



## Developments in the Banking Sector

*The banking sector's profit growth derived from operations in Hong Kong was more subdued in 1994 after three extremely good years. Growth in loan demand moderated, interest rate spreads narrowed slightly and investment income declined. Nonetheless, the basic economic fundamentals remain sound and the return on assets enjoyed by locally incorporated banks remains high.*

### Overview

After three very favourable years the banking sector was faced with greater challenges in 1994. In the external environment, the increase in US Fed funds rate on 4 February heralded an end to the low interest rate regime which the banks had previously enjoyed. The trend towards higher rates made itself felt in stock and bond markets around the world, including in Hong Kong where the property market was also affected. While these changes were safely accommodated, the profitability of the banking sector was influenced by reduced loan demand and slight narrowing of the interest rates spread, changes in the deposit mix and a sharp decline in investment income.

The licensed banks also had to cope with changes in the regulatory regime, in particular the partial deregulation of retail deposit interest rates and the disclosure for the first time by banks in general of their actual profits and transfers to inner reserves.

While 1995 is likely to be another more difficult year for the banking sector, its basic position remains

sound. Institutions are continuing to operate in a fundamentally strong economy. The return on assets enjoyed by locally incorporated banks remains high and they are well capitalised by international standards. Institutions in Hong Kong are therefore well placed to meet the challenges ahead. They will however need to keep a tight grip on costs, ensure that asset quality is not sacrificed and continue to diversify their sources of income.

### Interest rate deregulation

The competitive environment within which licensed banks operate was altered in the December quarter of the year by changes to the IRR governing retail deposit interest rates.

Historically, under the IRR made by the Committee of HKAB, the Committee has been authorised to determine the maximum rates of interest paid to customers on HK dollar deposits of less than HK\$500,000 and with a maturity of less than 15 months. Following a report published in February 1994 by the Consumer Council on the banking industry, the Monetary Authority advised, and the

Government accepted, that any deregulation of retail deposit interest rates should be undertaken with caution. It was however agreed that the interest rate cap could safely be removed from time deposits. This took into account the fact that such deposits made up only about 4% of total HK dollar deposits and were already subject to competition from unregulated foreign currency swap deposits (which are, in essence, HK dollar deposits).

The first step in the deregulation involved the removal on 1 October of restrictions on time deposits fixed for more than one month. As a second step, all deposits fixed for more than seven days were liberalised on 3 January 1995.

The third phase, due on 1 April 1995, would have liberalised all remaining deposits except those repayable at 24 hours call. The Monetary Authority decided, however, in March 1995 that further time was needed to assess the impact of the first two phases. This reflected the difficulty of interpreting the statistics for deposit movements in January and February which had been distorted by various

factors, including the effect of the Lunar New Year on the amount of cash held by the public. The Monetary Authority will conduct a full assessment, based on a longer run of statistics and taking into account the half-year results of the banking sector, in the third quarter of 1995.

## Funding

### (a) Customer deposits

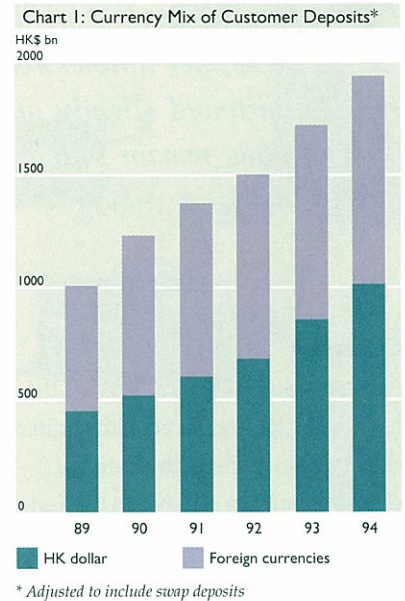
Although the impact of deregulation may become more significant in the longer term, other factors had a more immediate influence on the banking sector's pattern of funding in 1994. The rise in interest rates made time deposits in general more attractive while the decline in the stock and property markets reduced the demand for transaction balances. Moreover, strong competition for HK dollar deposits among the licensed banks led to the payment of relatively high interest rates on large time

deposits which are not subject to the IRR.

This was reflected in changes in the composition of deposits. While total HK dollar deposits continued to rise quite rapidly in 1994, this was at a slower pace than in 1993 (18.4% against 25.5%). The slower growth reflected falls in the level of HK dollar demand and savings deposits (of 4.7% and 2.5% respectively) after substantial increases in 1993. HK dollar time deposits (adjusted to include swap deposits) rose by 36.0%, however, reflecting their increased attraction as an investment medium (Table 1). By contrast, the growth rate of foreign currency deposits remained low, with the amount outstanding rising by only 7.1% in 1994 (Chart 1).

