DEVELOPMENTS IN THE BANKING SECTOR

The movement into time deposits continued in the first quarter of 1995, stimulated by the second stage of interest rate deregulation and a sharp rise in interest rates in January. However, competition for HK dollar deposits eased somewhat towards the end of the quarter as reflected in declining interest rates. Despite the impact of deregulation, the overall net interest margin of the locally incorporated banks showed little change. Growth in total domestic lending revived slightly despite a continued slow-down in property-related lending. HK dollar liquidity continued to improve with a further reduction in the HK dollar loan to deposit ratio.

Interest Rate Deregulation

The second phase of interest rate deregulation commenced on 3 January with the removal of the cap on time deposits of less than HK$500,000 and fixed for more than 7 days.

January saw a sharp surge in interest rates as the HK dollar came under temporary pressure. This intensified the impact of the second stage of deregulation and the newly deregulated time deposits rose sharply during the month while HK dollar savings and demand deposits and swap deposits dropped sharply. The fall in savings and demand deposits also reflected however the large rise in notes in circulation ahead of Chinese New Year. By the end of the quarter, these effects had largely unwound : interest rates had fallen back and savings and demand deposits had recovered somewhat.

As an example of these movements, the average interest rate on one-month deregulated time deposits increased by 155bp in January, largely reflecting the movement in the equivalent HIBOR. In line with the subsequent softening of HIBOR, the average rate fell back by 99bp by the end of the quarter. The net increase of 56bp over the quarter was therefore only 6bp above the 50bp rise that occurred in deposits still regulated by the Interest Rate Rules. Overall, the average interest rate on deregulated time deposits at end-March was only 13bp higher than it would have been if there had been no deregulation, although there was a more significant increase in the two-week interest rate.

Funds continued to flow into deregulated HK dollar time deposits during Q1 1995. According to the survey of 40 licensed banks conducted by the Monetary Authority, deregulated time deposits had risen by HK$50.8bn (129%) by end-March. However, much of this represented switching out of swap deposits which declined markedly by HK$32.5%bn (31.4%). Savings and demand deposits dropped significantly in January by HK$12.7bn (4.7%) and HK$6.7bn (7.5%) respectively. But both recorded increases in February and March with the unwinding of the special factors affecting the deposit mix mentioned above. Overall, savings and demand deposits of the surveyed banks dropped by a total of HK$10.4bn (2.9%) in the first quarter.

The third phase of deregulation was originally scheduled to take place on 1 April 1995. This would have covered HK dollar time deposits fixed for more than 24 hours and up to and including seven days. However, in view of the more volatile world financial markets in early 1995, as evidenced by the Mexican crisis and the Barings collapse (see below), and the fact that the picture on deposit movements was distorted by the special factors in January, the Monetary Authority decided that the third phase should be deferred to allow more time to assess the impact of the first two phases of deregulation. A full assessment will be conducted in August/September which will take into account the half-year results of banks and the volatility of their deposit bases.

Barings

Barings Brothers & Co., Limited, a UK bank, was forced to cease trading on 27 February 1995 because of losses caused by dealings in derivatives by one of its traders in its subsidiary in Singapore. On the same day, Barings was instructed by the Monetary Authority to close its Hong Kong Branch, which is a restricted licence bank, for normal business until further notice and to take various measures designed to safeguard the assets of the Branch.

Barings' collapse had little impact on depositors and the banking system in Hong Kong. The HK dollar was not affected by the incident. Barings' Hong Kong Branch engaged mainly in corporate advisory business and its balance sheet was very small. Following the acquisition by the Dutch bank, ING, of almost all of the business, assets and liabilities of the Barings Group from the Administrators in the UK, restrictions on Barings' activities in Hong Kong were uplifted on 4 April 1995.

The Barings case has reinforced the importance of banks maintaining adequate risk management systems and internal controls to guard against the risks arising from their derivatives operations. The Monetary Authority had already issued in December 1994 guidelines to authorised institutions on their trading in derivatives. As a preliminary response to the Barings incident, the HKMA issued in March a letter to all institutions requiring those which are engaging in trading derivatives, or funding group companies in the trading of derivatives, to undertake an immediate review of their internal control systems. Such institutions were required to report to the HKMA the results of their review. Authorised institutions which do not engage in the trading of derivatives or funding such activities by other group companies were required to confirm this and consult the Monetary Authority before entering into such activities. These reports are still being analysed by the Monetary Authority. Slightly more than 100 institutions have indicated that they trade in derivatives, albeit in most cases on a limited scale. Some control weaknesses have been revealed which will be addressed with the institutions concerned.

