DEREGULATION OF INTEREST RATE RULES

As part of the Banking Sector Reform Programme to promote competition in the banking industry, the Hong Kong Monetary Authority (HKMA) undertakes to deregulate the remaining interest rate rules in two phases. Phase 1 of the deregulation, which is scheduled for July 2000, will remove the interest rate cap on time deposits with a maturity of less than 7 days and the prohibition on benefits for all deposits with the exception of Hong Kong dollar savings and current accounts. An analysis by the HKMA of the prevailing economic and financial conditions indicates that the environment is not unfavourable for this phase of the deregulation to take place. With the support of the Exchange Fund Advisory Committee, the Banking Advisory Committee and the Deposit-taking Companies Advisory Committee, the HKMA and the banking industry agree that Phase 1 of the deregulation should proceed on 3 July 2000. This article explains the considerations behind this decision.

Background

Following the deregulation undertaken in 1994 and 1995, the interest rates of more than 99% of all HK dollar fixed time deposits or around 70% of total HK dollar deposits are now free to fluctuate in accordance with competitive market forces. The remaining interest rate rules (IRRs) cover time deposits with a maturity below 7 days, current accounts and savings accounts deposits (which amounted to 0.1%, 5.9% and 27.7% of total HK dollar deposits respectively as at 31 December 1999).

In 1998, the HKMA commissioned the Banking Sector Consultancy Study to examine the strategic outlook of the banking sector over the next five years. Deregulation of the remaining IRRs was one of the regulatory issues examined in the Study. In response to the recommendations of the Study, the HKMA has developed a three-year reform programme to further develop the Hong Kong banking sector. As part of the programme to promote competition in the banking sector, the HKMA has proposed to deregulate the remaining IRRs in two phases:

Phase 1
- Removal of interest rate ceilings on time deposits less than 7 days
- Removal of prohibitions on benefits for deposits[1]

Phase 2
- Removal of all current and savings account interest rate rules

Provided that the prevailing economic and financial conditions are not unfavourable, Phase 1 of the deregulation will take place in July 2000 and Phase 2 will take place 12 months after the Phase 1 relaxation. In this connection, a set of monitoring indicators has been developed to gauge whether the prevailing economic and financial environments are not unfavourable for deregulation.

Assessment of the Prevailing Economic and Financial Environment

The set of monitoring indicators comprises both quantitative and qualitative factors. They correlate closely with stable conditions for banking. Specific and objective criteria have been set out for the quantitative factors. As for the qualitative factors, the HKMA will monitor for the absence of

1 During Phase 1 of the deregulation, the prohibitions on benefits for all HK$ and foreign currency deposits will be removed **except in the case of HK$ current and savings accounts**. This is to avoid banks competing to offer benefits for the latter two types of deposits, which would effectively bring forth Phase 2 of the deregulation.

foreseeable significant international or regional economic upheavals which might create unstable conditions. The performance of the monitoring indicators are discussed in the following paragraphs.

Two Consecutive Quarters of Real GDP Growth

The HKMA has proposed that deregulation should be carried out in a stable economic environment to avoid compromising the stability of the banking sector. Two consecutive quarters of positive GDP growth would generally indicate that the economy is in the process of recovery and the environment would be more favourable for deregulation to take place.

As a result of the Asian financial crisis, the Hong Kong economy suffered from five consecutive quarters of economic contraction (see Chart 1). It was not until the second quarter of 1999 that the economy returned to positive growth (1.1%) on the back of an improved global economy and a rebound in private consumption and external trade. The economic recovery gathered further momentum in the third and fourth quarter of 1999 as GDP growth accelerated to 4.4% and 8.7% respectively. Up to now, three consecutive quarters of positive GDP growth have been recorded. Looking forward, it is likely that the macro-economic environment will continue to improve. Market economists generally forecast that the economy will grow by around 5% in 2000.

Differential between HIBOR and US dollar LIBOR has Stabilised and is Close to the Pre-crisis Levels

The differential between Hong Kong dollar interest rates (i.e. HIBOR) and United States dollar rates (i.e. US dollar LIBOR) is the premium demanded by the market for holding Hong Kong dollars. It is indicative of market confidence in the Hong Kong dollar.

