

Developments in the banking sector

by the Banking Policy Department

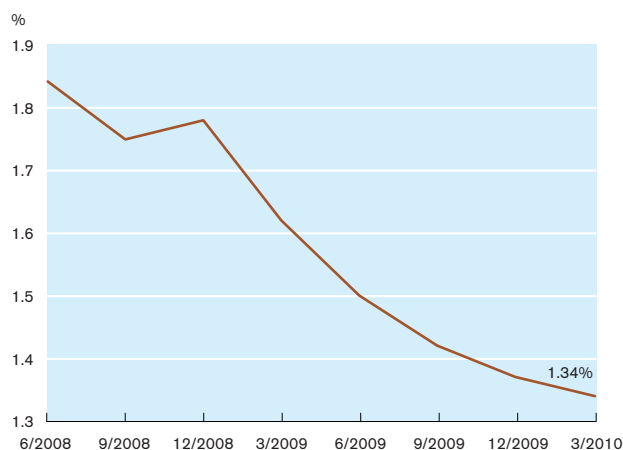
As global economic momentum gathered pace, the aggregate pre-tax operating profit of retail banks' Hong Kong offices for the first quarter of 2010 rose by 13.5% compared with the same quarter last year. Although solid loan growth was seen across major economic sectors, a prolonged low-interest-rate environment coupled with aggressive pricing competition remained a drag on net interest income. The asset quality of retail banks continued to improve during the quarter and the consolidated capital adequacy ratio of locally incorporated authorized institutions (AIs) strengthened to 17.0% at the end of March 2010 from 16.8% at the end of December 2009.

HIGHLIGHTS OF KEY TRENDS

Profitability recovered

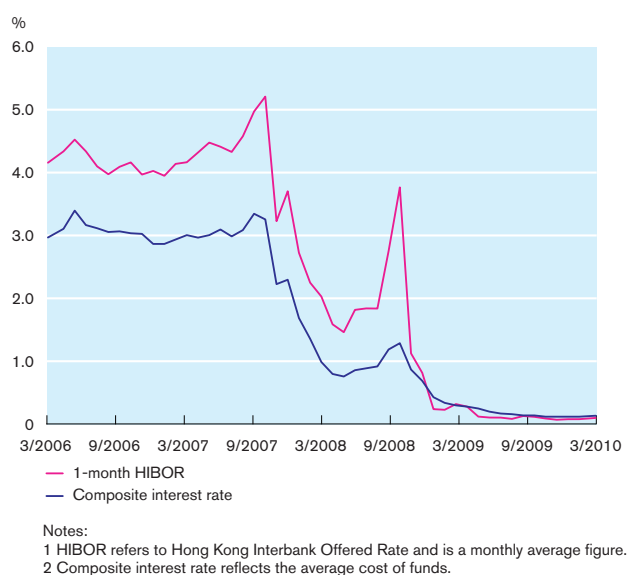
The aggregate pre-tax operating profit of retail banks' Hong Kong offices in the first quarter of 2010 was 13.5% higher than a year ago. This was attributable to the improvement in fees and commission income, and the lowering of provisioning levels following global recovery, which more than offset the decline in net interest income.

CHART 1
Net interest margin of retail banks
(quarterly annualised)



The quarterly annualised net interest margin (NIM) of retail banks narrowed further to 1.34% in the first quarter from 1.37% in the previous quarter (Chart 1). Although loan activities increased during the quarter, the low-interest-rate environment along with intensifying pricing competition as reflected by the increased popularity of HIBOR mortgage loans further weighed on NIM (Chart 2).

CHART 2
HIBOR and composite interest rate



Retail banks' fees and commission income surged by 34.5% in the first quarter compared with the same quarter of 2009. Improved market sentiment induced an increase in the volumes of stock broking and loan underwriting, and also the demand for wealth management and insurance products, thereby boosting fees and commission income. Nevertheless, this income in Q1 was little changed from the previous quarter.

The cost-to-income ratio of retail banks increased to 48.3% in the first quarter from 45.3% in the same quarter last year. The increase was driven by higher staff and other expenses, such as marketing and IT expenses.

