

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 recorded a modest growth of 4.5% in the first three quarters of 2016 compared with the same period last year. The growth was mainly attributed to increases in income from foreign exchange and derivatives operations (+35.7%) and in dividends received from subsidiaries (+117.4%), and a decline in operating expenses (-4.9%), though partly offset by a fall of 14% in fee and commission income (Table 1).

The year-to-date annualised net interest margin of retail banks improved to 1.32% in the first three quarters from 1.30% in the first half of 2016 (Chart 1). It stayed at broadly the same level as in the same period of 2015.

As retail banks' total deposits increased at a faster pace than total loans, the loan-to-deposit ratio of retail banks declined to 55.2% at the end of the third quarter from 57.0% a quarter earlier (Chart 4). Retail banks' total loans increased by 1.0% during the period, with loans for use in Hong Kong (including trade finance) rising by 1.2% and loans for use outside Hong Kong expanding by 0.2% (Chart 6).

Retail banks' classified loan ratio edged up to 0.81% at the end of the third quarter from 0.80% a quarter earlier, but remained at a low level by historical standards (Chart 8).

For the banking sector as a whole, total Mainland-related lending increased by 3.2% to HK\$3,552 billion (15.9% of total assets) at the end of the third quarter from HK\$3,443 billion (15.6% of total assets) a quarter earlier (Table 2). The classified loan ratio of Mainland-related lending dropped to 0.89% from 0.92% during the period (Table 3).

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

The total market value of debt securities held by the surveyed authorized institutions (AIs) increased by 26.9% to HK\$4,538 billion at the end of the third quarter of 2016 from HK\$3,577 billion a year ago. The notable rise was largely driven by an increase in holdings of non-structured debt securities (Chart 13). Most of the non-structured debt securities were investment grade securities issued by sovereigns and banks (Table 4). As deposit growth continued to outpace loan growth during the last four quarters, surveyed AIs invested their excess funds into debt securities, resulting in a further expansion of their debt securities portfolios.

The total notional amount of outstanding derivatives contracts held by the surveyed AIs rose by 5.4% to HK\$81 trillion at the end of June 2016 from a year earlier (Chart 15). Over-the-counter (OTC) swap and forward contracts accounted for about 90% of all derivatives contracts held (Table 5). Similar to previous periods, most derivatives contracts held were exchange rate contracts and interest rate contracts, which together accounted for 98.2% of the total notional amount of all outstanding derivatives contracts at the end of June 2016 (Table 6). Separately, the off-balance sheet securitisation exposures of the surveyed AIs remained insignificant, with aggregate amount of exposures totalling HK\$7.6 billion at the end of June 2016.

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

Banking sector performance

Profitability

TABLE 1

Profitability of retail banks' Hong Kong offices

Key items	Q1 – Q3 2016 vs. Q1 – Q3 2015	
	Percentage change	Contribution to the percentage change in profitability (ppt)
Income from foreign exchange and derivatives operations	+35.7%	+4.5
Dividends from subsidiaries and associates	+117.4%	+3.5
Net interest income	+0.9%	+1.0
Total operating expenses	-4.9%	+4.1
Fee and commission income	-14.0%	-7.8
Pre-tax operating profit	+4.5%	