During the economic boom between 1996 and Q1 1997, the interest rate level in Hong Kong was generally close to the level in the U.S. (see Chart 2). The quarterly average differential between HIBOR and LIBOR (from 1-month to 6-month) was in the range of 3 to 19 basis points during this period. After the advent of the Asian turmoil in July 1997, the differential between HIBOR and US dollar LIBOR (again from 1-month

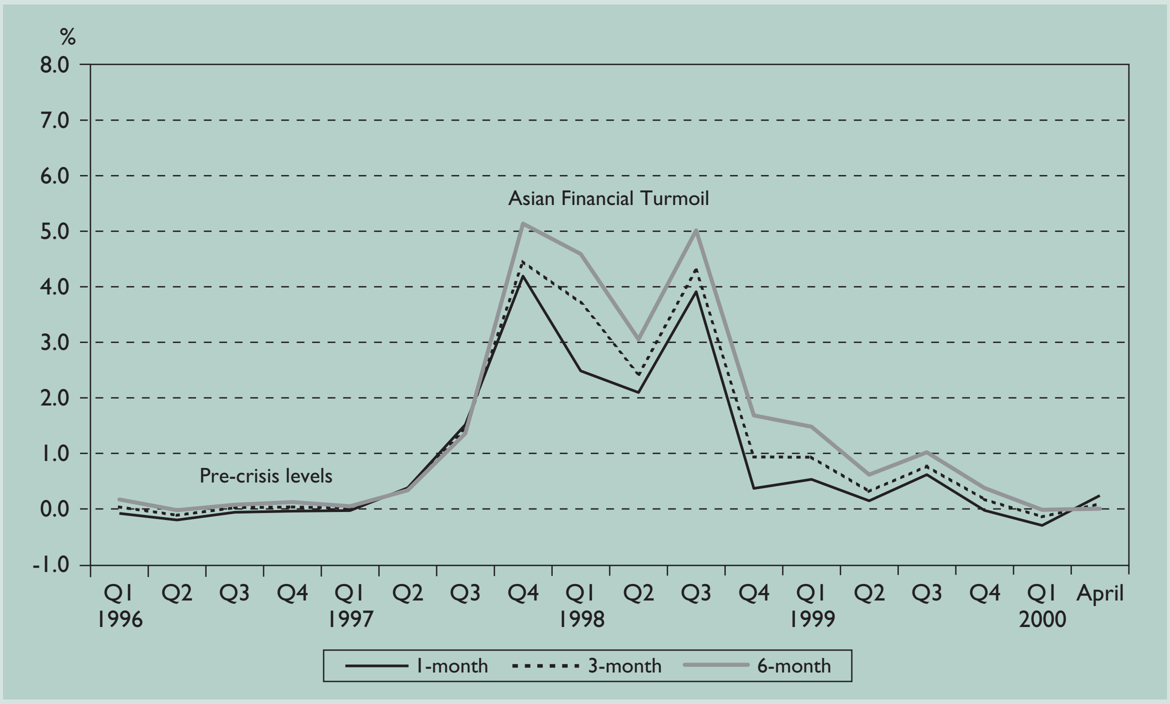
Chart 1

GDP (year-on-year rate of change in real terms)

Source: Census & Statistics Department

Chart 2

Quarterly Average Differential between HK$ and US$ Interest Rates #



Source: Bloomberg

 # Quarterly average of differential between daily HIBOR fixing and US$ LIBOR fixing

to 6-month) widened to an average level of 200 to 500 basis points due to the repeated attacks on the Hong Kong dollar.

Since the seven technical measures were introduced to strengthen the currency board system in Q3 1998, the differential between HIBOR and US dollar LIBOR has trended downwards. As the economy gradually recovers, the differential has further narrowed and has returned to the pre-crisis level. In Q1 2000, the 1-month, 3-month and 6-month HIBOR rates were on average below the corresponding LIBOR rates. While the HIBOR rates for April 2000 were slightly higher than the corresponding LIBOR rates, the differentials were still at a level comparable to the pre-crisis level. This indicates that market confidence in the Hong Kong dollar has already returned on the back of a better economic outlook for Hong Kong.

