

Developments in the banking sector

by the Banking Policy Department

Notwithstanding the impact of SARS in the second quarter, retail banks performed quite well in 2003. This was evident particularly in the second half of the year, in line with economic recovery. Preliminary figures indicate that retail banks' aggregate pre-tax operating profits in respect of their Hong Kong offices rose compared with 2002. Good performance in treasury operations, increased income from fees and commissions and reduced bad debt provisions were the key contributing factors. Benefiting from the recovery in consumer and property market sentiment, overall asset quality improved in the fourth quarter. Consistent with the sharp decline in personal bankruptcies, credit card charge-offs decreased. The negative equity problem also eased with the recovery in property prices. Domestic lending rose after having fallen for two consecutive quarters.

Interest rate movements

Domestic interest rates fell to a new low in the fourth quarter as the banking sector was flush with liquidity, particularly with the capital inflow during the quarter. HIBORs dropped by a larger magnitude than time deposit rates. The average one-month HIBOR

contracted by 87 basis points to 0.12%, compared to a decline of 6 basis points in the average one-month time deposit rate to 0.02% (Chart 1). With the best lending rate¹ (BLR) remaining unchanged at 5.00%, the average spread between BLR and the one-month HIBOR widened to 4.88% and that between BLR and the one-month time deposit rate to 4.98% (Chart 2).

CHART 1

HIBORs and time deposit rates quarterly average

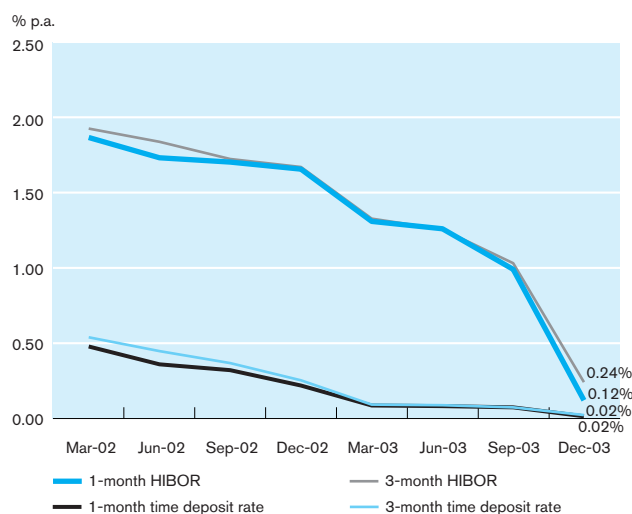
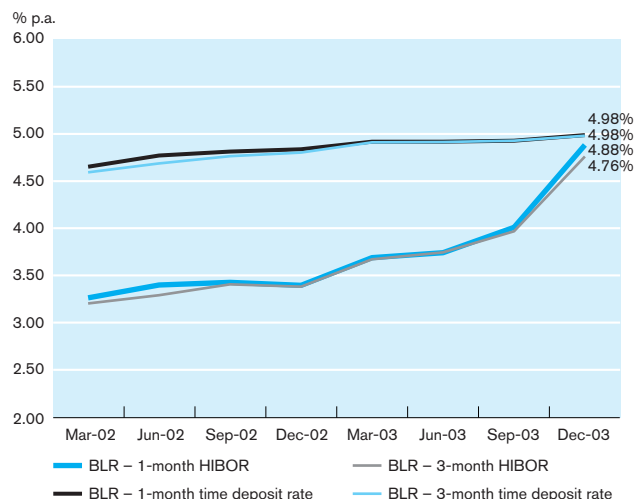


CHART 2

BLR - HIBOR/time deposit rate differentials quarterly average



¹ Best lending rate refers to the rate quoted by the Hongkong and Shanghai Banking Corporation Limited.

