

Developments in the banking sector

by the Banking Policy Department

The aggregate pre-tax operating profit of retail banks' Hong Kong offices for the first quarter of 2011 rose by 26.6% from the same period last year. The strength in profitability was supported by increases in non-interest income and generally strong asset quality. A moderate improvement in net interest income was also noted, possibly led by the strong loan growth in the first quarter of 2011. However, retail banks' net interest margin (NIM) continued to narrow further to 1.23% from 1.26% in the fourth quarter of 2010 and 1.34% in the first quarter of 2010. The consolidated capital adequacy ratio of locally incorporated authorized institutions (AIs) remained stable at 16.0% at the end of March 2011 compared with 15.9% at the end of December 2010.

HIGHLIGHTS OF KEY TRENDS

Profitability strengthened

The aggregate pre-tax operating profit of retail banks' Hong Kong offices in the first quarter of 2011 increased by 26.6% compared with the same period a year ago. The strong performance was attributable to growth in income from foreign exchange operations and trading in derivatives, and improvement in fees and commissions income.

The quarterly annualised NIM of retail banks narrowed further to 1.23% in the first quarter of 2011 from 1.26% in the previous quarter and 1.34% in the first quarter of 2010 (Chart 1). Although net interest income (i.e. the numerator) rose steadily over the period, the decline was mostly due to an increase in interest bearing assets (i.e. the denominator). Meanwhile, it is worth noting that the funding cost of retail banks rose in the first quarter of 2011. The composite interest rate, which reflects the average cost of funds, was higher than the one-month HIBOR during the quarter (Chart 2).

CHART 1

Net interest margin of retail banks
(quarterly annualised)

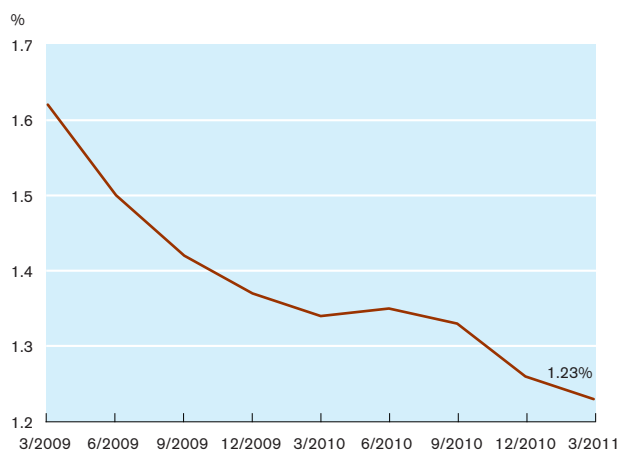
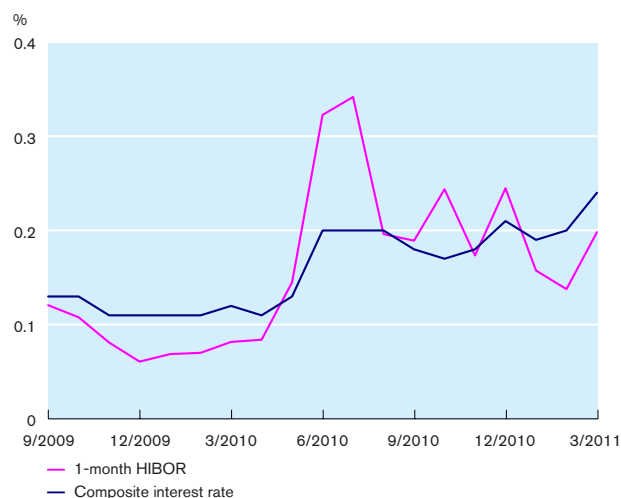


CHART 2

Interest rates



Notes:

- 1 HIBOR refers to Hong Kong Interbank Offered Rate and is a monthly average figure.
- 2 Composite interest rate reflects the average cost of funds.

Retail banks' income from fees and commissions surged 12.3% in the first quarter of 2011 compared with the same period a year ago.

The cost-to-income ratio of retail banks fell to 46.0% in the first quarter of 2011, compared with 48.2% in the same period last year. The decline mainly reflected the fact that despite an increase in staff expenses (i.e. the numerator) during the period, operating income (i.e. the denominator) grew even faster.

Retail banks' net charge for debt provisions declined to HK\$0.2 billion in the first quarter of 2011 from HK\$0.6 billion in the same period a year earlier.

Asset quality improved further

The aggregate value of classified loans fell further by 8.7% in the first quarter of 2011, following a decrease of 7.1% in the previous quarter. This, together with a sharp increase in loans, meant that the classified loan ratio decreased for a seventh consecutive quarter to 0.66% at the end of March from 0.77% at the end of 2010 (Table 1 and Chart 3). The ratio of overdue and rescheduled loans also declined to 0.52% from 0.60% at the end of 2010.

The HKMA's quarterly Credit Card Lending Survey showed that the quality of surveyed institutions' credit card portfolios continued to improve. Credit card lending overdue for more than 90 days decreased to HK\$162 million at the end of March from HK\$173 million at the end of 2010, driving the delinquency ratio lower to 0.19% from 0.20% at the end of 2010 (Chart 4). The quarterly annualised charge-off ratio remained relatively stable at 1.55% compared with 1.56% in the final quarter of 2010.