With the economic conditions improving, retail banks' net charge for debt provisions fell to HK\$0.6 billion in the first quarter from HK\$2.8 billion in the same quarter last year. As the financial markets were relatively less volatile during the quarter, impairment allowances for securities holdings were nearly zero in 2010 Q1 compared with HK\$1.2 billion in 2009 Q1. Some banks even recorded a write-back in impairment allowances.

Asset quality improved further in the first quarter of 2010

The aggregate value of classified loans fell further by 6% in the first quarter, following a 5% decrease in the previous quarter. The classified loan ratio decreased for the third consecutive quarter to 1.20% at the end of March (Table 1 and Chart 3). The ratio of overdue and rescheduled loans also declined to 0.78% at the end of March from 0.88% at the end of December 2009.

CHART 3

Asset quality of retail banks

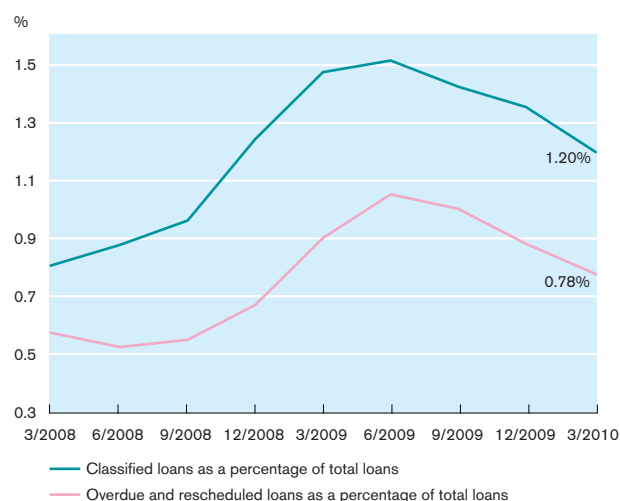


TABLE 1

Quality of loans and advances of retail banks*

	Mar 2009	Jun 2009	Sep 2009 (% of total loans)	Dec 2009	Mar 2010
Special mention loans	2.44	2.35	2.12	1.91	1.72
Classified loans (gross)	1.47	1.51	1.42	1.35	1.20
of which					
Substandard	0.64	0.60	0.59	0.59	0.51
Doubtful	0.76	0.79	0.71	0.64	0.59
Loss	0.07	0.11	0.12	0.11	0.10
Classified loans (net of specific provisions)	1.00	1.01	0.94	0.90	0.78
Overdue > 3 months and rescheduled loans	0.90	1.05	1.00	0.88	0.78
of which					
Overdue > 3 months	0.69	0.75	0.71	0.59	0.51
Rescheduled loans	0.21	0.30	0.29	0.29	0.27

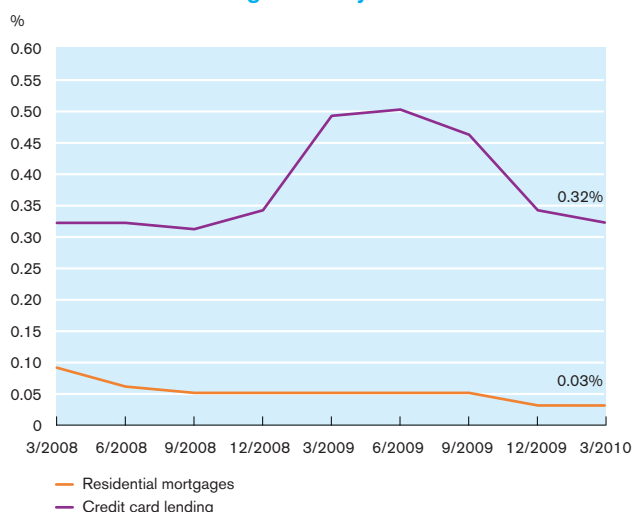
* Period-end figures covering Hong Kong offices and overseas branches of the banks.

Note: Figures may not add up to total because of rounding.

The HKMA's quarterly Credit Card Lending Survey shows that the quality of the surveyed institutions' credit card portfolios improved in tandem with the local economy. Credit card lending overdue for more than 90 days decreased to HK\$232 million at the end of March from HK\$255 million at the end of December 2009, pushing the delinquency ratio down to 0.32% from 0.34% (Chart 4). The quarterly annualised charge-off ratio also fell to 2.39% in 2010 Q1 from 3.10% in 2009 Q4.

