DEVELOPMENTS IN THE BANKING SECTOR

There were signs of improvement in the performance of banks in the September quarter. Lending to customer continued to fall albeit at a slower rate. Helped by a higher net interest margin and flat operating expenses, pre-provisions operating profits increased, although the performance of individual banks remained mixed. The slight increase in the ratio of classified loans and the decline in such loans in absolute terms indicated that asset quality was stabilizing.

Interest Rate Movements

Domestic interest rates moved higher in the September quarter in line with the higher US interest rates. The average 1-month HIBOR and 3-month HIBOR rose by 90 and 84 basis points to 5.93% and 6.12% respectively, as opposed to declines of 35 basis points and 52 basis points in the June quarter. Time deposit rates however increased less than HIBORs in the September quarter, reflecting ample liquidity in the banking sector. The average 1-month and 3-month time deposit rates increased by 30 basis points to 4.55% and 22 basis points to 4.72%, compared with declines of 52 and 66 basis points respectively in the preceding quarter.

In response to the 25 basis points increase in the US Fed Funds Rate, the Hong Kong Association of Banks raised the savings rate by the same magnitude to 3.75% on 30 August 1999 - the first rate rise in Hong Kong since January 1998. Commercial banks followed by raising the best lending rate (BLR) by the same amount to 8.50% from 8.25%. Because the increase in funding costs outpaced that of the BLR, the average spread between BLR and 1-month HIBOR narrowed to 2.49% in the September quarter from 3.34% in the June quarter, and that for 3-month HIBOR to 2.31% from 3.09%. The average spread between BLR and 1-month time deposit rate contracted to 3.87% from 4.12%, and that for 3-month time deposit rate to 3.71% from 3.87%.

Balance Sheet Developments

Customer Deposits

Customer deposits rose by 3.5% in the September quarter, following an increase of 1.4% in the June quarter. Foreign currency deposits showed strong growth of 7.6% compared with a moderate increase of 1.3% in the preceding quarter. US dollar deposits grew by 6.1% in the September quarter following a rise of 1.2% in the preceding quarter, while non-US dollar deposits rose sharply by 9.7% following a rise of 1.5%. On the other hand, the growth of Hong Kong dollar deposits moderated to 0.3% in the September quarter from 1.4% in the June quarter. This resulted in a fall in the proportion of Hong Kong dollar deposits to total customer deposits from 57.0% at end-June to 55.3% at end-September.

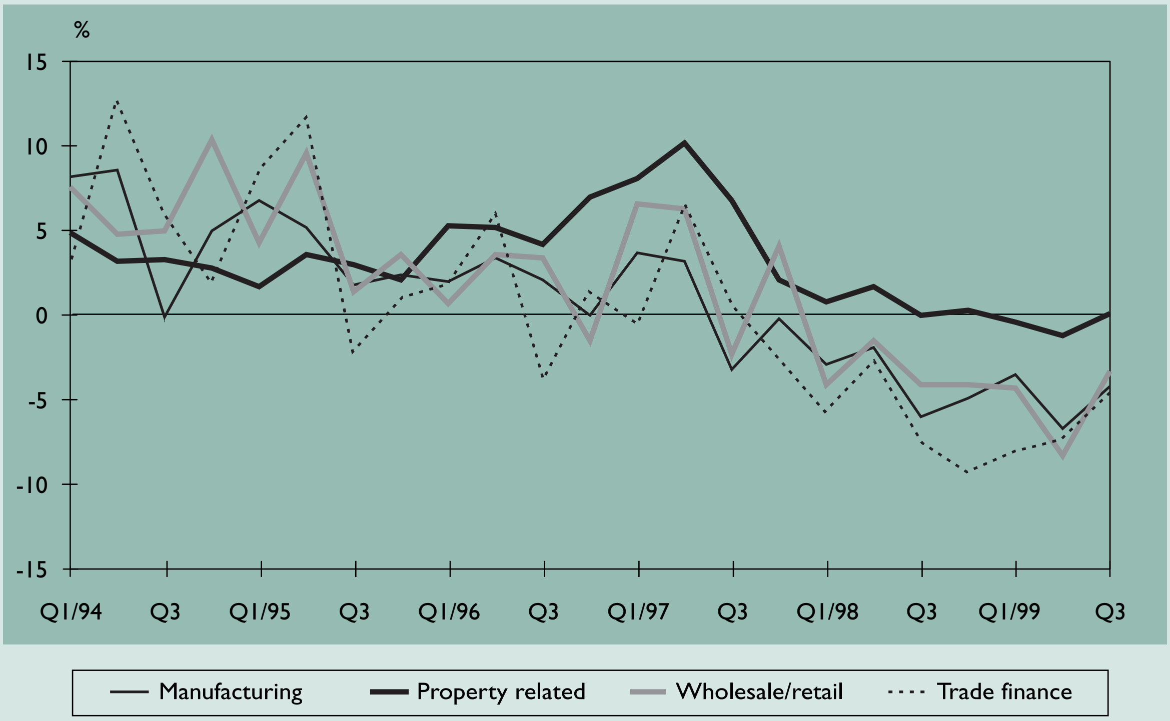
The moderation in growth of Hong Kong dollar deposits was mainly due to a decrease in saving deposits. Saving deposits fell by 3.9% in the September quarter, against a rise of 7.7% in the June quarter. By contrast, demand deposits continued to grow by 2.3%, following an increase of 1.2% in the preceding quarter. Meanwhile, time deposits also rose in the September quarter by 1.7%, after falling 0.7% in the June quarter. The growth in time deposits was more pronounced for deposits with longer maturity. Hong Kong dollar time deposits maturing between one to three months rose notably by 17.1% as compared with a fall of 6.5% in the preceding quarter and the decline in time deposits maturing over three months moderated to 0.2% from 10.8%. On the contrary, time deposits maturing within one month fell by 4.0%, after rising 3.8% in the June quarter.

