

# Developments in the banking sector

by the Banking Policy Department

Retail banks' profitability in the first half of 2009 remained under pressure amid signs of stabilisation. Although the aggregate pre-tax operating profit of retail banks' Hong Kong offices declined by 20% compared with the same period last year, it was almost double that of the second half of 2008. The annualised net interest margin of retail banks fell to 1.55% from 1.92% in the same period last year. The net charge for debt provisions further increased during the first half compared with the same period last year. The asset quality of retail banks continued to worsen, though the rate of deterioration slowed. The consolidated capital adequacy ratio of locally incorporated authorized institutions (AIs) rose further and was well above the international standard of 8% at the end of June 2009.

## Profitability remained under pressure

The profitability of retail banks in the first half of 2009 remained under pressure in a difficult operating environment, but there were signs of stabilisation. The aggregate pre-tax operating profits of retail banks' Hong Kong offices declined by 20% during the period when compared with the same period last year, but it was almost double the level recorded in the second half of 2008.

The annualised net interest margin (NIM) of retail banks fell to 1.55% in 2009 H1 compared with 1.92% in the same period last year. Measured on a quarterly annualised basis, NIM continued to drop to 1.48% in the second quarter from 1.62% in the previous quarter (Chart 1). The continued decrease in NIM of retail banks was mainly due to loans being re-priced at lower interest rates and the limited room for lowering funding costs, which were already close to zero (Chart 2). Moreover, retail banks deployed

CHART 1

Net interest margin of retail banks  
(quarterly annualised)

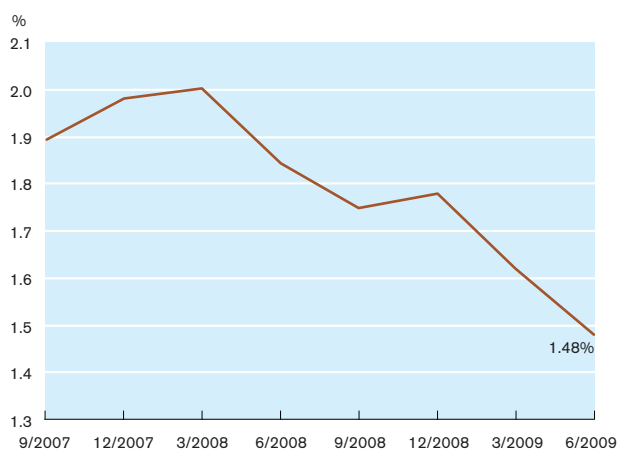
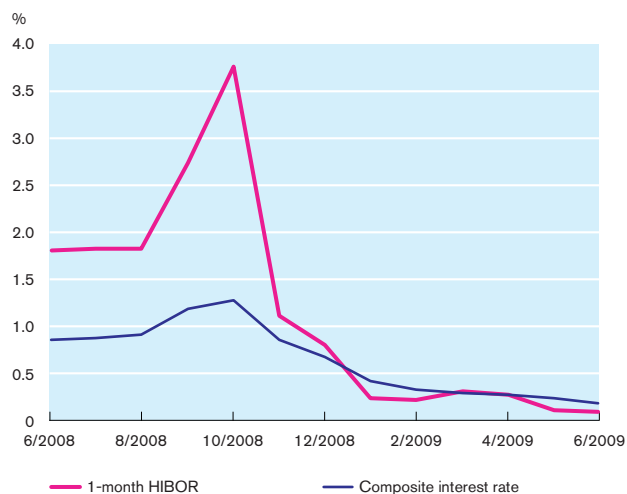


CHART 2

HIBOR and composite interest rate



Notes:

- 1 Hong Kong Interbank Offered Rates (HIBORs) are monthly average figures.
- 2 Composite interest rate reflects the average costs of funds.

their surplus funds by increasing their holdings of negotiable debt instruments (NDIs) mainly in the form of government bills, notes and bonds, which generally offered lower interest returns.

Weak market sentiment led to a decrease in income from stock broking, wealth management, insurance business and other investment products. Retail banks' income from fees and commissions fell by 15% in 2009 H1 when compared with 2008 H1. However, it is worth noting that income from this source improved markedly in 2009 Q2 when compared with the previous quarter. The improvement was largely attributable to a buoyant domestic stock market and IPO activities in the second quarter. A rise in loan underwriting income resulted from increased lending activity also contributed to the improvement. Overall, the non-interest income of retail banks in 2009 H1 was maintained at a level similar to that of 2008 H1.

The cost-to-income ratio of retail banks rose to 45.8% in 2009 H1 compared with 41.6% in 2008 H1. The increase in the ratio was mainly driven by a reduction in operating income.