CHART 4

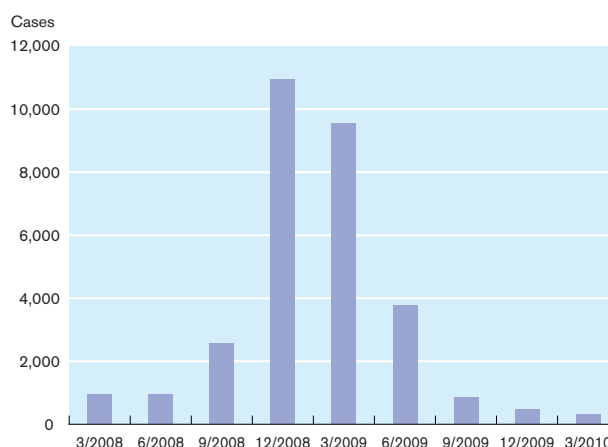
Delinquency ratios of residential mortgages and credit card lending of surveyed institutions



The credit quality of retail banks' residential mortgage lending remained sound. The mortgage delinquency ratio and rescheduled loan ratio edged down to record low levels of 0.03% and 0.07% respectively at the end of March (Chart 4). The outstanding number of residential mortgage loans in negative equity fell to 303 at the end of March from 466 at the end of December 2009 (Chart 5).

CHART 5

Residential mortgage loans in negative equity

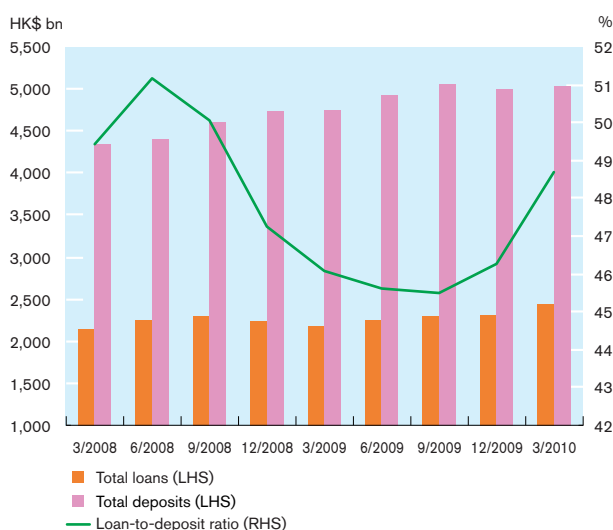


Loan-to-deposit ratio rose

Retail banks' total loans and advances expanded by 5.8% in the first quarter following a 0.6% increase in the previous quarter. On the other hand, retail banks' customer deposits edged up by 0.5% during the quarter after a 1.0% decrease in 2009 Q4. Thus, the overall loan-to-deposit ratio of retail banks rose to 48.7% at the end of March from 46.3% at the end of December 2009 (Chart 6). Hong Kong-dollar loans and advances grew by 3.7% while Hong Kong-dollar

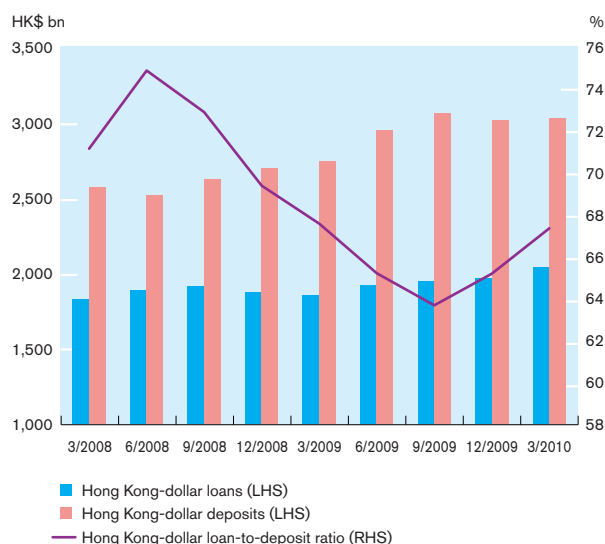
CHART 6

Totals loans and customer deposits of retail banks



deposits rose by 0.4%. Accordingly, the Hong Kong-dollar loan-to-deposit ratio increased to 67.3% at the end of March from 65.2% at the end of December 2009 (Chart 7).