Negotiable Instruments

The outstanding amount of negotiable certificate of deposits (NCDs) grew by 0.8% in the September quarter after dropping 2.1% in the June quarter. Similar to the June quarter, floating rate

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).

instruments dominated the primary NCDs market in anticipation of higher money market rates. However, the share of floating rate NCDs to total new issues fell to 60.8% in the September quarter from 73.0% in the preceding quarter. The share of NCDs held by authorized institutions fell to 56.3% from 57.3%.

During the September quarter, the banking sector's holdings of Hong Kong dollar negotiable debt instruments (other than NCDs) rose by 12.7% and those of the local banks by 8.8%. This growth seems to have reflected a combination of excess bank liquidity, positioning ahead of Y2K (as shown in a build-up of Exchange Fund paper) and some substitution of corporate debt securities for bank loans. During the year to date, the local banks' holdings of Hong Kong dollar "other negotiable debt instruments" (including corporate bonds and convertible loans stocks) rose by 15.3% and in absolute terms the amount of increase roughly offset the decline in the local banks' Hong Kong dollar loans for use in Hong Kong during the same period.

Lending

Reflecting banks' cautious lending attitude, loans and advances declined for the ninth straight quarter, albeit at a much slower pace of 1.0% in the September quarter compared with 5.2% in the June quarter. The decline in both domestic lending[1] and offshore loans moderated. Due to a slow-down in the contraction in the Japanese banks' euroyen activities, offshore loans, a major area of decline in the past quarters, fell only by 0.3% in the September quarter after declining 8.6% in the June quarter. Domestic lending fell by 1.2% in the September quarter after dropping 3.6% in the June quarter.

1 Domestic lending in Hong Kong comprises trade financing and other loans for use in Hong Kong.

Property lending rose by 0.3% following a decline of 1.3% in the preceding quarter. The rise was due to the increase in loans for property development and residential mortgage loans which more than offset the decline in loans for property investment. Loans for property development increased by 1.8% in the September quarter after falling for four consecutive quarters. Although loans for property investment continued to decline in the September quarter, the decline moderated to 1.0% from 6.3% in the June quarter. After rising 2.4% in the June quarter, residential mortgage loans (excluding loans under Home Ownership Scheme and Private Sector Participation Scheme) grew at a slower pace of 0.5% in the September quarter. According to the monthly residential mortgage survey, refinancing loans for residential mortgage continued to grow in September. This reflected banks competitive strategy for mortgage business in view of its high quality and their cautious attitude towards other types of lending.

Lending to most other economic sectors showed smaller decline in the September quarter. The decline in loans for trade financing moderated to 4.4% in the September quarter from 7.4% in the June quarter and the decline in loans for manufacturing dropped to 4.2% from 6.7%. Loans for wholesale & retail trade continued to shrink by 3.3%, albeit much lesser than the 8.3% fall in the preceding quarter. The growth of credit card receivables however moderated to 2.4% in the September quarter from 3.0% in the June quarter. On the other hand, lending to stockbrokers contracted significantly by 36.4% in the September quarter after a marked growth of 71.6% in the June quarter. Loans to non-stockbroking companies and individuals for the purchase of shares also dropped by 20.8%, reversing a rise of 29.6% in the preceding quarter.

Loan-to-Deposit Ratio

As a result of continued increase in Hong Kong dollar deposits and decline in Hong Kong dollar loans, the Hong Kong dollar loan-to-deposit ratio for the banking sector as a whole fell further to 94.1% at end-September from 95.4% at end-June.