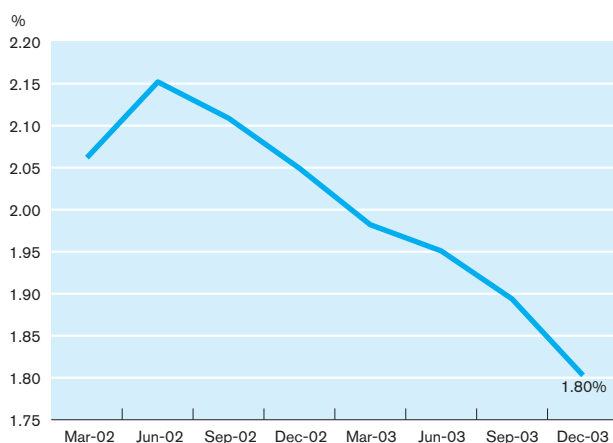
Retail banks' profitability

Benefiting from the upturn in the domestic economy following the SARS outbreak, most retail banks recorded profit growth in 2003. Preliminary figures indicate that retail banks' aggregate pre-tax operating profits in respect of their Hong Kong offices increased by 5.3% in 2003. Gains from treasury operations, increased income from fees and commissions arising from the pick-up in stock market activity in the second half and strong trade financing, as well as lower consumer bad debt charges, outweighed the effect of reduced net interest income. Accordingly, non-interest income increased and accounted for 34% of total operating income in 2003, up from 30% in 2002.

The continued squeeze on margins on residential mortgage lending and refinancing and the lower yield on free funds resulted in an overall decline in net interest income despite the widening of spreads between BLR and funding costs. As a consequence, the net interest margin contracted to 1.91% in 2003 from 2.09%^r a year ago (Chart 3).

CHART 3

Net interest margin (quarterly annualised)
(retail banks)



Although there was a mild pick-up in other operating costs, total operating costs of retail banks declined in 2003 on the back of the banks' continued efforts in tightening expenses in the areas of staff and rental costs. As a result, the cost-income ratio fell to 38.7% from 39.3%^r a year earlier.

In light of the improving economic conditions, the bad debt charge declined in the fourth quarter. Helped by lower bankruptcy-related write-offs and higher repayment power as a result of the improved labour market, the decrease in bad debt charge in the second half of the year more than offset the increase in the first half. For the year as a whole, retail banks' overall bad debt charge decreased to 0.29% of average total assets, down from 0.34% in 2002 (Chart 4).

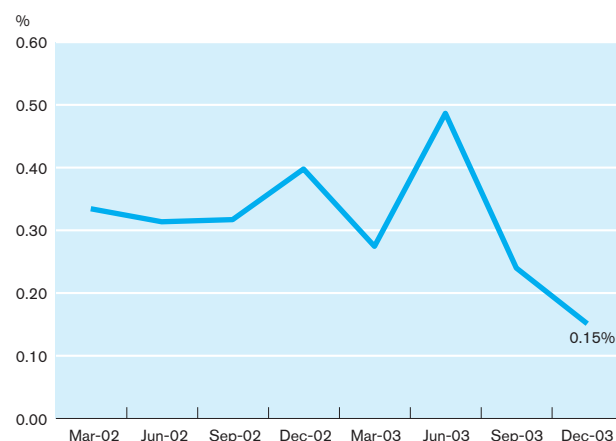
Retail banks' asset quality

Overall quality

Overall asset quality improved notably in the fourth quarter, particularly in the consumer lending portfolio. This is evidenced by the improvement in various

CHART 4

Bad debt charge as percentage of average total assets (quarterly annualised)
(retail banks)



^r Figure revised.

TABLE 1
Asset quality¹ of retail banks

	Dec-02	Mar-03	Jun-03	Sep-03	Dec-03
	as % of total loans				
Pass loans	88.87	88.49	88.55	88.39	89.55
Special mention loans	6.09	6.47	6.63	7.02 ^r	6.54
Classified loans (gross) ²	5.04	5.03	4.83	4.59 ^r	3.91
o/w Substandard	1.86	1.83	1.65	1.67 ^r	1.39
Doubtful	1.97	2.02	2.07	1.95	1.75
Loss	1.21	1.18	1.10	0.96	0.77
Classified loans (net) ³	3.53	3.52	3.31	3.17 ^r	2.74
Overdue > 3 months and rescheduled loans	3.59	3.64	3.62	3.58	2.83
o/w Overdue > 3 months	2.77	2.79	2.64	2.71	2.05
Rescheduled loans	0.82	0.85	0.98	0.86	0.79
Non-performing loans ⁴	3.94	4.03	3.92	3.61 ^r	3.17

Notes:

¹ Period-end figures relate to Hong Kong offices and overseas branches.

² Classified loans are those loans graded as "substandard", "doubtful" or "loss".

