

# Developments in the banking sector

by the Banking Policy Department

Fuelled by the growing momentum in economic recovery, retail banks' aggregate pre-tax operating profits in respect of their Hong Kong offices increased in the first half of 2004 compared with the same period last year. The main reason for the increase was sharply lower debt provisions as a result of the improvement in the overall asset quality and write-back of provisions compared with a year previously, during which substantial provisions were made due to SARS. A continued increase in non-interest income offset the effects of a decline in net interest income. In light of the improving employment situation and decreasing bankruptcies, credit card charge-offs continued to decline. With the continued recovery in property values, the number of negative equity residential mortgages reduced further. Domestic lending increased on the back of the economic recovery.

## Interest rate movements

Domestic interest rates firmed in the second quarter. Given the very liquid position of the banking sector, short-term rates remained near to zero. However, on the expectation of increased interest rates in the US, long-term interbank rates increased by more than

equivalent time deposit rates. The average three-month HIBOR rose by 22 basis points to 0.30% while the average three-month time deposit rate rose by only 1 basis point to 0.02% (Chart 1). Despite the 25 basis point increase in the US Fed funds target rate at the end of June, the best lending rate<sup>1</sup> (BLR) remained unchanged at 5.00%. This resulted in a narrowing in the average spread between BLR and the one-month HIBOR to 4.90% and that between BLR and the one-month time deposit rate to 4.99% (Chart 2).

CHART 1

HIBORs and time deposit rates quarterly average

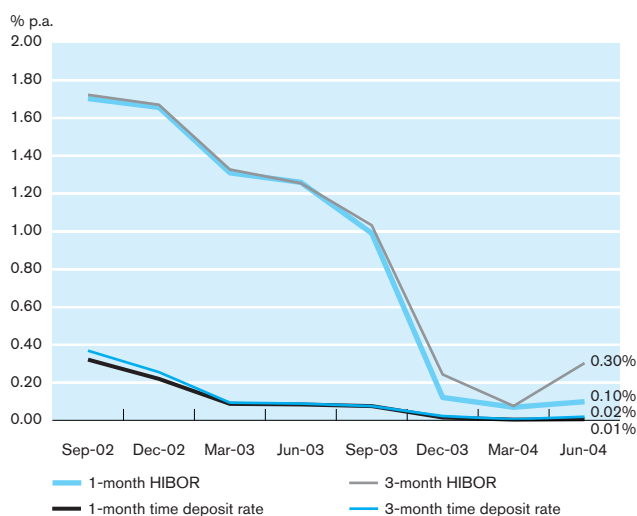
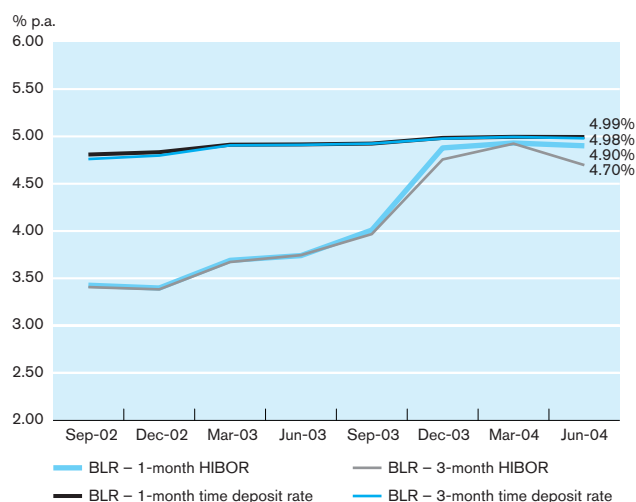


CHART 2

BLR - HIBOR/time deposit rate differentials quarterly average



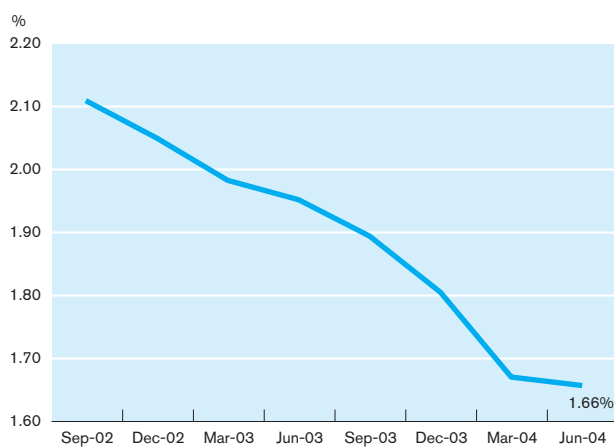
<sup>1</sup> Best lending rate refers to the rate quoted by The Hongkong and Shanghai Banking Corporation Limited.

