 Q3 following a decline in 2009 Q2. By contrast, loans to the electricity and gas sector decreased in 2009 Q3 after the expansion in 2009 Q2. Meanwhile, credit card lending declined over the assessment period.

Retail banks' aggregate exposures to non-bank Chinese entities rose to HK$741 billion (9.5% of total assets) at the end of September 2009 from HK$615 billion (8.2% of total assets) at the end of March 2009. For the banking sector as a whole, the total amount of non-bank China exposures also increased to HK$973 billion (8.1% of total assets) from HK$825 billion (7.0% of total assets) during the same period. The banking sector's aggregate exposures to companies and individuals for purchasing properties in Mainland China increased to HK$14.5 billion at the end of September 2009 from HK$14.2 billion at the end of March 2009.

More AIs indicated an optimistic outlook for loan demand

According to the HKMA Survey on Credit Condition Outlook in September 2009, the number of surveyed AIs that expected domestic loan demand to grow in the next six months had outnumbered those with the opposite view since March 2009 (Table 3).

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

TABLE 3
Expectation of domestic loan demand in the next six months

	Sep 2008	Dec 2008	Mar 2009	Jun 2009	Sep 2009
			(% of total respondents)		
Increase considerably	5	0	0	0	0
Increase somewhat	5	10	14	24	38
Remain stable	29	24	43	57	48
Decrease somewhat	57	62	43	19	14
Decrease considerably	5	5	0	0	0

Note: Figures may not add up to 100% due to rounding.
Source: HKMA Survey on Credit Condition Outlook.

APPENDIX

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

	Sep 2008	Jun 2009	Sep 2009
Interest rate			
1-month HIBOR[2] (quarterly average)	2.14	0.16	0.10
3-month HIBOR (quarterly average)	2.42	0.59	0.23
BLR[3] and 1-month HIBOR spread (quarterly average)	3.11	4.84	4.90
BLR and 3-month HIBOR spread (quarterly average)	2.83	4.41	4.77
Composite interest rate[4]	1.18	0.19	0.13
		Retail banks	
Balance sheet developments[5]			
Total deposits	4.6	3.8	2.6
Hong Kong dollar	4.2	7.5	3.8
Foreign currency	5.2	-1.1	0.9
Total loans	2.3	2.8	2.4
Domestic lending[6]	2.6	3.4[r]	2.1
Loans for use outside Hong Kong[7]	-0.4	-3.8[r]	4.9
Negotiable instruments			
Negotiable certificates of deposit (NCD) issued	-0.9	-14.4	1.9
Negotiable debt instruments held (excluding NCD)	-2.8	19.3	9.7
Asset quality[8]			
As percentage of total loans			
Pass loans	97.61	96.14	96.47
Special mention loans	1.43	2.35	2.12
Classified loans[9] (gross)	0.96	1.51	1.42
Classified loans (net)[10]	0.70	1.01[r]	0.95
Overdue > 3 months and rescheduled loans	0.55	1.05	1.00
Profitability			
Bad debt charge as percentage of average total assets[11]	0.09	0.16	0.12
Net interest margin[11]	1.86	1.55	1.50
Cost-to-income ratio[12]	43.7	45.8	49.1
Liquidity ratio (quarterly average)	42.9	48.2	47.5
		Surveyed institutions	
Asset quality			
Delinquency ratio of residential mortgage loans	0.05	0.05	0.05
Credit-card lending			
Delinquency ratio	0.31	0.50	0.46
Charge-off ratio — quarterly annualised	2.74	4.61	4.08
— year-to-date annualised	2.67	4.17	4.08
		All locally incorporated AIs	
Capital adequacy ratio (consolidated)	13.8	16.4[r]	16.6

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.
12 Year-to-date figures.

r Revised figure.