³ Net of specific provisions.

⁴ Loans on which interest has been placed in suspense or on which interest accrual has ceased.

^r Revised figures due to late adjustments.

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

problem loan ratios (Table 1). The overdue and rescheduled loan ratio fell to 2.83%, close to pre-Asian crisis levels. The overall classified loans and non-performing loans ratios also fell to 3.91% and 3.17% from 4.59% and 3.61% respectively at end-September (Chart 5). The ratio of specific provisions to total classified loans declined slightly to 30% from 31% at end-September (Chart 6).

Quality of residential mortgage portfolio

The quality of the overall residential mortgage portfolio improved in the fourth quarter. The

mortgage delinquency ratio fell below 1%, to 0.86% at end-December compared with 1.05% at end-September. With the rescheduled loan ratio falling to 0.52% from 0.55% at the end of the third quarter, the combined ratio improved to 1.38% from 1.60% (Chart 7).

The number of residential mortgage loans in negative equity decreased to around 67,600 at end-December, reflecting the recovery in property prices as a result of improved property market sentiment. The total value of these loans is estimated at around HK\$107 billion, with the unsecured portion

CHART 5

Asset quality of retail banks

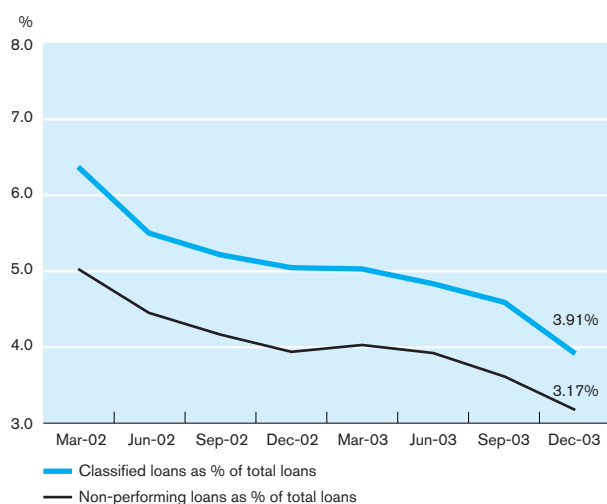
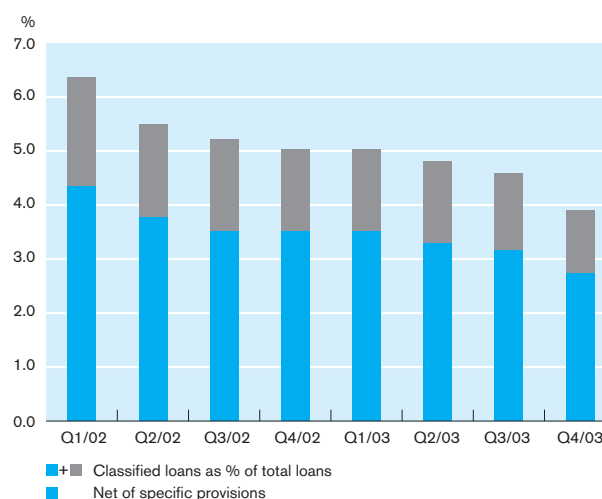


CHART 6

Asset quality (retail banks)



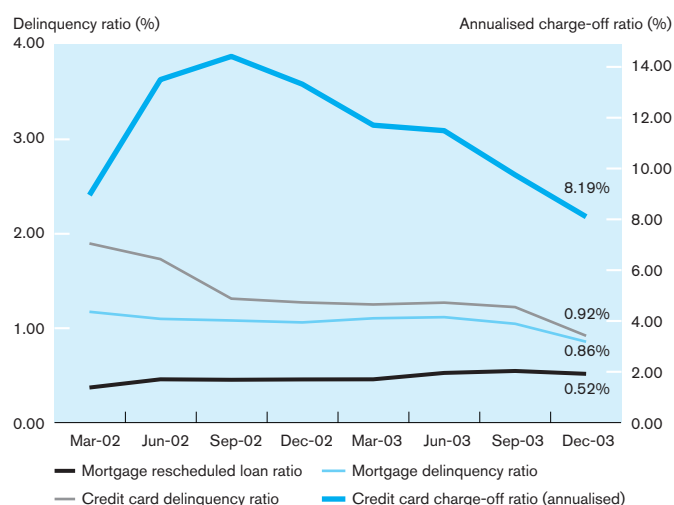
standing at about HK\$23 billion. The overall loan-to-value ratio on negative equity loans remained at around 128%. Reflecting the risk of the remaining negative equity loans with higher loan-to-value ratios, the interest rate being charged on those loans averaged 0.94% below BLR at end-December, compared with 1.09% below BLR at end-September. About 57% of negative equity homeowners were paying an interest rate below BLR as at end-December. The three-month delinquency ratio of negative equity mortgage loans² improved to 2.11% from 2.16% at end-September.

