

Developments in the banking sector

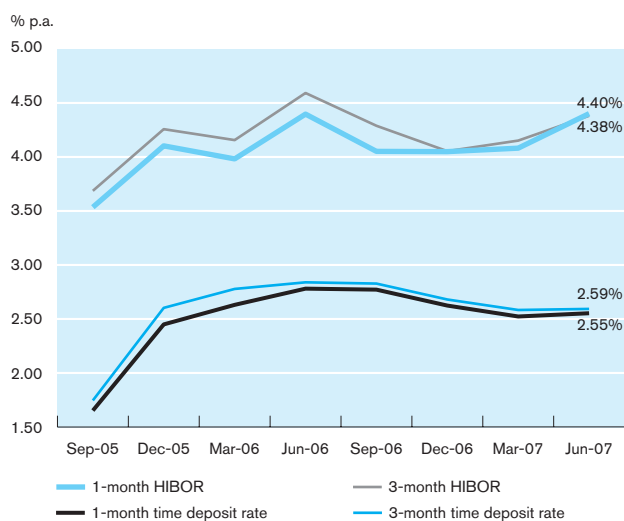
by the Banking Policy Department

Retail banks delivered respectable profit growth in the first half of 2007. Both net-interest and non-interest income recorded strong growth during the period. The increase in total income more than offset the increase in operating expenses and new provisions. Net interest margin widened further compared with the same period last year. In tandem with the US Fed funds target rate, best lending rates of retail banks remained unchanged in the first six months of 2007. However, banks' funding cost increased as reflected by the rising composite interest rate. The loan portfolio continued to grow in the past two quarters mainly due to increase in share finance lending. Benefiting from the robust domestic economy, overall asset quality improved further.

Interest rate movements

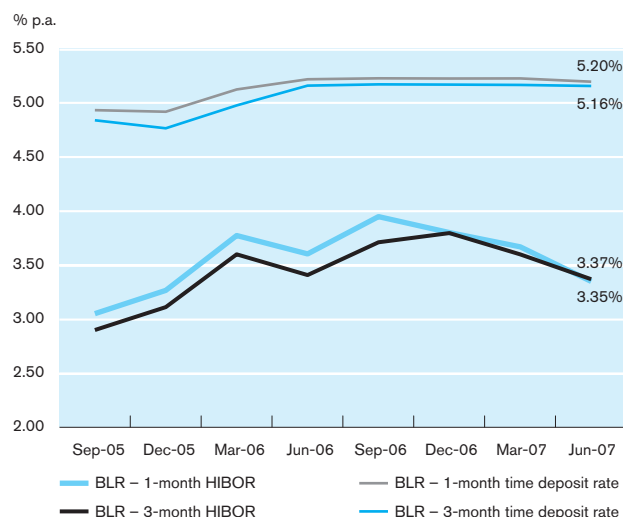
Best lending rates (BLR) remained unchanged in the first half of 2007 at either 7.75% or 8.00%, which was in line with a stable US Fed funds target rate. Average HIBORs¹ increased, while average time deposit rates remained stable (Chart 1).

CHART 1
HIBORs and time deposit rates
(quarterly average)



Correspondingly, the average spreads between BLR² and HIBORs narrowed, while those between BLR and time deposit rates were stable (Chart 2).

CHART 2
Differentials between best lending rate and
HIBORs/time deposit rates
(quarterly average)



¹ With reference to the HKD Interest Settlement Rates released by the Hong Kong Association of Banks.

² With reference to the rate quoted by The Hongkong and Shanghai Banking Corporation Limited.

