

DESPITE THE CHALLENGING OPERATING ENVIRONMENT IN 1995, THE UNDERLYING PROFITABILITY OF THE LOCAL BANKING SECTOR WAS BETTER THAN ORIGINALLY EXPECTED. THE CURRENT PROGRAMME OF INTEREST RATE DEREGULATION WAS COMPLETED WITHOUT ADVERSE EFFECTS ON BANKS. IN GENERAL, THE BANKING SECTOR REMAINED WELL CAPITALISED, HIGHLY LIQUID AND PROFITABLE. THIS REFLECTED AN INCREASE IN THE NET INTEREST MARGIN AND IMPROVED OPERATING EFFICIENCY. GROWTH IN DOMESTIC LENDING MODERATED ON THE BACK OF MORE SUBDUED ECONOMIC GROWTH AND THE DECLINE IN CONSUMER DEMAND. THE SECTOR'S HK DOLLAR LIQUIDITY POSITION CONTINUED TO IMPROVE.

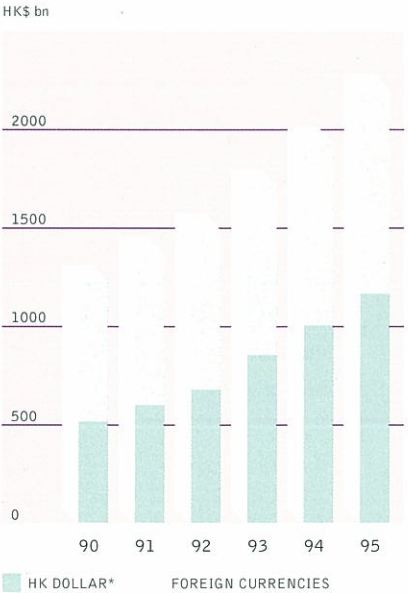
OVERVIEW

In line with expectations, 1995 proved to be a challenging year for the Hong Kong banking industry. However, underlying profitability was better than originally anticipated, reflecting rapid growth in net interest income, a revival in other operating income and improved operating efficiency.

In the external environment, the Mexican crisis prompted a brief speculative attack on some Asian currencies during January. This in turn triggered a sharp rise in domestic interest rates as the HK dollar came under temporary pressure. However, the effect on banks' cost of funds was short-lived. The banking industry has also had to cope with some slowdown in domestic economic growth which has impacted on the demand for loans. But with a more buoyant residential mortgage market, this has

not had a significant adverse impact on the profitability of banks. The industry has also adjusted well to the further improvements in liberalisation and transparency including increased financial

CHART 1: CURRENCY MIX OF CUSTOMER DEPOSITS



\* Including swap deposits

disclosure requirements and, for licensed banks, the implementation of the final two stages in the deregulation of interest rates.

The bad debt charge rose quite sharply in percentage terms in 1995 as might be expected given the low base in 1994 and the combined impact of slower domestic growth, continuing tight liquidity in China and higher interest rates. But, in general, asset quality held up better than might have been expected.

Looking ahead into 1996, the banking sector remains well capitalised, highly liquid and profitable and is therefore well placed to adapt to the increasingly competitive operating environment. Notwithstanding the sector's current robust position, banks will need to ensure that asset quality is maintained and continue to seek to diversify income sources and improve operating efficiency.

INTEREST RATE DEREGULATION

The Government decided on 26 September 1995 that the third phase of interest rate deregulation should include all time deposits governed by the Interest Rate Rules (IRR) fixed for seven days or with a call or notice period of seven days and that there should be no further move below seven days. As a result, the Hong Kong Association of Banks (HKAB) amended the IRR to remove the interest rate cap on seven-day deposits on 1 November 1995. The current programme of deregulation has now come to an end.