CHART 1

Net interest margin of retail banks (year-to-date annualised) increased steadily

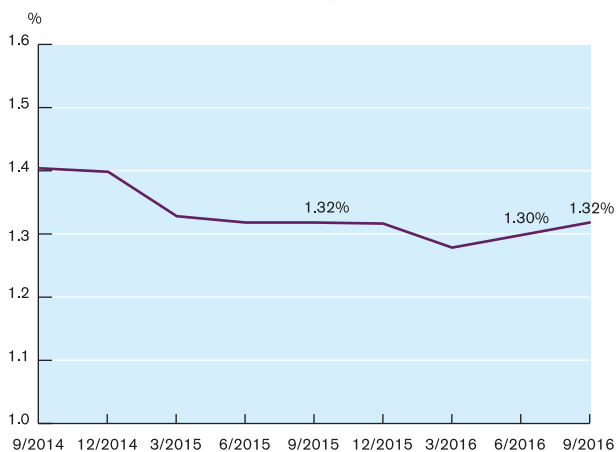


CHART 3

Cost-to-income ratio of retail banks (year-to-date) continued to improve

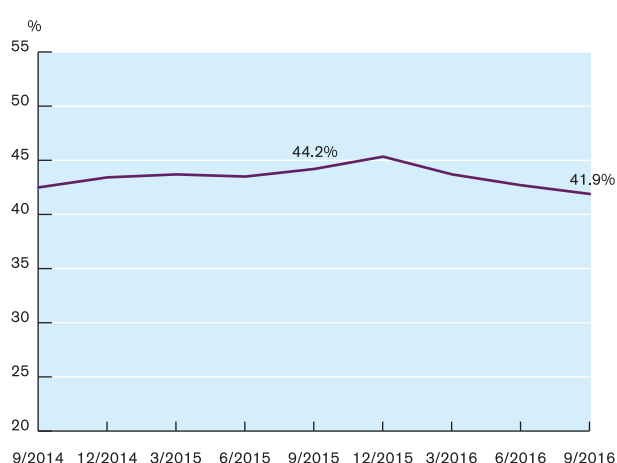
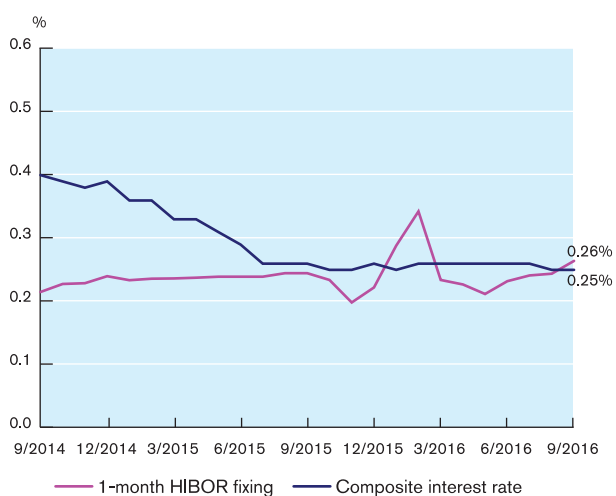


CHART 2

Hong Kong-dollar interbank interest rates edged up while composite interest rate remained largely flat



Notes:

- HIBOR fixing refers to the Hong Kong Dollar Interbank Offered 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 of retail banks.

Loans and deposits

CHART 4

Retail banks' total deposits rose at a faster pace than total loans

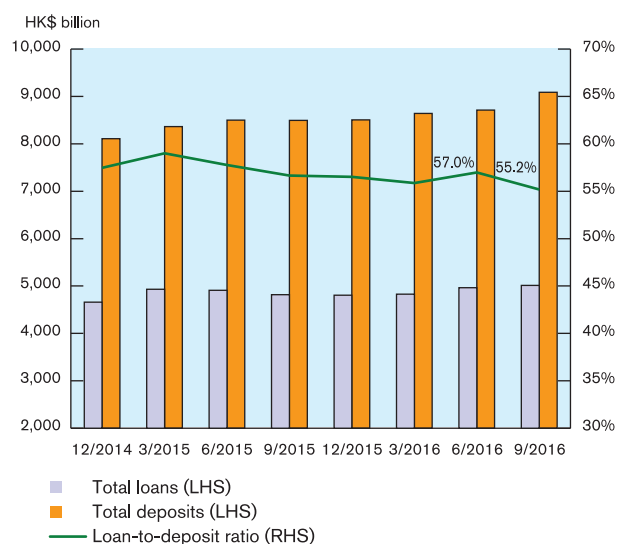


CHART 5

Retail banks' Hong Kong-dollar deposits also expanded at a faster pace than Hong Kong-dollar loans

