DEVELOPMENTS IN THE BANKING SECTOR

The operating environment for banks remained difficult in the second quarter. Lending volume showed flat growth due to slower economic activity and to the cautious lending policies of banks. Profits fell in the first half of the year reflecting a lower net interest margin, the flat lending volume and a rise in provisions for bad debts. The local banking industry is nevertheless still profitable and its capital strength continues to be strong. Local banks should thus have the strength to manage their way successfully through the current difficulties.

Interest Rate Movements

Money market rates moved higher in June as a result of renewed volatility in the regional financial markets due to the weaker yen and the shrinkage of interbank liquidity arising from the selling of the Hong Kong dollar. The surge was short-lived, however, with interbank term rates, especially those at the longer-end of the maturity spectrum, quickly falling back as the yen stabilised and selling pressure on the currency eased.

For the June quarter as a whole, the average overnight and 1-week HIBOR rose by 5 and 40 basis points compared with the previous quarter, to 5.44% and 6.55% respectively. These increases compared with declines of 167 and 365 basis points in the March quarter and reflected funding pressure at the shorter end of the interbank market. In contrast, one-month HIBOR declined by 35 basis points to 7.29% while 3-month HIBOR fell by 119 basis points to 7.68%. These compared with declines of 142 and 101 basis points in the March quarter. In line with the decline in HIBOR, time deposit rates dropped in the June quarter. One-month time deposit rate[1] fell by another 18 basis points to 6.79%, following a drop of 49 basis points in the March quarter. Similarly, the 3-month time deposit rate fell by 82 basis points to 7.26%, having risen by 12 basis points in the March quarter.

With the Best Lending Rate (BLR) remaining unchanged at 10.0%, interest rate spreads between BLR and HIBOR and between BLR and time deposit rates increased in the June quarter. The average spread between BLR and 1-month HIBOR increased to 2.71% in the June quarter (compared with 2.51% in the March quarter) while that with 3-month HIBOR rose to 2.32% (compared with 1.29%). The average spread between BLR and 1-month time deposit rate also widened to 3.21% and that with the 3-month time deposit rate[1] to 2.74% (compared with 3.19% and 2.08% in the March quarter). However, the actual spreads are in fact narrower because banks paid additional margins (on top of the quoted rates) to attract deposits.

Balance Sheet Developments

Customers Deposits

Customer deposits fell modestly, by 0.2% in the June quarter, after a rise of 1.8% in the March quarter. Hong Kong dollar deposits showed flat growth after a 1.3% rise in the March quarter. Foreign currency deposits reversed from a 2.5% rise in the March quarter to a fall of 0.4% in the June quarter. US dollar deposits rose by 4.5% but non-US dollar foreign currency deposits showed a bigger decline of 6.1%. The latter was partly due to the fall in deposits from overseas affiliates of some banks and partly due to the valuation effect of the weaker yen.

The breakdown of Hong Kong dollar deposits showed that demand deposits fell by 12.8% in the

[1] These are period average figures quoted by 10 major banks for deposit amounts less than HK$100,000 as reported in the Hong Kong Monetary Authority (HKMA) Monthly Statistical Bulletin.

June quarter (after dropping by 3.0% in the March quarter), while savings deposits declined by 14.6% (against a rise of 7.9%). Reflecting depositors' preference for time deposits as banks offered higher rates for term deposits, time deposits grew by 6.0% in the June quarter, having fallen by 0.4% in the previous quarter. Unlike the preceding quarter, the growth was mainly concentrated in deposits of shorter maturities. Time deposits maturing within one month and within one to three months rose by 4.7% and 9.4% respectively in the June quarter, reversing declines of 5.8% and 4.2% in the March quarter. Growth in time deposits maturing in more than 3 months moderated from the 73.4% growth in the March quarter to 11.2% in the June quarter. The ratio of Hong Kong dollar deposits to total customer deposits remained stable, at around 57% of total deposits.

Negotiable Instruments

Interest rate volatility and poor market sentiment resulted in fewer issues of negotiable certificate of deposits (NCDs). The outstanding amount of NCDs fell by 0.4% in the June quarter to HK$220.2 bn, following modest growth of 0.5% in the March quarter. Continuing the trend of the past two quarters, fixed rate instruments continued to predominate although their share of total NCDs issued fell to 52.4% in the June quarter from 65.7% in the March quarter. The ratio of NCDs held by authorized institutions dropped to 59.0% from 62.2%.