Balance sheet developments

Customer Deposits

The strong competition for HK dollar deposits prevalent in the previous quarter eased considerably in the March quarter. Total HK dollar deposits of the banking sector (including swap deposits) have continued to increase at a faster rate than Hong Kong dollar loans over the last six months (by 7.1% compared with 5.1% for loans) thus reducing the need to bid actively for deposits. Interest rates on large time deposits declined during the first quarter and were generally below HIBOR. This trend was also reflected in the narrowing of the interest rate differentials between deregulated time deposits and savings deposits. The gap between the average interest rate on one-month time deposits and the savings rate dropped from 280bp in January to 131bp in March. This reduced the relative advantage of holding money balances in the form of time deposits rather than savings deposits. The fall in cash held by the public after the Chinese New Year contributed to some recovery of demand deposits.

Table 1

HK Dollar Deposit Mix

Amount (HK$ bn)

	Demand	Savings	Deposits Time*	Swap	Time @
Q1/94	103.8	270.6	424.9	80.2	505.1
% growth	-1.3	-4.0	6.3	11.7	7.1
Q2/94	101.1	279.3	464.8	90.7	555.6
% growth	-2.6	3.2	9.4	13.1	10.0
Q3/94	103.7	283.2	494.8	102.0	596.8
% growth	2.6	1.4	6.5	12.4	7.4
Q4/94	100.1	274.7	537.2	103.8	641.0
% growth	-3.4	-3.0	8.6	1.8	7.4
Q1/95	103.4	263.8	615.4	71.2	686.5
% growth	3.3	-4.0	14.6	-31.4	7.1

Note: % growth denotes the quarter-on-quarter growth of the deposits.
* excludes swap deposits
@ includes swap deposits

Total customer deposits of the banking sector as a whole rose by 4.8% compared to 3.5% in Q4 1994 and 0.6% in Q1 1994. Strong increases in HK dollar time deposits ($78.2bn or 14.6% excluding swap deposits) and non-US dollar foreign currency time deposits ($40.6bn or 10.8%) more than offset a significant fall in swap deposits ($32.6bn or 31.4%). The growth in non-US dollar foreign currency time deposits was partly due to the valuation effect following the strong appreciation of major foreign currencies against the HK dollar. HK dollar savings deposits fell by $10.9bn, or 4.0%, over the quarter as a whole, but showed signs of recovering within the period. HK dollar demand deposits showed a modest increase ($3.3bn or 3.3%), reversing the downward trend evident over the past year.

Interest spreads between BLR and deregulated deposits narrowed sharply in the first month of the quarter (by up to 155bp), but widened again during the rest of the quarter. In March, these spreads were the same or wider than they had been in the last quarter of 1994. The spread between BLR and the savings rate remained unchanged at 4.75%. The spreads between BLR and HIBOR narrowed by 80-130bp at the start of the quarter but more than recovered during February and March. Reflecting the diminishing impact of deregulation on spreads during the quarter, the net interest margin of the local banks (net interest income as a percentage of average interest bearing assets) remained at 2.32% (annualized), the same as in both the previous quarter and the first quarter of 1994.

Certificates of deposit

The improvement in HK dollar liquidity may also have reduced the need to issue negotiable certificates of deposit (NCDs). At end-March, total NCDs issued and outstanding amounted to $110.7bn. The 3.8% growth during the quarter was significantly lower than the average quarterly growth during 1994 (18.2%). This slow-down reflected a sharp deceleration in issues of HK dollar denominated paper, which grew by 3.7% compared with 26.8% in Q4 1994. Floating, rather than fixed, rate instruments continued to account for the bulk of new issues. Of the $11.0bn of new issues made during the quarter, $7.9bn (or 72%) were floating rate.

In line with the reduced supply, growth in holdings of NCDs by authorised institutions slowed to 11.9% compared with 28.9% in Q4 1994. However, holdings of other negotiable debt instruments denominated in non-US dollar foreign currencies increased by 20.2% compared with a fall of 10.0% in the previous quarter. This was largely attributable to an increase in holdings of foreign currency government paper, although the appreciation of major non-US dollar foreign currencies against the HK dollar was also a contributory factor.