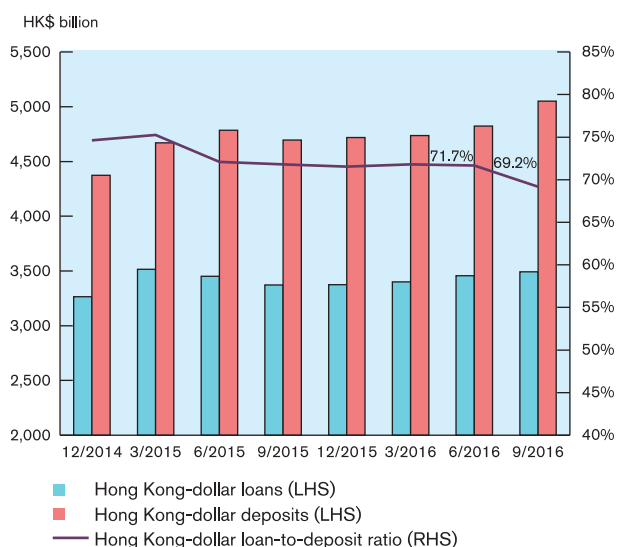
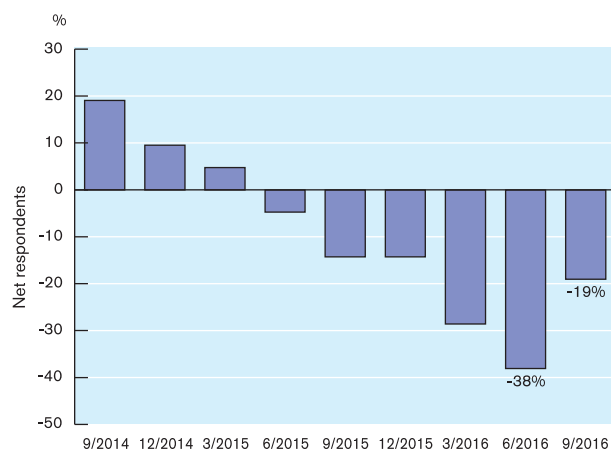


CHART 7

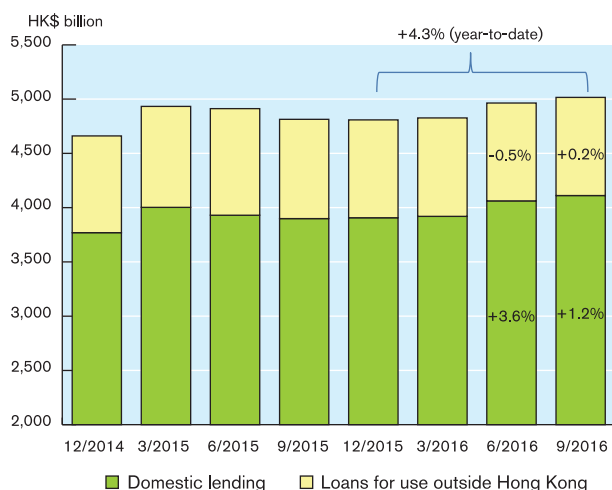
Fewer respondents expected loan demand to decline in the next three months



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

CHART 6

Retail banks' domestic lending and loans for use outside Hong Kong increased



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 growth rate from prior quarter end.

Within domestic lending, the percentage changes in the amount of credit extended to the key economic sectors in the third quarter of 2016 were:

Financial concerns	+7.4%
Wholesale and retail trade	+1.8%
Property lending	+1.3%
Trade finance	-2.2%

Mainland-related lending

TABLE 2

Mainland-related lending

	Jun 2016 HK\$bn	Sep 2016 HK\$bn
Mainland-related loans excluding trade finance	3,138	3,258
Trade finance	305	294
Total	3,443	3,552

Asset quality

TABLE 3

Quality of loans and advances of retail banks*

	Sep 2015	Dec 2015	Mar 2016	Jun 2016	Sep 2016
	<i>% of total loans</i>				
Special mention loans	1.36	1.44	1.45	1.40	1.51
Classified loans (gross)	0.56	0.69	0.78	0.80	0.81
of which:					
Substandard	0.27	0.30	0.33	0.31	0.28
Doubtful	0.27	0.35	0.41	0.45	0.49
Loss	0.02	0.04	0.04	0.04	0.04
Classified loans (net of specific provisions)	0.40	0.49	0.56	0.56	0.55
Overdue > 3 months and rescheduled loans	0.35	0.45	0.54	0.58	0.57
of which:					
Overdue > 3 months	0.29	0.39	0.49	0.50	0.49
Rescheduled loans	0.06	0.06	0.06	0.08	0.08
	<i>% of Mainland-related lending</i>				
Classified loans (gross) of Mainland-related lending**	0.81	0.78	0.94	0.92	0.89

