

# Developments in the banking sector

by the Banking Policy Department

The aggregate pre-tax operating profit of retail banks rose by 10.5% in the first three quarters of 2010 compared with the same period last year. The net interest margin (NIM) narrowed further to 1.32% in the third quarter. In general, retail banks reported sharp loan growth during the third quarter and asset quality indicators continued to improve. The consolidated capital adequacy ratio of locally incorporated authorized institutions (AIs) remained stable at 16.1% at the end of September.

## HIGHLIGHTS OF KEY TRENDS

### Improved profitability

The aggregate pre-tax operating profit of retail banks' Hong Kong offices in the first three quarters of 2010 increased by 10.5% compared with the same period a year ago, as much lower credit provisions and improved income from fees and commissions lifted profitability.

The quarterly annualised NIM of retail banks narrowed further to 1.32% in the third quarter of 2010 from 1.35% in Q2, as the increase in net interest income (i.e. the numerator) was outpaced by that of interest bearing assets in Q3 (Chart 1). Loans, particularly in share-finance<sup>1</sup>, property, and wholesale and retail trade, accounted for much of the sharp increase in retail banks' loan portfolios. The slight decline in Hong Kong dollar interest rates in Q3 somewhat reduced interest income from assets priced with reference to HIBOR (Chart 2).

CHART 1

Net interest margin of retail banks  
(quarterly annualised)

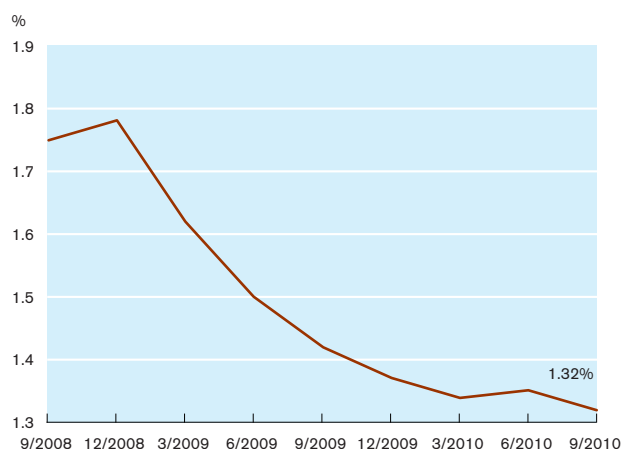
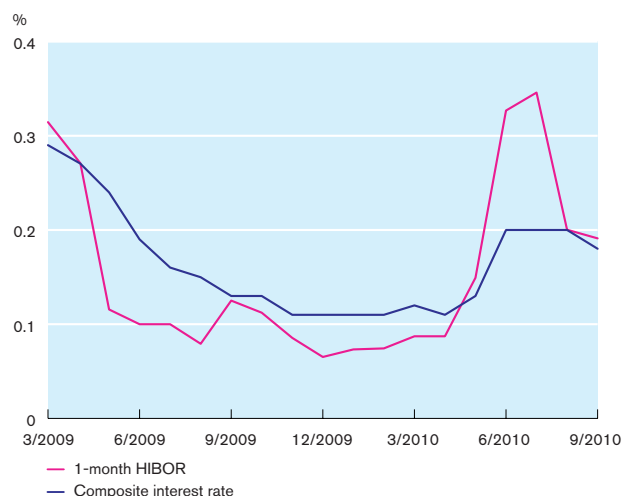


CHART 2

Interest rates



Notes:

1 HIBOR refers to Hong Kong Interbank Offered Rate and is a monthly average figure.  
2 Composite interest rate reflects the average cost of funds.

<sup>1</sup> Share-finance lending includes loans to stockbrokers and loans to non-stock companies and individuals to purchase shares.

Retail banks' income from fees and commissions surged by 11.9% in the first three quarters of 2010 compared with the same period a year ago.

The cost-to-income ratio of retail banks rose slightly to 49.7% in the first three quarters of 2010, compared with 49.0% in the same period of 2009. The rise was mainly driven by increases in staff and rental expenses.

Retail banks' net charge for debt provisions contracted sharply to HK\$1.4 billion in the first three quarters of 2010 from HK\$5.8 billion in the same period last year. Retail banks even reported a small write-back on the net charge for other provisions. This compared with a net charge of HK\$1.0 billion in the first three quarters of 2009, which mainly reflected impairment allowances for debt securities held by retail banks.