Quality of credit card portfolio

Attributable to on-going debt rescheduling arrangements as well as the sharp decline in number of personal bankruptcies and improved employment situation, the quality of the credit card portfolio continued to improve in the fourth quarter. As in the case of the mortgage delinquency ratio, the credit card delinquency ratio fell below 1%, to 0.92% at end-December from 1.23% at the end of the third quarter. Taking into account the HK\$166 million outstanding rescheduled card receivables within the card portfolio, the combined ratio of delinquent and rescheduled receivables stood at 1.22% at end-December. The aggregate amount charged off declined for the fifth consecutive quarter, to HK\$1.13 billion or 2.05% of average receivables

CHART 7

Asset quality of credit card and mortgage lending (surveyed institutions)



during the quarter (Chart 7). Accordingly, the annualised quarterly charge-off ratio fell from 9.85% in the third quarter to 8.19%, the lowest since the fourth quarter of 2001.

Local authorized institutions' capital strength

Reflecting the increase in risk-weighted assets, the average consolidated capital adequacy ratio of all local authorized institutions fell slightly to 15.4% from 15.6% at end-September 2003 (Table 2).

TABLE 2

Consolidated capital adequacy ratio (All locally incorporated AIs)

(HK\$ mn)	Dec-02	Mar-03	Jun-03	Sep-03	Dec-03
Total capital base after deductions ¹	303,900	308,212	307,655	311,965	314,244
of which core capital	251,745	259,440	263,659	266,483	268,927
Total risk-weighted exposures	1,931,991	1,932,415	1,973,508	1,998,563	2,042,977
Capital adequacy ratio	15.7%	15.9%	15.6%	15.6%	15.4%

Notes:

¹ Total capital base after deductions refers to total core and supplementary capital after deductions as specified under the Third Schedule to the Banking Ordinance.

² Negative equity residential mortgage loans delinquent for more than three months as a percentage of total negative equity residential loans.

CHART 8

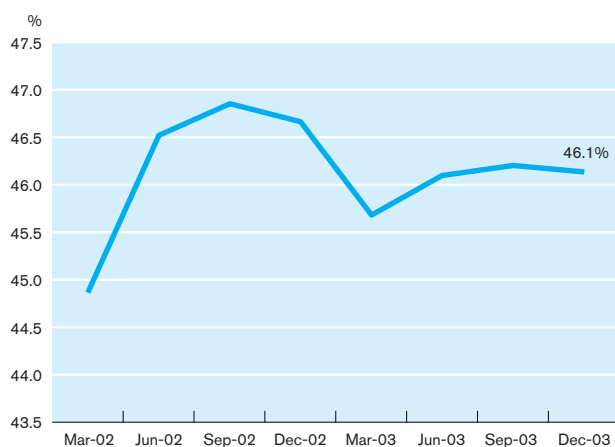
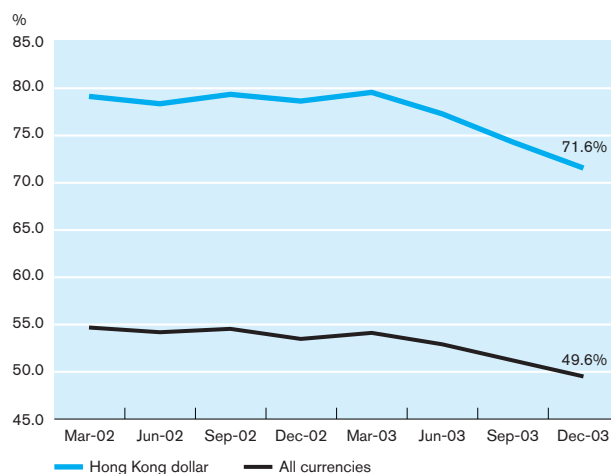
Average liquidity ratio
(retail banks)

CHART 9

Loan-to-deposit ratio
(retail banks)

Retail bank's liquidity

Retail banks' average liquidity ratio³ remained stable at 46% for the fourth quarter, well above the minimum statutory requirement of 25% (Chart 8). The main components of liquifiable assets continued to be marketable debt securities and net interbank claims.

