

With the operating environment less buoyant, the banking sector's profit growth was more subdued in the first nine months of 1994. The corrections in the property market and stock market and higher interest rates encouraged a portfolio shift to money balances for holding purposes as reflected in a significant increase in time deposits and swap deposits. At the same time, loan growth moderated. As a result, the HK dollar liquidity of the banking sector improved with a reduction in the HK dollar loan to deposit ratio and a sharp increase in institutions' holdings of negotiable debt instruments.

Performance of the banking sector

Profit growth of the banking sector as a whole was more subdued in the first nine months of 1994.

This was partly due to some erosion of the net interest margin as interest rates rose and depositors shifted into higher yielding time and swap deposits (see below). This coincided with a sharp drop in investment income reflecting the difficult bond market conditions and more subdued equity markets so far this year. Loan growth was also somewhat slower than in the same period of 1993, and the residential mortgage market in particular is now less active. At the same time, operating expenses rose more rapidly, leading to a deterioration in the cost-income ratio for the sector as a whole.

Against these negative factors, the credit environment faced by the banking sector remains favourable and the provision for bad and doubtful debts has declined compared with the same period of last year.

The above trends need to be put in perspective. It was always unlikely that the strong profit growth of the last three years could be sustained by the sector as a whole, particularly once interest rates had begun to rise. Despite this, a number of individual banks are continuing to record significant increase in profits and although the return on assets of the locally incorporated banks has fallen somewhat in the first nine months of the year, it remains high by international standards. However, with more competitive conditions likely to result from the removal of time deposits from the Interest Rate Rules (IRR) of the Hong Kong Association of Banks, the 1994 performance emphasises the need for authorised

institutions to keep a continuing tight grip on asset quality and close control of operating costs.

Funding

Following closely the interest rate increases in the US, the savings rate and the time deposit rates governed by the IRR were raised three times during the first nine months of 1994, by a total of 150 basis points and 200 basis points respectively. The banking sector absorbed part of the increase as the major commercial banks increased their Best Lending Rates ("BLR") by 125 basis points, resulting in a narrowing of the interest margins between BLR and savings rate by 25 basis points and between BLR and the IRR time deposit rates by 75 basis points (Table 1).

The sector's funding cost was also affected by a shift of deposits from demand and savings deposits to higher yielding HK dollar time deposits and foreign currency swap deposits. The growth in total HK dollar deposits (including swap deposits) for the first three quarters was 14.6%, compared with 14.0% in the same period of 1993. Within this, however, demand deposits fell by 1.3% while savings deposits rose by only 0.5%. By contrast, HK dollar time deposits rose by 23.8% and swap deposits by 42.1% (Tables 2 and 3). The strong growth in HK dollar time deposits mainly occurred in non-IRR governed deposits, reflecting the keen competition for larger deposits by institutions even before the de-regulation of the IRR came into effect.

Apart from the rise in interest rates, which has increased the relative attraction of bank deposits as a savings medium, the corrections in the stock market and in the property market (the latter following the announcement of the Government's anti-speculation measures in June)

Table 1
Movement of IRR Deposit Rates and Best Lending Rate (Jan 94 – Sept 94)

Period	IRR deposit rates						Best lending rate
	Savings	7 days' call	1 month	3 months	6 months	12 months	
01.01.94 to 27.03.94	1.50	1.50	2.25	2.75	3.00	3.75	6.50
28.03.94 to 22.05.94	2.00	2.25	3.00	3.50	3.75	4.50	6.75
23.05.94 to 21.08.94	2.50	3.00	3.75	4.25	4.50	5.25	7.25
22.08.94 to 30.09.94	3.00	3.50	4.25	4.75	5.00	5.75	7.75

Source: HKAB

Table 2
Monthly Growth and Total Amount of Deposits by Currency (Dec 1993 – Sept 1994)