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USD	7728	7735
AUD	6873	6083
CAD	5689	5701
GBP	1179	1182
DEM	5211	5224
JPY	7169	7181

# GUIDE TO APPLICANTS

organization under the Banking Ordinance



This decision followed a review by the HKMA of the first two stages of deregulation in the nine-month period to June 1995. The HKMA's review concluded that the first two stages of deregulation had been a success. Over 99% of previously regulated time deposits had been deregulated. Consumers had benefited from wider access to market rates at little cost in terms of loss of liquidity. The banking sector had also absorbed the effects well, remaining profitable and robust. Aggregate after tax profits of the banks surveyed in the first half of 1995 improved over the same period of 1994 and return on assets was unchanged. Deposit migration had stabilised and interest rates had eased subsequent to the sharp rise in January 1995.

Notwithstanding the good results so far, there was continuing apprehension among both the banking industry and market analysts about the possible impact of further deregulation of very short term deposits, particularly those at 24-hour call. It was considered that this might provoke destabilising

shifts of deposits from current accounts and savings accounts, and between banks, particularly at times when competition for deposits was more fierce. In the light of these concerns, the Government concluded that the benefits of further deregulation below seven days would not outweigh the possible costs.

After deregulation of seven-day deposits, all the recognised maturity brackets specified in the IRR have been deregulated with the exception of 24-hour call deposits. This is a logical place to stop since it leaves a "firewall" to serve as a buffer between deregulated time deposits and current and savings accounts. This should mitigate potentially destabilising migration of deposits and is consistent with the Government's previously stated position that there should be no deregulation of current and savings accounts for the time being.

**FUNDING**

**(a) customer deposits**

During the first part of 1995, the continued high interest rate

environment increased the relative attractiveness of holding money balances in time deposits while the sluggish stock and property markets, together with the decline in retail sales, reduced the demand for transaction balances. However, this trend took a turn in the latter part of the year as the differential between time deposit rates and the savings rate declined and the stock market and primary property market both showed signs of recovery.

HK dollar interbank rates and deregulated time deposit rates increased sharply in January, as the HK dollar came under temporary pressure. This intensified the impact of the second stage of deregulation which had taken effect on 3 January 1995 with the lifting of the interest rate cap on all retail deposits of over seven days' maturity. This gave a further boost to the competition for deposits which had been evident in the last quarter of 1994. By the end of the first quarter, however, these effects had largely unwound and rates decreased gradually during the rest of the year as competition for deposits slackened and it became

**TABLE 1: HK DOLLAR INTEREST RATES MOVEMENT (PERIOD AVERAGE FIGURES)**

	TIME DEPOSITS			HIBOR			SAVINGS DEPOSITS	BEST LENDING RATE
	1-MONTH	3-MONTH	12-MONTH	1-MONTH	3-MONTH	12-MONTH		
<b>Q4 1994</b>	4.58	5.68	6.62	5.25	5.77	6.74	3.33	8.08
<b>Q1 1995</b>	6.10	6.51	7.38	6.40	6.78	7.69	4.05	8.80
<b>Q2 1995</b>	5.56	5.80	6.35	5.88	6.06	6.64	4.25	9.00
<b>Q3 1995</b>	5.40	5.54	5.81	5.83	5.94	6.23	4.25	9.00
<b>Q4 1995</b>	5.22	5.34	5.53	5.81	5.92	6.06	4.24	8.99
<b>1994</b>	3.55	4.13	5.12	4.39	4.76	5.64	2.45	7.26
<b>1995</b>	5.56	5.79	6.26	5.97	6.17	6.64	4.20	8.95



evident that the rise in US interest rates had plateaued. By the end of the year, banks were paying an average rate of 5.18% on deregulated one-month time deposits, 7 bp lower than what the maximum rate on such deposits would probably have been if the interest rate cap had not been removed. Notwithstanding this, average rates for 1995 as a whole were higher than in 1994. The average deregulated one-month deposit rate was 5.56% compared with an average of 3.55% in 1994. The average savings rate and the best lending rate (BLR) also rose, from 2.45% and 7.26% in 1994 to 4.20% and 8.95% respectively in 1995. Both of these rates were reduced by 25bp on 27 December 1995 following an equivalent cut in Fed Funds rates on 20 December 1995.

