Implementation of the first phase of deregulation of time deposits in the December quarter gave an added boost to the trend towards higher yielding time deposits. Profitability of the banking sector during 1994 was influenced by reduced loan demand, narrowing of the interest rates spread and change in the deposit mix. However, the overall net interest margin stood up quite well. HK dollar liquidity of the banking sector in the December quarter improved with a reduction in the HK dollar loan to deposit ratio and continued sharp increase in institutions' holdings of negotiable debt instruments.

Interest Rate Deregulation

The December quarter commenced with the implementation of the first phase of the deregulation of time deposits governed by the Interest Rate Rules (IRR) of the Hong Kong Association of Banks (HKAB). The interest rate cap on time deposits of less than HK$500,000 and fixed for more than one month was removed on 1 October.

Banks responded by adjusting interest rates for such deposits close to the market rates of equivalent swap deposits. By the end of the year, banks were paying an average rate of about 6.1% on deregulated three-month deposits, 60 basis points higher than the maximum rate would have been if the cap had not been removed.

There were indications of deposit migration from savings and demand deposits into the deregulated time deposits. According to a monthly survey of 40 licensed banks conducted by the Monetary Authority, the HK dollar demand and savings deposits of the survey group fell by HK$2.0bn (2.1%) and a net HK$8.6bn (3.1%) respectively during the December quarter of 1994 while deregulated time deposits rose by HK$13.6bn (75.4%). It is however difficult to determine to what extent this movement was directly related to the deregulation, although it will undoubtedly have played a part.

The deregulation has also dampened the growth of foreign currency swap deposits[1] which are close substitutes for the deregulated time deposits. Having risen by 42% in the first nine months of the year, they rose by less than 2% in the December quarter.

The deregulation is still at an early stage and full effects on funding costs, and on the behaviour of banks and their customers, have still to make themselves felt. Although the effects of deregulation have not been unduly disruptive so far, banks have expressed concern that deregulation of very short-term deposits in subsequent phases, particularly 24-hour call deposits, could have a destabilising effect on the deposit structure of individual banks and push up funding costs if there is a substantial migration from saving deposits.

To minimise such risks, the timetable for further deregulation provides that the removal of the interest rate cap from 24-hour call deposits will be done in stages. Each stage will be subject to both the Monetary Authority and HKAB being satisfied that it will not cause instability in the banking and monetary systems.

Funding

Customer deposits

The conditions conducive to the shift to higher yielding time deposits persisted in the December quarter. The upward trend of deposit interest rates was given an added boost by the first phase of interest rate deregulation and the increase in US interest rates in November which triggered a 75 basis points increase in retail interest rates governed by the IRR. Moreover, continued strong competition for HK dollar deposits among the licensed banks led to the payment of relatively high interest rates on large time deposits which are not subject to the IRR. It was not uncommon for banks to offer interest rates of as much as two percentage

1 Foreign currency swap deposits are deposits involving customers buying foreign currencies in the spot market and placing them as deposits with authorised institutions, while at the same time entering into a contract to sell such foreign currencies (principal plus interest) forward in line with the maturity of such deposits. For most analytical purposes, they should be regarded as HK dollar time deposits.

Table 1
HK Dollar Deposit Mix

Amount (HK$ bn)

	Deposits			
	Demand	Savings	Time	Swap
Q4/93	105.1	281.7	399.6	71.8
Q1/94	103.8	270.6	424.9	80.2
% growth	-1.3	-4.0	6.3	11.7
Q2/94	101.1	279.3	464.8	90.7
% growth	-2.6	3.2	9.4	13.1
Q3/94	103.7	283.2	494.8	102.0
% growth	2.6	1.4	6.5	12.4
Q4/94	100.1	274.7	537.2	103.8
% growth	-3.4	-3.0	8.6	1.8

Note: % growth denotes the quarter-on-quarter growth of the deposits.

points above the Hong Kong Interbank Offer Rate (HIBOR) for such deposits. The continued decline in the stock and property market reduced the demand for transaction balances and encouraged a portfolio shift to money balances for holding purposes.

This was reflected in the composition of deposits (Table 1). The growth in customer deposits slowed to 3.5% in the December quarter (from 4.7% in the September quarter), reflecting falls in the level of HK dollar demand and savings deposits (of 3.4% and 3.0% respectively). By contrast, HK dollar time deposits (adjusted to include swap deposits) rose sharply by 7.4%. The month of December also saw a rise in the HK dollar savings deposits, partly reversing the fall in the previous two months. However, this will have reflected at least in part the crediting of interest on savings deposits at the year-end.

Interest spreads showed a tendency to narrow during the quarter, with the deregulated three-month time deposit in particular rising relative to the equivalent HIBOR and to BLR. However, the average margin between the savings deposit rate and BLR remained unchanged at 4.75%.

Certificates of deposit

The issue of negotiable certificates of deposit (NCDs), in particular those denominated in HK dollars, continued to surge in the December quarter. At end-December, the total of NCDs outstanding in all currencies had risen to HK$106.7bn, an increase of 18.5% over the level at end September. Over HK$64 bn of this was accounted for by HK dollar denominated NCDs which increased by 26.8% during the quarter. This reflected the continuing desire of banks to obtain medium term (over one year) HK dollar funding. This has been attractive for banks wishing to improve the asset/liability structure of their balance sheet and in particular to build up stable long term funding for the financing of infrastructure projects.

Much of the issues have been taken up by other authorised institutions for whom NCDs are an attractive asset both on yield considerations and as a source of liquidity. Holdings of NCDs by authorised institutions rose faster in the December quarter (by 29% as against 23% in the September quarter). Most of the growth occurred in HK dollar issues which recorded a sharp increase of 48%.