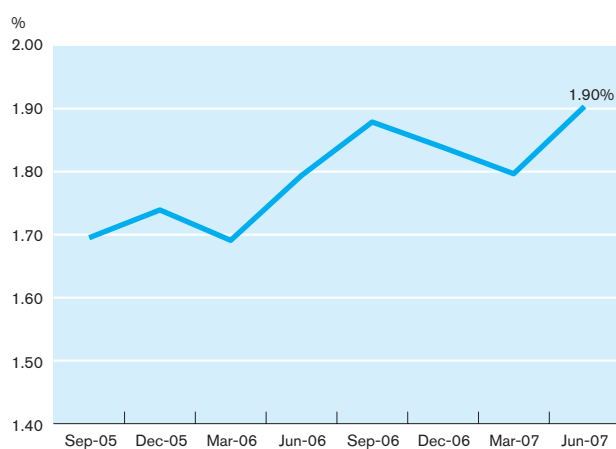
Retail banks' profitability

Despite increasing funding cost, the profitability of Hong Kong retail banks continued to rise in the first half of 2007. The aggregate pre-tax operating profits of retail banks' Hong Kong offices increased by 24.1% compared with the same period of 2006. The significant increase in pre-tax operating profits was mainly due to the buoyant domestic stock market, which fuelled sharp increases in the income from fees and commission. The increase in total operating income more than offset the increase in operating expenses and new provisions made.

Owing to the 17.8% increase in net interest income in the first half of 2007, net interest margin widened to 1.85% from 1.74% in the same period last year (Chart 3). Non-interest income also increased by

CHART 3

Retail banks' net interest margin
(quarterly annualised)



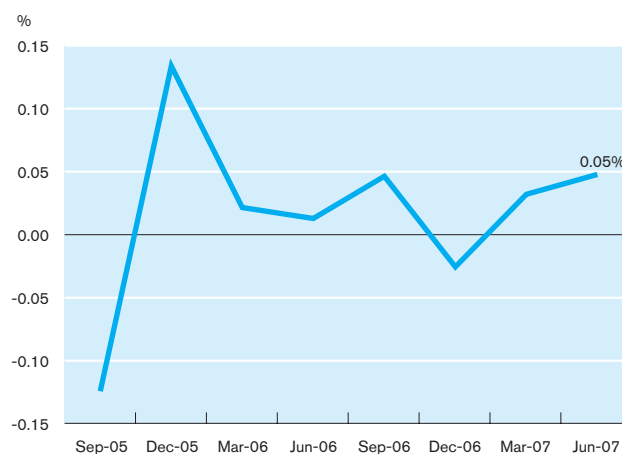
28.8% mainly due to equity-related fees and commission. Consequently, the proportion of non-interest income to total operating income increased to 41.4% from 39.2% in the first half of 2006.

Retail banks' cost-to-income ratio dropped to 39.9% from 41.5% in the first half of 2006, as total income increased faster than operating expenses.

Retail banks' bad debt charge increased significantly compared with the same period last year (Chart 4). Nevertheless, it remained a small proportion of average total assets, 0.04% in the first half of 2007 compared with 0.02% in the same period of 2006.

CHART 4

Retail banks' bad debt charge as percentage
of average total assets
(quarterly annualised)



Retail banks' asset quality

Overall quality

The asset quality of retail banks further improved in the second quarter as indicated by the decline in all problem loan ratios (Table 1). The overdue and

rescheduled loan ratio fell to 0.68% and the classified loan ratio to 0.9% (Chart 5). The classified loan ratio net of specific provisions also fell to 0.68% (Chart 6). The ratio of specific provisions to total classified loans was stable at 24%.

TABLE 1
Asset quality¹ of retail banks

	Jun-06	Sep-06	Dec-06	Mar-07	Jun-07
	as % of total loans				
Pass loans	96.15	96.44	96.65	97.11	97.37
Special mention loans	2.55	2.37	2.24	1.89	1.73
Classified loans (gross)²	1.29	1.19	1.11	1.00	0.90
<i>o/w Substandard</i>	0.50	0.45	0.44	0.40	0.36
<i>Doubtful</i>	0.58	0.57	0.55	0.51	0.48
<i>Loss</i>	0.21	0.17	0.12	0.09	0.07
Classified loans (net)³	0.94	0.88	0.85	0.76	0.68
Overdue > 3 months and rescheduled loans	0.96	0.92	0.80	0.69	0.68
<i>o/w Overdue > 3 months</i>	0.69	0.65	0.54	0.46	0.46
<i>Rescheduled loans</i>	0.27	0.27	0.26	0.23	0.22