The net charge for debt provisions increased by more than twofold in 2009 H1 when compared with the same period last year, owing to the deteriorating credit quality of loans. Nevertheless, the net charge for debt provisions was 48% lower than that reported in 2008 H2. Meanwhile, the net charge for other provisions in 2009 H1, most of which related to impairment allowances for securities holdings, also

fell by more than 60% and 80% compared with 2008 H1 and 2008 H2 respectively as a result of improved financial market performance.

### Asset quality continued to worsen although the rate of deterioration slowed

The credit quality of retail banks' loan portfolios continued to worsen, although the rate of deterioration slowed. The aggregate value of classified loans grew by 5% in 2009 Q2 after an increase of 14% in the previous quarter. The classified loan ratio edged up to 1.51% at the end of June from 1.47% at the end of March (Table 1 and Chart 3). The ratio of overdue and rescheduled loans also rose to 1.05% at the end of June from 0.90% at the end of March.

CHART 3

#### Asset quality of retail banks

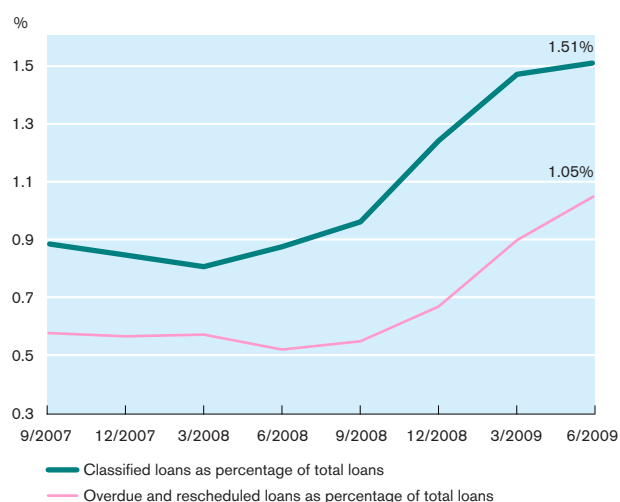


TABLE 1

#### Quality of loans and advances of retail banks\*

	Jun 2008	Sep 2008	Dec 2008 (% of total loans)	Mar 2009	Jun 2009
<b>Special mention loans</b>	<b>1.38</b>	<b>1.43</b>	<b>2.20</b>	<b>2.44</b>	<b>2.35</b>
<b>Classified loans (gross)</b>	<b>0.88</b>	<b>0.96</b>	<b>1.24</b>	<b>1.47</b>	<b>1.51</b>
of which					
Substandard	0.38	0.33	0.50	0.64	0.60
Doubtful	0.44	0.56	0.67	0.76	0.80
Loss	0.05	0.07	0.07	0.07	0.11
<b>Classified loans (net of specific provisions)</b>	<b>0.68</b>	<b>0.70</b>	<b>0.84</b>	<b>1.00</b>	<b>1.02</b>
<b>Overdue &gt; 3 months and rescheduled loans</b>	<b>0.53</b>	<b>0.55</b>	<b>0.67</b>	<b>0.90</b>	<b>1.05</b>
of which					
Overdue > 3 months	0.36	0.40	0.48	0.69	0.75
Rescheduled loans	0.16	0.15	0.19	0.21	0.30

\* Period-end figures covering Hong Kong offices and overseas branches of the banks.

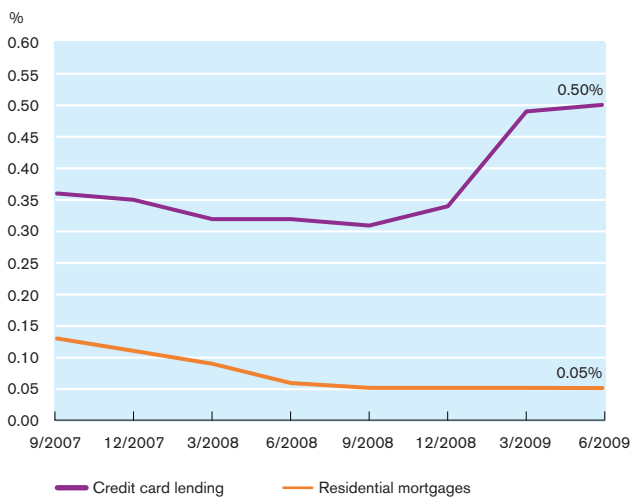
Figures may not add up to total due to rounding.