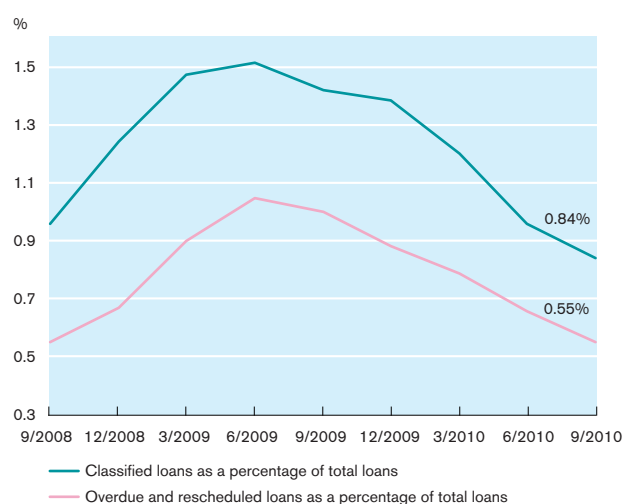
## Improved asset quality

The aggregate value of classified loans fell further by 3.6% in 2010 Q3, following a decrease of 15% in the second quarter. Together with a sharp increase in loans, the classified loan ratio decreased for a fifth consecutive quarter to 0.84% at the end of

September from 0.96% in the previous quarter (Table 1 and Chart 3). The ratio of overdue and rescheduled loans also declined to 0.55% at the end of September from 0.66% in the previous quarter.

The HKMA's quarterly Credit Card Lending Survey showed that the quality of surveyed institutions' credit card portfolios continued to improve. Credit card lending overdue for more than 90 days decreased to HK\$171 million at the end of September 2010 from HK\$189 million at the end of June 2010, driving the

**CHART 3**  
Asset quality of retail banks



**TABLE 1**

Quality of loans and advances of retail banks\*

	Sep 2009	Dec 2009	Mar 2010 (% of total loans)	Jun 2010	Sep 2010
<b>Special mention loans</b>	<b>2.12</b>	<b>1.88</b>	<b>1.72</b>	<b>1.53</b>	<b>1.43</b>
<b>Classified loans (gross)</b>	<b>1.42</b>	<b>1.38</b>	<b>1.20</b>	<b>0.96</b>	<b>0.84</b>
<i>of which</i>					
<i>Substandard</i>	0.59	0.62	0.50	0.39	0.30
<i>Doubtful</i>	0.71	0.64	0.60	0.47	0.47
<i>Loss</i>	0.12	0.11	0.10	0.09	0.08
<b>Classified loans (net of specific provisions)</b>	<b>0.94</b>	<b>0.92</b>	<b>0.78</b>	<b>0.60</b>	<b>0.50</b>
<b>Overdue &gt; 3 months and rescheduled loans</b>	<b>1.00</b>	<b>0.88</b>	<b>0.79</b>	<b>0.66</b>	<b>0.55</b>
<i>of which</i>					
<i>Overdue &gt; 3 months</i>	0.71	0.59	0.51	0.44	0.40
<i>Rescheduled loans</i>	0.29	0.29	0.28	0.22	0.16

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

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

delinquency ratio lower to 0.22% from June's 0.25% (Chart 4). The quarterly annualised charge-off ratio also fell to 1.92% from 2.31% in 2010 Q2.

The credit quality of retail banks' residential mortgage lending remained sound with the delinquency ratio edging down further to 0.02% at the end of September (Chart 4). The outstanding number of residential mortgage loans in negative equity fell to 152 at the end of September from 310 at the end of June (Chart 5).