CHART 7
Hong Kong-dollar loans and customer deposits of retail banks



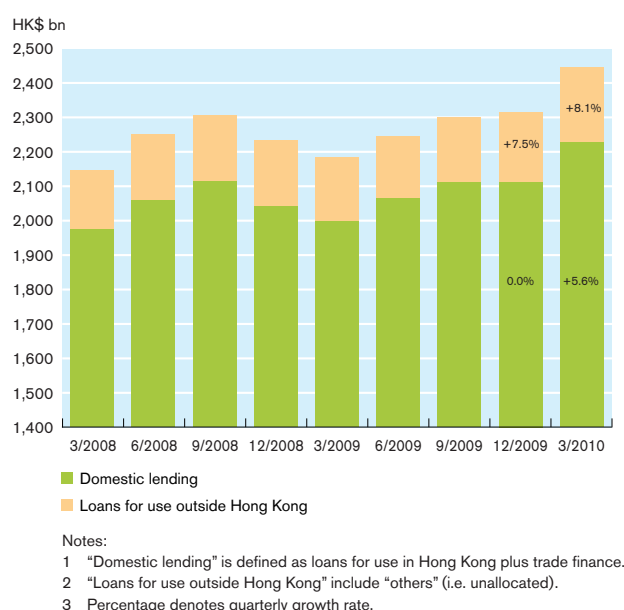
Domestic lending and loans for use outside Hong Kong rose

Domestic lending (loans for use in Hong Kong plus trade finance) rose by 5.6% in the first quarter after remaining stable in the final quarter of 2009 (Chart 8). Loan growth was observed across the board, with property lending being the largest contributor. Loans for use outside Hong Kong grew further by 8.1% during the quarter after a 7.5% increase in 2009 Q4.

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

Wholesale and retail trade	+13.3%
Manufacturing	+9.3%
Trade finance	+12.4%
Property lending	+4.8%

CHART 8
Loans and advances of retail banks



Retail banks' total non-bank China exposures¹ rose to HK\$835.1 billion (10.7% of total assets) at the end of March from HK\$764.1 billion (9.8% of total assets) at the end of December 2009. For the banking sector as a whole, non-bank China exposures increased to HK\$1,111.8 billion (9.1% of total assets) from HK\$1,005.7 billion (8.3% of total assets) in the same period.

Als were more optimistic about loan demand

According to the HKMA's Opinion Survey on Credit Condition Outlook in March 2010, more surveyed Als were optimistic about the domestic loan demand in the coming six months when compared with December 2009. The net proportion of respondents expecting loan demand to increase (i.e. percentage of respondents expecting loan demand to increase minus the percentage expecting loan demand to decline) widened to 67% from 47% in

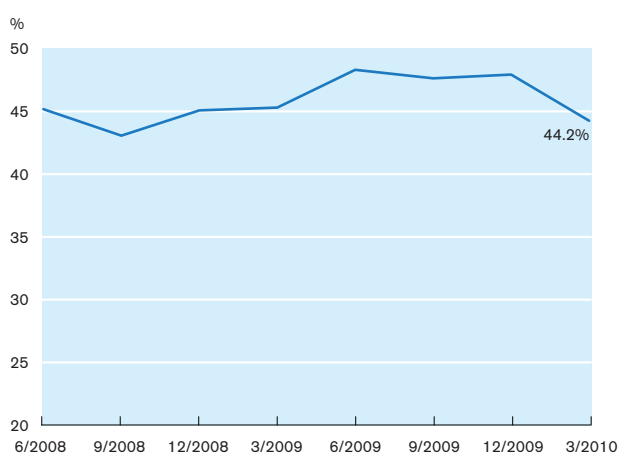
¹ Including exposures booked in the retail banks' banking subsidiaries in Mainland China.

December 2009 (Table 2). The majority of surveyed AIs were optimistic about loan demand from non-bank Mainland entities and manufacturing along with building and construction, property development and investment in the next six months.

Average liquidity ratio remained at a comfortable level

The quarterly average liquidity ratio of retail banks decreased to 44.2% in 2010 Q1 from 47.8% in the previous quarter due to a fall in net interbank claims, but the ratio remained well above the statutory minimum of 25% (Chart 9).