## Retail banks' profitability

Fuelled by the continuing economic recovery, retail banks by and large recorded profit growth in the first half of 2004. Their aggregate pre-tax operating profits in respect of their Hong Kong offices increased by 25.7% compared with the first half of last year, with the sharp reduction in provisions being the main factor for this growth. Other factors contributing to the good performance included continued gains from treasury operations as well as increased income from fees and commissions arising mainly from wealth management and trade financing. These positive developments offset the effects of the decline in net interest income. As a result, non-interest income increased to 39% of total operating income in the first half of 2004, up from 33% in the same period last year.

Due to the narrowing of spreads between BLR and funding costs and the continued squeeze in margins on residential mortgage lending and refinancing as well as the lower yield on free funds, retail banks' net interest income declined despite an expansion in interest bearing assets. Accordingly, the net interest margin contracted to 1.66% from 1.97% a year previously (Chart 3).

**CHART 3**  
Net interest margin (quarterly annualised)  
(retail banks)



Retail banks' cost-income ratio increased to 40.0% from 36.8% in the first half of 2003. Increases in staff costs and other expenses arising from business expansion were largely responsible for the increase in retail banks' total operating costs.

On the back of improving economic conditions and asset quality, the bad debt charge declined notably in the first half compared with a year previously, during which substantial provisions due to SARS were made. Attributable to write-back of provisions experienced by some banks, which more than offset the bad debt charge, retail banks as a whole recorded a net write-back in the first half of 2004. As a result, retail banks' ratio of overall bad debt charge to average total assets was -0.02%, compared with 0.38% a year previously (Chart 4).

**CHART 4**  
Bad debt charge as percentage of average total assets (quarterly annualised)  
(retail banks)

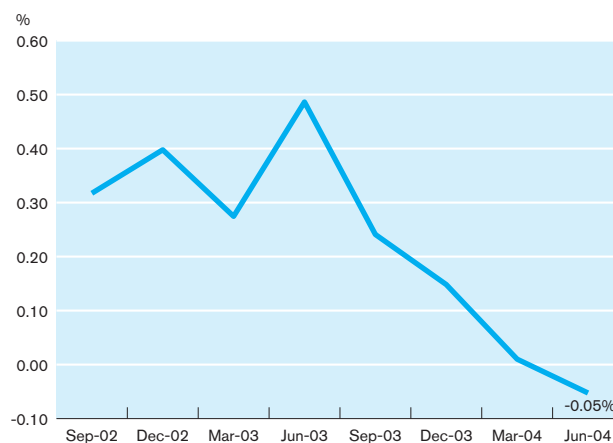


TABLE 1

Asset quality<sup>1</sup> of retail banks

	Jun-03	Sep-03	Dec-03	Mar-04	Jun-04
	as % of total loans				
Pass loans	88.55	88.39	89.53	90.07	91.41
Special mention loans	6.63	7.01	6.53	6.26	5.59
<b>Classified loans (gross)<sup>2</sup></b>	<b>4.83</b>	<b>4.59</b>	<b>3.94</b>	<b>3.66</b>	<b>2.99</b>
o/w Substandard	1.65	1.67	1.42	1.36	1.19
Doubtful	2.07	1.95	1.74	1.56	1.26
Loss	1.10	0.96	0.77	0.74	0.55
<b>Classified loans (net)<sup>3</sup></b>	<b>3.31</b>	<b>3.17</b>	<b>2.78</b>	<b>2.62</b>	<b>2.16</b>
<b>Overdue &gt; 3 months and rescheduled loans</b>	<b>3.62</b>	<b>3.58</b>	<b>2.87</b>	<b>2.61<sup>r</sup></b>	<b>2.09</b>
o/w Overdue > 3 months	2.64	2.71	2.04	1.83	1.43
Rescheduled loans	0.98	0.86	0.83	0.78	0.66
<b>Non-performing loans<sup>4</sup></b>	<b>3.92</b>	<b>3.61</b>	<b>3.17</b>	<b>2.92</b>	<b>2.28</b>

Notes:

<sup>1</sup> Period-end figures relate to Hong Kong offices and overseas branches.<sup>2</sup> Classified loans are those loans graded as "substandard", "doubtful" or "loss".<sup>3</sup> Net of specific provisions.<sup>4</sup> Loans on which interest has been placed in suspense or on which interest accrual has ceased.<sup>r</sup> Revised figures due to late adjustments.

