

Developments in the banking sector

by the Banking Supervision Department

HIGHLIGHTS OF KEY TRENDS

Banking sector performance

The aggregate pre-tax operating profit of retail banks' Hong Kong offices edged down by 0.9% in the first three quarters of 2015 compared with the same period last year. In spite of growth in fee and commission income (+10.7%) and net interest income (+2.6%), the rising operating expenses (+9.1%) and loan impairment charges (+67%) weighed on retail banks' profitability (Table 1).

The year-to-date annualised net interest margin of retail banks narrowed to 1.32% in the first three quarters of 2015 from 1.41% in the same period last year (Chart 1), due to a number of factors such as the decrease in average interest spread of renminbi assets as well as investment of excess funds by retail banks in lower-yielding assets (e.g. interbank placement as well as Exchange Fund Bills and Notes).

Retail banks' total loans and advances and total deposits decreased by 2.0% and 0.1% respectively in the third quarter of 2015 from a quarter earlier. Hong Kong dollar loans and advances and Hong Kong dollar deposits recorded slightly higher reduction of 2.3% and 1.9% respectively during the same period (Charts 7 and 8).

For the banking sector as a whole, total Mainland-related lending decreased by 3.1% to HK\$3,378 billion (15.7% of total assets) at the end of the third quarter from HK\$3,486 billion (15.9% of total assets) at the end of the second quarter (Table 3).

Results of surveys on selected debt securities and off-balance sheet exposures to derivatives and securitisations¹

The total market value of the selected debt securities held by the surveyed authorized institutions (AIs) at the end of June 2015 was HK\$2,215 billion, 21.5% higher than a year earlier, mainly attributed to an increase in the holdings of non-structured securities (Chart 13). Most of the non-structured debt securities continued to be investment grade securities (Chart 14) issued by banks, sovereigns and corporates (Table 4). The substantial increase in debt securities holdings was partly due to subdued loan demand during the first half of 2015, causing the surveyed AIs to invest excess funds into debt securities.

The total notional amount of outstanding derivatives contracts held by the surveyed AIs rose by 7.4% to HK\$76 trillion at the end of June 2015 from a year earlier (Chart 15). There was no significant change in the composition by type of product and by type of underlying risk. Over-the-counter (OTC) swaps and forwards contracts continued to account for about 90% of all derivatives contracts held (Table 5). As in the previous year, most derivatives contracts held by the surveyed AIs were interest rate contracts and exchange rate contracts, respectively accounting for 36.9% and 60.6% of the total notional amount (Table 6). Separately, the off-balance sheet securitisation exposures of the surveyed AIs remained minimal, with aggregate exposure amounting to HK\$10 billion at end-June 2015.

Key performance indicators of the banking sector are provided in the Appendix.

¹ Starting from the December 2015 issue, the results of the surveys are published annually in this article alongside other banking sector statistics.

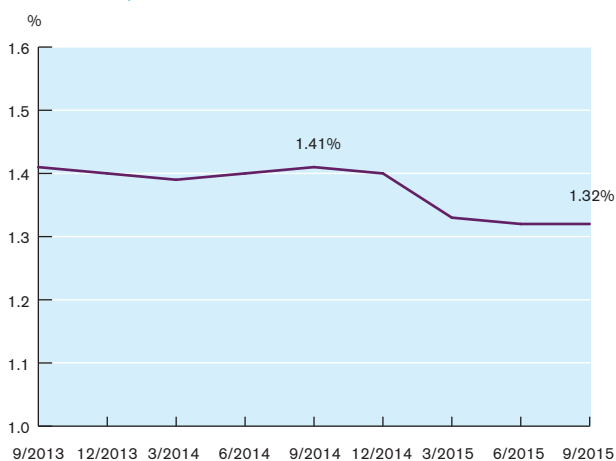
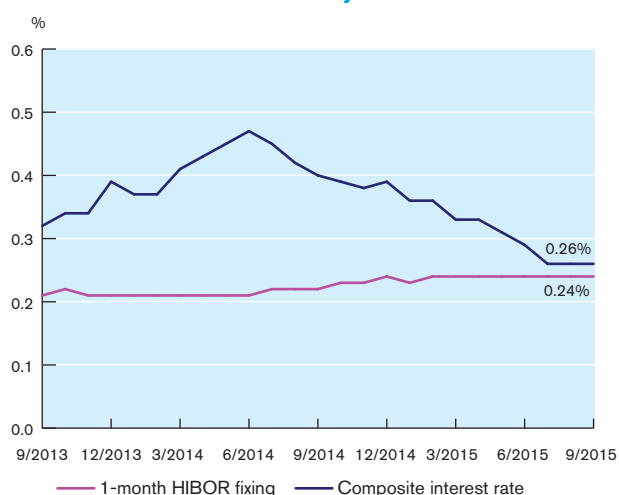
Banking sector performance