Capital Adequacy Ratio of the Banking Sector Remains at Traditionally High Levels

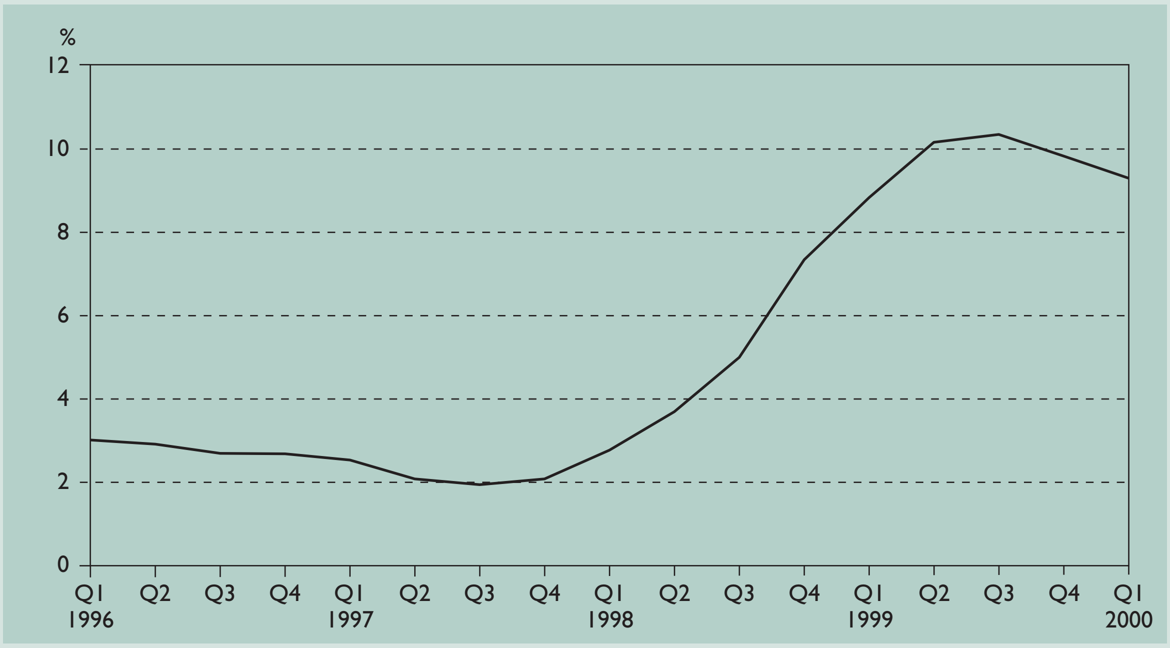
The capital adequacy ratio of the banking sector was consistently higher than 17% during 1996 and 1997. This was well above the minimum standard of 8% set by the Basel Committee on Banking Supervision.

Despite the impact of the regional turmoil, banks in Hong Kong remained very well capitalised. As a result of banks adopting cautious lending policies and the subdued demand for loans, the risk weighted exposures of the banking sector have fallen since the start of the Asian crisis. With capital base remaining roughly stable, this has resulted in a steadily rising trend in the capital adequacy ratio until Q3 1999 (see Chart 3). The decline in the capital adequacy ratio in Q4 1999 was due to a large local banking group distributing a special dividend out of its reserves to its parent company. As of 31 March 2000, the aggregate capital adequacy ratio of all locally incorporated institutions stood at 18.91%, compared with 17.83% as of 31 December 1996. With this high level of capital adequacy ratio, the banking sector has a sufficient cushion to absorb any negative impact of deregulation, which is in any case unlikely to be significant for the first phase of deregulation.