CHART 4

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

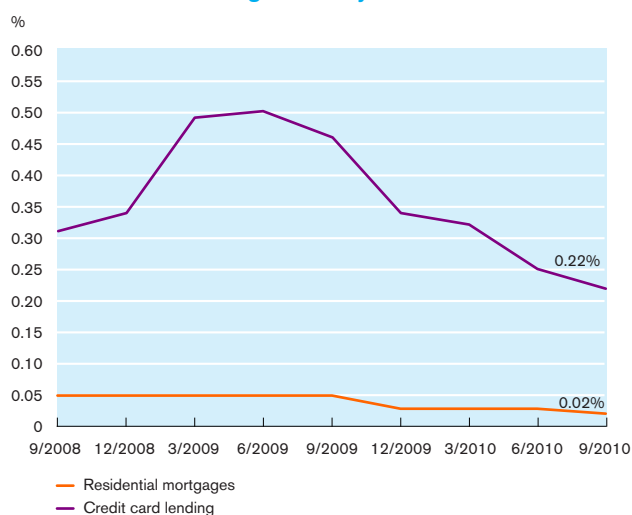
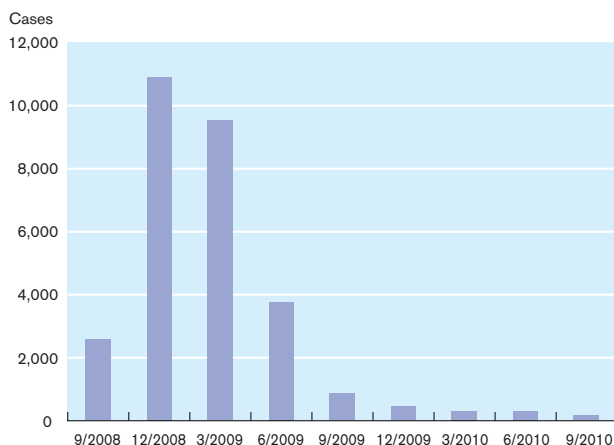


CHART 5

#### Residential mortgage loans in negative equity



## Higher loan-to-deposit ratios

Retail banks' total loans and advances expanded by 10.7% in 2010 Q3 while customer deposits grew by 7.0%. As a result, the overall loan-to-deposit ratio of retail banks extended its upward trend, reaching 53.2% at the end of September, compared with 51.4% at the end of June (Chart 6). Hong Kong-dollar loans and deposits also grew at a similar pace of 9.3% and 9.6% respectively. This resulted in the Hong Kong-dollar loan-to-deposit ratio remaining relatively stable at 70.2% compared with 70.4% at the end of June 2010 (Chart 7).

CHART 6

#### Total loans and customer deposits of retail banks

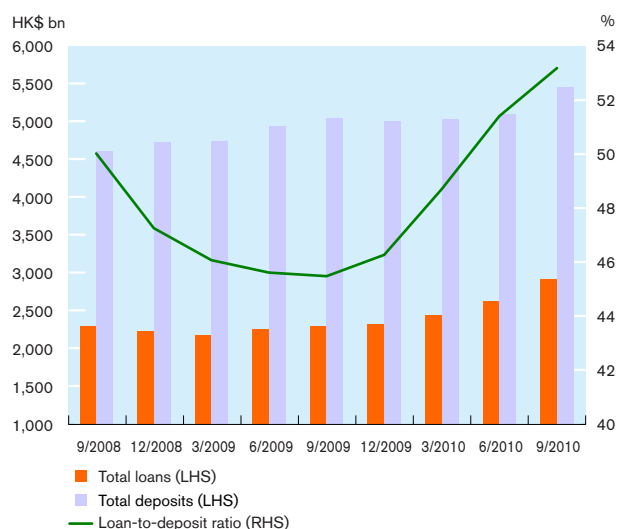
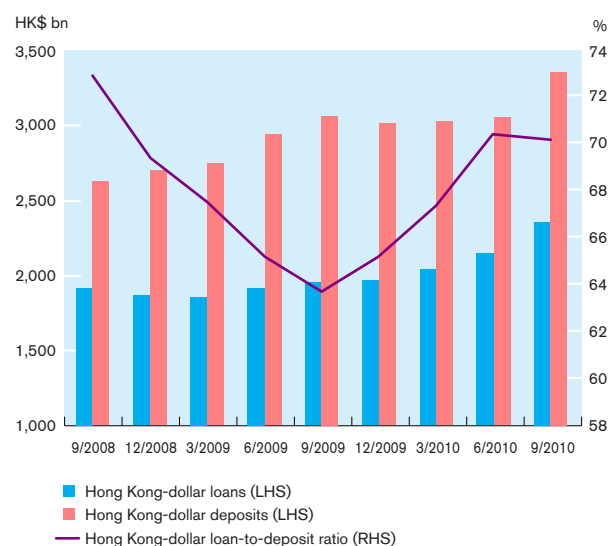