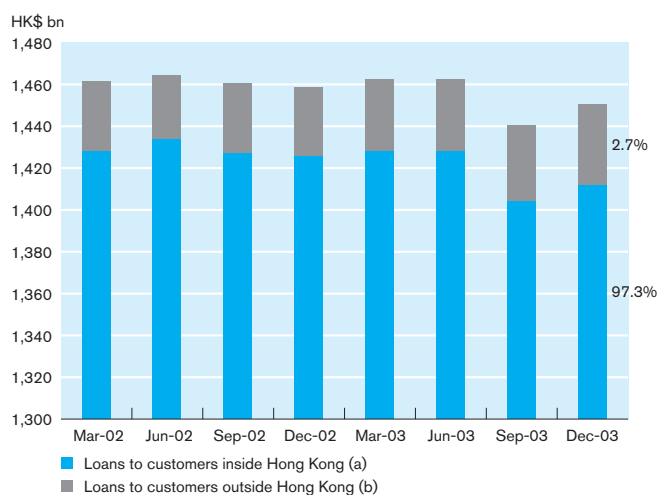
With the growth in deposits outpacing that of loans, the overall loan-to-deposit ratio dropped to a new low of 49.6% from 51.2% and the Hong Kong dollar ratio to 71.6% from 74.3% (Chart 9).

Retail banks' lending

Stimulated by improved business sentiment arising from the economic recovery and the positive economic outlook, domestic loans of retail banks grew by 0.5% in the fourth quarter after having fallen for two consecutive quarters. This, coupled with the

6.5% increase in offshore loans, resulted in an increase of 0.7% in retail banks' total loans, against a decline of 1.5% in the third quarter (Chart 10).

CHART 10

Loans to customers inside and outside Hong Kong
(retail banks)

Notes:

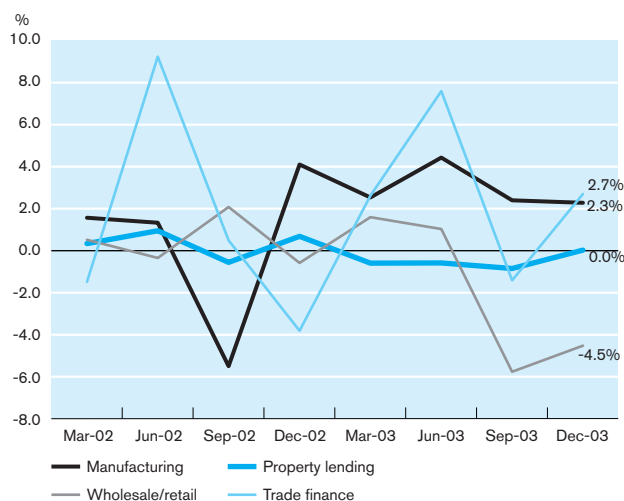
(a) Defined as loans for use in Hong Kong plus trade financing loans.

(b) Includes "others" (i.e. unallocated).

³ All authorized institutions in Hong Kong are required to meet a minimum monthly average liquidity of 25%. This is calculated as the ratio of liquifiable assets (e.g. marketable debt securities and loan repayment within one month subject to their respective liquidity conversion factors) to qualifying liabilities (basically all liabilities due within one month). The method of calculation and its component are specified in the Fourth Schedule of the Banking Ordinance.

CHART 11

Loans for use in Hong Kong by selected sectors (retail banks) quarterly percentage change



N.B. Property lending denotes lending for property development & investment and residential mortgage loans (excluding lending under the Home Ownership Scheme, the Private Sector Participation Scheme & the Tenants Purchase Scheme).