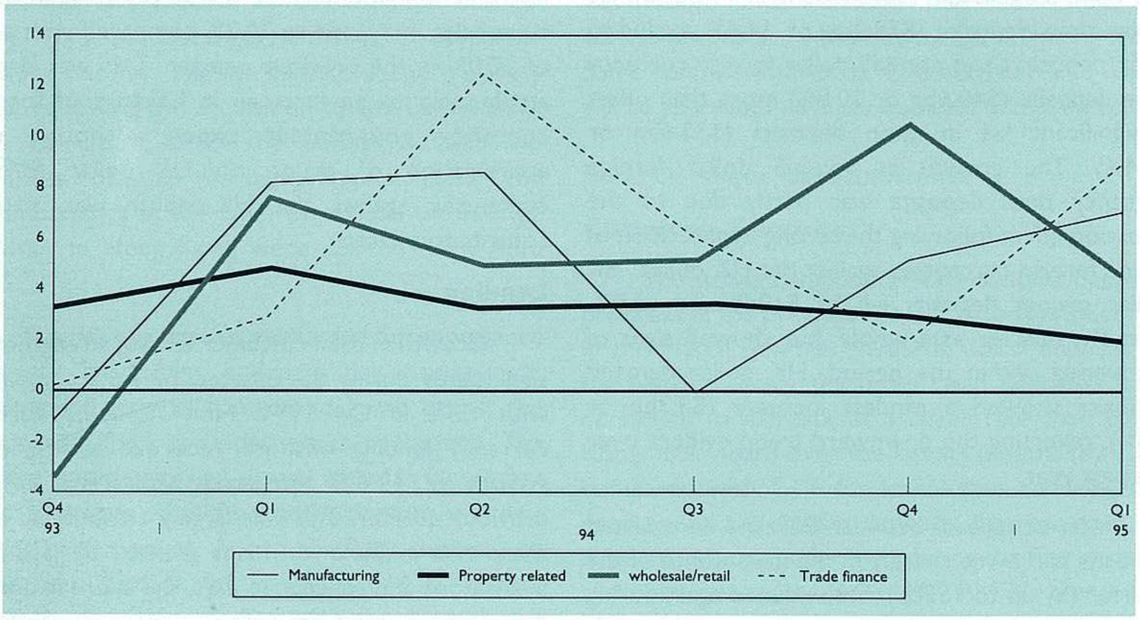
Lending

Growth in total customer lending strengthened significantly during the quarter, by 7.6% compared with 1.8% in Q4 1994. Non-US dollar foreign currency lending offshore recorded a significant growth of 12.6% compared with 1.3% in the previous quarter. This was largely attributable to a sharp rise in Euro-yen loans granted by Japanese institutions and reflects, in part, the appreciation of the yen against the HK dollar.

Domestic lending showed a more modest recovery, growing by 3.3% compared with 2.8% in the previous quarter. This increase was driven by a revival in trade finance, which grew by 8.7% compared with 1.9% in Q4 1994. Growth in other loans for use in Hong Kong moderated slightly (by 2.8% compared with 2.9% in Q4 1994), on the back of increased interest rates, with a slow down evident in a number of economic sectors, most notably in property-related lending, wholesale/retail trade and credit card loans. Against this, lending to the manufacturing sector rose by 6.8% compared with 5.0% in Q4 1994.

Growth in lending for property development and investment (including civil engineering) continued to slow (by 2.1% compared with 5.3% in Q4 1994). Growth in residential mortgages (including loans under the Home Ownership Scheme and Private Sector Participation Scheme) remained sluggish at 1.4%, although there were some signs of increased activity in March following the release during the quarter of a number of new developments. A significant proportion of the rise in lending to financial concerns (6.5% compared with 1.2% in Q4 1994) was attributable to finance companies associated with property developers. Total property-related lending (excluding the latter) accounted for 38.7% of domestic lending at end-March 1995, down slightly on the end-December 1994 figure

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



(39.1%). If the indirect lending to the property sector is also included, the equivalent figures were 39.9% and 40.2% respectively.

Loan to deposit ratio

As the growth of HK dollar deposits (3.7%) continued to exceed the growth of HK dollar loans (2.4%), the HK dollar loan to deposit ratio of the banking sector fell to 108.8% at end-March from 110.2% at end-December 1994 and 111.5% at end-December 1993. The ratio of the locally incorporated banks also improved from 72.1% to 71.6% in Q1 1995.

– Prepared by the Banking Policy Department