DEVELOPMENTS IN THE BANKING SECTOR

Both HK dollar deposits and loans slowed over the quarter. The average cost of funds declined while the best lending rate remained firm enabling the sector to benefit from a further widening in interest margins. However, the level of bad debt provisions of local banks increased slightly, underlining the need for banks to keep the level of their provisions under close review.

Interest rate deregulation

The Government decided on 26 September that the third phase of interest rate deregulation should include all time deposits governed by the Interest Rate Rules (IRR) fixed for 7 days or with a call or notice period of 7 days and that there should be no further move below 7 days. The current programme of deregulation has therefore come to an end.

This decision followed a review by the HKMA of the first two stages of deregulation in the nine-month period to June 1995. The HKMA's review concluded that deregulation so far has been a success. Over 99% of previously regulated time deposits have been deregulated. Consumers have benefited from wider access to market rates at little cost in terms of loss of liquidity. The banking sector has also absorbed the effects well, remaining profitable and robust. Aggregate after tax profits of the banks surveyed in the first half of 1995 improved over the same period of last year and return on assets was unchanged. Deposit migration has stabilised and interest rates have eased subsequent to the sharp rise in January.

After deregulation of 7-day deposits, all the recognised maturity brackets specified in the IRR will have been deregulated with the exception of 24-hour call deposits. This is a logical place to stop since it leaves a "firewall" to serve as a buffer between deregulated time deposits and current and savings accounts. This should avoid any potentially destabilising migration of deposits and is consistent with the Government's previously stated position that there should be no deregulation of current and savings accounts before 1997.

In response to the Government's decision, the Hong Kong Association of Banks has amended the IRR to implement the deregulation of 7-day deposits on 1 November 1995.

Disclosure of Inner Reserves

As part of the effort to improve financial disclosure by authorised institutions, the HKMA undertook in mid-1995 a review of the disclosure of balance sheet inner reserves.

The review took into account market reaction to the disclosure of transfers to inner reserves in the banks' 1994 accounts and the views of banks, auditors and market analysts. The review concluded that the disclosure of transfers to inner reserves in the 1994 accounts had not caused any major adverse impact on the banks and that the disclosures in the 1994 accounts had already prepared the way for disclosure of balance sheet inner reserves. The banks consulted by the HKMA have raised no objection to making the disclosure in their 1995 accounts.

In light of the above, the HKMA announced in September its decision to recommend the disclosure of balance sheet inner reserves by locally incorporated banks in respect of their annual accounts for financial years ending on or after 31 December 1995. The HKMA's announcement emphasised the need to put in perspective the size and significance of the inner reserves of individual banks. Inner reserves are an historical legacy and different banks will have different levels of inner reserves reflecting their past policy in making such transfers. It is important to realise that inner reserves are only one component of banks' capital base, and that the key measure of the capital strength of banks is not inner reserves but the capital adequacy ratio (which will also be disclosed in the 1995 accounts). In this regard, banks in Hong Kong are well capitalised by international standards.

Balance Sheet developments

Customer deposits

Growth in total customer deposits of the sector declined further to 2.3% in the September quarter compared with 3.9% in the June quarter and 4.7% in the same period in 1994. This slowdown was mainly attributable to significantly weaker growth in non-US dollar foreign currency deposits (0.8% compared with 7.6% in the June quarter), although a decline in the growth of HK dollar deposits (to 3.6% from 5.2% in the June quarter) was also a contributory factor. The former reflects in part the negative valuation effect of the depreciation of major foreign currencies against the HK dollar over the period. In contrast, US dollar deposits saw a modest recovery of 0.7% compared with a decline of 1.9% in the June quarter.

Growth in HK dollar time deposits (adjusted to include swaps) dropped further to 4.5% from 6.3% in the previous quarter. Growth in savings deposits also declined (to 3.5% from 5.7%), but remained notably stronger than in the same period in 1994 (1.4%). Demand deposits fell by a further 2.5% over the quarter. Migration from swap deposits in favour of time deposits continued, but at a slower rate (-9.6% compared with -11.5% in the June quarter).

