DEVELOPMENTS IN THE BANKING SECTOR

The impact of interest rate deregulation on deposit movements and interest rates has further stabilised in the June quarter. Competition for HK dollar deposits continued to ease as reflected in declining interest rates. Local banks performed well in the first half of 1995 due to widening interest margins, improved investment income and a modest recovery in demand for customer loans.

Interest Rate Deregulation

Deposit movements and interest rates further stabilised in the June quarter after the sharp fluctuations in January. According to the survey of 40 licensed banks conducted by the Monetary Authority, savings deposits rose by a total of HK$15.0 bn (5.8%). Demand deposits decreased by HK$4.2 bn (4.6%), but this was mainly the result of a sharp drop in April of HK$6.9 bn due to the customary shifting of tax revenues by the Hong Kong Government from current accounts into other banking accounts. Deregulated time deposits continued to rise, but at a much slower average monthly growth rate of 5.7% in the June quarter, down from the peak of 69.2% in January. Much of this represented switching out of swap deposits which fell by HK$8.1 bn (11.5%).

Subsequent to the sharp surge in January, interest rates on deregulated time deposits continued to adjust downwards in the June quarter. As an example, the average interest rate on one-month deregulated time deposits fell by 15 bp during the quarter to 5.41% in June. This was 114 bp below the peak in January (6.55%), reflecting the easing of conditions in the interbank market and the drop in the corresponding HIBOR of 131 bp since January. Overall, the average interest rate on deregulated time deposits at end-June was 103 bp higher than the pre-deregulation level at end September 1994. However, after allowing for the 125 bp increase in HKAB rates during this period, the end-June average interest rate was 22 bp lower than it would have been if there had been no deregulation. This suggests that as deregulated rates follow more closely the interbank rates, depositors may not necessarily gain a better rate after deregulation.

The Monetary Authority is conducting a full assessment of the impact of the first two phases of deregulation. The review will analyse the effects of deregulation on deposit movements, interest rates, banks' funding costs and the stability of their deposit base. It will also take account of the banks' results in the first half of 1995.

Amendments to the Banking Ordinance

The Banking (Amendment) Ordinance 1995 was enacted on 28 June and published in the Gazette on 30 June. The Ordinance rationalises the authorisation framework by making the Monetary Authority the licensing authority for all three types of authorised institutions and strengthens the checks and balances in the authorisation arrangements. The Ordinance also defines more clearly the scope, objectives, duties and powers of the Manager appointed under the Ordinance to take control of a problem authorised institution.[1]

The commencement date of the Ordinance will be published in the Gazette in due course, after the Monetary Authority publishes a comprehensive Guide to Applicants. It is hoped to achieve this in the final quarter of this year. The Guide will provide guidance to applicants and authorised institutions on the authorisation procedures under the new structure and set out the Monetary Authority's supervisory principles and policies. A Banking Supervision Review Committee will be established in the Authority to consider and make recommendations to the Chief Executive on major authorisation issues.

Balance sheet developments

Customer deposits

Growth in total customer deposits of the banking sector as a whole slowed to 3.9% in the June quarter from 4.8% in the previous quarter, but was higher than the same period last year

1 For a more detailed discussion, see "Banking Amendment Bill 1995" in the February 1995 issue of the *Quarterly Bulletin*.

(3.3%). The slowdown was mainly attributable to a drop of 1.9% in US dollar deposits. In contrast, HK dollar and non US dollar foreign currency deposits continued to rise by 5.2% and 7.6% respectively, compared with 3.7% and 8.1% in the March quarter. The continued rise in the non-US dollar deposits was due partly to the valuation effect following the appreciation of major foreign currencies against the US and HK dollar.