Notes:

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

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

³ Net of specific provisions

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

CHART 5

Retail banks' asset quality (1)

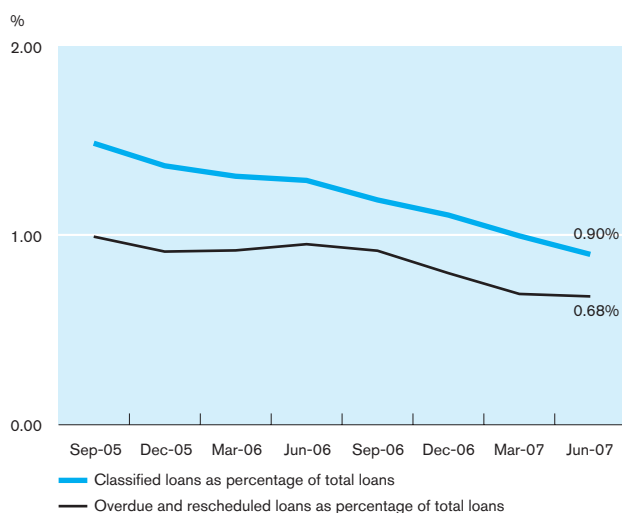
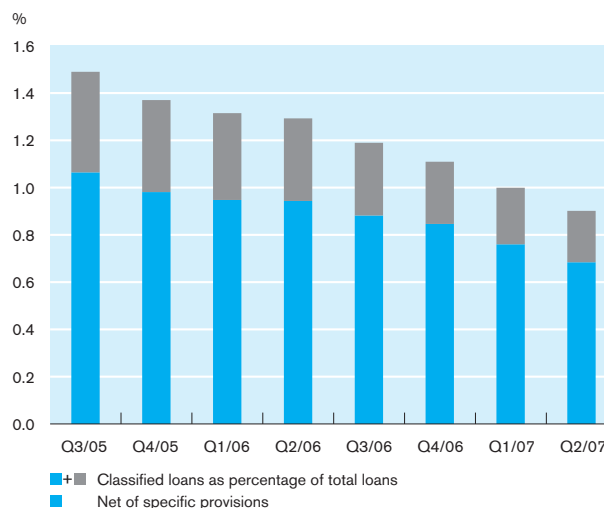


CHART 6

Retail banks' asset quality (2)

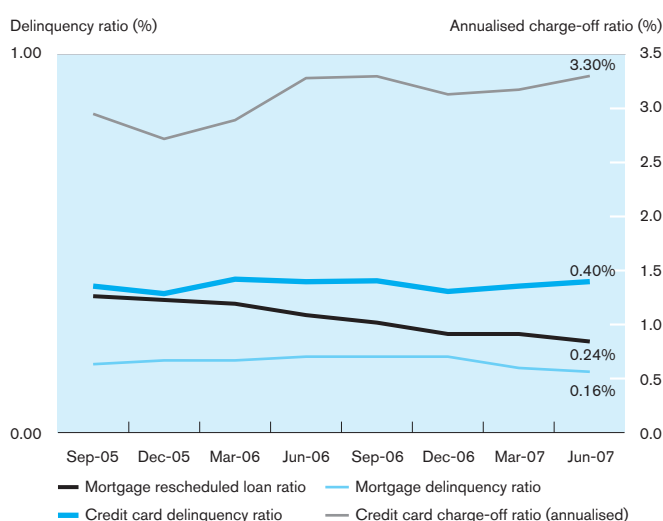


Quality of residential mortgage lending

The quality of banks' residential mortgage lending remained good in the second quarter of 2007. The mortgage delinquency ratio edged lower to 0.16% at the end of June (Chart 7). With the rescheduled loan ratio falling to 0.24%, the combined ratio of delinquent and rescheduled loans recorded a new low of 0.39%³ from 0.43% at the end of March 2007.

CHART 7

Asset quality of credit card and mortgage lending by surveyed institutions



The number of residential mortgages in negative equity decreased from 6,700 cases (valued at HK\$11 billion) at the end of March to some 4,700 cases with an aggregate value of HK\$8 billion at the end of June. The three-month delinquency ratio of negative equity

residential mortgage loans (RMLs) rose to 1.42% from 1.32% at the end of March due to the contraction of the portfolio of negative equity RMLs.