CHART 7

#### Hong Kong-dollar loans and customer deposits of retail banks

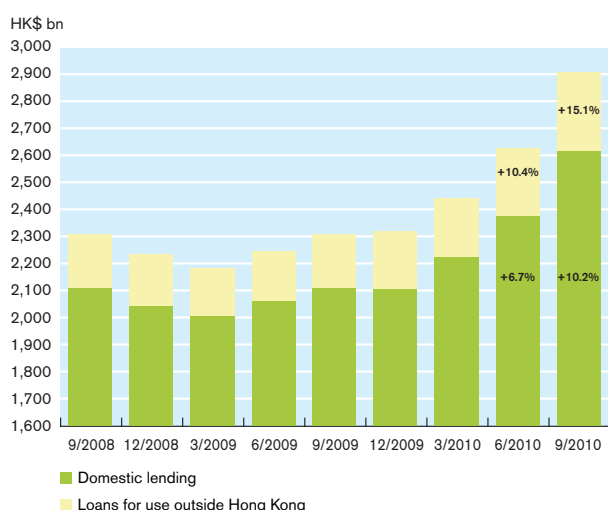


## Increased domestic lending and loans for use outside Hong Kong

Domestic lending (loans for use in Hong Kong plus trade finance) rose by 10.2% in 2010 Q3 after rising 6.7% in Q2 (Chart 8). The increase was mainly due to share-finance lending, property lending and loans to wholesale and retail trade. An increase of over 300% in share-finance lending in Q3 was likely correlated to the buoyant IPO activities in the third quarter. Loans for use outside Hong Kong continued to grow rapidly by 15.1% in 2010 Q3 after a 10.4% increase in Q2.

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	+19.0%
Manufacturing	+7.9%
Trade finance	+10.7%
Property lending	+5.8%

Retail banks' total non-bank China exposures<sup>2</sup> rose to HK\$1,037.8 billion (11.8% of total assets) at the end of September 2010 from HK\$902.5 billion (11.2% of total assets) at the end of June 2010. For the banking sector as a whole, non-bank China exposures increased to HK\$1,423.9 billion (10.5% of total assets) from HK\$1,246.8 billion (10.0% of total assets) in the same period.

## Als optimistic about loan demand

According to the HKMA Opinion Survey on Credit Condition Outlook in September 2010, surveyed Als remained optimistic about the domestic loan demand in the next six months. However, the optimism was lower than that reported in the previous quarter with 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) declining to 62% in September from 67% in the previous quarter (Table 2). The majority of surveyed Als were optimistic about loan demand in trade finance along with building and construction, property development and investment in the next six months. On the other hand, there was a rise in the number of surveyed Als expecting a decrease in RMLs in the next six months.

<sup>2</sup> Including exposures booked in the retail banks' banking subsidiaries in Mainland China.

TABLE 2

## Expectation of domestic loan demand in the next six months

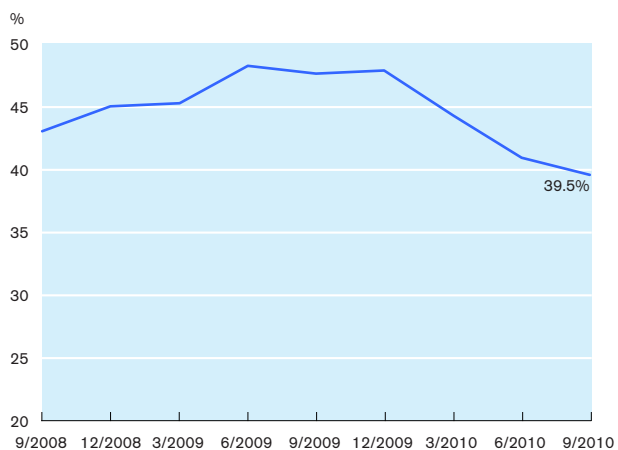
	Sep 2009	Dec 2009	Mar 2010	Jun 2010	Sep 2010
	(% of total respondents)				
Increase considerably	0	0	0	0	0
Increase somewhat	38	52	67	67	62
Remain stable	48	43	33	33	38
Decrease somewhat	14	5	0	0	0
Decrease considerably	0	0	0	0	0

### Average liquidity ratio well above statutory minimum

The quarterly average liquidity ratio of retail banks fell to 39.5% in 2010 Q3 from 40.9% in Q2, but still well above the minimum of 25% (Chart 9). The decline continued to reflect a re-allocation of assets from the more liquid instruments (such as debt securities and interbank claims) into loans and advances (which were generally less liquefiable).