Profitability

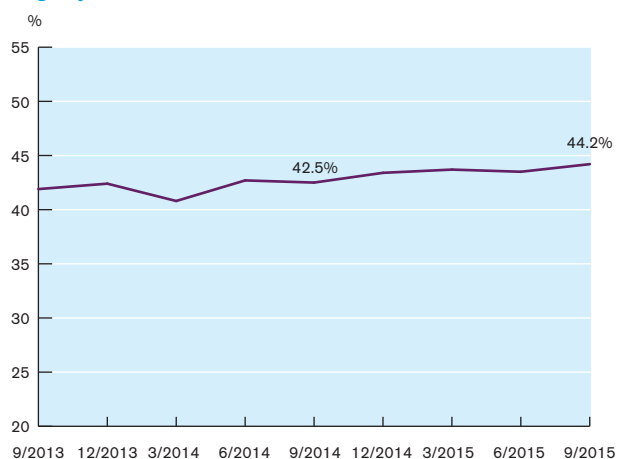
TABLE 1
Retail banks' key performance

Year-on-year change	Q1–Q3 2015
Net interest income	+2.6%
Income from fees and commissions	+10.7%
Operating expenses	+9.1%
Loan impairment charges	+67%*
Pre-tax operating profit	-0.9%

* The significant percentage change was partly due to low-base effect.

CHART 1
Net interest margin of retail banks (year-to-date annualised) narrowed

CHART 2
Interest rates remained broadly stable

Notes:

- HIBOR fixing refers to the Hong Kong Dollar Interest Settlement Rates released by the Hong Kong Association of Banks and is a monthly average figure.
- Composite interest rate is a weighted average interest rate of all Hong Kong dollar interest bearing liabilities.

CHART 3
Cost-to-income ratio of retail banks (year-to-date) rose slightly


Asset quality

TABLE 2

Quality of loans and advances of retail banks*

	Sep 2014	Dec 2014	Mar 2015	Jun 2015	Sep 2015
	% of total loans				
Special mention loans	1.04	1.10	1.14	1.28	1.36
Classified loans (gross)	0.43	0.46	0.46	0.49	0.56
of which					
Substandard	0.19	0.19	0.20	0.25	0.27
Doubtful	0.22	0.25	0.24	0.21	0.27
Loss	0.03	0.02	0.03	0.03	0.02
Classified loans (net of specific provisions)	0.31	0.32	0.32	0.35	0.40
Overdue > 3 months and rescheduled loans	0.27	0.29	0.28	0.29	0.35
of which					
Overdue > 3 months	0.22	0.23	0.23	0.24	0.29
Rescheduled loans	0.05	0.06	0.05	0.06	0.06

* 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.

CHART 4

Asset quality of retail banks' loan portfolio deteriorated slightly but remained healthy by historical standard

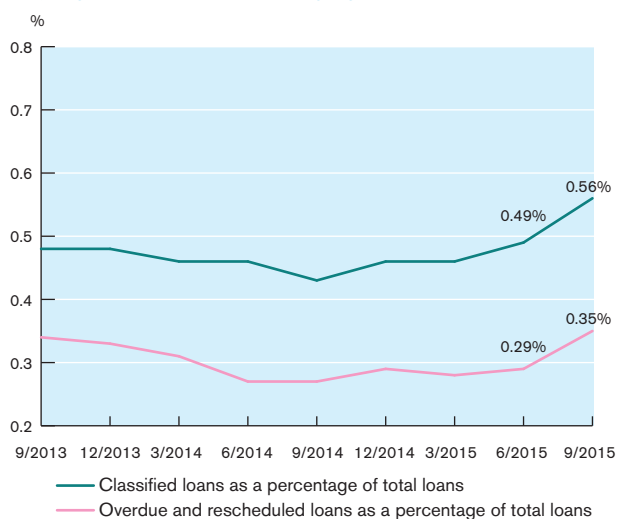


CHART 6

Residential mortgage loans in negative equity stayed at zero for four consecutive quarters