Quality of credit card portfolio

The quality of credit card lending continued to deteriorate in the second quarter as indicated by an increase in both the charge-off amount and the delinquent amount. The charge-off amount rose to HK\$564 million from HK\$555 million in the first quarter. As a result, the charge-off ratio increased to 0.83% of average receivables from 0.79% in the first quarter. Although the annualised quarterly charge-off ratio rose to 3.30% from 3.17% in the first quarter (Chart 7), this remained well below the peak of 14.55% experienced in the third quarter of 2002. Similarly, the credit card delinquency ratio edged up to 0.40% at the end of June, from 0.39% at the end of March, with a 5.3% increase in the amount delinquent for more than 90 days. The combined delinquent and rescheduled ratio edged up to 0.47% from 0.46% at the end of March.

Local authorized institutions' capital strength

Preliminary statistics indicated that the average consolidated capital adequacy ratio of all locally incorporated authorized institutions declined slightly to 13.4% from 13.6% at the end of March (Table 2). This level remained well above the statutory requirement and international standards.

TABLE 2

Consolidated capital adequacy ratio (All locally incorporated AIs)

(HK\$ million)	Jun-06	Sep-06	Dec-06	Mar-07 ²	Jun-07
Total capital base after deductions ¹ of which core capital	429,572 381,806	451,015 402,674	456,851 399,052	471,041 372,590	481,926 372,863
Total risk-weighted exposures	2,836,954	3,002,292	3,072,618	3,462,101	3,593,061
Capital adequacy ratio	15.1%	15.0%	14.9%	13.6%	13.4%
Core ratio	13.5%	13.4%	13.0%	10.8%	10.4%

Notes:

¹ Before 1 January 2007, total capital base after deductions refers to total core and supplementary capital after deductions as specified under the Third Schedule to the Banking Ordinance. From 1 January 2007, the item is specified under the Banking (Capital) Rules.

² On 1 January 2007, a revised capital adequacy framework ('Basel II') was introduced for locally incorporated authorized institutions.

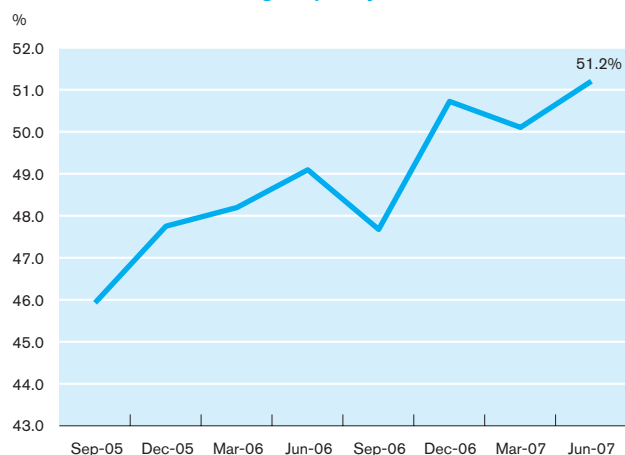
³ Not the sum of the two ratios, due to rounding.

Retail banks' liquidity

The average liquidity position of retail banks increased further. The average liquidity ratio⁴ rose to 51.2% from 50.1% in the first quarter, well above the statutory minimum requirement of 25% (Chart 8).