CHART 9

## Liquidity ratio of retail banks (quarterly average)



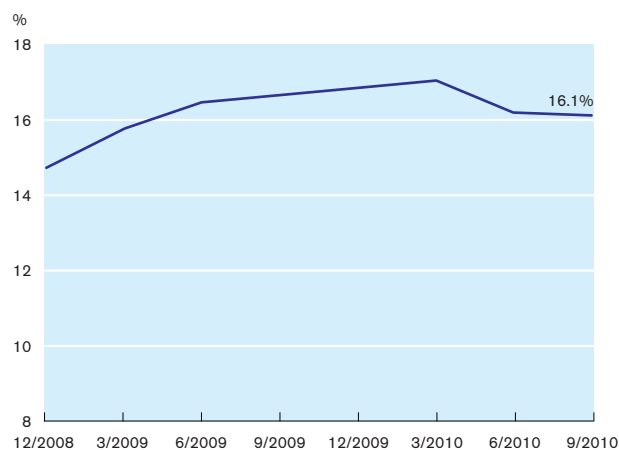
### Als well capitalised

The consolidated capital adequacy ratio of locally incorporated Als was stable at 16.1% at the end of September compared with 16.2% at the end of June 2010 (Chart 10). The ratio remained well above 8%.

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 SECTOR<sup>1</sup> (%)

	Sep 2009	Jun 2010	Sep 2010
<b>Interest rate</b>			
1-month HIBOR <sup>2</sup> (quarterly average)	0.10	0.18	0.24
3-month HIBOR (quarterly average)	0.23	0.25	0.33
BLR <sup>3</sup> and 1-month HIBOR spread (quarterly average)	4.90	4.82	4.76
BLR and 3-month HIBOR spread (quarterly average)	4.77	4.75	4.67
Composite interest rate <sup>4</sup>	0.13	0.20	0.18
<b>Retail banks</b>			
<b>Balance sheet developments<sup>5</sup></b>			
Total deposits	2.6	1.3	7.0
Hong Kong dollar	3.8	1.0	9.6
Foreign currency	0.9	1.8	3.0
Total loans	2.4	7.0	10.7
Domestic lending <sup>6</sup>	2.1	6.7	10.2
Loans for use outside Hong Kong <sup>7</sup>	4.9	10.4	15.1
Negotiable instruments			
Negotiable certificates of deposit (NCD) issued	1.9	11.5	58.8
Negotiable debt instruments held (excluding NCD)	9.7	-1.7	4.0
<b>Asset quality<sup>8</sup></b>			
As a percentage of total loans			
Pass loans	96.47	97.50	97.72
Special mention loans	2.12	1.53	1.43
Classified loans <sup>9</sup> (gross)	1.42	0.96	0.84
Classified loans (net) <sup>10</sup>	0.94	0.60	0.50
Overdue > 3 months and rescheduled loans	1.00	0.66	0.55
<b>Profitability</b>			
Bad debt charge as percentage of average total assets <sup>11</sup>	0.12	0.03	0.03
Net interest margin <sup>11</sup>	1.51	1.34	1.33
Cost-to-income ratio <sup>12</sup>	49.0	49.3	49.7
<b>Liquidity ratio (quarterly average)</b>	47.5	40.9	39.5
<b>Surveyed institutions</b>			
<b>Asset quality</b>			
Delinquency ratio of residential mortgage loans	0.05	0.03	0.02
Credit-card lending			
Delinquency ratio	0.46	0.25	0.22
Charge-off ratio — quarterly annualised	4.08	2.31	1.92
— year-to-date annualised	4.08	2.30	2.13
<b>All locally incorporated AIs</b>			
<b>Capital adequacy ratio (consolidated)</b>	16.7	16.2	16.1

## Notes:

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

<sup>2</sup> With reference to the Hong Kong-dollar Interest Settlement Rates released by the Hong Kong Association of Banks.

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

<sup>4</sup> 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 on the HKMA website.

<sup>5</sup> Quarterly change.

<sup>6</sup> Loans for use in Hong Kong plus trade finance.

<sup>7</sup> Including "others" (i.e. unallocated).

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

<sup>9</sup> Classified loans are those loans graded as "substandard", "doubtful" or "loss".

<sup>10</sup> Net of specific provisions/individual impairment allowances.

<sup>11</sup> Year-to-date annualised.

<sup>12</sup> Year-to-date figures.