The quality of retail banks' debt securities investment portfolios was relatively stable during the first two quarters of 2009. Debt securities investments classified as "substandard", "doubtful" or "loss" remained steady at 0.06% of the banks' assets at the end of June and at the end of March. Debt securities investments classified as "special mention" declined to 0.37% of the banks' assets at the end of June from 0.39% at the end of March.

The HKMA's quarterly Credit Card Lending Survey shows that the credit quality of the surveyed institutions' credit card lending continued to deteriorate. Credit card lending overdue for more than 90 days increased to HK\$357 million at the end of June from HK\$350 million at the end of March. The delinquency ratio increased marginally to 0.50% at the end of June from 0.49% at the end of March (Chart 4). The quarterly annualised charge-off ratio rose to 4.61% in 2009 Q2 from 3.92% in 2009 Q1.

CHART 4

#### Delinquency ratios of residential mortgages and credit card lending of surveyed institutions

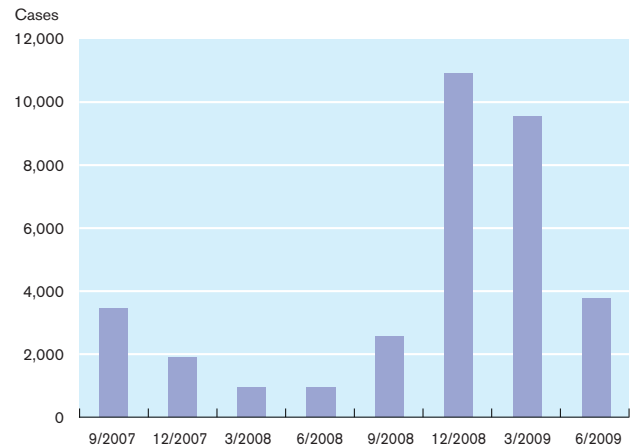


The asset quality of retail banks' residential mortgage lending remained good. The mortgage delinquency ratio was stable at 0.05% at the end of June while the rescheduled loan ratio edged down to 0.12% at the end of June from 0.13% at the end of March (Chart 4). The outstanding number of residential mortgage loans in negative equity fell to 3,767 at the

end of June from 9,553 at the end of March as property prices continued to rise during the second quarter (Chart 5).

CHART 5

#### Residential mortgage loans in negative equity

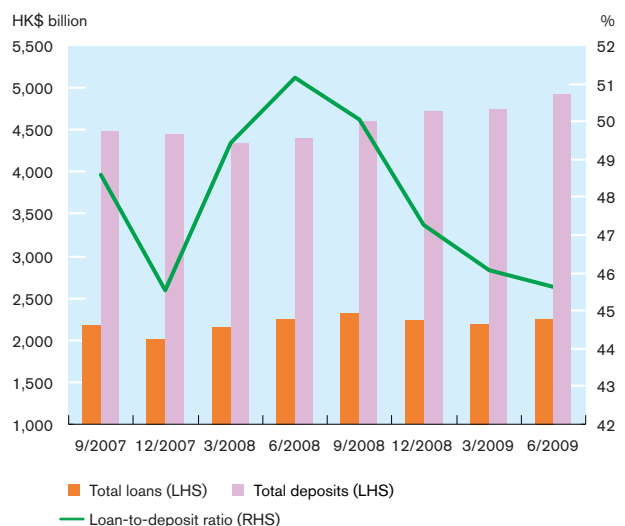


## Loan-to-deposit ratios continued to fall

Retail banks' total loans and advances rebounded by 2.8% in 2009 Q2 after a 2.2% decline in the previous quarter. Meanwhile, retail banks' customer deposits increased by 3.8% and 0.3% in Q2 and Q1 respectively. Thus, the overall loan-to-deposit ratio of retail banks fell to 45.6% at the end of June from 46.1% at the end of March (Chart 6). Hong Kong-dollar loans and advances increased by 3.7% and

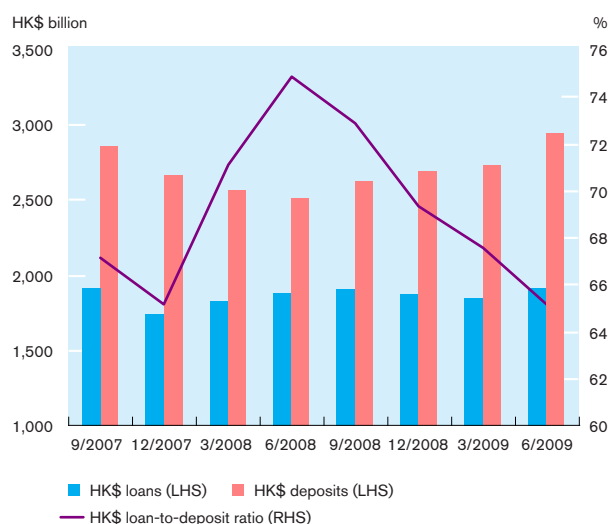
CHART 6

#### Retail banks' total loans and customer deposits



Hong Kong-dollar deposits increased by 7.5%. Accordingly, the Hong Kong-dollar loan-to-deposit ratio also fell to 65.2% at the end of June from 67.6% at the end of March (Chart 7).