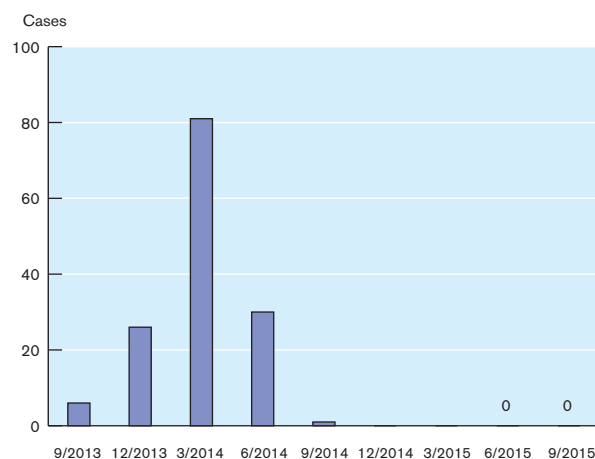


CHART 5

Delinquency ratios of residential mortgages and credit card lending of surveyed AIs stayed relatively low

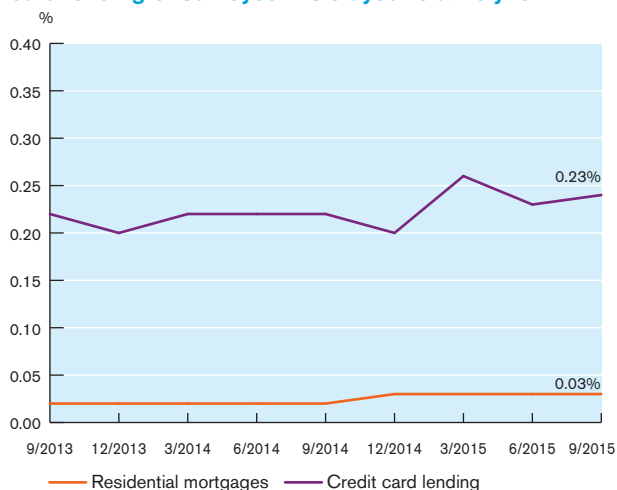


CHART 7

Total loans and deposits of retail banks fell slightly

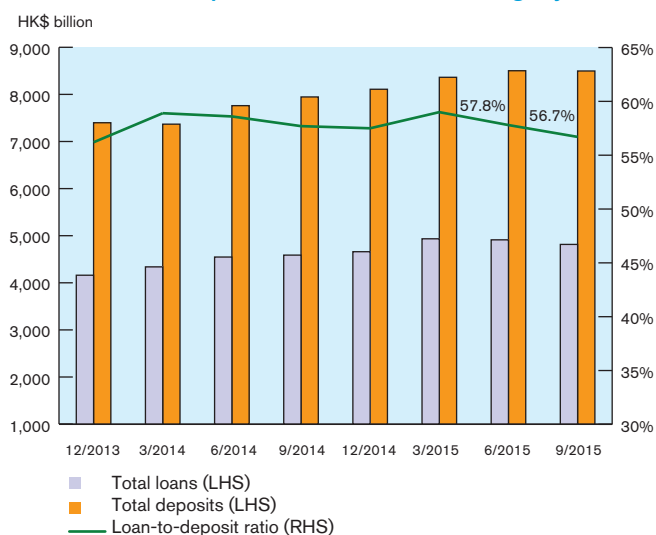


CHART 8

Hong Kong dollar loans and deposits of retail banks declined

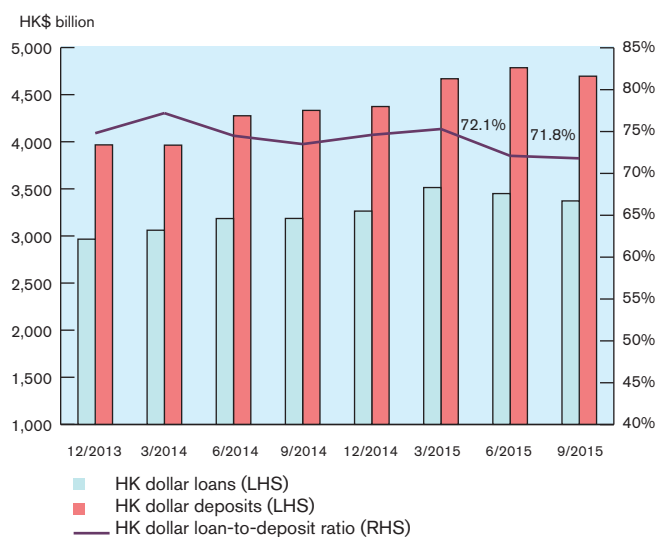
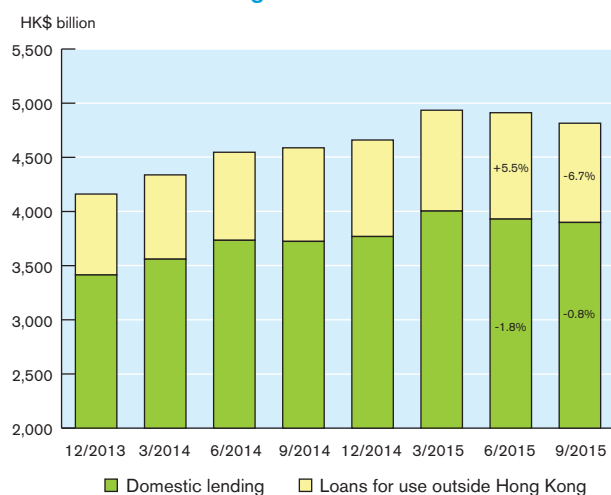


CHART 9

Domestic lending and loans for use outside Hong Kong of retail banks both registered a decline



Notes:

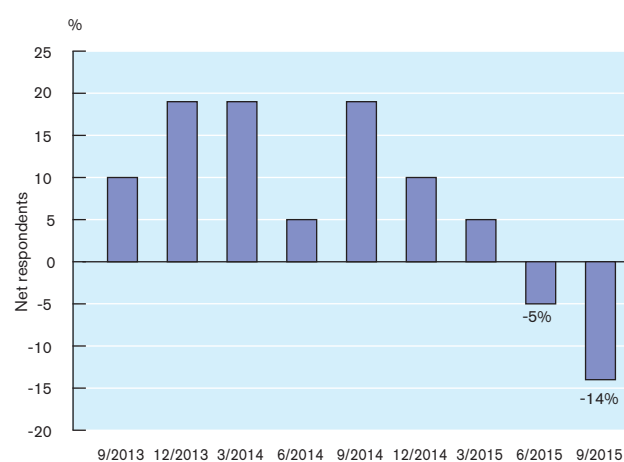
- 1 "Domestic lending" is defined as loans for use in Hong Kong plus trade finance.
- 2 "Loans for use outside Hong Kong" include "others" (i.e. unallocated).
- 3 Percentage denotes quarterly growth rate.

Within domestic lending of retail banks, the percentage changes in the amount of credit extended to the key economic sectors in the third quarter of 2015 were:

Manufacturing	+5.0%
Property lending	+2.6%
Wholesale and retail trade	-3.8%
Trade finance	-8.6%

CHART 10

More respondents expected loan demand in the next three months to decline



Note: Net respondents refer to the percentage of respondents expecting loan demand to increase minus the percentage expecting loan demand to decline.