Loans to customers inside Hong Kong by various economic sectors

As shown in Chart 11, except for lending to the wholesale and retail trade sector, which fell by 4.5% having fallen by 5.8% in the third quarter, lending to most sectors increased :

- On the back of the growth in external trade, trade financing loans grew by 2.7% against a decline of 1.4%.
- Driven by the improving investment sentiment and increased stock market activity during the quarter, loans to finance share purchases increased by 20.7% against a decline of 1.6% in the third quarter. Within this, loans to stockbrokers rose sharply by 33.1% following a decrease of 2.7%. Loans to non-stockbroking companies and individuals to purchase stocks reversed a decline of 0.6% to grow by 8.7%.
- Loans to financial concerns also increased by 2.8% after rising by 5.0% in the previous quarter.

- In line with the revival in the property market, both residential mortgage lending and lending for property investment increased, by 0.5% and 0.8% respectively, compared with declines of 0.4% and 1.1% respectively in the preceding quarter. Offsetting the increases was a 5.0% decrease in lending for property development. As a result, property lending as a whole remained unchanged. Loans for the purchase of flats under the Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme continued to fall for the eighth consecutive quarter, by 3.0%, reflecting the cessation of the sale of flats under these schemes.
- Lending to the electricity, gas and telecommunications sector rose by 9.4%.

Lending to telecommunications sector

Retail banks' lending to the telecommunications sector rose by HK\$2.2 billion to HK\$9.4 billion, accounting for 0.7% of their total domestic loans. Similarly, the banking sector as a whole also recorded an increase in their lending to this sector by HK\$2.5 billion to HK\$20.0 billion, representing 1.1% of the banking sector's total domestic loans.

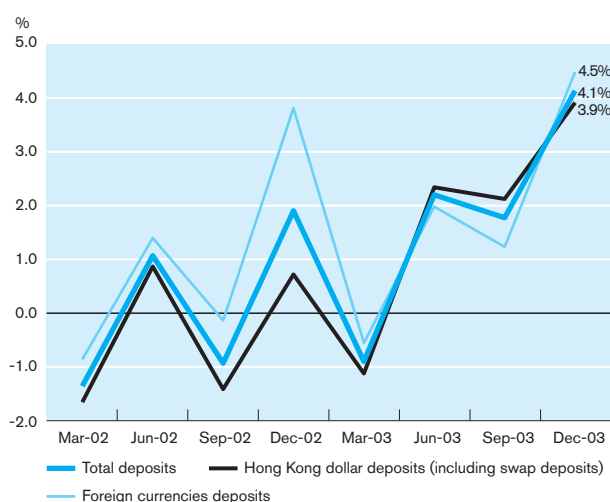
Exposure to non-bank Chinese entities

Retail banks' aggregate exposure to non-bank Chinese entities fell to HK\$98.38 billion (2.5% of total assets) at end-September 2003 from HK\$101.5 billion in the second quarter, largely as a result of continuing loan repayments. Exposure of the banking sector as a whole to non-bank Chinese entities also fell, to HK\$131.62 billion (2.0% of total assets).

Credit card receivables

Underpinned by a combination of strengthened consumer confidence, increased spending during the festive season and the payment of salary tax using credit cards, which more than offset the transfer of HK\$169 million of rescheduled receivables outside

CHART 12

Customer deposits (retail banks)
quarterly percentage change

the card portfolio, credit card receivables for the surveyed group of institutions rose by 4.3% in the fourth quarter. The total number of credit card accounts also increased by 0.4%.

Retail banks' customer deposits

Largely due to the continued inflow of funds, retail banks' customer deposits rose further by 4.1% following an increase of 1.8% in the preceding quarter. Both Hong Kong dollar and foreign currency deposits rose, by 3.9% and 4.5% after increases of 2.1% and 1.2% respectively in the preceding quarter (Chart 12). US dollar deposits rose by 5.5% while other foreign currency deposits increased by 2.2%. The proportion of Hong Kong dollar deposits to total deposits was stable at 61%.