CHART 8

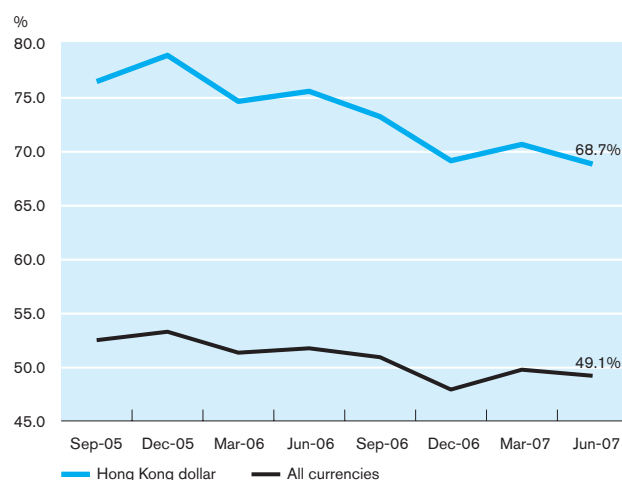
Retail banks' average liquidity ratio



As deposits grew faster than loans, retail banks' overall loan-to-deposit ratio for all currencies fell to 49.1% from 49.7% at the end of March and to 68.7% from 70.6% for Hong Kong dollar over the same period (Chart 9).

CHART 9

Retail banks' loan-to-deposit ratio

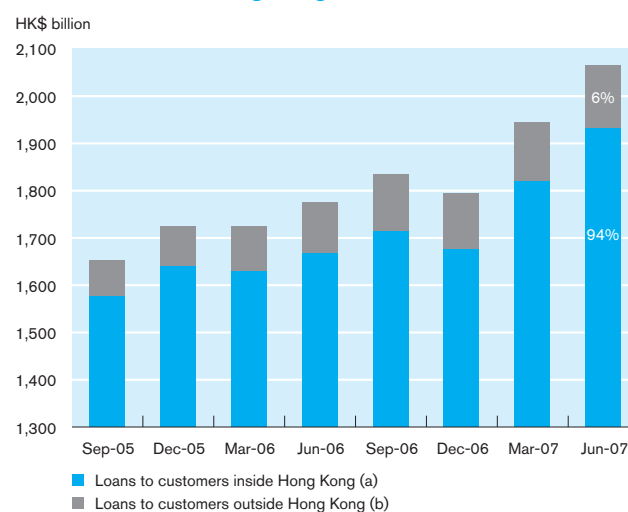


Retail banks' lending

Domestic lending of retail banks increased by 6.1% in the second quarter, following an 8.7% increase in the first quarter. The increase was mainly led by share-finance lending arising from IPO activities and the buoyant domestic stock market. Together with an increase of 6.3% in loans for use outside Hong Kong, retail banks' total loans increased by 6.1% in the second quarter (Chart 10).

CHART 10

Retail banks' loans to customers inside and outside Hong Kong



Notes:

(a) Defined as loans for use in Hong Kong plus trade-financing loans.
 (b) Includes "others" (i.e. unallocated).

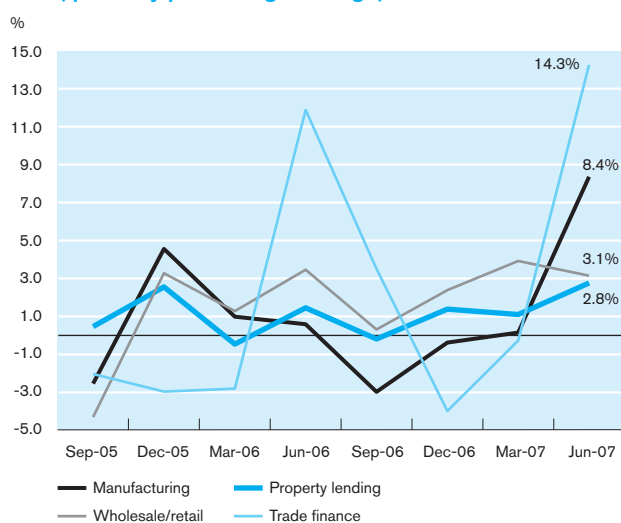
⁴ All authorized institutions in Hong Kong are required to meet a minimum monthly average liquidity of 25%. This is calculated as the ratio of liquefiable assets (e.g. marketable debt securities and loan repayment within one month subject to their respective liquidity conversion factors) to qualifying liabilities (basically all liabilities due within one month). The method and components of calculation are specified in the Fourth Schedule of the Banking Ordinance.