### (b) The impact of deregulation

The trend towards higher yielding time deposits was given an added



boost in the final quarter of the year by the first phase of deregulation. As noted above, this affected time deposits of less than HK\$500,000 and fixed for more than one month. The banks responded to the removal of the interest rate cap on such deposits by paying interest rates close to those on swap deposits. By year-end, banks were paying an average rate of about 6.1% on deregulated three-month deposits, 60 bp higher than the maximum rate would have been if the cap had not been removed.

According to a survey of 40 licensed banks conducted by the Monetary Authority, the HK dollar demand and savings deposits of the survey group fell by HK\$1.9 bn and HK\$8.6 bn respectively in the December quarter of 1994 while deregulated time deposits rose by HK\$13.6 bn. It is

**Table 1: Composition of HK Dollar Customer Deposits (a)**

HK\$bn	Demand	Savings	Time (b)	Swap	Total
1990	54 (10)	159 (31)	239 (46)	68 (13)	520 (100)
1991	69 (11)	229 (38)	265 (44)	40 (7)	604 (100)
1992	87 (13)	245 (36)	293 (43)	59 (9)	684 (100)
1993	105 (12)	282 (33)	400 (47)	72 (8)	858 (100)
1994	100 (10)	275 (27)	537 (53)	104 (10)	1,016 (100)

(a) Figures in brackets show the percentage shares.

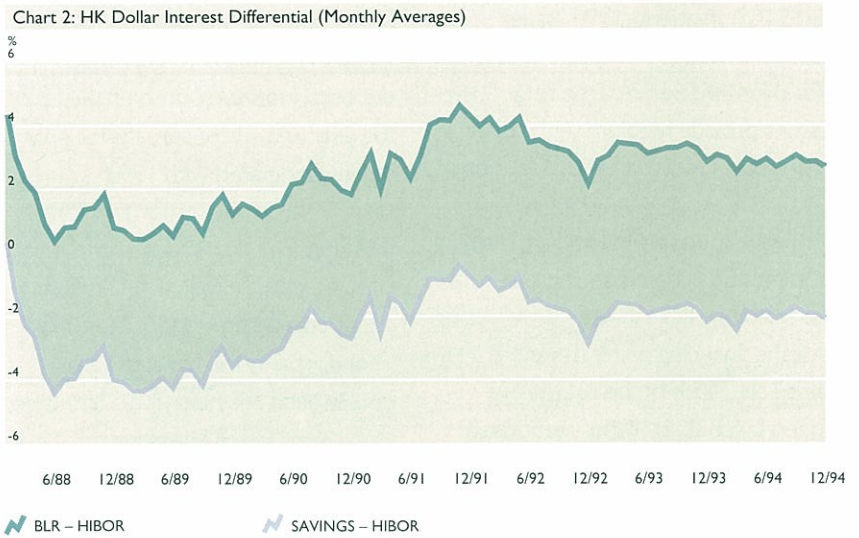
(b) Excluding swap deposits.

however difficult to determine to what extent this movement was directly related to the deregulation, although it will undoubtedly have played a part.

Deregulation has also slowed the growth of swap deposits. Having risen by 42.1% in the first nine months of the year, swap deposits rose by less than 2% in the final quarter. With the smaller time deposits now paying interest rates comparable to those on the equivalent swap deposits, the appeal of the latter has been reduced.

**(c) Competition for deposits**

Although growth in HK dollar lending slowed somewhat in 1994, competition for HK dollar deposits remained keen. In part, this seems to have been motivated by the desire of banks to expand (or simply protect) their deposit base and to strengthen their liquidity. Some banks may however also have wished to exploit profitable lending opportunities. As a result, it was not uncommon for banks to offer interest rates of as much as two percentage points above HIBOR for large customer deposits. Their ability to do so was assisted by the continuing wide margin between HIBOR and BLR which, in the case of one-month HIBOR, averaged about 2.9 percentage points in 1994 (Chart 2). However, this margin fell during the year and this trend continued into the early part of 1995, reducing the headroom available to the banks to



pay above-HIBOR rates to customers. The Monetary Authority issued a warning to banks about this practice in early 1995, noting that it was unwise to rely too heavily on expensive and potentially volatile wholesale deposits.