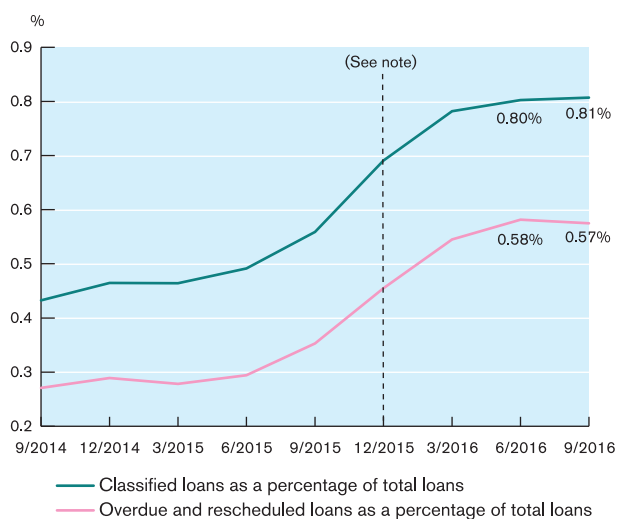
Note: Figures may not add up to total due to rounding.

* Figures prior to December 2015 covered retail banks' Hong Kong offices and overseas branches. Starting from December 2015, the coverage was expanded to include the banks' major overseas subsidiaries.

** Figures covered retail banks' Hong Kong offices, Mainland branches and subsidiaries.

CHART 8

Asset quality of retail banks' loan portfolio was stable in the third quarter and remained healthy by historical standards



Note: Figures prior to December 2015 covered retail banks' Hong Kong offices and overseas branches. Starting from December 2015, the coverage was expanded to include the banks' major overseas subsidiaries.

CHART 9

Delinquency ratios of residential mortgages and credit card lending continued to stay at low levels

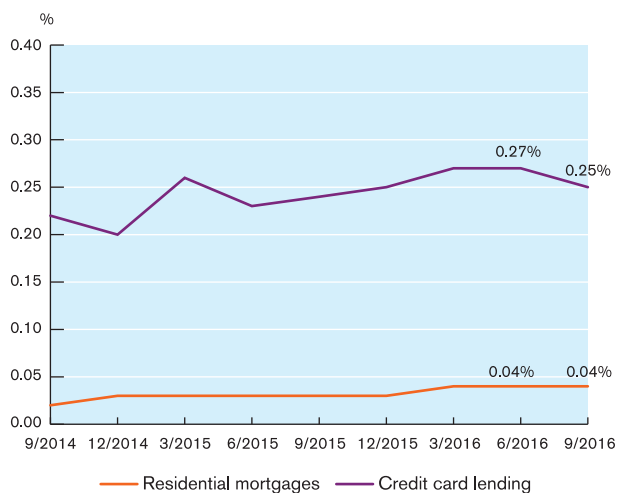
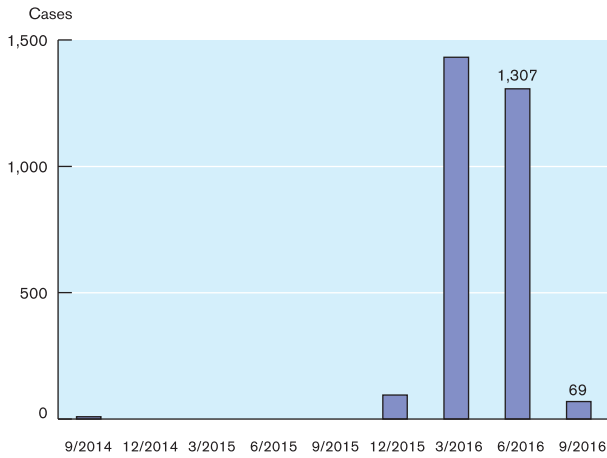


CHART 10

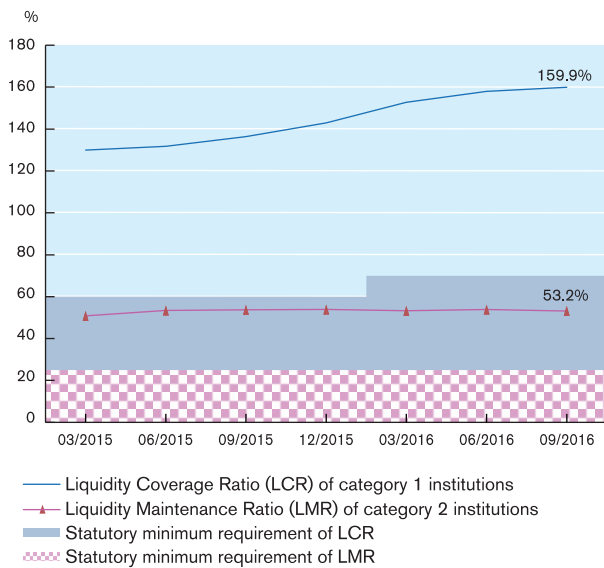
The number of residential mortgage loans in negative equity fell