Chart 3
Capital Adequacy Ratio
(all local AIs - consolidated position)

Source: HKMA Banking Statistics Section

Chart 4
Classified Loan Ratio (all local banks)



Source: HKMA Banking Statistics Section

Signs of Improvement in the Classified Loans Ratio for the Sector

Asset quality of the Hong Kong banking sector deteriorated sharply during 1998 and 1999. The classified loans ratio of the local banks, which is the ratio of loans classified as Substandard or below to total loans outstanding, reached 10.14% in the second quarter of 1999 (see Chart 4) compared with 2.08% at end-June 1997. Although the ratio rose slightly further to 10.33% in the third quarter, it fell back to 9.81% at end-December 1999 and further down to 9.28% at end-March 2000. Other measures of asset quality such as the overdue loans ratio and the rescheduled loans ratio also improved. As the economy continues to revive and the problem associated with lending to Chinese enterprises gradually subsides, the reversing trend in classified loans ratio is likely to be sustained. Banks generally expect bad debt provisions to fall sharply in 2000.

Absence of Significant Narrowing of Net Interest Margins of the Banking Sector Similar to that Experienced During the Period of the Asian Crisis

The Asian crisis put the profitability of the banking sector under considerable stress. The impact was evidenced by a sharp fall of 24 basis points in the net interest margin of local banks between Q3 1997 and Q3 1998 (see Chart 5). Since the introduction of the seven technical measures to strengthen the currency board system in September 1998, the funding cost of the sector stabilised and was on a declining trend during 1999, reflecting the ample liquidity in the banking system. This has offset the impact on the banks of the downward pressure on lending margins and the impact on interest income of non-accrual loans. As a result, the net interest margin of local banks has gradually recovered from 2.18% in Q3 1998 to 2.30% in Q4 1999 and widened further to 2.40% in the first quarter of the year. Looking ahead, lending margins remain under pressure for the time being, but this may be alleviated as economic recovery gathers momentum.

Absence of Severe Strains on the Profitability of a Significant Proportion of the Local Banking Sector

After an extremely difficult year in 1998, the operating environment for local banks has gradually improved. Although performance of individual banks has varied, pre-tax operating profits of the 31 local banks as a whole increased by 14.8% in

Chart 5
Net Interest Margin (all local banks)

Source: HKMA Banking Statistics Section

1999 compared with 1998. The recovery was attributable to growth in interest-bearing assets, slight improvement in the net interest margin and reduction in operating expenses.

Looking forward to 2000, the banks are expecting further improvements in profitability, largely driven by the reduction in bad debt charges.

Absence of Foreseeable Significant International or Regional Economic Upheavals

The global economy improved further in 1999. Both the U.S. and the Euro area recorded healthy growth last year. Despite higher interest rates and the recent correction in US asset prices, there is still no clear moderation in the growth momentum of the U.S. and Europe. In the Asian region, while the latest economic indicators in Japan revealed mixed performance, most other Asian economies have reported strong and broad-based recovery in the second half of 1999. Growth in Mainland China has also continued at a steady rate of 7-8% per annum. Exchange rates for the regional currencies further stabilised, indicating that capital flows in and out of the region are getting less volatile. In summary, there does not appear to be any signs of major international or regional economic threats.

Conclusion

The above analysis shows that the banking sector has been gradually recovering from the Asian financial crisis. Although the amount of problem loans remains high by historical standards, signs of improvement have already emerged. The domestic and external environment has also become more favourable to the banks. On the whole, the monitoring indicators seem to suggest that the outlook for the banking sector in 2000 is more optimistic and there does not appear to be significant unfavourable factors which would call for a slow down of the first stage of the deregulation process. The initial stage is in any case unlikely to have a major impact on the behaviour of interest rates given that it affects directly only a very small proportion of the deposit base.

In light of the above analysis, the HKMA's assessment is that the prevailing economic and financial environments are not unfavourable for Phase I of the deregulation of remaining IRRs to proceed as planned in July 2000. This view is endorsed by the Exchange Fund Advisory Committee, the Banking Advisory Committee and the Deposit-taking Companies Advisory Committee. The HKMA and the banking industry therefore agree that Phase I of the deregulation should proceed on 3 July 2000 unless there is any major economic or financial upheaval in Hong Kong or elsewhere before the date of deregulation.

- Prepared by the Banking Development Division