These factors impacted on the composition of HK dollar deposits during the course of the year. While growth in total HK dollar deposits remained strong, the pace slowed somewhat compared with 1994 (15.3% against 18.4%). Time deposits (excluding swaps) grew by 34.1%, which was in line with the increase in 1994. Foreign currency swap deposits, however, fell by 52.0% due to the convergence of time deposit rates towards swap deposit rates in the wake of deregulation. As a whole, time deposits and swap deposits grew by 20.2%, compared with 36.1% in 1994. Savings deposits showed some recovery in growth (9.5%) after falling in 1994 and demand deposits were unchanged. Both categories lost some market share of total HK dollar deposits. Time deposits (excluding swap

CHART 2: HK DOLLAR INTEREST DIFFERENTIAL (MONTHLY AVERAGES)  
PERCENTAGE

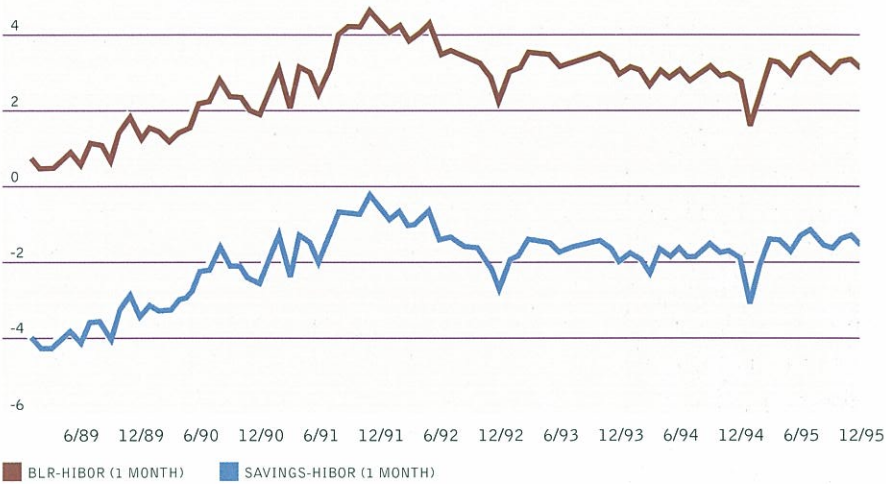
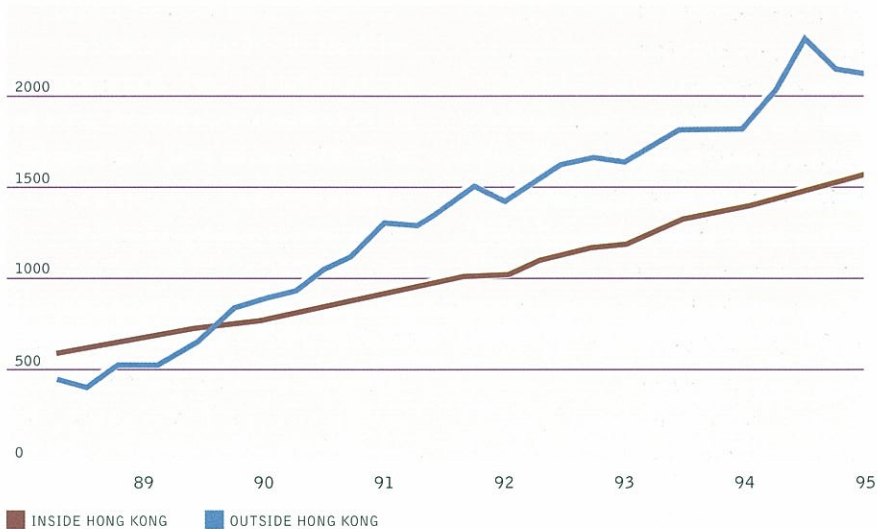


CHART 3: LOANS FOR USE INSIDE AND OUTSIDE HONG KONG  
HK\$ bn



deposits) accounted for 62% of the total at end 1995, a significant increase over the previous year. Within this category, there was significant growth in deregulated time deposits which accounted for around 12% of total HK dollar deposits at end 1995. Prior to deregulation the equivalent percentage had been only about 3%. As already indicated, much of this

increase represented switching out of swap deposits.