Loans to customers inside Hong Kong by various economic sectors

There was growth in lending to most economic sectors in the first half of 2007 (Chart 11). As stock market activity remained buoyant in the first half of 2007, loans for share finance increased further by 45.5% in the second quarter after rising more than eight times in the preceding one. Loans to non-stockbroking companies and individuals to purchase stocks grew by 62.4% after increasing more than threefold in the first quarter. Similarly, loans to stockbrokers increased by 37.4% after having risen by more than eighteen times in the last quarter.

CHART 11

Retail banks' loans for use in Hong Kong by selected sectors (quarterly percentage change)



Note: 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).

Trade financing loans increased by 14.0%, while loans to the manufacturing sector rose by 8.5% in the first six months of the year.

Lending to the wholesale and retail trade sector increased by 3.1% following a 3.9% increase in the first quarter. Property lending also registered a moderate increase in the first half of the year.

Credit card receivables

Credit card receivables fluctuated in the past two quarters. They declined in the first quarter of 2007 because of seasonal factors before recovering in the second quarter. According to the HKMA's regular survey, total credit card receivables increased by 2.1% in the second quarter despite the transfer of some HK\$143 million of rescheduled receivables (representing 0.2% of average receivables) to outside the credit card portfolio. The total number of credit card accounts registered a quarterly growth of 2.4% at the end of June 2007 after a 1.1% increase in the first quarter.

Exposure to non-bank Chinese entities

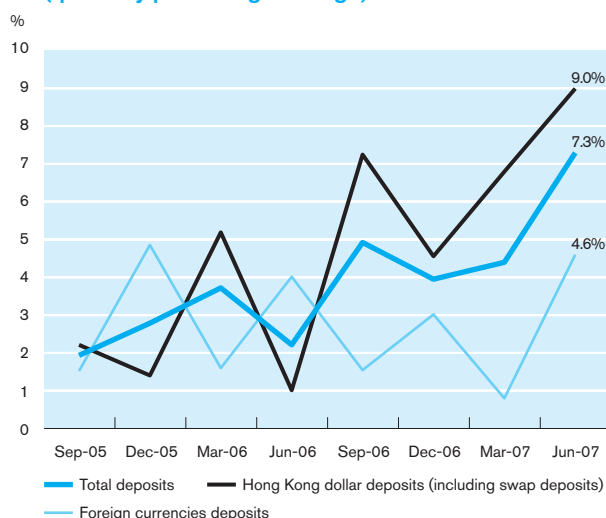
Retail banks' aggregate exposure to non-bank Chinese entities declined to HK\$402.9 billion (6.2% of total assets) at the end of June from HK\$454.6 billion (7.4% of total assets) at the end of March. The exposure of the total banking sector also reduced to HK\$581.7 billion (5.7% of total assets) from HK\$600.7 billion (6.3% of total assets). The reduction followed the incorporation of Mainland subsidiaries by some retail banks, resulting in some of the banks' Mainland-related exposures being transferred out. Exposures to companies and individuals for purchasing properties in the Mainland decreased to HK\$13.6 billion at the end of June, from HK\$20.6 billion at the end of March.

Retail Banks' Customer Deposits

Retail banks' customer deposits steadily increased in the first half of 2007. Growth accelerated to 7.3% in the second quarter after rising 4.4% in the first quarter. The increase in customer deposits was broad based. Both Hong Kong dollar and foreign currency deposits increased, by 9.0% and 4.6% respectively in the second quarter, following increases of 6.8% and 0.8% in the previous quarter (Chart 12). As a result, the proportion of Hong Kong dollar deposits to total deposits increased to 63%.

CHART 12

Retail banks' customer deposits (quarterly percentage change)



The increase in Hong Kong dollar deposits was mainly in demand and time deposits. Hong Kong dollar demand deposits jumped by 35.2%, after rising 12.6% in the first quarter (Table 3). Hong Kong dollar time deposits increased by 6.3% compared with an increase of 13.8% in the first quarter.