Lending

Loans and advances shrank for the fourth straight quarter, by 3.4% in the June quarter following a 9.7% drop in the March quarter. Continuing the trend of the previous quarter, the decline in loans and advances was due mainly to the 7.9% drop in offshore loans which reflected the yen depreciation and a further contraction in Euroyen activities.

Domestic loans were broadly unchanged in the June quarter after a drop of 0.8% in the March quarter. The flat growth reflected banks' continued caution in extending new loans and weak loan demand.

Property lending continued to record a modest 1.2% rise in the June quarter despite the lacklustre performance of the property market. This followed a rise of 0.8% in the March quarter. Loans for property development rebounded by 4.2% in the June quarter after a 1.2% drop in the March quarter. However, the fall in loans for property investment accelerated from 0.5% to 1.5% and growth in residential mortgage loans (excluding loans under Home Ownership Scheme and Private Sector Participation Scheme) moderated further from 2.2% to 1.7%. Property lending as a percentage of loans for use in Hong Kong rose slightly from 44.9% in the March quarter to 45.4% in the June quarter, largely because of a fall in lending to the other sectors.

Lending to most other economic sectors continued to decline, albeit at a slower pace in the June quarter. The decline in trade financing moderated from 5.7% in the March quarter to 2.4% in the June quarter; loans for manufacturing dropped by 1.9% following a decline of 2.9% and loans for wholesale & retail trade shed 1.5% after a fall of 4.1%. Reflecting diminished activity in the equity market, lending to stockbrokers fell by 19.6% in the June quarter, following the 37.1% drop in the March quarter. On consumer lending, after having fallen 1.1% in the March quarter, credit card receivables grew by 7.3% in the June quarter. Loans to individuals for other private purposes rose by 0.9% after a 1.5% rise in the March quarter.

Loan-to-Deposit Ratio

The Hong Kong dollar loan-to-deposit ratio for the banking sector as a whole rose from 111.3% at end-March to 111.5% at end-June. The ratio for local banks also rose from 78.5% to 78.9%. On the other hand, the overall loan-to-deposit ratio of local banks fell from 67.3% in the March quarter to 66.4% in the June quarter.

Assets Quality

As expected, the financial difficulties of the region and the slowdown in the Hong Kong economy have resulted in further deterioration in bank asset quality in the June quarter. Loans overdue for more than 3 months increased from

1.98% at end-March to 2.53% at end-June while rescheduled loans rose from 0.22% to 0.43%. The total of the two figures at end-June was 2.96%.

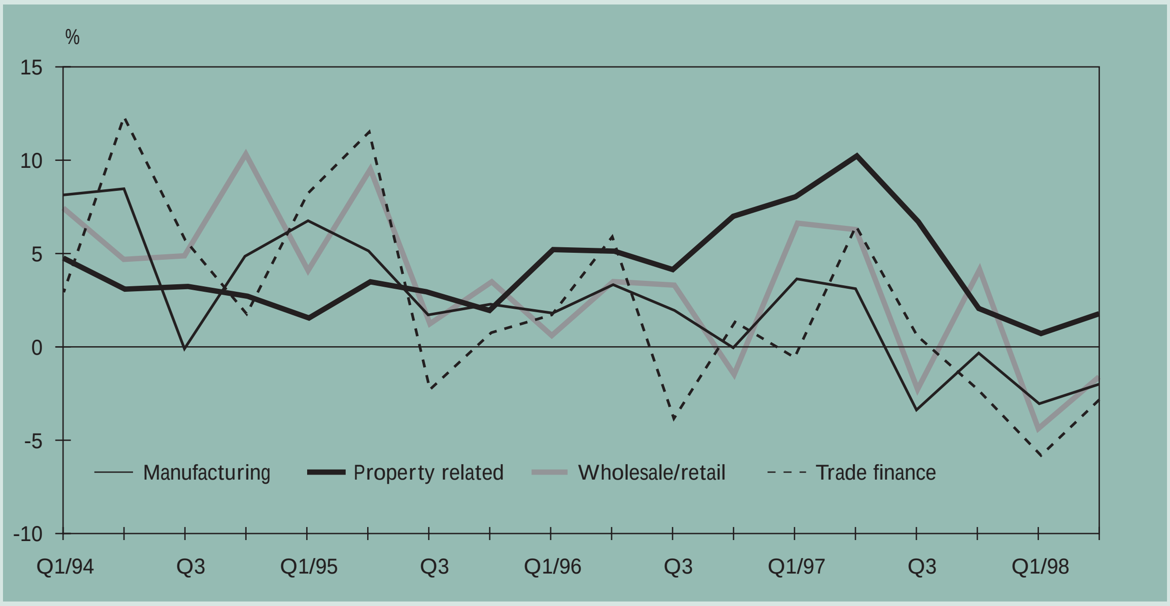
A broader definition of problem loans is "classified loans" (i.e. loans classified as substandard, doubtful and loss). This takes account not only of the period that loans are overdue but more forward-looking and qualitative factors such as the business prospects of the borrower, cash flow and payment capability. The classification of individual loans is also influenced by the extent to which they are covered by collateral since this will affect the collectability of such loans (by contrast the figures for overdue loans do not take account of the existence of collateral). As in the first quarter, classified loans rose more sharply than overdue and rescheduled loans, increasing from 2.77% at end-March to 3.69% at end-June. This may be because more loans are being classified as the value of collateral falls and no longer fully covers the value of principal and accrued interest. However, it also suggests that institutions are adopting a prudent approach by not simply relying on the period overdue as the criteria for classifying loans. Despite the rise in both definitions of problem loans, the amounts involved remain well within manageable proportions.