Foreign currency deposits grew by 12.1% (against 7.1% in 1994), mainly due to a stronger rise in time deposits (12.5%). This perhaps partly reflected migration of deposits from the domestic currency to foreign currencies as the interest rates on these became relatively more attractive.

**TABLE 2: COMPOSITION OF HK DOLLAR CUSTOMER DEPOSITS <sup>(a)</sup>**

HK\$ bn	DEMAND	SAVINGS	TIME <sup>(b)</sup>	SWAP	TOTAL
<b>1991</b>	69	229	265	40	604
	(11)	(38)	(44)	(7)	(100)
<b>1992</b>	87	245	293	59	684
	(13)	(36)	(43)	(9)	(100)
<b>1993</b>	105	282	400	72	858
	(12)	(33)	(47)	(8)	(100)
<b>1994</b>	100	275	538	104	1,016
	(10)	(27)	(53)	(10)	(100)
<b>1995</b>	100	301	721	50	1,171
	(9)	(26)	(62)	(4)	(100)

(a) Figures in brackets show the percentage shares.

(b) Excluding swap deposits.

### (b) Certificates of Deposit

The sector's demand for medium to long-term funds remained strong. This was due partly to increased demand for working capital in preparation for financing major infrastructure projects such as the new airport, and partly to banks' desire to further improve their maturity profile. This helped maintain strong growth in Negotiable Certificates of Deposit (NCD) issues, in particular those denominated in HK dollars. In some cases, the relatively low funding costs associated with NCD issues have also made them an attractive form of medium to long-term financing.

The total amount of NCDs issued and outstanding rose by 31.7% over the year. Issues denominated in HK dollars accounted for more than two thirds of the outstanding balance. Floating rate instruments continued to dominate the bulk of the new issues.

Growth in authorised institutions' holdings of NCDs also remained strong, notably issues denominated in HK dollars which rose by \$20.6 bn or 57.2% over the year. The sector's demand for NCDs was boosted by an increasing number of issues launched during the year which qualified as eligible securities for discounting under the LAF. In total, there were seven of these. While NCD issues continued to attract non-bank investors, the proportion of HK dollar denominated paper held outside the banking sector declined from 43.9% at end 1994 to 38.4% at end 1995.

### (c) interest rate margins

Although the rise in funding costs in January compressed margins, this was only temporary and margins widened again during the rest of the year. The differential between BLR and the three-month time deposit rate rose from 2.29% in the first quarter to 3.65% in the final quarter

of the year. Combined with the increased value of the banks' interest-free funds because of the higher average level of interest rates (the so-called "endowment effect"), the net interest margin<sup>1</sup> increased. That of the local banks rose from 2.32% in 1994 to 2.49% in 1995.

### LENDING

Total customer lending grew at a similar pace to 1994 (14.5% against 14.3%). However, within this, loans for use outside Hong Kong picked up while domestic lending slowed.

Loans for use outside Hong Kong and denominated in non-US dollar foreign currencies grew by 17.9% (against 13.4% in 1994), due partly to the increased Euro-yen activities of Japanese institutions in Hong Kong. Loans for use in Hong Kong, which had grown by 17.0% in 1994, slowed to 11.1% in 1995. A number of sectors showed reasonable, albeit slower, growth during the year: for example, manufacturing (17.0% against 23.3% in 1994), wholesale and retail trade (20.1% against 30.7%) and financial concerns (about 14.5% in both years). The most significant decline was, however, in growth in lending for building, construction, property development and investment which dropped from 18.0% to 4.3%. Within this, total lending for property development (in particular residential properties) actually fell by 1.8%, an indicator of the slowdown in the property market. In contrast, private residential mortgage lending (excluding loans under the Government's Home Ownership Scheme (HOS) and Private Sector

<sup>1</sup> Defined as net interest income as a percentage of average interest-bearing assets.