**CHART 7**  
Retail banks' Hong Kong-dollar loans and customer deposits



**CHART 8**  
Loans and advances of retail banks



The percentage changes in the amount of credit extended to different economic sectors are shown below:

Wholesale and retail trade	+2.6%
Manufacturing	-4.1%
Property lending	+1.3%
Trade finance	+4.7%

## Domestic lending rose but loans for use outside Hong Kong declined

Domestic lending (loans for use in Hong Kong plus trade finance) increased by 3.5% in 2009 Q2 after falling 2.2% in 2009 Q1 (Chart 8). This was largely attributable to a rise in share-margin financing as a result of increased IPO activities and the buoyant domestic stock market; and an increase in property lending during the quarter. Loans for use outside Hong Kong declined further by 4.8% in Q2 after falling 2.7% in Q1.

Retail banks' total non-bank China exposures<sup>1</sup> rose to HK\$635.0 billion (8.3% of total assets) at the end of June from HK\$615.4 billion (8.2% of total assets) at the end of March. For the banking sector as a whole, non-bank China exposures increased to HK\$852.1 billion (7.2% of total assets) from HK\$824.7 billion (7.0% of total assets) in the same period.

<sup>1</sup> Including exposures booked in the retail banks' banking subsidiaries in Mainland China.

## More AIs indicated positive outlook for loan demand

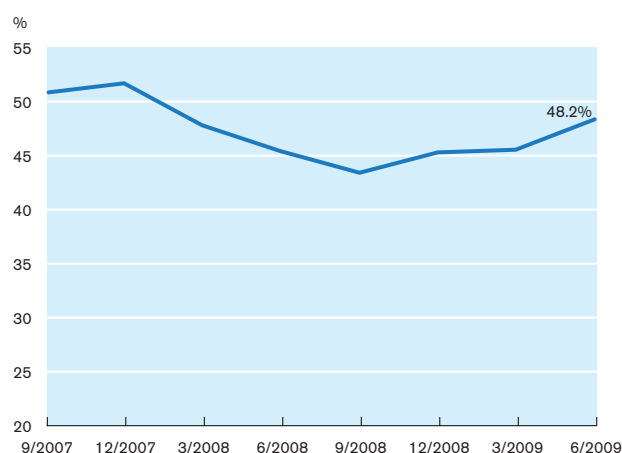
According to the HKMA Survey on Credit Outlook in June 2009, the number of surveyed AIs that expected domestic loan demand to grow in the next six months outnumbered those with an opposite view for the first time since June 2008 (Table 2). More surveyed AIs expected loan demand in residential mortgage lending to increase in the coming six months while demand in wholesale and retail trade was expected to decline.

## Average liquidity ratio remained at a comfortable level

The quarterly average liquidity ratio of retail banks rose to 48.2% in 2009 Q2 from 45.2% in the previous quarter, well above the statutory minimum of 25% (Chart 9).

CHART 9

Retail banks' liquidity ratio (quarterly average)



The continued inflow of funds into the Hong Kong banking sector further strengthened the liquidity position of retail banks. Retail banks deployed their surplus funding by increasing their holdings of NDIs by around 20%, mainly in government bills, bonds and notes. This reflected a cautious approach on the part of retail banks in investing their funds in higher credit-quality and more liquid instruments to enhance their overall liquidity position.

## Local AIs were generally well capitalised

The capital positions of locally incorporated AIs remained strong. The consolidated capital adequacy ratio of locally incorporated AIs rose to 16.5% at the end of June from 15.8% at the end of March (Chart 10). The improvement was mainly due to an increase in capital base.

