

DEVELOPMENTS IN THE BANKING SECTOR

Corporations' repatriation of offshore deposits back to Hong Kong and a rise in US dollar deposits resulted in an increase in customers deposits in the September quarter. Lending to customers continued to shrink. Due to tightness in interbank liquidity, funding costs of banks rose further, resulting in the narrowing of net interest margins. Problem loans continued to increase, resulting in further provisions for bad debts. On balance, however, the aggregate profitability of local banks showed no further deterioration and their capital strength remained strong.

Interest Rate Movements

Interest rates moved higher during the greater part of the September quarter. They peaked in end-August when the Hong Kong financial markets were under severe speculative attack which caused a tightening in interbank liquidity. Interest rates fell back after the Hong Kong Monetary Authority put in place seven monetary measures on 5 September to strengthen the currency board arrangements and to deter speculation on the Hong Kong dollar.

For the September quarter as whole, average 1-month HIBOR rose by 209 basis points to 9.37% while 3-month HIBOR rose, by 214 basis points to 9.82%, against declines of 35 and 119 basis points respectively in the June quarter. Time deposits rates also rose as competition for deposits intensified. The average 1-month and 3-month time deposits rates increased by 87 and 105 basis points to 7.65% and 8.31% respectively, as compared with declines of 18 and 82 basis points in the June quarter.

Reflecting the increase in funding costs and with the Best Lending Rate (BLR) remaining unchanged at 10.0%, average spreads between BLR and HIBOR and BLR and time deposits continued to narrow. The average spread between BLR and 1-month HIBOR contracted to 0.63% in the September quarter from 2.71% in the June quarter, and that of 3-month HIBOR to 0.18% from 2.32%. The average spread between BLR and 1-month time deposit rate narrowed to 2.35%, and that of 3-month time deposit rates to 1.69%. They were 3.21% and 2.74% respectively in the June quarter.

Balance Sheet Developments

Customers Deposits

Customers deposits rose by 6.2% in the September quarter, after a drop of 0.2% in the June quarter. Within the currency breakdown, Hong Kong dollar deposits grew by 5.4% from almost zero growth in the preceding quarter. Foreign currency deposits rose by 7.3%, against a modest decline of 0.4% in the June quarter. The rebound in foreign currency deposits was attributable mainly to strong growth in US dollar time deposits, which rose 14.8%. This sharp rise in time deposits boosted growth in US dollar deposits to 12.9% in the September quarter, up from 4.6% in the June quarter.

The recovery of Hong Kong dollar deposits was aided by corporations' repatriation of offshore deposits back to Hong Kong. This followed an announcement on 22 June regarding the exemption of profit tax on interest income derived from corporate deposits. The fall in demand deposits moderated to 1.3% in the September quarter from 12.8% in the June quarter while saving deposits rose 0.3%, against a sharp fall of 14.6% in the previous quarter. Time deposits continued to grow at a faster pace, by 7.3% in the September quarter (compared with 6.0% in the June quarter) as banks offered higher rates to tap customers deposits.

Continuing a trend of the previous quarter, growth of time deposits was mainly concentrated in deposits of shorter maturities. Time deposits maturing within one month rose by 9.6% in the September quarter, up from 4.7% in the June

quarter. However, growth of time deposits maturing within one to three months moderated to 6.2% from 9.4%, and those maturing in more than three months, to 2.0% from 11.2%.

Negotiable Instruments

The unfavourable market conditions - reduced activity in the capital market and interest rate volatility - continued to curb new issuance of negotiable certificate of deposits (NCDs). The outstanding amount of NCDs dropped by 0.7% to HK\$218 bn in the September quarter, having fallen 0.8% (revised) in the June quarter. The share of NCDs held by authorised institutions fell to 56.3% from 59.2%.

Unlike the previous three quarters, floating rate instruments dominated over fixed rate instruments in the September quarter. Floating rate instruments accounted for an increasing share of the NCD market, at 77.2% in the September quarter, up from 47.6% in the June quarter. Most NCDs issued in the September quarter were denominated in Hong Kong dollars. This reflected banks' desire to improve their Hong Kong dollar liquidity through the issuance of NCDs.

Lending

Loans and advances shrank for the fifth straight quarter, by 6.5% in the September quarter, following a drop of 3.4% in the June quarter. The decline was partly due to the fall in offshore loans and partly due to the slowdown in the Hong Kong economy. Reflecting the contraction in Euroyen activities, offshore loans declined markedly, by 13.8% in the September quarter, having fallen 7.9% in the preceding quarter. Domestic loans fell 1.5% in the September quarter after recording zero growth in the June quarter. The decline of domestic loans reflected subdued loan demand and banks' cautious lending attitude.

Property lending, the mainstay of loan expansion in Hong Kong, fell in the September quarter. Due to the decline in property development and investment, property lending fell by 0.3% in the September quarter, against a rise of

1.2% in the June quarter. Within the composition of property lending, loans for property development fell by 4.4% against a rise of 4.1% in the June quarter, while the decline in loans for property investment moderated to 1.0% from 1.4%. Growth in residential mortgage loans (excluding loans under Home Ownership Scheme and Private Sector Participation Scheme) slowed to 1.3% from 1.7%. Property lending as a percentage of loans for use in Hong Kong rose slightly from 45.4% to 46.0%, largely because of the fall in lending to other sectors.

Attributable to subdued credit demand and weak investment sentiment, lending to most other sectors continued to fall in the September quarter. Loans for trade financing dropped further by 7.3% from the 2.6% decline in the June quarter, and the decline in loans for manufacturing industry accelerated to 6.0% from 1.9%. Lending to stockbrokers also shed 18.2% after a 19.8% fall in the previous quarter. In line with the lackluster performance of retail sales, loans for wholesale and retail trade continued to drop by 4.1% following a 1.5% decline in the June quarter. On consumer loans, growth of credit card receivables moderated to 2.3% from 7.3% and loans to individuals for other private purposes fell by 3.7%, compared with a rise of 0.9% in the June quarter.