Participation Scheme (PSPS)), picked up compared with 1994, recording growth of 16.0%, compared with 12.5% in the previous year. This reflected the stimulus given to demand in the primary market by the price-cutting and marketing campaigns of the developers, as they attempted to reduce inventories. The secondary market for residential properties remained subdued although there were some signs of revival towards the end of the year. Total property lending (excluding civil engineering work and HOS & PSPS) as a percentage of loans for use in Hong Kong remained stable at 39%.

Despite the sluggish consumer demand, credit card receivables including the effect of one institution's purchase of the credit card business of its subsidiary rose by 35.6% during 1995, compared with 22.2% in 1994. This was partly

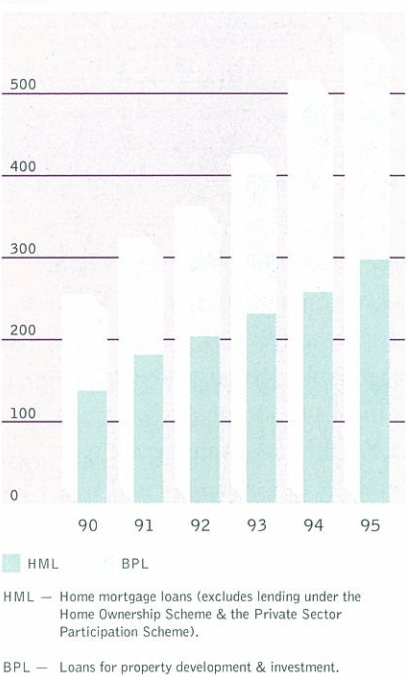
due to more intensive promotion of this product by the banks as they tried to diversify sources of income. As yet there is little concrete evidence of "distress" borrowing due to strain on personal finances or of deterioration in asset quality. But these are areas which will require close attention by the banks.

Trade finance grew very strongly in the first half of the year in line with the robust growth of Hong Kong's trade, but fell back in the second half. The increase for the year as a whole was 19.3% against 26.4% in 1994.

#### LOAN TO DEPOSIT RATIO

With the growth of HK dollar deposits outstripping loans, the loan to deposit ratio for the banking sector as a whole continued to improve to 105.7% at end 1995 from 110.2% a year earlier. The ratio for the locally incorporated banks also

CHART 4: PROPERTY-RELATED LOANS  
HK\$ bn



improved from 72.1% to 70.2%. As in previous years, the sector's available HK dollar resources were supplemented by net issues of NCDs (\$35.3 bn) and net borrowing from

TABLE 3: HK DOLLAR LOAN/CUSTOMER DEPOSIT RATIO (a)

	1991	1992	1993	1994	1995
Local banks	0.77	0.77	0.75	0.72	0.70
Chinese banks	0.92	0.88	0.80	0.71	0.72
Multi-branch foreign banks					
Japan	5.35	4.85	3.99	4.53	5.16
USA	1.49	1.26	1.21	1.29	1.19
Others	1.34	1.36	0.82	0.87	0.77
Single-branch foreign banks					
Japan	11.59	13.56	6.58	11.30	11.19
USA	3.72	3.36	3.08	4.66	2.52
Others	3.71	5.23	3.28	4.34	2.25
All banks	1.11	1.09	1.02	1.01	0.96
All RLBs	4.18	4.47	9.16	10.86	10.08
All DTCs	2.73	3.68	4.42	4.50	6.51
All RLBs & DTCs	3.36	4.09	6.30	7.01	8.32
All AIs	1.20	1.19	1.12	1.10	1.06

(a) Including swap deposits



banks abroad (\$87.8 bn). Within this total, net HK dollar borrowing from banks in China continued to rise from \$52 bn at end 1994 to \$59 bn at end 1995.