Liquidity conditions

CHART 11

Liquidity position of the banking sector remained sound

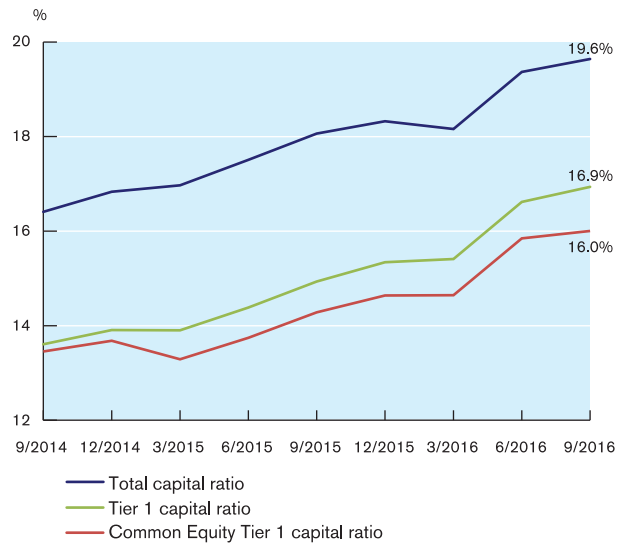


Note: For a category 1 institution, the statutory minimum requirement of LCR applicable for 2016 is 70%. A category 2 institution must maintain a LMR of not less than 25% on average in each calendar month.

Capital adequacy

CHART 12

Locally incorporated AIs remained well capitalised

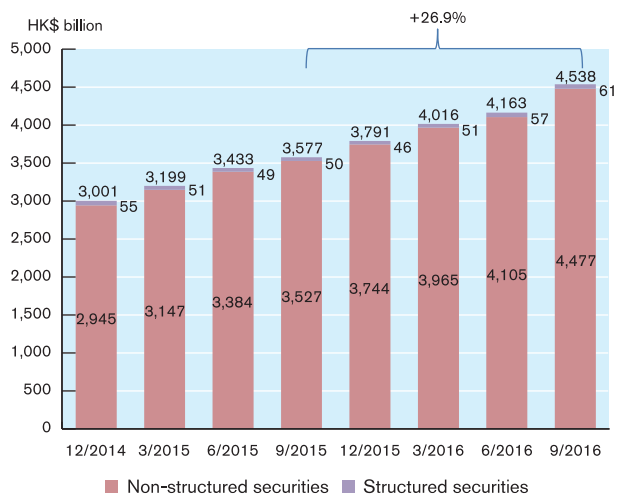


Results of surveys on debt securities and off-balance sheet exposures to derivatives and securitisations

Debt Securities Held¹

CHART 13

Surveyed AIs recorded a notable increase in their holdings of non-structured securities while holdings of structured securities remained insignificant