Lending

Growth in lending picked up slightly in the December quarter by 1.7% compared with 0.7% in the September quarter. Notwithstanding this, growth in loans for use in Hong Kong slowed down significantly in the second half of the year (rising by only 5.5% compared with 11.4% in the first half). This partly reflected the impact of higher interest rates on loan demand, the decline in activity in the property market and banks' continuing tight lending policies which affected the growth of residential mortgage lending.

Growth of lending for residential mortgage and property development and investment slowed down further to 1.4% and 2.9% respectively in the December quarter (compared with 1.5% and 5.1% respectively in the September quarter). The annualised rate of growth of these loans for the last quarter of 1994 was 5.6% and 10.8% respectively, significantly lower than the actual growth of 12.5% and 15.4% for the whole year (15.1% and 27.9% in 1993). Other sectors which showed faster rates of increase in the December quarter were manufacturing (+6%), transport (+5%), wholesale trade (+8%) and credit card (7.5%) (Chart 1).

Loan to deposit ratio

With HK dollar deposits rising slightly faster than HK dollar loans in the December quarter, the HK dollar loan to deposit ratio of the banking sector fell slightly to 110% at end-December from 110.9% at end-September. The ratio of the locally incorporated banks also improved from 73.3% to 72.1%. As the growth in HK dollar deposits (3.3%) exceeded the growth in HK dollar loans (2.5%), the funding gap was narrowed by HK$5.1 bn in the December quarter. This, coupled with the additional funding provided by net NCDs issued and other sources, resulted in a decrease in the sector's net interbank borrowing of HK$ 34.3 bn.

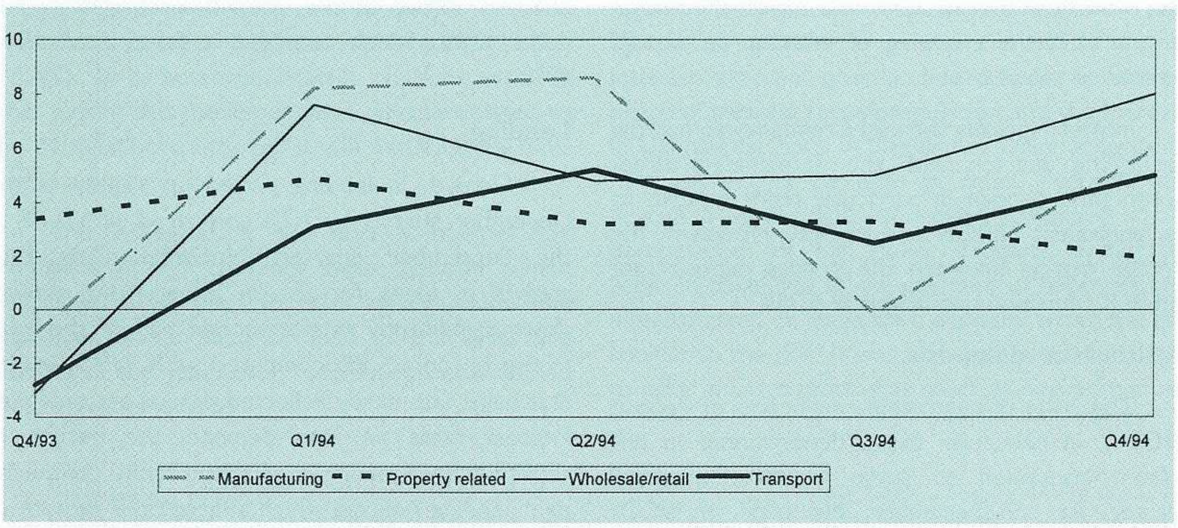
The surplus HK dollar funding was also channelled into an increase of HK$8.1bn in holdings of HK dollar negotiable debt instruments (other than NCDs), including Exchange Fund Bills and Notes.

Profitability

As noted in the November Bulletin, profit growth of the banking sector slowed in 1994 and this has been reflected in the annual results announced by some banks. This was possibly the result of slower growth in net interest income due to the factors already described, i.e. slower loan growth, changes in the deposit mix and narrowing of interest spreads. However, despite the latter two influences, the overall net interest margin of the locally incorporated banks fell only slightly during the year. This reflected the positive effect of higher interest rates on the value of interest-free balances (the so-called "endowment" effect). Of more importance in explaining slower income growth in 1994, however, was the sharp fall in investment income as a result of the more difficult stock and bond market conditions. This item had given a strong boost to profits in 1993.

Another positive factor in 1994 was the continuing low need to make provisions for bad debts. As a percentage of total assets, such provisions fell to 0.05% at end-1994 compared with 0.12% at end-1993.

Chart 1
Loans for use in Hong Kong by selected sectors, quarter-on-quarter change (%)



Outlook for 1995

While 1995 is likely to be another more difficult year for the banking sector, its basic position remains sound. Institutions are continuing to operate in a fundamentally strong economy. The return on assets enjoyed by locally incorporated banks remains among the highest in the world and they are highly capitalised by international standards. The consolidated capital adequacy ratio of locally incorporated authorised institutions at end-September (the most recent available figure) had improved to 17.6% from 17% at end-1993. Although there are variations among individual institutions, practically all have ratios well into double figures. Banks in Hong Kong are therefore well placed to face the future. They will however need to keep a tight grip on costs, ensure that asset quality is not sacrificed and continue to diversify their sources of income.

– Prepared by the Banking Policy Department