Mainland-related lending and non-bank exposures

TABLE 3

Mainland-related lending

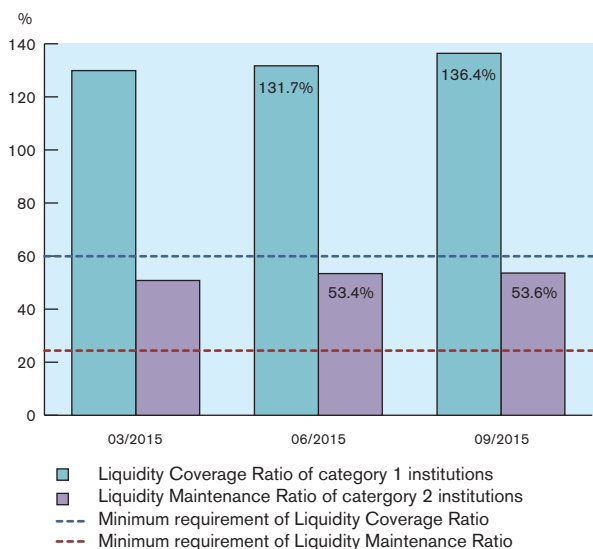
	Jun 2015 HK\$bn	Sep 2015 HK\$bn
Mainland-related loans excluding trade finance	3,114	3,062
Trade finance	373	315
Total	3,486	3,378

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

Liquidity conditions

CHART 11

Liquidity ratios (quarterly average) remained well above the regulatory minimum

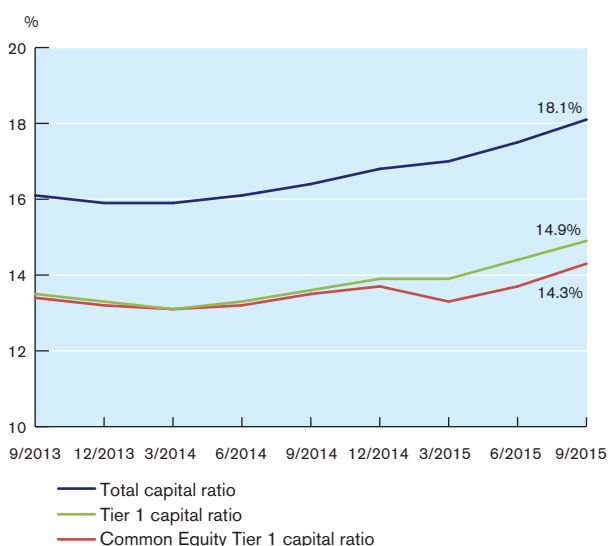


Note: For a category 1 institution, the minimum requirement for Liquidity Coverage Ratio began at 60% on 1 January 2015, rising in equal annual steps of 10 percentage points to reach 100% on 1 January 2019. A category 2 institution must maintain a Liquidity Maintenance Ratio of not less than 25% on average in each calendar month.

Capital Adequacy

CHART 12

Locally incorporated AIs remained well capitalised



Selected debt securities and off-balance sheet exposures to derivatives and securitisations

Selected Debt Securities Held²

CHART 13

Surveyed AIs recorded an increase in the holdings of non-structured securities while their holdings of structured securities remained insignificant

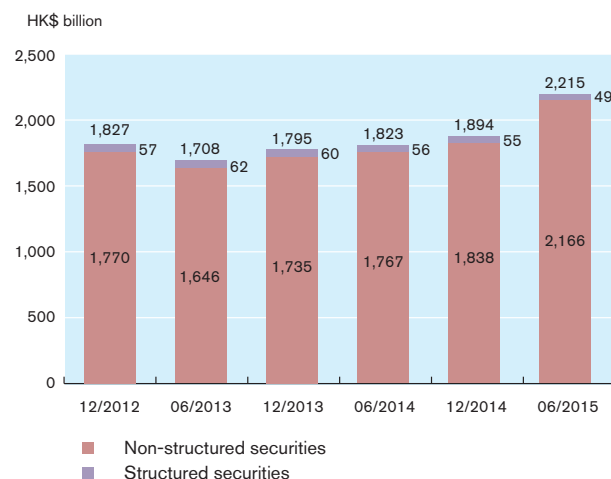
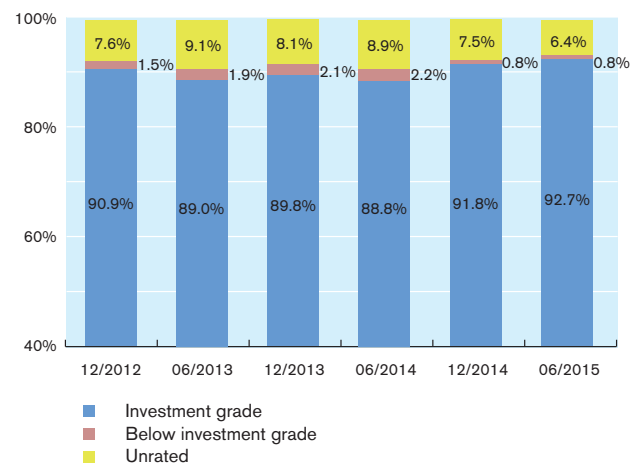