Month	Monthly Growth (%)			Total Amount (HK\$ Mn)		
	Foreign Currency	HK\$	All Currencies	Foreign Currency	HK\$	All Currencies
Dec 93	0.17	(14.32)	(7.62)	864,281	858,241	1,722,522
Jan 94	1.23	11.62	6.41	874,874	957,979	1,832,852
Feb 94	(1.21)	(8.26)	(4.90)	864,254	878,829	1,743,083
Mar 94	(1.16)	0.07	(0.54)	854,204	879,416	1,733,620
Apr 94	1.03	2.53	1.79	863,038	901,693	1,764,731
May 94	(1.46)	2.33	0.47	850,395	922,695	1,773,090
Jun 94	0.65	1.43	1.06	855,922	935,897	1,791,819
Jul 94	2.22	0.94	1.55	874,929	944,704	1,819,633
Aug 94	1.71	1.68	1.70	889,926	960,563	1,850,489
Sept 94	0.27	2.41	1.38	892,358	983,724	1,876,082

Source: HKMA

Table 3
**Monthly Growth and Total Amount of Hong Kong Dollar
 Time Deposits and Foreign Currency Swap Deposits
 (Dec 1993 – Sept 1994)**

Month	Monthly Growth (%)		Total Amount (HK\$ Mn)	
	Time	Swap	Time	Swap
Dec 93	(29.01)	4.65	399,610	71,800
Jan 94	21.19	1.01	484,305	72,526
Feb 94	(14.28)	1.05	415,138	73,289
Mar 94	2.35	9.44	424,899	80,209
Apr 94	1.81	1.91	432,599	81,742
May 94	5.11	7.52	454,719	87,893
Jun 94	2.22	3.24	464,820	90,740
Jul 94	0.86	5.79	468,830	95,992
Aug 94	2.23	3.50	479,304	99,353
Sept 94	3.24	2.67	494,823	102,003

Source: HKMA

will have encouraged a portfolio shift from these assets back to money balances for holding purposes. This would tend to be reflected in faster growth in time deposits and swap deposits. The sharp rise in the latter may also be due to the widening spread between the HK dollar interbank offer rates (on which swap deposits are priced) and IRR-governed rates.

HK dollar deposits (including swap deposits) rose at a faster percentage rate than HK dollar loans in the first nine months of the year with the result that the HK dollar loan to deposit ratio improved from 111.5% at end-December 1993 to 110.9% at end-September. (If HK dollar negotiable certificates of deposit (NCDs) issued in Hong Kong and held by the public are included within deposits, the ratio was 108% at end-September.)

The Hong Kong banking sector also increased its net borrowing from banks abroad in HK dollars by HK\$32.9 bn during the first nine months of the year. Most of this represented an increase in net liabilities to banks in China. With growth in HK dollar loans financed by the increase in customer deposits (including NCDs held outside the banking sector), the surplus HK dollar funding was channelled into an increase of HK\$50 bn in holdings of negotiable debt instruments (other than

NCDs), including Exchange Fund Bills and Notes. The HK dollar liquidity of the banking sector thus improved during the year.