**(d) Certificates of deposit**

The desire to obtain HK dollar funding also manifested itself in a large increase in issues of negotiable certificates of deposit (NCDs) during 1994. The total amount of NCDs outstanding rose by HK\$52 bn to

HK\$107 bn at end-1994. Issues denominated in HK dollars accounted for over HK\$64 bn of the total. Such issues provide medium term (over one year) funding and have thus been attractive for banks wishing to improve the asset/liability structure of their balance sheets and, in particular, to build up stable longer-term funding for the financing of infrastructure projects. Much of the issues have been taken up by other authorised institutions for whom NCDs are an attractive asset both on yield considerations and as a source of liquidity. Two of the issues launched during the year achieved credit ratings which made them eligible securities for discounting under LAF. Notwithstanding such interbank purchases, NCDs also have a market among non-bank investors: the outstanding amount of NCDs denominated in HK dollars and held outside the banking system rose by 57.6% to HK\$28 bn at end-1994.

**(e) Interest rate margins**

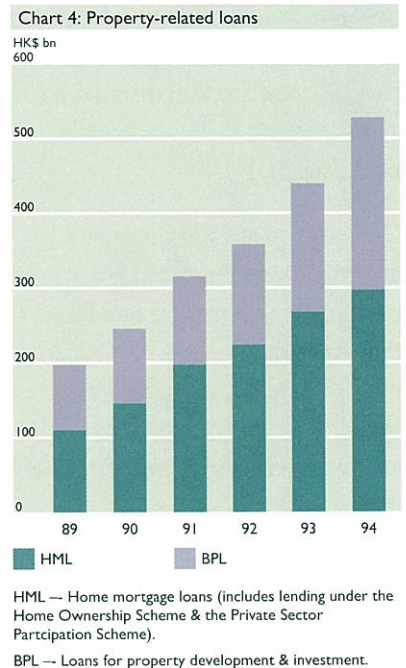
NCDs are issued at a margin above HIBOR of, say, 50 bp. With administrative expenses added to the overall cost, these instruments are thus relatively expensive though this may be a reasonable price to pay for medium term funding. Banks' funding costs were also under some pressure from a narrowing of their interest spreads during the year. In particular, the gap between BLR and retail deposit rates was narrowed in March 1994 when the former was raised by only 25 bp compared with a rise of

50 bp in the savings account rate and 75 bp in the rates on retail time deposits. However, on average during the year as a whole spreads fell only slightly compared with 1993.

**Lending**

Lending growth slowed in 1994 to 14.3% compared with 15.7% in 1993. This was partly the result of some deceleration in lending for use outside Hong Kong which is largely denominated in foreign currencies (Chart 3). Loans for use in Hong Kong by the banking sector as a whole rose by 17.9%, only slightly less than the 18% growth registered in 1993. However, the slowdown was much more pronounced in the second half of the year when loans for use in Hong Kong rose by only 5.8% compared with 11.4% in the first half. This partly reflected the impact of higher interest rates on loan demand and the decline in activity in the property market, coupled with the banks' continuing tight lending policies, which affected the growth of residential mortgage lending (Chart 4).

Residential mortgage lending (excluding loans under the Government's Home Ownership Scheme and Private Sector Participation Scheme) grew by 12.5% in 1994, compared with a growth of over 15% in 1993. Lending for building, construction, property development and investment showed a more marked slowdown in 1994 (rising by 18% against 27.9% in 1993)



in keeping with the Monetary Authority's advice that the banks should moderate the growth in their property lending. Sectors that showed faster rates of increase in 1994 were manufacturing (+23.3%), transport (+13.5%) and wholesale and retail trade (+30.7%). However, credit card lending which had grown by about 40% in 1993 slowed to an increase of only 7.5% (the growth rate has been adjusted to include the account receivables securitised by an institution in October) (Chart 5).

**Loan to deposit ratio**

With HK dollar deposits rising slightly faster than HK dollar loans, the loan-to-deposit ratio of the banking sector fell to 110% at end-1994 from 112% a year earlier. The ratio of the locally incorporated banks also improved

from 75% to 74% (Table 2). As in previous years, the HK dollar resources available to the banks for lending purposes were supplemented by net issues of NCDs and net borrowing from banks abroad. In particular, net borrowing in HK dollars from banks in China rose by over HK\$22 bn to HK\$52 bn at end-1994 (Chart 6).