TABLE 3

Hong Kong dollar deposit mix

Amount (HK\$ billion)

	Retail banks		
	Demand	Savings	Time*
Jun/06	188.2	779.8	1,067.8
% growth	(2.4)	1.2	1.5
Sep/06	200.7	819.2	1,163.6
% growth	6.6	5.0	9.0
Dec/06	219.0	924.2	1,139.8
% growth	9.1	12.8	(2.0)
Mar/07	246.7	893.1	1,297.6
% growth	12.6	(3.4)	13.8
Jun/07	333.6	943.3	1,379.1
% growth	35.2	5.6	6.3

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

* Includes swap deposits

Negotiable Instruments

Negotiable debt instruments (NDIs) held

Retail banks' holdings of NDIs (excluding negotiable certificates of deposits (NCDs)) fell 4.2% in the three-month period to the end of June but still increased 8.6% from a year ago (Chart 13). The NDIs held by retail banks constituted 20.3% of their assets. The share of foreign currency denominated NDIs held dropped to 63.9% from 65.0% at the end of March because of a faster decline in the holding of foreign currency denominated NDIs. Breakdowns of NDIs by instrument types and counterparties are shown in Charts 14 and 15 respectively.

CHART 13

Negotiable debt instruments held by retail banks (currency breakdown)

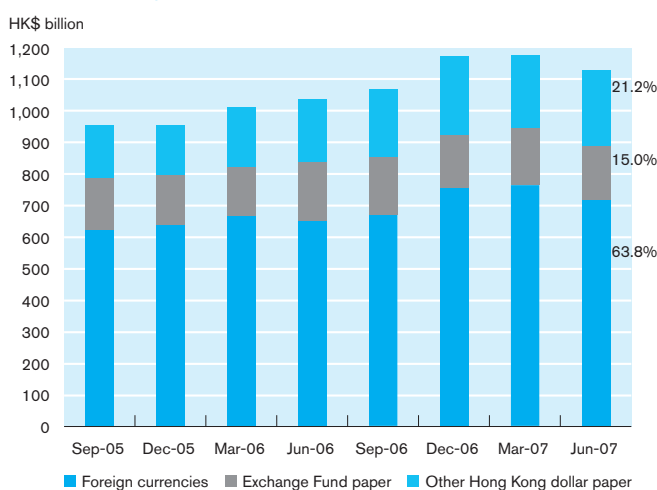


CHART 14

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

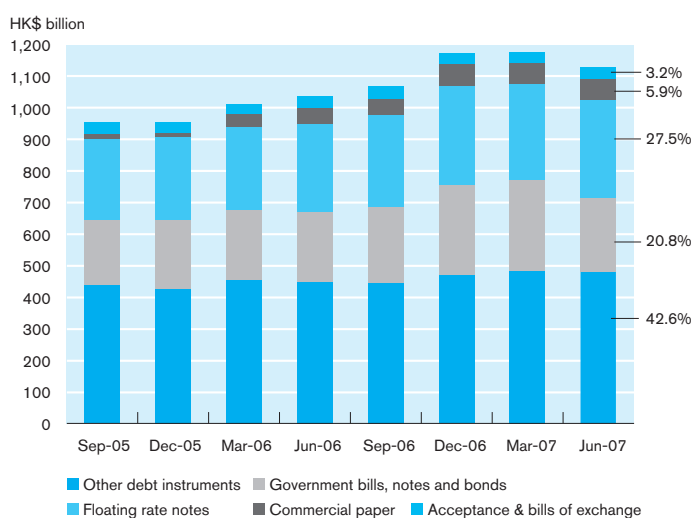
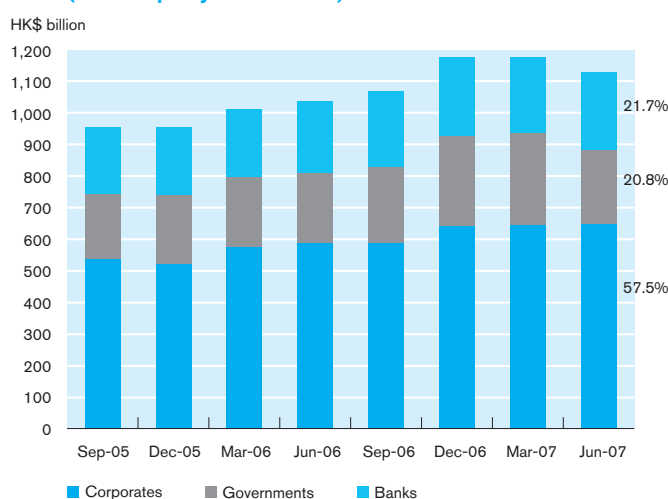