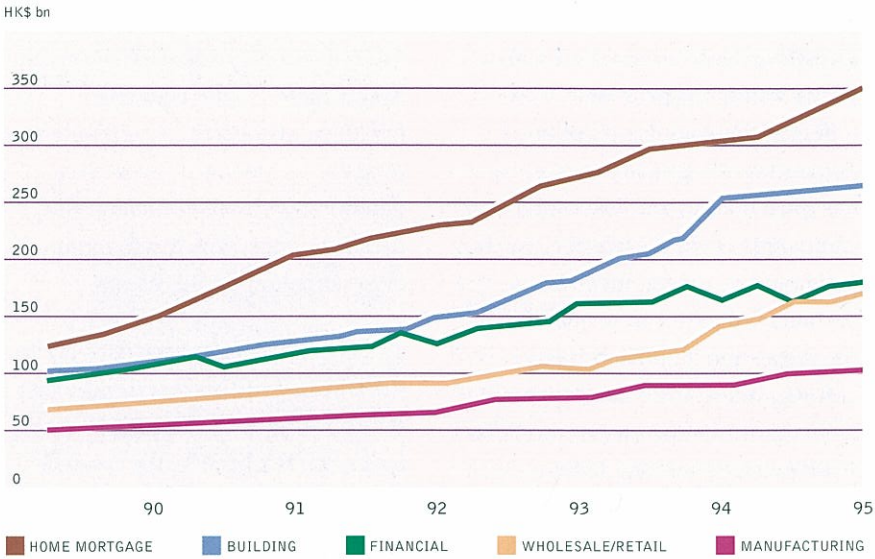
### INVESTMENTS

Banking institutions continued to use their surplus funding to hold more liquid assets such as NCDs, as already referred to, and other negotiable debt instruments. A substantial proportion of the excess HK dollar funding of the sector was invested in Exchange Fund Bills and Notes, which increased by \$5 bn (11.6%) to \$48 bn at end 1995. The bulk of the surplus foreign currency funding of the banking sector was invested in foreign government paper (up \$20.6 bn) and floating rate notes (up \$19.0 bn).

### PROFITABILITY

Despite the challenging operating

CHART 5: LOANS FOR USE IN HONG KONG BY SELECTED SECTORS



environment, the underlying profitability of the banking sector was better than originally expected during 1995. For the sector as a whole, pre-tax operating profits in respect of Hong Kong offices grew by 19.6% in 1995, reversing a small decline of 1.1% in 1994. The

performance of the locally incorporated banks was even better as their pre-tax operating profits increased by 21.7%, representing a significant rebound from the more modest growth seen in 1994 (5.5%). Post-tax profits of the local banks grew by 12.2% in 1995, up from 8.7% in 1994. This more modest recovery reflected the reduced importance of one-off items which had influenced the post-tax results for 1994. (These special factors affected the comparison between the fourth quarters of the two years. This explains why the growth in post-tax profits for the first three quarters of 1995 (about 16%) was higher than that for 1995 as a whole.) The post-tax return on assets (ROA) for 1995, remained in line with that for 1994 at 1.85% (for breakdown see Table 4). The ROA based on pre-tax operating profits increased however from 1.86% to 2.01%.