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

## Retail banks' asset quality

## Overall quality

Reflecting the continued improvement in overall asset quality in the second quarter, all problem loan ratios declined (Table 1). The overdue and rescheduled loan ratio fell back to the end-1997 level at 2.09%, and the overall classified loans and non-performing loans ratios fell to 2.99% and 2.28% from 3.66% and 2.92% respectively at the end of March (Chart 5). The ratio of specific provisions to total classified loans declined slightly to 28% from 29% at the end of March (Chart 6).

CHART 5

## Asset quality of retail banks

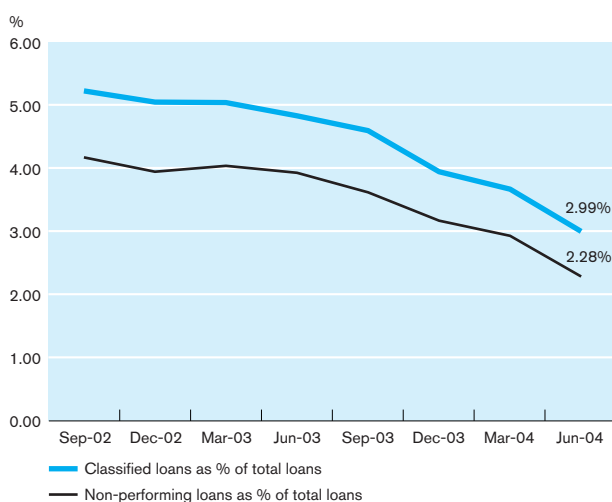
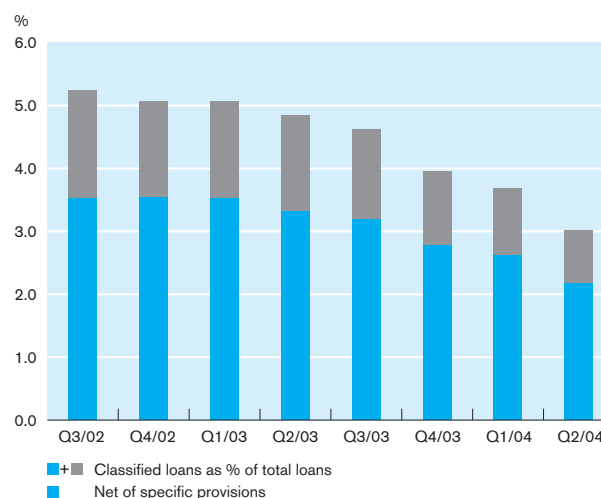


CHART 6

## Asset quality (retail banks)



## Quality of residential mortgage portfolio

The improving trend in the quality of the overall residential mortgage portfolio continued in the first half of 2004. The mortgage delinquency ratio fell to a 5-year low of 0.57% at the end of June from 0.70% at the end of March. With the rescheduled loan ratio standing at 0.49% at the end of the second quarter, the combined ratio improved to 1.07% from 1.19% (Chart 7).