Competition for HK dollar deposits continued to ease in the June quarter. The need to bid actively for deposits has been reduced by the continuing tendency for total HK dollar deposits of the banking sector (including swap deposits) to increase at a faster rate than HK dollar loans (5.2% compared with 3.9% for loans). Expectations of a downward move in interest rates further suppressed the local interbank rates, and hence the deregulated time deposit rates. On average HIBOR and deregulated time deposit rates fell noticeably at the longer end, for example by 100 bp in respect of deposits fixed for 12 months, causing the yield curve to flatten over the quarter. Best Lending Rate remained unchanged during the quarter at 9%. This, together with the easing in competition for HK dollar deposits, enabled banks to benefit from a widening of interest margins.

The narrowing of the interest rate differential between savings and time deposits, coupled with the more active stock market, reduced the relative attractiveness of holding money balances in the form of time deposits. This has prompted a recovery in HK dollar savings deposits ($15.1bn or 5.7%) and a slowing in the growth of time deposits ($43.0bn or 6.3% adjusted to include swap deposits); indeed time deposits of under one month fell by 1.0% over the quarter. Demand deposits fell by $3.7bn or 3.6% over the quarter, mainly due to the customary shift of tax revenue by the Hong Kong government mentioned earlier.

Certificates of deposit

Issues of NCDs picked up again following a quiet March quarter. This probably reflects the banking sector's increased demand for working capital, in particular in preparation for financing major infrastructure projects such as the new airport, as well as a desire by banks to improve further the maturity structure of their balance sheets. In some cases, the low funding costs associated with NCD issues have also made them an attractive form of medium to long term finance.

As at end-June, total NCDs issued and outstanding amounted to $118.9 bn representing a 7.4% increase over the quarter, compared with 3.8% in the March quarter. However, this remains well below the average quarterly growth rate of 18.2% seen during 1994. Floating rate instruments,

Table 1
HK Dollar Deposit Mix

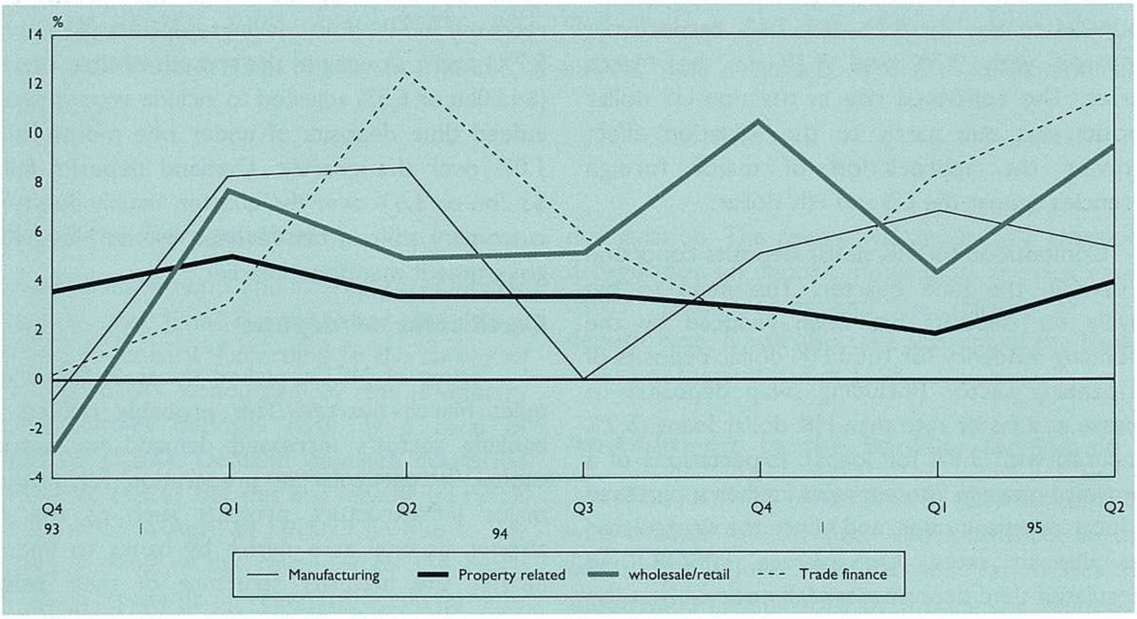
Amount (HK$ bn)