The improved underlying profitability of locally incorporated banks reflected a significant increase in net interest income which rose by

TABLE 4: RETURN ON ASSETS FOR THE LOCALLY INCORPORATED BANKS

COMPONENTS OF ROA	CONTRIBUTION TO ROA % OF AVERAGE TOTAL ASSETS	
	1994	1995
1. Net interest margin	2.18	2.33
2. Other operating income	1.04	1.08
3. Total operating income (1 + 2)	3.22	3.41
4. Operating expenses	1.30	1.31
5. Bad debt charge	0.05	0.08
6. Other provisions	0.01	0.01
7. Operating profit before tax (3 - 4 - 5 - 6)	1.86	2.01
8. Profit on disposals and exceptional items	0.24	0.10
9. Profit before tax (7 + 8)	2.10	2.11
10. Taxation	0.28	0.29
11. Extraordinary items	0.03	0.03
12 Post-tax profits (ROA) (9 - 10 + 11)	1.85	1.85



**TABLE 5: ASSET CLASSIFICATION – 1995**

	<b>PERFORMING(%)</b>	<b>SPECIAL MENTION(%)</b>	<b>SUBSTANDARD(%)</b>	<b>DOUBTFUL(%)</b>	<b>LOSS(%)</b>
Total Credit Exposures					
(a) all authorised institutions	98.28%	1.09%	0.22%	0.36%	0.07%
(b) all local banks	97.16%	1.41%	0.42%	0.96%	0.05%

*Total credit exposures include loans & advances, balances due from banks, acceptances and bills of exchange held, commitments and contingent liabilities and accrued interest.*

19.4% compared with 13.7% in 1994. This was largely attributable to the recovery in interest spreads during the year which, together with the strong endowment effect, resulted in the increase in the net interest margin already referred to. Other operating income also rebounded after the decline in 1994.

Another positive factor was the improved operating efficiency of local banks. With total operating income up by 18.4% (compared with 6.9% in 1994) and operating expenses growing by 12.7% (compared with 13.8%), the cost to income ratio improved from 40% in 1994 to 38% in 1995.

Against this, the bad debt charge of the local banks rose by 70% during 1995. However, this was from a very low base in 1994 when some banks benefited from releases in provisions. It is also relevant to note that despite the sharp fall in property prices in 1995, there has been no noticeable deterioration in the delinquency rate of residential mortgages. Despite the increase in 1995, the bad debt charge remained very low as a percentage of assets, rising from 0.05% in 1994 to only 0.08% in 1995. This figure is still very favourable by international standards, but institutions will need

to remain vigilant against possible further deterioration.

#### **CAPITAL ADEQUACY**

In line with the recommendations of the Best Practice Guide issued by the HKMA, all local banks for the first time disclosed in their 1995 accounts their balance sheet inner reserves and their capital adequacy ratios. The figures for inner reserves were largely in line with market expectations and produced little market reaction. The HKMA stressed in its public comments that inner reserves are a historical legacy and that the capital adequacy ratio is a more important indicator of capital strength. The ratios published by individual banks served to confirm the strong capital position of banks in Hong Kong.

As at end 1995, the consolidated capital adequacy ratio of the locally incorporated institutions was 17.5% compared with 17.4% at end 1994.

#### **THE NEW LOAN CLASSIFICATION SYSTEM**

The HKMA introduced in December 1994 a new measure which requires authorised institutions to report on a quarterly basis their assets according to a standardised loan classification system. Under the system, assets are classified as Performing, Special

Mention, Substandard, Doubtful or Loss, with the latter three categories collectively regarded as non-performing assets. Banks are also required to report the provisions made against the various categories.

The aggregate results based on the loan classification returns submitted by authorised institutions convey the same message as the bad debt charge: that is, while there were some slight signs of deterioration in asset quality over the year, the overall position remained strong by international standards. As at end 1995, the ratio of performing credit exposures to total credit exposures was 98.28% for the banking sector as a whole and 97.16% for locally incorporated banks, down slightly from 98.40% and 97.12% respectively a year earlier. The marginal decline reflected a slight rise in the proportion of "special mention" exposures (i.e. those which display signs of weakness but which are not yet classified as non-performing) from 0.90% to 1.09% for the sector and from 1.21% to 1.41% for locally incorporated banks. There was little change in the proportion of non-performing assets.