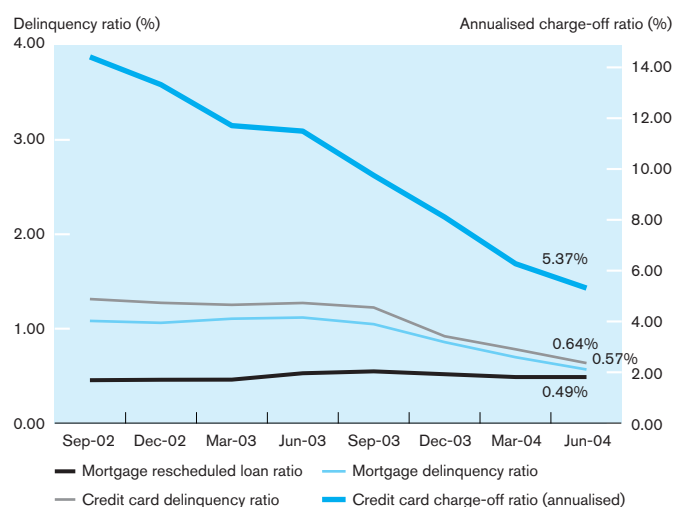
Helped by the continued recovery in property values, banks' residential mortgage loans in negative equity decreased to around 28,200 cases at the end of June with an estimated aggregate value of HK\$48 billion. The unsecured portion of these loans was around HK\$8 billion, down from HK\$36 billion a year previously. With increased collateral values and continued reductions in outstanding balances due to loan repayments, the overall loan-to-value ratio on negative equity loans declined to 121% from 125% at the end of March. Reflecting the higher associated risks of loans in negative equity, the weighted average interest rate was 0.65% below BLR, compared with 0.74% below BLR at the end March. Consistent with the improving economic conditions, the three-month delinquency ratio of negative equity mortgage loans<sup>2</sup> improved to 1.97% from 2.19% at the end of March.

### Quality of credit card portfolio

Debt rescheduling arrangements as well as the decreasing trends in both personal bankruptcies and unemployment continued to be the driving factors behind the improvement in the quality of the credit card portfolio in the second quarter. The amount charged off in the second quarter decreased for the seventh consecutive quarter to HK\$0.72 billion or 1.34% of average receivables during the quarter. Accordingly, the annualised quarterly charge-off ratio improved to 5.37% from 6.34% in the first quarter (Chart 7), the lowest level since the third quarter of 2001. Meanwhile, the credit card delinquency ratio

CHART 7

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



also fell to 0.64% at the end of June, a level last seen at the end of 1997. Together with the HK\$73 million outstanding rescheduled card receivables within the card portfolio, the combined ratio of delinquent and rescheduled receivables declined to 0.77% from 1.12% at the end of March.

### Local authorized institutions' capital strength

With the growth in risk-weighted assets outpacing that of capital base due to increased lending, the average consolidated capital adequacy ratio of the locally incorporated authorized institutions decreased slightly to 15.9% from 16.2% at the end of March (Table 2).

TABLE 2

### Consolidated capital adequacy ratio (All locally incorporated AIs)

(HK\$ mn)	Jun-03	Sep-03	Dec-03	Mar-04	Jun-04
Total capital base after deductions <sup>1</sup> of which core capital	307,654 263,659	311,964 266,483	311,644 266,693	330,112 285,314	332,419 290,426
Total risk-weighted exposures	1,973,508	1,998,599	2,042,768	2,040,148	2,086,821
Capital adequacy ratio	15.6%	15.6%	15.3%	16.2%	15.9%

Notes:

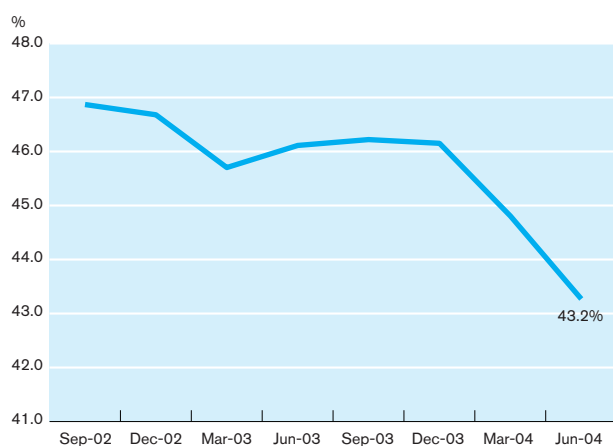
<sup>1</sup> Total capital base after deductions refers to total core and supplementary capital after deductions as specified under the Third Schedule to the Banking Ordinance.