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

CHART 10

Capital adequacy ratio of locally incorporated AIs

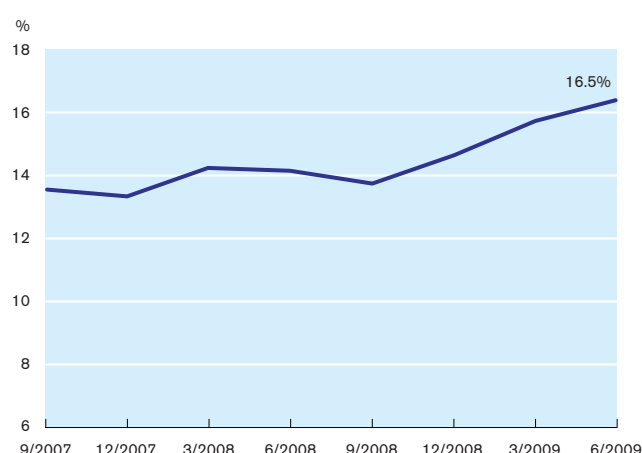


TABLE 2

Expectation of domestic loan demand in the next six months

	Jun 2008	Sep 2008	Dec 2008	Mar 2009	Jun 2009
	(% of total respondents)				
Increase considerably	0	5	0	0	0
Increase somewhat	33	5	10	14	24
Remain stable	62	29	24	43	57
Decrease somewhat	5	57	62	43	19
Decrease considerably	0	5	5	0	0

Note: Figures may not add up to 100% due to rounding.

## APPENDIX

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

	Jun 2008	Mar 2009	Jun 2009
<b>Interest rate</b>			
1-month HIBOR <sup>2</sup> (quarterly average)	1.62	0.25	0.16
3-month HIBOR (quarterly average)	2.03	0.87	0.59
BLR <sup>3</sup> and 1-month HIBOR spread (quarterly average)	3.63	4.75	4.84
BLR and 3-month HIBOR spread (quarterly average)	3.22	4.13	4.41
Composite interest rate <sup>4</sup>	0.85	0.29	0.19
<b>Retail banks</b>			
<b>Balance sheet developments<sup>5</sup></b>			
Total deposits	1.4	0.3	3.8
Hong Kong dollar	-2.0	1.7	7.5
Foreign currency	6.3	-1.6	-1.1
Total loans	5.0	-2.2	2.8
Domestic lending <sup>6</sup>	4.3	-2.2	3.5
Loans for use outside Hong Kong <sup>7</sup>	13.3 <sup>r</sup>	-2.7	-4.8
Negotiable instruments			
Negotiable certificates of deposit (NCD) issued	-22.3	-22.5	-14.4
Negotiable debt instruments held (excluding NCD)	-2.4 <sup>r</sup>	-5.0	19.3
<b>Asset quality<sup>8</sup></b>			
As percentage of total loans			
Pass loans	97.75	96.09	96.14
Special mention loans	1.38	2.44	2.35
Classified loans <sup>9</sup> (gross)	0.88	1.47	1.51
Classified loans (net) <sup>10</sup>	0.68	1.00	1.02
Overdue > 3 months and rescheduled loans	0.53	0.90	1.05
<b>Profitability<sup>11</sup></b>			
Bad debt charge as percentage of average total assets	0.05	0.18	0.16
Net interest margin	1.92	1.62	1.55
Cost-to-income ratio	41.6	45.3	45.8
<b>Liquidity ratio (quarterly average)</b>	45.1	45.2	48.2
<b>Surveyed institutions</b>			
<b>Asset quality</b>			
Delinquency ratio of residential mortgage loans	0.06	0.05	0.05
Credit card receivables			
Delinquency ratio	0.32	0.49	0.50
Charge-off ratio — quarterly annualised	2.78	3.92	4.61
— year-to-date annualised	2.68	3.92	4.17
<b>All locally incorporated AIs</b>			
<b>Capital adequacy ratio (consolidated)</b>	14.2	15.8 <sup>r</sup>	16.5

## Notes:

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

<sup>2</sup> With reference to the Hong Kong-dollar Interest Settlement Rates released by the Hong Kong Association of Banks.

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

<sup>4</sup> The composite interest rate is a weighted average interest rate of all Hong Kong-dollar interest-bearing liabilities, which include deposits from customers, amounts due to banks, negotiable certificates of deposit and other debt instruments, and Hong Kong-dollar non-interest-bearing demand deposits on the books of banks. Further details can be found in the HKMA website.

<sup>5</sup> Quarterly change.

<sup>6</sup> Loans for use in Hong Kong plus trade finance.

<sup>7</sup> Includes "others" (i.e. unallocated).

<sup>8</sup> Figures related to retail banks' Hong Kong office(s) and overseas branches.

<sup>9</sup> Classified loans are those loans graded as "substandard", "doubtful" or "loss".

<sup>10</sup> Net of specific provisions/individual impairment allowances.

<sup>11</sup> Year-to-date annualised.

<sup>r</sup> Revised figure.