			Deposits		
	Demand	**Savings**	**Time***	**Swap**	**Time @**
Q2/94	101.1	279.3	464.5	90.7	555.3
% 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	7.5
Q4/94	100.1	274.7	537.6	103.8	641.4
% growth	-3.4	-3.0	8.6	1.8	7.5
Q1/95	103.4	263.8	615.4	71.2	686.5
% growth	3.3	-4.0	14.5	-31.4	7.0
Q2/95	99.7	278.9	666.6	63.0	729.6
% growth	-3.6	5.7	8.3	-11.5	6.3

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

Chart 1

Loans for use in Hong Kong by Selected Sectors, quarterly percentage change



all of which were denominated in HK dollars, accounted for two-thirds of new issues, perhaps reflecting the sector's expectation that interest rates have reached their peak. In line with the increased supply, the sector's holdings of NCDs picked up by 20.7% compared with 11.7% in the March quarter. Growth in holdings of other negotiable debt instruments remained strong at over 7% (adjusted to exclude the reclassification effect of the Repo transactions of Exchange Fund Bills and Notes). As in the previous quarter, this was partly due to the appreciation of major foreign currencies against the HK dollar during the period, but also reflected strong growth in holdings of paper denominated in non US dollar foreign currencies.

Lending

Growth in total customer loans accelerated to 9.8% following a rise of 7.5% in the March quarter. Most of the increase was accounted for by the rise in offshore loans in non US dollar foreign currencies (15.6%). This was partly due to the currency valuation effect mentioned above, but also reflected an increase in Euroyen activities by Japanese institutions in Hong Kong. Domestic lending grew by a more modest 3.6% with the growth concentrated in trade financing (11.6%) and private residential mortgage lending (7.1%). This was in line with the rise in the value of both exports and imports and the resurgence of activity in the primary market for residential properties over the period.

Growth in lending for property development and investment (including civil engineering) continued to slow (to 1.1% compared with 2.1% in the previous quarter). However, due to the faster growth in residential mortgage loans, total property related lending as a proportion of domestic lending remained virtually unchanged over the quarter (38.8%).

Growth in lending to other economic sectors was mixed. Credit card balances and lending to the wholesale and retail trade saw a strong recovery, while lending to financial concerns (excluding authorised institutions) and the transport industry fell over the quarter.

Loan to deposit ratio

With the growth in HK dollar deposits continuing to outstrip the growth in loans, the HK dollar loan to deposit ratio for the sector as a whole fell from 108.8% at end-March to 107.4% at end-June. The ratio for locally incorporated banks also improved from 71.6% to 71.3%.

Performance of the banking sector

The banking sector has enjoyed a better than expected performance in the first half of 1995 and this has been reflected in the half-year results announced by some banks. The after-tax profits of the Hong Kong offices of the banking sector as a whole rose by 13.8% compared with the first half of 1994, while locally incorporated banks recorded a rise of 16.2%. This good performance was supported by a moderate improvement in the banks' net interest margin. In the case of the local banks, their margin improved to 2.40% (annualised) compared with 2.33% for 1994. This reflects improvements in the gross interest yield due to the maintenance of an unchanged Best Lending Rate in this period and to the positive effect of higher interest rates on the value of interest-free balances (the "endowment" effect). These two factors taken together more than offset the increase in interest costs. Investment income of the sector also saw a strong recovery compared with the first half of 1994 on the back of the improved stock and bond markets.

Another positive factor in the first half was the continuing low need to make provisions for bad debts. As a percentage of total average assets, such provisions by local banks were maintained at the low level of 0.03% in the first half of 1995, the same as for the first half of 1994. While this seems to reflect continuing good asset quality, it cannot be assumed that this situation will persist indefinitely and it is therefore important that banks should keep the level of their provisions under close review.

– Prepared by the Banking Policy Department