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

## Retail bank's liquidity

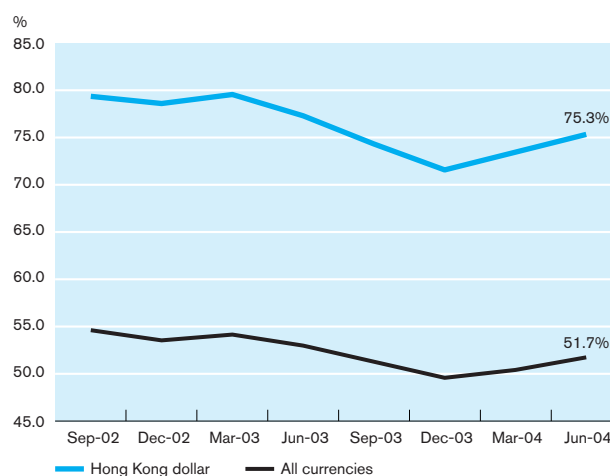
Retail banks' average liquidity ratio<sup>3</sup> remained strong at about 43% for the second quarter, well above the minimum statutory requirement of 25% (Chart 8). The main components of liquifiable assets continued to be marketable debt securities and net interbank claims.

**CHART 8**  
Average liquidity ratio  
(retail banks)



With loans increasing but deposits remaining largely unchanged in the second quarter, the overall loan-to-deposit ratio increased to 51.7% from 50.4% at the end of March and the Hong Kong dollar ratio to 75.3% from 73.4% (Chart 9).

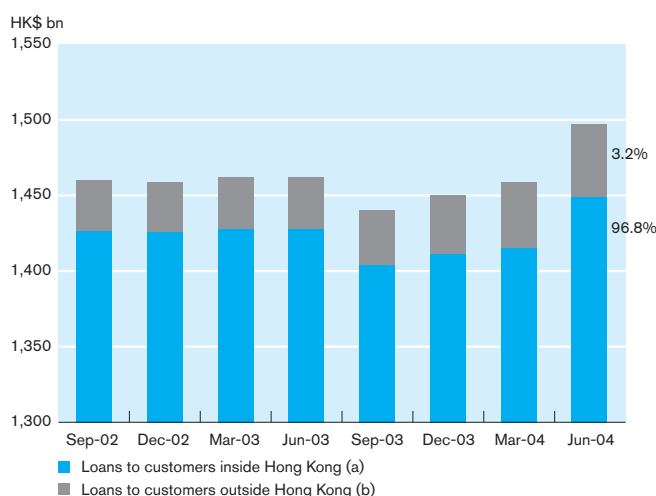
**CHART 9**  
Loan-to-deposit ratio  
(retail banks)



## Retail banks' lending

Lifted by the strong growth in trade financing and increased consumer spending following the revival of consumer confidence, the domestic lending of retail banks increased by 2.4% in the second quarter following a 0.3% rise in the first quarter. Together with the 10.2% increase in offshore loans, retail banks' total loans increased by 2.7% after having risen by 0.6% in the first 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).

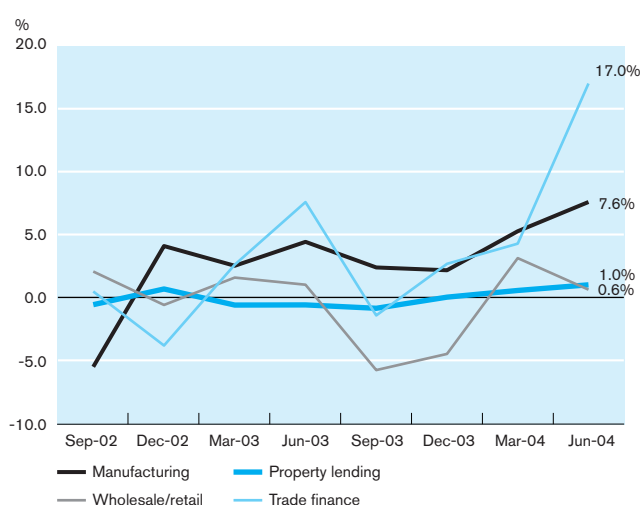
<sup>3</sup> All authorized institutions in Hong Kong are required to meet a minimum monthly average liquidity of 25%. This is calculated as the ratio of liquifiable assets (e.g. marketable debt securities and loan repayment within one month subject to their respective liquidity conversion factors) to 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.

## Loans to customers inside Hong Kong by various economic sectors

Owing to the improving business sentiment arising from better economic prospects, domestic loan demand increased in the second quarter. Chart 11 reveals that lending to most sectors increased:

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).