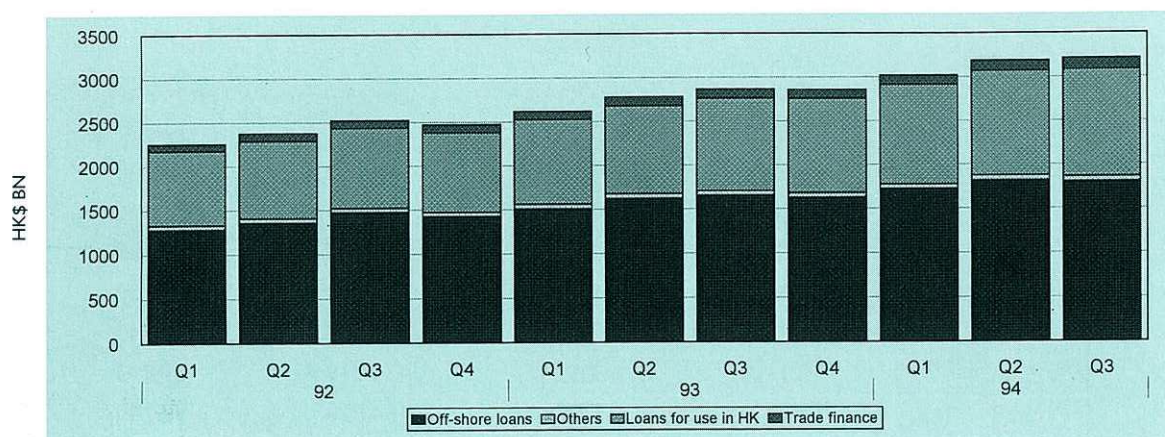
Negotiable certificates of deposit

As already noted, the significant increase in the issue of NCDs, and the holding of these instruments by authorised institutions, was a significant feature of the year.

At end-September, the total of NCDs outstanding in all currencies had risen to over HK\$90 bn, an increase of 64.6% over the level at end-December 1993. Over HK\$50 bn of this was accounted for by HK dollar denominated NCDs which increased by 51.3% over the nine months. Even banks with a large retail deposit base have issued NCDs to tap medium to long-term funds. This has reflected efforts by banks to improve the maturity structure of their assets and liabilities, particularly in view of the growing proportion of loans accounted for by relatively long-term residential mortgage loans; they may also have wished to secure in advance medium and long term funding to support loans to finance the airport and other infrastructural projects.

The issuance of NCDs has attracted substantial funds from non-bank investors into the banking

Chart I
Loans and Advances analysed by type in all currencies (Q1/92 – Q3/94)



Source: HKMA

sector for investment purposes. During the nine months to end-September, NCDs issued in Hong Kong and held by the public rose to HK\$60.3 bn, representing a 73.8% increase over the end-1993 level. While holdings of HK dollar denominated NCDs rose sharply within this total, the preference of the public is for NCDs denominated in foreign currencies (HK\$34 bn or 56% of total public holdings) and for fixed rate instruments.

By contrast, floating rate instruments appeal mainly to the banking sector. During 1994, holdings of NCDs (issued in Hong Kong) by authorised institutions rose by 49% to HK\$29.8 bn, with particularly sharp growth of 37.7% in the third quarter. Most of the outstanding amount and of the 1994 increase was accounted for by holdings of HK dollar instruments. Apart from their attractions as interest-earning assets in their own right, such instruments help authorised institutions to comply with the new liquidity guidelines issued by the HKMA and, in the case of issues which carry a credit rating, provide banks with securities which are eligible for Repo under the Liquidity Adjustment Facility. The same factors may have influenced the growth in other types of negotiable debt instruments already referred to.

Loans and advances

During the first three quarters of 1994, the banking sector's total lending to non-bank customers

grew more slowly, by 12.3% compared with 15.9% in the same period of last year. This was partly the result of more moderate growth in offshore lending as Euro-yen loans booked by branches of Japanese banks fell in the third quarter. But the growth in HK dollar denominated lending also slowed during the period from 5.7% in the first quarter to 2.7% in the third (Chart I).

This latter trend will have reflected in part the effect of the higher interest rates on credit demand. But slower growth in residential mortgage loans following the Government's anti-speculation measures announced in June was also a factor. According to the results of the HKMA monthly survey, such lending rose by 0.4% in July and by 0.7% in August and September, compared with monthly average growth of 1.4% in the first six months of the year.

The trend in lending for property development and investment has been distorted by the reclassification by certain banks of their lending in this category. However, adjusting for these changes, it appears that such lending may have grown by about 13% in the first nine months of 1994 which would represent a slowing-down compared with the same period of 1993. As a result, total property lending as a percentage of banks' domestic lending fell slightly in 1994, but remains at around 37%. *

— Prepared by the Banking Policy Department