Loan-to-Deposit Ratio

Reflecting the increase in Hong Kong deposits and the decline in Hong Kong dollar loans, the Hong Kong dollar loan-to-deposit ratio of the banking sector fell to 104.0% at end-September from 111.5% at end-June. The ratio for local banks also dropped to 74.8% from 78.9%. The overall loan-to-deposit ratio of local banks at end-September was 62.0%, down from 66.4% at end-June.

Assets Quality

Amid the slowdown in the Hong Kong economy and the unstable external financial environment, deterioration in banks' asset quality continued. For local banks, loans overdue for more than three months increased to 3.18% at end-

September from 2.53% at end-June. Along with the rise of rescheduled loans to 0.63% from 0.43%, the percentage of overdue and rescheduled loans stood at 3.81% at end-September, up from 2.96% at end-June. A broader definition of problem loans - "classified loans¹" - also rose, to 4.92% at end-September from 3.69% at end-June. The sharper rise in classified loans reflects the fact that banks do not simply take the delinquency period into account in deciding whether to classify loans.

Within the overall total, the quality of credit card accounts deteriorated in September. The rate of delinquent accounts (overdue for more than 90 days to total receivables) and the charge-off ratio rose further, to 1.08% and 3.49% respectively at end-September, from 0.94% and 2.75% at end-June. Nevertheless, compared to markets such as the United States, the charge-off ratio remains low.

According to the monthly mortgage survey, mortgage loans overdue for more than three

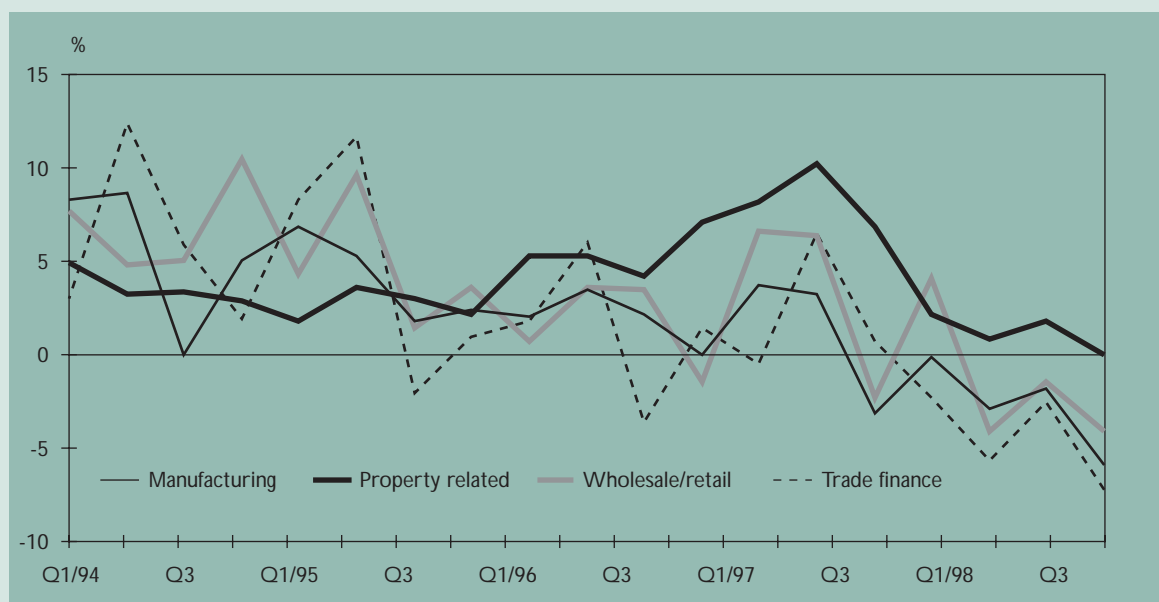
months as a share of total mortgage portfolio rose to 0.53% at end-September from 0.29% at end-June. Despite the increase in overdue mortgage loans, the mortgage portfolio continued to perform much better than the rest of the loan portfolio.

Profitability

Local banks continued to make profits in the first nine months of the year although at a sharply lower rate as compared with last year. The bad debt charge as a percentage of total average assets stood at a relatively high level of 0.37% (annualized) in the first 9 months of the year, up from 0.15% in 1997. Reflecting the rise in funding costs, the net interest margin of local banks narrowed further to 2.27% (annualized) for the first 9 months of the year, down from 2.43% in 1997.

The operating environment for local banks will remain difficult in the coming months. In particular, the bad debt charge is likely to rise further by the

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).

¹ These which are classified as "substandard", "doubtful" or "loss".

end of 1998. Nevertheless, the capital strength of banks continues to be strong. The average consolidated capital adequacy ratio of local incorporated institutions rose to 18.6% at end-September from 18.2% at end-June. ☺

- Prepared by the Banking Policy Division

Table 1
HK\$ Deposit Mix

Amount (HK\$ bn)

	Deposits				
	Demand	Savings	Time *	Swap	Time @
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	1,120.9	35.2	1,156.1
% growth	(12.8)	(14.6)	6.8	(12.4)	6.0
Sep/98	89.8	310.8	1,206.9	33.9	1,240.9
% growth	(1.3)	0.3	7.7	(3.5)	7.3

Notes: % growth denotes the quarter-on-quarter growth of the deposits

* excludes swap deposits

@ includes swap deposits