- Underpinned by the robust external trade, trade financing loans grew at a faster pace of 17.0% compared with 4.3% in the first quarter.
- Loans to the manufacturing sector rose by 7.6% after rising by 5.3% in the first quarter.
- Reflecting the slowdown in stock market activities and IPO activities during the second quarter, loans to finance share purchases dropped by 3.1% against an increase of 3.7% in the first quarter. Within the total, loans to non-stockbroking companies and individuals to purchase stocks fell by 7.1% compared with an increase of 21.0% in the first quarter.

However, loans to stockbrokers reversed a decline of 10.7% to grow by 1.5%.

- Loans to financial concerns increased by 4.4% against a decline of 1.0% in the previous quarter.
- Property lending increased by 1.0% after rising by 0.6% in the first quarter. The increase was due to the 4.0% increase in lending for property investment, which more than offset the declines of 0.1% and 0.8% in residential mortgage lending and lending for property development respectively. Loans for the purchase of flats under the Home Ownership Scheme, Private Sector Participation Scheme and Tenants Purchase Scheme continued to decline by 2.9% in the second quarter.
- Lending to the electricity and gas sector and recreational activities sector rose by 10.4% and 21.5% respectively.

## Lending to telecommunications sector

Retail banks' lending to the telecommunications sector decreased by HK\$1.3 billion to HK\$8.5 billion, accounting for 0.6% of their total domestic loans. Similarly, lending to this sector by the banking sector as a whole decreased by HK\$2.7 billion to HK\$15.7 billion, which represented 0.9% of the banking sector's total domestic loans.

## Exposure to non-bank Chinese entities

Retail banks' aggregate exposure to non-bank Chinese entities rose to HK\$115.3 billion (2.5% of total assets) at the end of June from HK\$105.0 billion at the end of March, largely due to increase in exposures to red-chip companies and their subsidiaries. The exposure of the banking sector to non-bank Chinese entities also increased to HK\$160.6 billion (2.2% of total assets).

## Credit card receivables

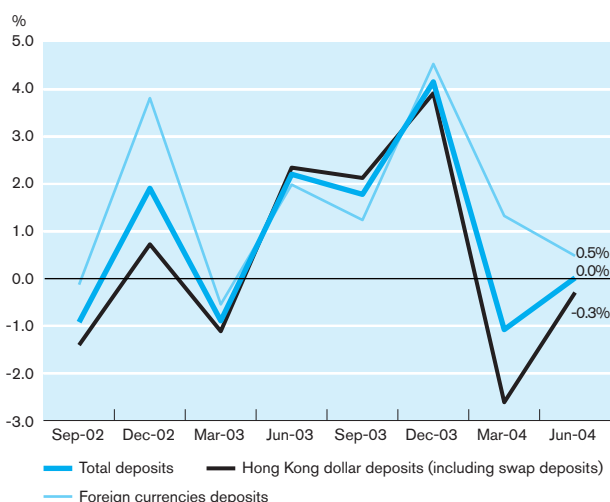
Reflecting increased consumer spending, total credit card receivables increased by 0.1% in the second quarter, following a transfer of around HK\$286 million rescheduled receivables (0.5% of average receivables) outside the credit card portfolio during the quarter. The total number of credit card accounts grew for the fourth consecutive quarter by 1.5%.

## Retail banks' customer deposits

Retail banks' customer deposits were largely unchanged in the second quarter after declining by 1.1% in the first quarter mainly as a result of the refund of IPO subscription monies. While Hong Kong dollar deposits decreased further by 0.3% after falling by 2.6% in the first quarter, foreign currency deposits rose by 0.5% following an increase of 1.3% (Chart 12). Of all foreign currency deposits, US dollar deposits grew by 2.8% while non-US dollar deposits fell by 4.1%. The proportion of Hong Kong dollar deposits to total deposits remained stable at around 60%.

CHART 12

### Customer deposits (retail banks) quarterly percentage change



Having declined for fourteen consecutive quarters, Hong Kong dollar time deposits increased by 0.8% after a decrease of 14.1% in the preceding quarter (Table 3). As a result, the share of Hong Kong dollar time deposits to Hong Kong dollar total deposits rose to 32.7% from 32.4% in the first quarter. Hong Kong dollar demand deposits continued to increase, but at a slower pace of 3.5% compared with 7.2% in the preceding quarter. Conversely, Hong Kong dollar savings deposits dropped, by 1.8%, compared with an increase of 3.4% in the preceding quarter.