CHART 15

Negotiable debt instruments held by retail banks (counterparty breakdown)



Nevertheless, NCDs held by retail banks registered an increase of 0.4% in the first quarter and 2.9% in the second. They represented 1.1% of retail banks' total assets at the end of June 2007. In line with the increase in the supply of Hong Kong dollar denominated NCDs, the share of NCD holdings in Hong Kong dollar rose to 79.3% compared with 75.6% at the end of March.

Negotiable certificates of deposits issued

Retail banks' outstanding NCDs declined by 12.8% in the second quarter and by 25.1% compared with a year ago. The total NCDs outstanding continued to fall to 2.4% of retail banks' total liabilities at the end of June 2007. Hong Kong dollar denominated NCDs issued and outstanding increased but those denominated in foreign currencies decreased.

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

APPENDIX

KEY PERFORMANCE INDICATORS OF THE BANKING SECTOR¹ (%)

	Jun-06	Mar-07	Jun-07
Interest rate²			
1-month HIBOR	4.40	4.08	4.40
3-month HIBOR	4.59	4.15	4.38
BLR ³ and 1-month HIBOR spread	3.60	3.67	3.35
BLR ³ and 3-month HIBOR spread	3.41	3.60	3.37
Composite interest rate	3.16	3.00	3.09
Retail banks			
Balance sheet developments⁴			
Total deposits	2.2	4.4	7.3
Hong Kong dollar	1.0	6.8	9.0
Foreign currency	4.0	0.8	4.6
Total loans	3.0	8.4	6.1
Loans to customers inside Hong Kong ⁵	2.4	8.7	6.1
Loans to customers outside Hong Kong ⁶	13.0	4.2 ^r	6.3
Negotiable instruments			
Negotiable certificates of deposit issued	-3.2	-5.1	-12.8
Negotiable debt instruments held	2.6	0.1	-4.2
Asset quality⁷			
As percentage of total loans			
Pass loans	96.15	97.11	97.37
Special mention loans	2.55	1.89	1.73
Classified loans (gross) ⁸	1.29	1.00	0.90
Classified loans (net) ⁹	0.94	0.76	0.68
Overdue > 3 months and rescheduled loans	0.96	0.69	0.68
Profitability¹⁰			
Bad debt charge as percentage of average total assets	0.02	0.03	0.04
Net interest margin	1.74	1.80	1.85
Cost-income ratio	41.5	39.6	39.9
Liquidity ratio¹¹	49.1	50.1	51.2
Surveyed institutions			
Asset quality			
Delinquency ratio of residential mortgage loans	0.20	0.17	0.16
Credit card receivables			
Delinquency ratio	0.40	0.39	0.40
Charge-off ratio — quarterly annualised (adjusted)	3.28	3.17	3.30
— year-to-date annualised	2.98	3.17	3.17
All locally incorporated AIs			
Capital adequacy ratio (consolidated)¹²	15.1 ^r	13.6	13.4

Notes:

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

² With reference to the HKD Interest Settlement Rates released by the Hong Kong Association of Banks.

³ With reference to the rate quoted by The Hongkong and Shanghai Banking Corporation Limited.

⁴ Quarterly change.

⁵ Loans for use in Hong Kong plus trade-financing loans.

⁶ Includes "others" (i.e. unallocated).

⁷ Figures related to retail banks' Hong Kong office(s) and overseas branches.

⁸ Classified loans are those loans graded as "substandard", "doubtful" or "loss".

⁹ Net of specific provisions / individual impairment allowances.

¹⁰ Year-to-date annualised.

¹¹ Quarterly average.

¹² On 1 January 2007, a revised capital adequacy framework ('Basel II') was introduced for locally incorporated authorized institutions.

^r Revised figure.