Credit card debts overdue for more than 90 days rose from 0.80% of total receivables at end-March to 0.94% at end-June and the charge-off ratio (annualized) rose from 2.19% to 2.76%. This figure is still well below the charge-off ratio in markets such as the United States.

The Hong Kong Monetary Authority started collecting data on overdue mortgage loans in its monthly mortgage with effect from June. Mortgage loans overdue for more than three months as a share of the total mortgage portfolio remained at a low level of 0.29% at end-June.[2]

Chart 1

Loans for Use in Hong Kong by Selected Sectors
Quarterly % Change



N.B. Property related loans denotes lending for property development & investment (including civil engineering) and private residential loans (including lending under the Home Ownership Scheme & Private Sector Participation Scheme).

2 Previous estimates of the overdue ratio of mortgage loans were based on a smaller survey of institutions and are not therefore directly comparable with the end-June figure.

Profitability

The interim results of local banks have shown a decline in profitability in the first half of the year. On the basis of the figures reported to the HKMA in respect of Hong Kong offices only, operating profit before tax of local banks declined by 25% in the first half of the year compared with the same period of 1997. Income was adversely affected by the narrowing of interest margins caused by higher funding costs and the slower growth in the volume of lending. The net interest margin fell from 2.43% in 1997 to 2.31% (annualized) in the first half of 1998. The bad debt charge as a percentage of total average assets rose to 0.39% (annualized) in the June quarter from 0.15% in 1997, reflecting the deterioration of asset quality referred to above.

Nevertheless, despite the fall in profits, all local banks continued to make money in the first half and their capital strength remains strong (the consolidated capital adequacy ratio for local institutions as a whole based on the latest available statistics at end-March stood at 18.2%). The rise in the bad debt charge is from a low base and is inevitable in the current economic climate. It demonstrates that the banks are taking early action to deal with the decline in asset quality.

Table 1
HK$ Deposit Mix

Amount (HK$ bn)

	Deposits				
	Demand	**Savings**	**Time ***	**Swap**	**Time @**
Mar/97	117.1	355.8	942.1	35.8	977.9
% growth	(3.9)	(2.8)	7.8	(6.9)	7.2
Jun/97	123.2	381.3	1,024.5	37.4	1,061.9
% growth	5.3	7.2	8.8	4.4	8.6
Sep/97	123.3	348.0	1,092.2	35.9	1,128.1
% growth	0.1	(8.7)	6.6	(4.0)	6.2
Dec/97	107.6	336.1	1,051.7	42.3	1,094.0
% growth	(12.8)	(3.4)	(3.7)	17.9	(3.0)
Mar/98	104.3	362.7	1,049.9	40.2	1,090.1
% growth	(3.0)	7.9	(0.2)	(5.1)	(0.4)
Jun/98	91.0	309.9	1,120.7	35.2	1,155.9
% growth	(12.8)	(14.6)	6.7	(12.4)	6.0

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