TABLE 3

### Hong Kong dollar deposit mix

Amount (HK\$ bn)

	Retail banks		
	Demand	Savings	Time*
<b>Jun/03</b>	<b>143.4</b>	<b>728.9</b>	<b>810.9</b>
% growth	9.7	6.7	(2.4)
<b>Sep/03</b>	<b>162.9</b>	<b>767.9</b>	<b>788.2</b>
% growth	13.6	5.4	(2.8)
<b>Dec/03</b>	<b>203.4</b>	<b>927.1</b>	<b>655.8</b>
% growth	24.9	20.7	(16.8)
<b>Mar/04</b>	<b>218.1</b>	<b>958.2</b>	<b>563.3</b>
% growth	7.2	3.4	(14.1)
<b>Jun/04</b>	<b>225.7</b>	<b>941.1</b>	<b>567.7</b>
% growth	3.5	(1.8)	0.8

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

\* includes swap deposits

## Negotiable instruments

### Negotiable debt instruments held

Reversing the rising trend, retail banks' holding of NDIs (excluding negotiable certificates of deposits (NCDs)) dropped by 0.5% in the second quarter after increasing by 2.8% in the first quarter. However, compared with a year previously, retail banks' total holdings of NDIs were up by 7.6%. Much of the increase was in NDIs denominated in



foreign currency (Chart 13). The breakdowns of NDIs held by types of instruments and counterparties are shown in Charts 14 and 15 respectively.

CHART 13

#### Negotiable debt instruments held (retail banks) by currency breakdown

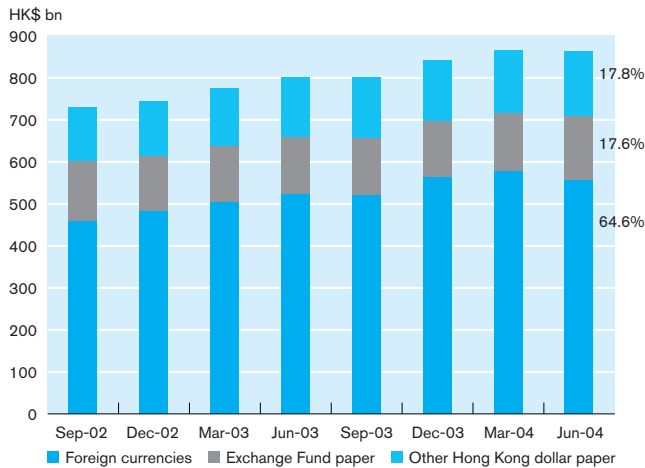


CHART 14

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

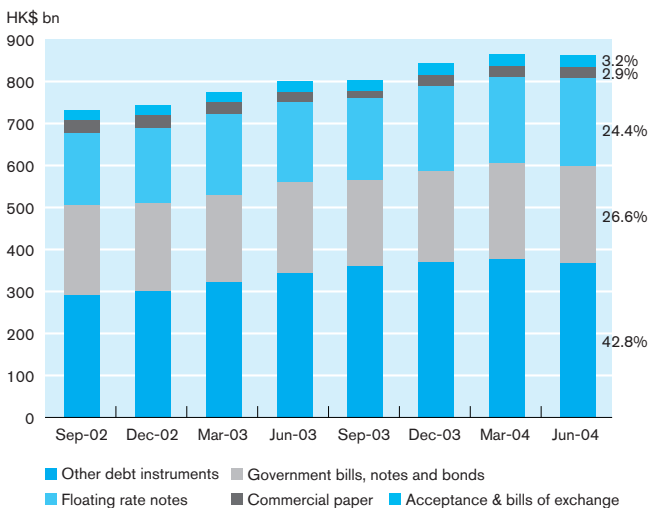
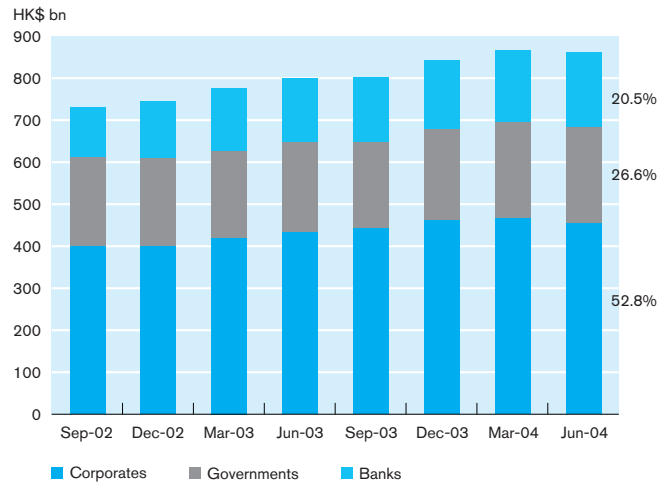