Hong Kong dollar time deposits continued to decline for the thirteenth consecutive quarter, and at a faster pace of 16.8% compared with 2.8% in the preceding quarter (Table 3). As a result, the share of Hong Kong dollar time deposits to Hong Kong dollar total deposits fell to 36.7% from 45.8% in the previous quarter. Conversely, Hong Kong dollar demand deposits increased sharply by 24.9%, having risen by 13.6% in the preceding quarter. Savings deposits also rose significantly, by 20.7%, compared with an increase of 5.4% in the preceding quarter. The above trends were prompted by the low prevailing interest

TABLE 3

Hong Kong dollar deposit mix

	Retail banks		
	Demand	Savings	Time*
Dec/02	133.8	668.1	861.3
% growth	9.9	6.2	(4.3)
Mar/03	130.7	683.3	830.6
% growth	(2.3)	2.3	(3.6)
Jun/03	143.4	728.9	810.9
% growth	9.7	6.7	(2.4)
Sep/03	162.9	767.9	788.2
% growth	13.6	5.4	(2.8)
Dec/03	203.4	927.1	655.8
% growth	24.9	20.7	(16.8)

Note: % growth denotes the quarter-on-quarter change in deposits.
* includes swap deposits

rates and an increased demand for transaction money in light of the buoyant stock market.

Negotiable instruments

Negotiable debt instruments held

Retail banks' holding of negotiable debt instruments (NDIs) (excluding negotiable certificates of deposits (NCDs)) continued to increase. At end-December, total holdings of NDIs by retail banks accounted for 21.7% of their total assets, compared to 20.9% a year ago. The increase was largely in NDIs denominated in foreign currency (see Chart 13). The breakdowns of NDIs held by types of instruments

CHART 13

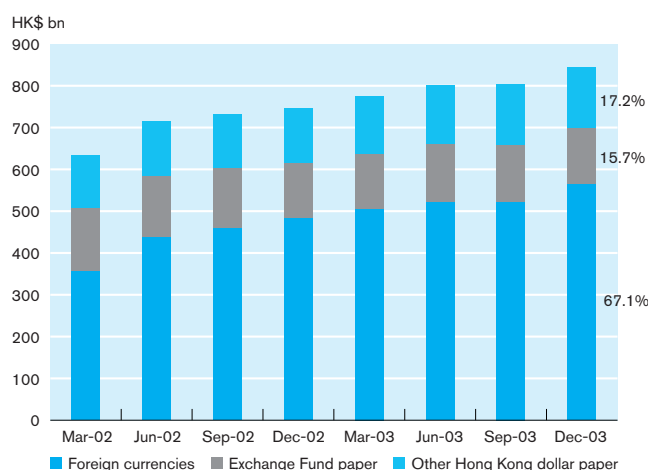
Negotiable debt instruments held (retail banks)
by currency breakdown

CHART 14

Negotiable debt instruments held (retail banks) by types of instruments

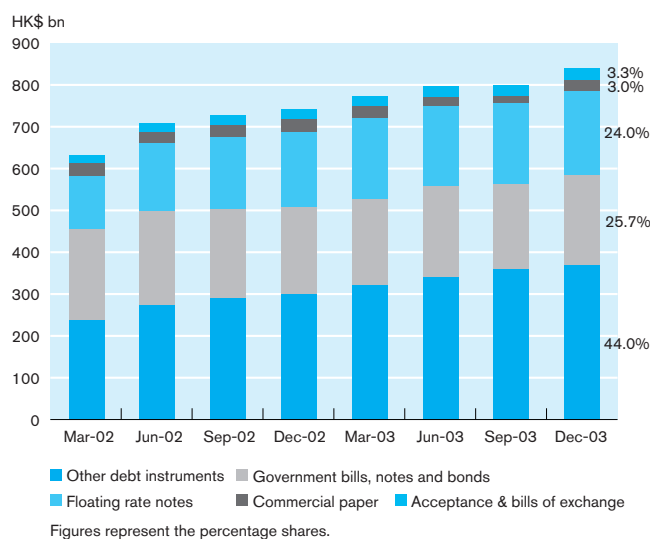
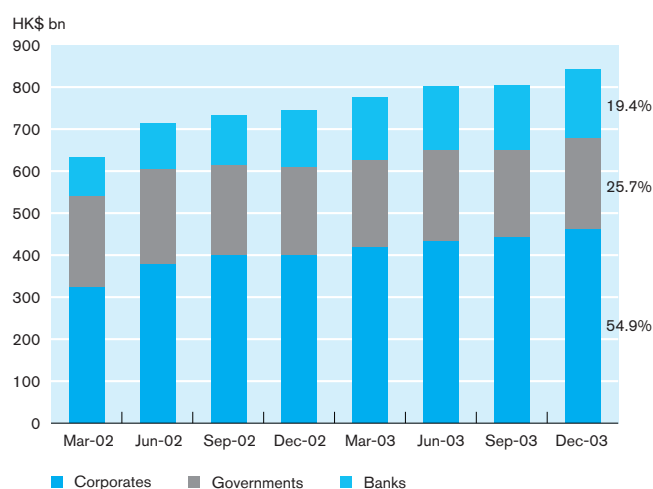