Despite the slowdown noted above, HK dollar deposits continued to grow at a faster rate than HK dollar loans (3.6% compared with 2.0%). The average cost of funds over the quarter dropped. For example, average one month HIBOR and time deposit rates were 5.83% and 5.40% respectively in the September quarter, slightly lower than the corresponding averages of 5.88% and 5.56% for the June quarter. As a result of the lower funding costs, the banking sector benefited from a decline in interest costs (defined as interest expenses as a percentage of average interest bearing liabilities).

The best lending rate remained unchanged at 9%. This together with the fall in the average cost of funds resulted in a further widening of interest margins. The average spread between the best lending rate and one-month time deposit rate was 3.60% and that between the best lending rate and one-month HIBOR was 3.17% in the September quarter, compared with 3.44% and 3.12% respectively in the June quarter. This resulted in a rise in the net interest margin over the quarter, despite competition in the residential mortgage market which prompted some banks to cut mortgage rates by 25-50 bp.

Negotiable instruments

Growth in issues of negotiable certificates of deposit (NCDs) remained strong in the September quarter. This reflected banks' continued demand for working capital, in particular in preparation for financing infrastructure projects such as the new airport, as well as a desire to improve further their liquidity and maturity profile. In line with the expectation that interest rates are on a downward trend in the medium term, floating rate instruments, in particular those denominated in HK dollars, continued to dominate the new issues.

As at end-September, total NCDs issued and outstanding amounted to $134.5 bn, representing a 13.2% increase over the quarter compared with 7.3% in the June quarter. Floating rate instruments continued to account for about two-thirds of the new issues. The share of outstanding NCDs held by the sector remained high at around 44% as at end-September.

Growth in holdings of other negotiable debt instruments fell from 9.1% in the June quarter to 2.6% in the September quarter (adjusted to remove the impact of the revised arrangement under which market makers' short positions in Exchange Fund Bills and Notes are covered by Repo transactions with the Exchange Fund). The more sluggish growth was mainly due to the redemption of some foreign government securities held by local authorised institutions.

Lending

Total customer lending fell by 3.3% over the quarter following a strong rise in the June quarter (9.8%). The fall was largely attributable to a combination of the negative valuation effect of the depreciation of the Japanese yen against the HK dollar and the seasonal slowdown in Euroyen activities. Growth in domestic loans continued to slow (to 2.1% compared with 3.6% in the June quarter), reflecting a fall in trade financing loans of 2.0% after the sharp rise (11.6%) in the June quarter. Growth in loans to manufacturing, wholesale and retail trade and to individuals in respect of credit cards also slowed.

Growth in lending for property development and investment (excluding civil engineering) however strengthened from 0.7% in the June quarter to 1.1% in the September quarter, with most of the increase (56.0%) in the residential sector. Growth in private residential mortgage loans slowed to 3.7% compared with 6.8% in the June quarter. This reflects the more subdued activity in the property market in July and August. Total property lending, defined as lending for property development and investment and private residential mortgage loans (excluding lending under the Home Ownership Scheme and Private Sector Participation Scheme), as a proportion of loans for use in Hong Kong remained flat at 39.0%.

Loan to deposit ratio

With HK dollar deposits continuing to grow faster than loans, the HK dollar loan to deposit ratio for the sector improved further from 107.4% at end-June to 105.8% at end-September. The ratio for locally incorporated banks also improved from 71.3% to 69.9%.

Profitability

Net profits of the locally incorporated banks arising from their offices in Hong Kong continued to grow at a healthy rate of over 16% in the first nine months of the year compared with the same period of 1994. This has reflected growth in income which has outstripped that in operating expenses and a continuing low bad debt charge of about 0.07% of total average assets (annualised). The latter ratio is, however, slightly higher than in the same period of 1994. Despite the impact of interest rate deregulation, the net interest margin of 2.45% (annualised) improved over 1994 as did the overall return on assets of 1.61% (annualised).

– Prepared by the Banking Policy Department