CHART 15

#### Negotiable debt instruments held (retail banks) by counterparty breakdown



Retail banks' holdings of NCDs decreased further by 3.8% after falling by 11.5% in the first quarter, to represent 2.1% of retail banks' total assets at the end of June.

#### Negotiable certificates of deposits issued

Issuance of NCDs by retail banks increased in the second quarter after declining in the preceding quarter. As a result, retail banks' outstanding amount of NCDs rose by 1.9% in the second quarter. Compared with a year previously, outstanding NCDs rose by 6.0%. Outstanding amount of NCDs accounted for about 4% of retail banks' total liabilities at the end of the second quarter.

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



## APPENDIX

KEY PERFORMANCE INDICATORS OF THE BANKING SECTOR<sup>1</sup> (%)

	Jun-03	Mar-04	Jun-04
<b>Interest rate<sup>2</sup></b>			
1-month HIBOR	1.26	0.07	0.10
3-month HIBOR	1.26	0.08	0.30
BLR and 1-month HIBOR spread	3.74	4.93	4.90
BLR and 3-month HIBOR spread	3.74	4.92	4.70
<b>Retail banks</b>			
<b>Balance sheet developments<sup>3</sup></b>			
Total deposits	2.2	-1.1	0.0
Hong Kong dollar	2.3	-2.6	-0.3
Foreign currency	2.0	1.3	0.5
Total loans	0.0	0.6	2.7
Loans to customers inside Hong Kong <sup>4</sup>	0.0	0.3	2.4
Loans to customers outside Hong Kong <sup>5</sup>	0.6	12.4	10.2
Negotiable instruments			
Negotiable debt certificates issued	0.4	-3.3	1.9
Negotiable debt instruments held	3.4	2.8	-0.5
<b>Asset quality<sup>6</sup></b>			
As % of total loans			
Pass loans	88.55	90.07	91.41
Special mention loans	6.63	6.26	5.59
Classified loans (gross) <sup>7</sup>	4.83	3.66	2.99
Classified loans (net) <sup>8</sup>	3.31	2.62	2.16
Overdue > 3 months and rescheduled loans	3.62	2.61 <sup>r</sup>	2.09
Non-performing loans <sup>9</sup>	3.92	2.92	2.28
<b>Profitability<sup>10</sup></b>			
Bad debt charge as % of average total assets	0.38	0.01	-0.02
Net interest margin	1.97	1.67	1.66
Cost income ratio	36.8	38.0	40.0
<b>Liquidity ratio<sup>11</sup></b>	46.1	44.8	43.2
<b>Surveyed institutions</b>			
<b>Asset quality</b>			
Delinquency ratio of residential mortgage loans	1.12	0.70	0.57
Credit card receivables			
Delinquency ratio	1.27	0.78	0.64
Charge-off ratio — quarterly annualised (adjusted)	11.60	6.34	5.37
— year-to-date annualised	11.77	6.34	5.79
<b>All locally incorporated AIs</b>			
<b>Capital adequacy ratio (consolidated)</b>	15.6	16.2	15.9

## Notes:

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

<sup>2</sup> Quarterly average.

<sup>3</sup> Quarterly change.

<sup>4</sup> Loans for use in Hong Kong plus trade financing loans.

<sup>5</sup> Includes "others" (i.e. unallocated).

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

<sup>7</sup> Classified loans are those loans graded as "substandard", "doubtful" or "loss".

<sup>8</sup> Net of specific provisions.

<sup>9</sup> Loans on which interest has been placed in suspense or on which interest accrual has ceased.

<sup>10</sup> Year-to-date annualised.

<sup>11</sup> Quarterly average.

<sup>r</sup> Revised figures due to late adjustments.