Table 1
HK$ Deposit Mix

Amount (HK$ bn)

	Demand	Savings	Deposits Time *	Swap	Time @
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
Dec/98	97.1	414.4	1,144.3	29.3	1,173.6
% growth	8.1	33.4	(5.2)	(13.7)	(5.4)
Mar/99	96.3	399.7	1,157.3	30.2	1,187.5
% growth	(0.8)	(3.6)	1.1	3.0	1.2
Jun/99	97.4	430.6	1,150.0	28.8	1,178.8
% growth	1.2	7.7	(0.6)	(4.5)	(0.7)
Sep/99	99.7	413.7	1,170.2	28.8	1,198.9
% growth	2.3	(3.9)	1.8	(0.1)	1.7

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

On the contrary, the ratio for local banks rose slightly to 70.5% from 70.3%. However, the overall loan-to-deposit ratio of local banks dropped to 55.0% at end-September from 56.5% at end-June.

Asset Quality

Problem loans of local banks (measured by those which have been classified as substandard, doubtful and loss) stabilized in the September quarter. Although the ratio of classified loans rose slightly to 10.33% of total loans from 10.14% in the previous quarter, this reflected a decline in total loans rather than a rise in the amount of classified loans. Indeed, classified loans fell slightly in absolute terms, as did the amount of loans which have been classified as "special mention". This seems to confirm anecdotal information from banks that the growth of new problem loans has slowed down (although uncertainties remain in relation to Mainland related exposures).

Somewhat in contrast to the trend in classified loans, overdue and rescheduled loans and loans which have been placed on a non-accrual basis grew in both absolute and percentage terms in the September quarter. The local banks' loans overdue for more than three months increased to 6.36% of total loans from 5.92%, while rescheduled loans[2] rose to 1.17% from 1.09%. Non-accrual loans rose to 7.22% from 6.70%. Despite this deterioration, it appears that banks to some extent adopted a pre-emptive approach by previously classifying the loans in question, with the result that the loans had gone overdue or been placed on non-accrual did not result in a corresponding increase in the amount of classified loans.

Table 2
Asset Quality[1] of All Local Banks

	Sep/98	Dec/98	Mar/99	Jun/99	Sep/99
	as % of total loans				
Pass loans	**88.22**	**84.61**	**82.18**	**81.77**	**81.43**
Special mention loans	**6.79**	**8.06**	**8.99**	**8.09**	**8.25**
Classified loans[2]	**4.99**	**7.33**	**8.82**	**10.14**	**10.33**
o/w Substandard	*2.23*	*3.18*	*3.94*	*4.80*	*4.33*
Doubtful	*2.65*	*3.93*	*4.61*	*5.02*	*5.56*
Loss	*0.11*	*0.22*	*0.27*	*0.31*	*0.43*
Overdue > 3 months and rescheduled[3] loans	**3.81**	**5.12**	**6.39**	**7.01**	**7.53**
o/w Overdue > 3 months	*3.18*	*4.04*	*5.41*	*5.92*	*6.36*
Rescheduled[3] loans	*0.63*	*1.08*	*0.98*	*1.09*	*1.17*
Non-accrual loans[4]	**-**	**-**	**-**	**6.70**	**7.22**

1. *Period-end figures relate to HK offices and overseas branches.*
2. *Classified loans are those loans graded as "substandard", "doubtful" or "loss".*
3. *Effective March 1999, those rescheduled loans which have also been reported under overdue for more than 3 months are excluded.*
4. *Loans on which interest has been placed in suspense or on which interest accrual has ceased. Not available prior to June 1999.*

Because of rounding, the figures set out in this table may not add up.

2 After the adjustment for some double counting of total overdue and rescheduled loans of banks.

According to the monthly residential mortgage survey, the ratio of mortgage loans overdue for more than three months as a percentage of total mortgage loans dropped from 1.14% at end-June to 1.11% at end-August before rising slightly to 1.12% at end-September.

There were also signs of improvement in the performance of credit cards. The delinquency ratio for credit cards (i.e. those overdue for more than 90 days) fell to 1.13% at end-September from 1.28% at end-June. The annualized charge-off ratio dropped to 4.98% at end-September from 5.00% at end-June.

Profitability

As a result of an increase in net interest income and flat operating expenses, pre-provisions operating profits of local banks in the first nine months of the year increased compared with the same period of last year. However, the aggregate figures conceal significant variations in the performance of individual banks. Post-provision profits fell because of the continuing need for bad debt provisions, though the aggregate decline significantly moderated compared with the performance in 1998.

For the first nine months of 1999, the net interest margin of local banks increased to 2.28% (annualized) from 2.27% (annualized) for the same period a year ago. The bad debt charge as a percentage of average total assets increased to 0.54% (annualized) from 0.38% in the same period of 1998. Nevertheless, this was lower than the 0.63% for the whole of 1998.

Local banks continued to be supported by high capital adequacy ratios. The average consolidated capital adequacy ratio of local institutions rose to 20.1% at end-September compared with 19.5% at end-June. This increase was partly due to the reduction in risk assets during the year.

— Prepared by the Banking Policy Division