CHART 15

Negotiable debt instruments held (retail banks) by counterparty breakdown



and counterparties are shown in Charts 14 and 15 respectively.

Retail banks' holdings of NCDs, on the other hand, fell by 1.0% against an increase of 1.8% in the third quarter, representing 2.5% of retail banks' total assets at end-December.

Negotiable certificates of deposits issued

Issuance of NCDs by retail banks decreased slightly in the fourth quarter after a modest increase in the preceding quarter. Outstanding issued NCDs, however, rose by 5.1% in the fourth quarter, as fewer NCDs were redeemed during the quarter. The outstanding issued NCDs for the year rose by 17.3%. Issued NCDs accounted for about 4% of retail banks' total liabilities at the end of 2003.

A table of key performance indicators of the banking sector is at Appendix.

APPENDIX

KEY PERFORMANCE INDICATORS OF THE BANKING SECTOR¹ (%)

	Dec-02	Sep-03	Dec-03
Interest rate²			
1-month HIBOR	1.66	0.99	0.12
3-month HIBOR	1.67	1.03	0.24
BLR and 1-month HIBOR spread	3.40	4.01	4.88
BLR and 3-month HIBOR spread	3.38	3.97	4.76
Retail banks			
Balance sheet developments³			
Total deposits	1.9	1.8	4.1
Hong Kong dollar	0.7	2.1	3.9
Foreign currency	3.8	1.2	4.5
Total loans	-0.1	-1.5	0.7
Loans to customers inside Hong Kong ⁴	-0.1	-1.7	0.5
Loans to customers outside Hong Kong ⁵	-2.3	5.7	6.5
Negotiable instruments			
Negotiable debt certificates issued	4.0	2.3	5.1
Negotiable debt instruments held	1.7	0.2	5.0
Asset quality⁶			
As % of total loans			
Pass loans	88.87	88.39	89.55
Special mention loans	6.09	7.02 ^r	6.54
Classified loans (gross) ⁷	5.04	4.59 ^r	3.91
Classified loans (net) ⁸	3.53	3.17 ^r	2.74
Overdue > 3 months and rescheduled loans	3.59	3.58	2.83
Non-performing loans ⁹	3.94	3.61 ^r	3.17
Profitability¹⁰			
Bad debt charge as % of average total assets	0.34	0.33	0.29
Net interest margin	2.09	1.94	1.91
Cost income ratio	39.3	37.6	38.7
Liquidity ratio¹¹	46.7	46.2	46.1
Surveyed institutions			
Asset quality			
Delinquency ratio of residential mortgage loans	1.06	1.05	0.86
Credit card receivables			
Delinquency ratio	1.28	1.23	0.92
Charge-off ratio — quarterly annualised (adjusted) ¹²	13.45	9.85	8.19
— year-to-date annualised	13.25	10.98	10.02
All locally incorporated AIs			
Capital adequacy ratio (consolidated)	15.7	15.6	15.4

Notes:

¹ Figures related to Hong Kong office(s) only except where otherwise stated.

² Quarterly average.

³ Quarterly change.

⁴ Loans for use in Hong Kong plus trade financing loans.

⁵ Includes "others" (i.e. unallocated).

⁶ Figures relate to retail banks' Hong Kong office(s) and overseas branches.

⁷ Classified loans are those loans graded as "substandard", "doubtful" or "loss".

⁸ Net of specific provisions.

⁹ Loans on which interest has been placed in suspense or on which interest accrual has ceased.

¹⁰ Year-to-date annualised.

¹¹ Quarterly average.

¹² Excluding certain charge-offs which will not be repeated in subsequent quarters and which it would not therefore be appropriate to annualise. The year-to-date figures are not similarly adjusted.

^r Revised figures due to late adjustments.