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

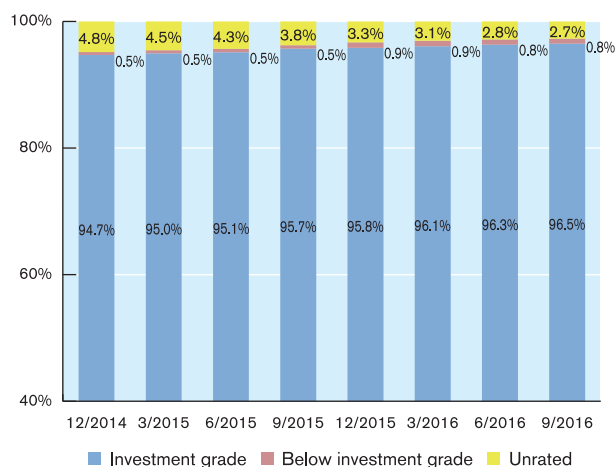


TABLE 4

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

(% of total)	All surveyed AIs							
	Dec 2014	Mar 2015	Jun 2015	Sep 2015	Dec 2015	Mar 2016	Jun 2016	Sep 2016
Sovereigns	56.8%	56.5%	55.6%	56.9%	56.7%	57.2%	54.1%	53.6%
of which:								
Exchange Fund bills and notes	29.0%	28.9%	26.2%	24.9%	24.1%	23.9%	24.1%	22.9%
US Treasury bills, notes and bonds	8.6%	9.1%	9.8%	10.8%	11.8%	10.5%	8.6%	8.2%
Public sector entities	6.3%	6.4%	6.3%	5.9%	5.9%	6.7%	6.6%	6.1%
Banks	24.2%	24.2%	24.8%	23.7%	24.5%	23.0%	25.3%	26.3%
Corporates	10.2%	10.4%	10.7%	10.7%	10.2%	10.2%	11.0%	10.6%
Others	2.6%	2.5%	2.6%	2.8%	2.7%	2.9%	3.0%	3.5%

¹ This section presents the results of the Survey on Selected Debt Securities Held. The results cover surveyed AIs' Hong Kong offices plus their overseas branches, with both banking book and trading book being included. Starting from the December 2016 issue, quarterly (instead of half-yearly) data are presented and the coverage of debt securities is expanded to include Exchange Fund bills and notes, and US Treasury bills, notes and bonds. Figures shown may not add up to total due to rounding.

Exposures to Derivatives²

CHART 15

Total notional amount of all outstanding derivatives contracts increased moderately

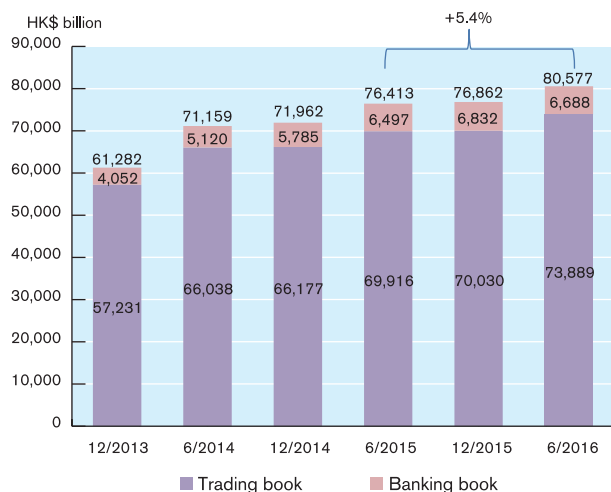


TABLE 5

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

(% of total)	All surveyed AIs					
	Dec 2013	Jun 2014	Dec 2014	Jun 2015	Dec 2015	Jun 2016
Derivatives product						
Exchange-traded derivatives	2.8%	2.6%	2.0%	2.3%	1.5%	1.7%
OTC derivatives	97.2%	97.4%	98.0%	97.7%	98.5%	98.3%
of which:						
Forwards	28.0%	29.3%	31.7%	32.4%	34.4%	35.4%
Swaps	61.2%	58.7%	58.4%	56.9%	57.5%	57.3%
Options	7.1%	8.5%	6.9%	7.2%	5.1%	4.1%
Credit derivatives	0.5%	0.4%	0.5%	0.5%	0.6%	0.7%
Others	0.4%	0.4%	0.5%	0.6%	0.9%	0.7%

TABLE 6

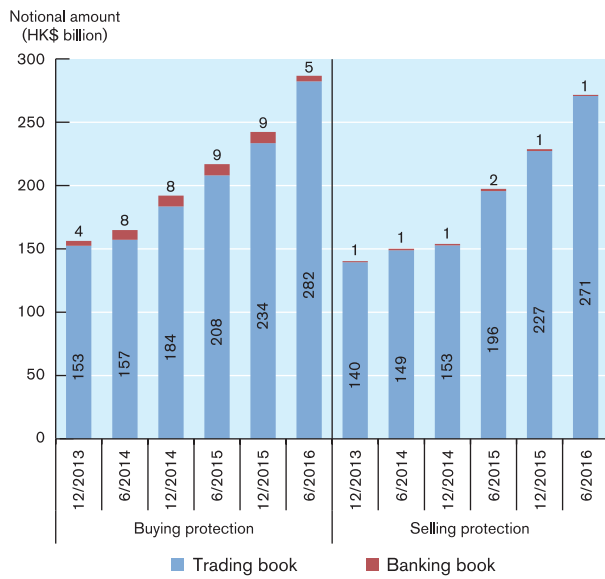
Derivatives contracts held were predominantly foreign exchange and interest rate contracts