### Investments

With the HK dollar resources available to the banking sector outstripping loan demand, institutions took the opportunity to build up their liquid assets in 1994. Apart from the increase in holdings of NCDs already referred to, institutions also acquired substantial amounts of other investments. In particular, holdings of

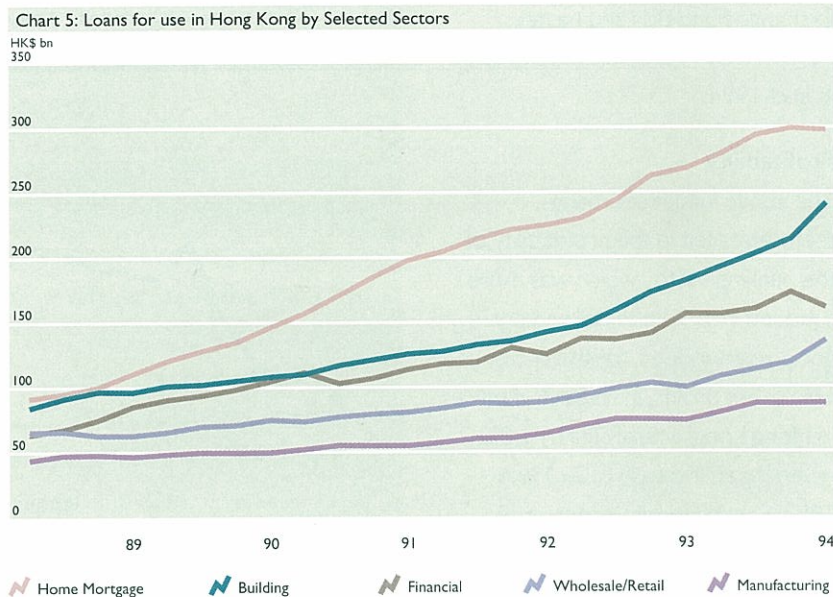


Table 2: HK Dollar Loan to Customer Deposit Ratio (a)

	1990	1991	1992	1993	1994
Local banks	0.75	0.75	0.76	0.75	0.74
Chinese banks	0.87	0.92	0.88	0.80	0.71
Multi-branch foreign banks:					
Japan	4.34	5.35	4.85	3.99	4.53
USA	1.33	1.49	1.26	1.21	1.29
Others	1.33	1.34	1.36	0.82	0.87
Single-branch foreign banks:					
Japan	15.54	11.59	13.56	6.58	11.30
USA	2.92	3.72	3.36	3.08	4.66
Others	3.56	3.71	5.23	3.28	4.34
All licensed banks	1.11	1.11	1.09	1.02	1.01
All RLBs	2.87	4.18	4.47	9.18	11.62
All DTCs	1.64	2.73	3.68	4.42	4.50
All RLBs & DTCs	2.08	3.36	4.09	6.30	7.19
All AIs	1.17	1.20	1.19	1.12	1.10

(a) adjusted to include swap deposits

Exchange Fund Bills and Notes increased by HK\$20 bn to HK\$43 bn at end-1994.

### Profitability

The above influences made themselves felt in the profitability of the banking sector which was more subdued in 1994 after three very good years. Indeed, for the sector as a whole, net profits, in respect of offices in Hong Kong, actually fell by 1.6%, reversing an increase of 22.1% in 1993. For the locally incorporated banks, however, net profits continued to rise, though at a slower pace than in 1993 (by 8.6% compared with 18.1%). The ROA of the locally incorporated banks thus fell to 1.83% in 1994 from 1.94% in the previous year. The ROA in 1994 is however still high by international standards and a number of individual banks continued to publish significant growth in profits for their operations as a whole.

Contributing to the lower aggregate ROA for the locally incorporated banks was slower growth in net interest income, which rose by 13.7% compared with 16.0% in 1993. This reflected the slower growth in lending volume, which was more significant in the case of the locally incorporated banks, and also in part the changes in deposit mix and the slight narrowing of interest spreads discussed above. However, the impact of the last two factors on the overall net interest margin (net