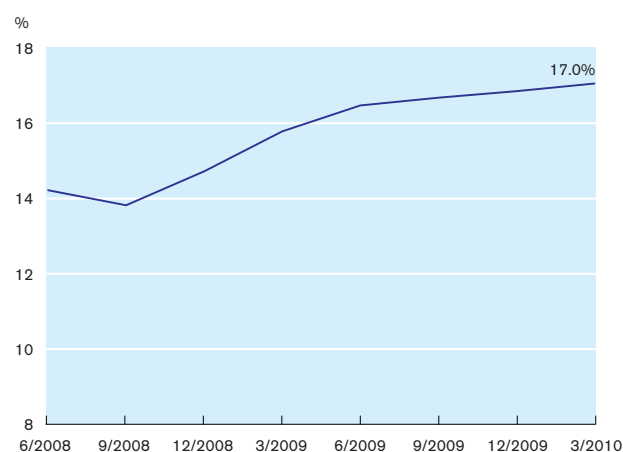
CHART 9
Liquidity ratio of retail banks (quarterly average)



Local AIs were generally well capitalised

The capital positions of locally incorporated AIs continued to strengthen. The consolidated capital adequacy ratio of locally incorporated AIs increased to 17.0% at the end of March from 16.8% at the end of December 2009 (Chart 10). The rise was attributable to capital issuance and increased reserves (the numerator) despite an increase in risk-weighted assets (the denominator).

CHART 10
Capital adequacy ratio of locally incorporated AIs



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

TABLE 2
Expectation of domestic loan demand in the next six months

	Mar 2009	Jun 2009	Sep 2009	Dec 2009	Mar 2010
	(% of total respondents)				
Increase considerably	0	0	0	0	0
Increase somewhat	14	24	38	52	67
Remain stable	43	57	48	43	33
Decrease somewhat	43	19	14	5	0
Decrease considerably	0	0	0	0	0

APPENDIX

KEY PERFORMANCE INDICATORS OF THE BANKING SECTOR¹ (%)

	Mar 2009	Dec 2009	Mar 2010
Interest rate			
1-month HIBOR ² (quarterly average)	0.25	0.08	0.07
3-month HIBOR (quarterly average)	0.87	0.15	0.13
BLR ³ and 1-month HIBOR spread (quarterly average)	4.75	4.92	4.93
BLR and 3-month HIBOR spread (quarterly average)	4.13	4.85	4.87
Composite interest rate ⁴	0.29	0.11	0.12
Retail banks			
Balance sheet developments⁵			
Total deposits	0.3	-1.0	0.5
Hong Kong dollar	1.7	-1.4	0.4
Foreign currency	-1.6	-0.4	0.8
Total loans	-2.2	0.6	5.8
Domestic lending ⁶	-2.2	0.0	5.6
Loans for use outside Hong Kong ⁷	-2.7	7.5	8.1
Negotiable instruments			
Negotiable certificates of deposit (NCD) issued	-22.5	0.8	17.3
Negotiable debt instruments held (excluding NCD)	-5.0	5.7	2.4
Asset quality⁸			
As a percentage of total loans			
Pass loans	96.09	96.74	97.08
Special mention loans	2.44	1.91	1.72
Classified loans ⁹ (gross)	1.47	1.35	1.20
Classified loans (net) ¹⁰	1.00	0.90	0.78
Overdue > 3 months and rescheduled loans	0.90	0.88	0.78
Profitability			
Bad debt charge as percentage of average total assets ¹¹	0.18	0.11 ^r	0.04
Net interest margin ¹¹	1.62	1.48	1.34
Cost-to-income ratio ¹²	45.3	49.7 ^r	48.3
Liquidity ratio (quarterly average)	45.2	47.8	44.2
Surveyed institutions			
Asset quality			
Delinquency ratio of residential mortgage loans	0.05	0.03	0.03
Credit-card lending			
Delinquency ratio	0.49	0.34	0.32
Charge-off ratio — quarterly annualised	3.92	3.10	2.39
— year-to-date annualised	3.92	3.71	2.39
All locally incorporated AIs			
Capital adequacy ratio (consolidated)	15.8	16.8 ^r	17.0

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.