(% of total)	All surveyed AIs					
	Dec 2013	Jun 2014	Dec 2014	Jun 2015	Dec 2015	Jun 2016
Underlying risk						
Interest rate risk	43.7%	40.7%	38.6%	36.9%	35.0%	35.3%
Foreign exchange risk	53.2%	56.8%	59.0%	60.6%	63.2%	62.9%
Equity risk	2.3%	1.9%	1.8%	1.9%	1.2%	1.1%
Commodity risk	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%
Credit risk	0.5%	0.4%	0.5%	0.5%	0.6%	0.7%
Other risks	0.2%	0.0%	0.1%	0.0%	0.0%	0.0%

² This section presents the results of the Survey on Off-balance Sheet Exposures in Derivatives and Securitisation Transactions. The results cover surveyed AIs' Hong Kong offices plus their overseas branches, with both banking book and trading book being included. Figures may not add up to total due to rounding.

CHART 16

The notional amount of credit derivatives contracts increased gradually but continued to account for a small share of total derivatives contracts held



APPENDIX

KEY PERFORMANCE INDICATORS OF THE BANKING SECTOR¹ (%)

	Sep 2015	Jun 2016	Sep 2016
Interest rates			
1-month HIBOR fixing ² (quarterly average)	0.24	0.22	0.25
3-month HIBOR fixing (quarterly average)	0.39	0.54	0.57
BLR ³ and 1-month HIBOR fixing spread (quarterly average)	4.76	4.78	4.75
BLR and 3-month HIBOR fixing spread (quarterly average)	4.61	4.46	4.43
Composite interest rate ⁴	0.26	0.26	0.25
Retail banks			
Balance sheet developments⁵			
Total deposits	-0.1	0.8	4.3
Hong Kong dollar	-1.9	1.9	4.7
Foreign currency	2.3	-0.5	3.9
Total loans	-2.0	2.8	1.0
Domestic lending ⁶	-0.8	3.6	1.2
Loans for use outside Hong Kong ⁷	-6.8	-0.5	0.2
Negotiable instruments			
Negotiable certificates of deposit (NCDs) issued	-20.2	-1.1	-5.1
Negotiable debt instruments held (excluding NCDs)	4.2	1.4	6.3
Asset quality			
As a percentage of total loans ⁸			
Pass loans	98.08	97.80	97.68
Special mention loans	1.36	1.40	1.51
Classified loans ⁹ (gross)	0.56	0.80	0.81
Classified loans (net) ¹⁰	0.40	0.56	0.55
Overdue > 3 months and rescheduled loans	0.35	0.58	0.57
Classified loan ratio (gross) of Mainland related lending ¹¹	0.81	0.92	0.89
Profitability			
Loan impairment charges as a percentage of average total assets ¹²	0.07	0.07	0.07
Net interest margin ¹²	1.32	1.30	1.32
Cost-to-income ratio ¹³	44.2	42.7	41.9
All AIs			
Liquidity ratios (quarterly average, consolidated)			
Liquidity Coverage Ratio — category 1 institutions	136.4	158.0	159.9
Liquidity Maintenance Ratio — category 2 institutions	53.8	53.8	53.2
Surveyed institutions			
Asset quality			
Delinquency ratio of residential mortgage loans	0.03	0.04	0.04
Credit card lending			
Delinquency ratio	0.24	0.27	0.25
Charge-off ratio — quarterly annualised	1.90	2.17	2.14
— year-to-date annualised	1.89	2.00	2.02
All locally incorporated AIs			
Capital adequacy (consolidated)			
Common Equity Tier 1 capital ratio	14.3	15.8	16.0
Tier 1 capital ratio	14.9	16.6	16.9
Total capital ratio	18.1	19.4	19.6

Notes:

1. Figures are related to Hong Kong offices only except where otherwise stated.
2. The Hong Kong Dollar Interbank Offered 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 on the HKMA website.
5. Quarterly change.
6. Loans for use in Hong Kong plus trade finance.
7. Including "others" (i.e. unallocated).
8. Figures prior to December 2015 are related to retail banks' Hong Kong offices and overseas branches. Starting from December 2015, the coverage was expanded to include retail banks' major overseas subsidiaries.
9. Classified loans are those loans graded as "substandard", "doubtful" or "loss".
10. Net of specific provisions/individual impairment allowances.
11. Figures are related to retail banks' Hong Kong offices, Mainland branches and subsidiaries.
12. Year-to-date annualised.
13. Year-to-date figures.