CHART 14

Non-structured debt securities held by surveyed AIs were predominantly investment grade securities



² This section presents the results of the Survey on Selected Debt Securities Held. Selected debt securities are debt securities other than Exchange Fund Bills and Notes and US Treasury bills, notes and bonds. The results presented are on a combined basis covering all surveyed AIs' banking book and trading book. Figures shown on charts and table may not add up to total due to rounding.

TABLE 4

Most of the non-structured debt securities were issued by banks, sovereigns and corporates

(% of total) Issuer or reference entity	All surveyed AIs					
	Dec 2012	Jun 2013	Dec 2013	Jun 2014	Dec 2014	Jun 2015
Sovereigns	37.0%	27.7%	31.8%	33.7%	30.7%	30.6%
Public sector entities ³	6.2%	6.9%	7.2%	6.5%	10.2%	9.8%
Banks	41.0%	45.5%	42.1%	39.8%	38.7%	38.8%
Corporates	12.1%	15.6%	15.5%	16.5%	16.3%	16.8%
Others	3.7%	4.3%	3.5%	3.5%	4.1%	4.1%

Exposures in Derivatives⁴

CHART 15

Total notional amount of all outstanding derivatives contracts increased further, albeit at a slower pace

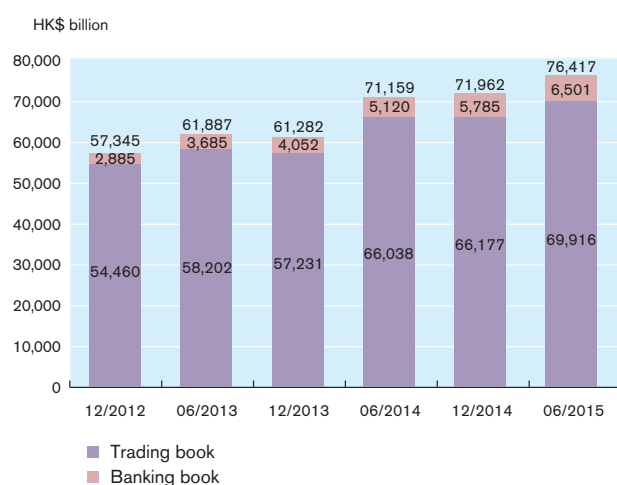


CHART 16

The notional amount of credit derivatives contracts rebounded since 2014 but remained only a marginal share of total derivatives contracts held



TABLE 5

OTC swaps and forwards contracts continued to account for about 90% of total derivatives contracts held by surveyed AIs

(% of total) Derivatives product	All surveyed AIs					
	Dec 2012	Jun 2013	Dec 2013	Jun 2014	Dec 2014	Jun 2015
Exchange-traded derivatives	2.4%	2.6%	2.8%	2.6%	2.0%	2.3%
OTC derivatives	97.6%	97.4%	97.2%	97.4%	98.0%	97.7%
of which						
Forwards	28.6%	29.4%	28.0%	29.3%	31.7%	32.4%
Swaps	61.5%	58.4%	61.2%	58.7%	58.4%	56.9%
Options	6.6%	8.5%	7.1%	8.5%	6.9%	7.2%
Credit derivatives	0.7%	0.6%	0.5%	0.4%	0.5%	0.5%
Others	0.2%	0.6%	0.4%	0.4%	0.5%	0.6%

³ Starting from position Dec 2014, debt securities issued by multilateral development banks were newly added to public sector entities.