Chart 6: Net HK Dollar Liabilities to Banks Outside HK

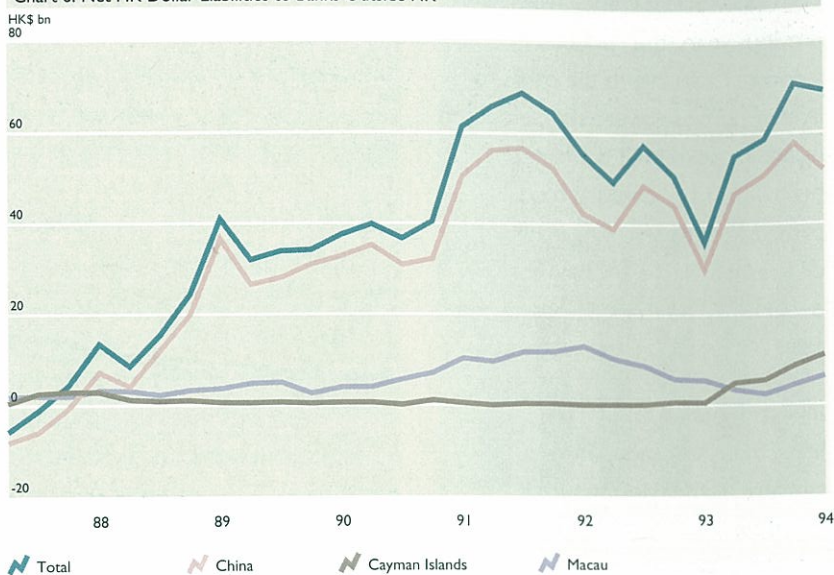


Table 3: Return on Assets for the Locally Incorporated Banks\*

Components of ROA	Contribution to ROA (% of average total assets)	
	1993	1994
1 Net interest margin	2.22	2.18
2 Other operating income	1.46	1.28
3 Total operating income (1+2)	3.68	3.46
4 Operating expenses	1.32	1.31
5 Bad debt charge	0.12	0.05
6 Other provisions	0.02	0.02
7 Profit on sale of fixed assets & extraordinary items	0.04	0.03
8 Profit before tax (3 - 4 - 5 - 6 + 7)	2.26	2.11
9 Taxation	0.32	0.28
10 Net Profit (ROA) (8-9)	1.94	1.83

\* Based on profit arising from offices in Hong Kong only.

interest income as a percentage of average total assets) was largely offset by the increased value of interest free balances due to higher interest rates (the so-called "endowment effect"). As a result, the net interest margin fell

only slightly to 2.18% (Table 3). Of more significance in its impact on the ROA was a sharp fall of 19.0% in investment income reflecting the difficult conditions in the bond and stock markets during the year. The fall

in this item in 1994 more than wiped out the favourable impact of healthy growth of 16.1% in fees and commissions.

With income growth depressed and operating expenses growing by 13.6%, the locally incorporated banks cost-income ratio rose to 38% from 36%. This is still low by international standards but banks will need to guard against further deterioration.

Against these negative factors, the decline in the already low bad debt charge (to only 0.05% of total assets) had a positive impact on profits. Further evidence of improving asset quality was given by a reduction in overdue and rescheduled loans as a percentage of the total loan book. However, it would appear that banks are now at the trough of the bad debt cycle, and with the rise in interest rates probably putting strain on the financial position of some borrowers, bad debts are likely to begin to rise.

### **Capital adequacy**

For the first time banks in general published details of their actual profits in 1994 and of their transfers to inner reserves. This was in keeping with the Best Practice Guide on financial disclosure issued by the Monetary Authority. In some cases the market reacted with disappointment to the

size of transfers made to inner reserves which were below expectations.

However, while the size of such transfers may be relevant for stock market valuation purposes it is important to realise that it has little direct bearing on the capital strength of the banks concerned. Inner reserves are only one part, and a relatively minor one, of the total capital base of banks in Hong Kong. Locally incorporated institutions remain highly capitalised by international standards. At end-1994, the consolidated capital adequacy ratio of the locally incorporated institutions had improved to 17.5% from 17.0% a year earlier. Although there are variations among individual institutions, practically all have ratios well into double figures.

The improvement in the capital adequacy ratio reflected an increase in the capital base due mainly to profit retentions and relatively slow growth in risk assets. On-balance sheet risk-weighted assets rose by only 8.0%, while off-balance sheet risk-weighted assets fell as some treasury business was transferred out of Hong Kong.



The second phase of coins of Queen Elizabeth II, 1978. Three new denominations—20 cent, \$2 and \$5—were introduced while the \$5 bank notes were withdrawn. The decagonal \$5 coin, which was found to be easily imitated by forgers, was replaced by a round \$5 coin two years later.

Panoramic view of Sha Tin New Town in 1978. At the far end of the reclamation pictured is the new Sha Tin Racecourse.