⁴ This section presents the results of the Survey on Off-balance Sheet Exposures in Derivatives and Securitisation Transactions. The results presented are on a combined basis covering all surveyed AIs' banking book and trading book. Figures shown on charts and tables may not add up to total due to rounding.

TABLE 6

Derivatives contracts held were predominantly foreign exchange and interest rate contracts

(% of total) Underlying risk	All surveyed AIs					
	Dec 2012	Jun 2013	Dec 2013	Jun 2014	Dec 2014	Jun 2015
Interest rate risk	46.2%	43.3%	43.7%	40.7%	38.6%	36.9%
Foreign exchange risk	51.3%	53.8%	53.2%	56.8%	59.0%	60.6%
Equity risk	1.7%	2.2%	2.3%	1.9%	1.8%	1.9%
Commodity risk	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%
Credit risk	0.7%	0.6%	0.5%	0.4%	0.5%	0.5%
Other risks	0.0%	0.1%	0.2%	0.0%	0.1%	0.0%

KEY PERFORMANCE INDICATORS OF THE BANKING SECTOR¹ (%)

	Sep 2014	Jun 2015	Sep 2015
Interest rate			
1-month HIBOR fixing ² (quarterly average)	0.22	0.24	0.24
3-month HIBOR fixing (quarterly average)	0.37	0.39	0.39
BLR ³ and 1-month HIBOR fixing spread (quarterly average)	4.78	4.76	4.76
BLR and 3-month HIBOR fixing spread (quarterly average)	4.63	4.61	4.61
Composite interest rate ⁴	0.40	0.29	0.26
Retail banks			
Balance sheet developments⁵			
Total deposits	2.4	1.7	-0.1
Hong Kong dollar	1.3	2.5	-1.9
Foreign currency	3.7	0.6	2.3
Total loans	0.9	-0.5	-2.0
Domestic lending ⁶	-0.3	-1.8	-0.8
Loans for use outside Hong Kong ⁷	6.2	5.5	-6.7
Negotiable instruments			
Negotiable certificates of deposit (NCD) issued	-3.9	-15.0	-20.2
Negotiable debt instruments held (excluding NCD)	-0.4	6.2	4.2
Asset quality⁸			
As a percentage of total loans			
Pass loans	98.53	98.23	98.08
Special mention loans	1.04	1.28	1.36
Classified loans ⁹ (gross)	0.43	0.49	0.56
Classified loans (net) ¹⁰	0.31	0.35	0.40
Overdue > 3 months and rescheduled loans	0.27	0.29	0.35
Profitability			
Bad debt charge as percentage of average total assets ¹¹	0.05	0.07	0.07
Net interest margin ¹¹	1.41	1.32	1.32
Cost-to-income ratio ¹²	42.5	43.5	44.2
All AIs			
Liquidity ratios (quarterly average, consolidated)¹³			
Liquidity coverage ratio — Category 1 institutions	n.a.	131.7	136.4
Liquidity maintenance ratio — Category 2 institutions	n.a.	53.4	53.6
Surveyed AIs			
Asset quality			
Delinquency ratio of residential mortgage loans	0.02	0.03	0.03
Credit card lending			
Delinquency ratio	0.22	0.23	0.24
Charge-off ratio — quarterly annualised	1.98	2.10	1.90
— year-to-date annualised	1.90	1.91	1.89
All locally incorporated AIs			
Capital adequacy (consolidated)			
Common Equity Tier 1 capital ratio	13.5	13.7	14.3
Tier 1 capital ratio	13.6	14.4	14.9
Total capital ratio	16.4	17.5	18.1

Notes:

- ¹ Figures are related to Hong Kong office(s) only except where otherwise stated.
- ² The Hong Kong Dollar Interest Settlement Rates are 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 Including "others" (i.e. unallocated).
- ⁸ Figures are 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.
- ¹³ A new data series was introduced for liquidity ratios which are defined in accordance with the Basel III framework starting from January 2015. For a category 1 institution, the minimum requirement for Liquidity Coverage Ratio began at 60% on 1 January 2015, rising in equal annual steps of 10 percentage points to reach 100% on 1 January 2019. A category 2 institution must maintain a Liquidity Maintenance Ratio of not less than 25% on average in each calendar month.