CHART 3

Asset quality of retail banks

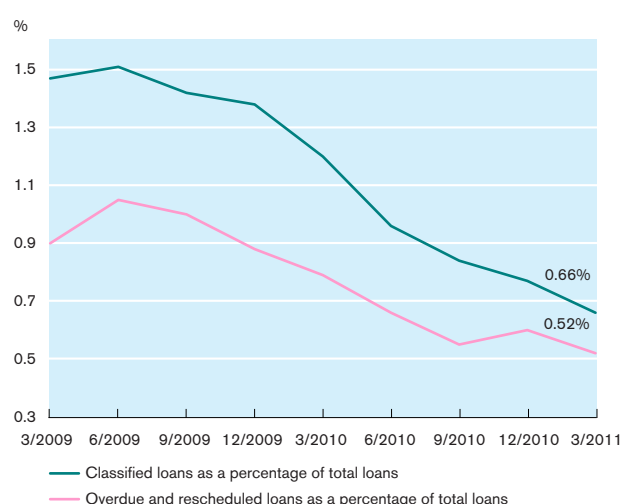


TABLE 1

Quality of loans and advances of retail banks*

	Mar 2010	Jun 2010	Sep 2010 (% of total loans)	Dec 2010	Mar 2011
Special mention loans	1.72	1.53	1.43	1.28	1.17
Classified loans (gross)	1.20	0.96	0.84	0.77	0.66
<i>of which</i>					
<i>Substandard</i>	0.50	0.39	0.30	0.27	0.23
<i>Doubtful</i>	0.60	0.47	0.47	0.44	0.38
<i>Loss</i>	0.10	0.09	0.08	0.06	0.05
Classified loans (net of specific provisions)	0.78	0.60	0.50	0.45	0.39
Overdue > 3 months and rescheduled loans	0.79	0.66	0.55	0.60	0.52
<i>of which</i>					
<i>Overdue > 3 months</i>	0.51	0.44	0.40	0.44	0.38
<i>Rescheduled loans</i>	0.28	0.22	0.16	0.15	0.14

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

Note: Figures may not add up to total because of rounding.

The credit quality of surveyed institutions' residential mortgage lending remained sound, with the delinquency ratio at 0.01% at the end of March (Chart 4). The outstanding number of residential mortgage loans in negative equity fell to 59 at the end of March from 118 at the end of 2010 (Chart 5).

Loan-to-deposit ratios rose

Retail banks' total loans and advances expanded by 6.4% in the first quarter of 2011 while customer deposits grew by 2.3%. As a result, the overall loan-to-deposit ratio of retail banks rose to 54.9% at the end of March, compared with 52.8% at the end of 2010 (Chart 6). Meanwhile, Hong Kong dollar

loans grew by 3.9% while Hong Kong dollar deposits fell by 0.5%. Therefore, the Hong Kong dollar loan-to-deposit ratio rose to 73.7% from 70.5% at the end of 2010 (Chart 7). Should the strong upward trend continue for much longer, funding and liquidity strains will inevitably emerge alongside concerns about concentration risks and the possible lowering of credit underwriting standards. To this end, the HKMA has stepped up its monitoring of AIs' business plans and funding strategies for the remainder of 2011.

CHART 4
Delinquency ratios of residential mortgages and credit card lending of surveyed institutions

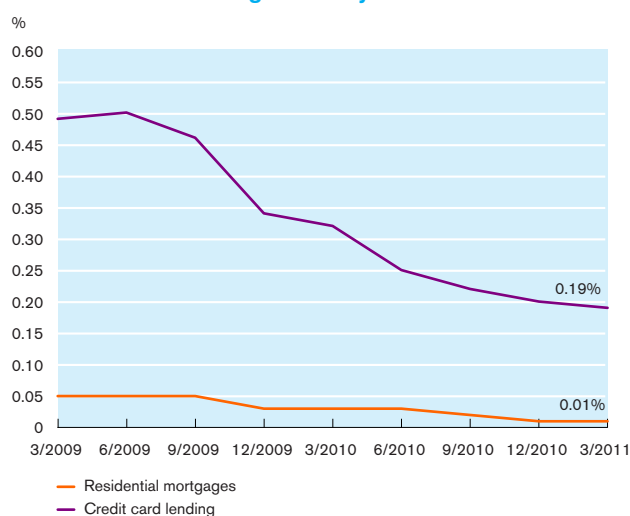


CHART 6
The total loans and customer deposits of retail banks

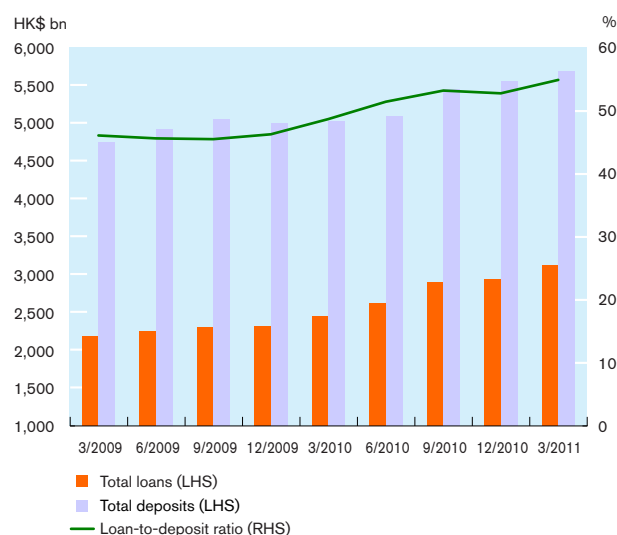


CHART 7
Hong Kong-dollar loans and customer deposits of retail banks

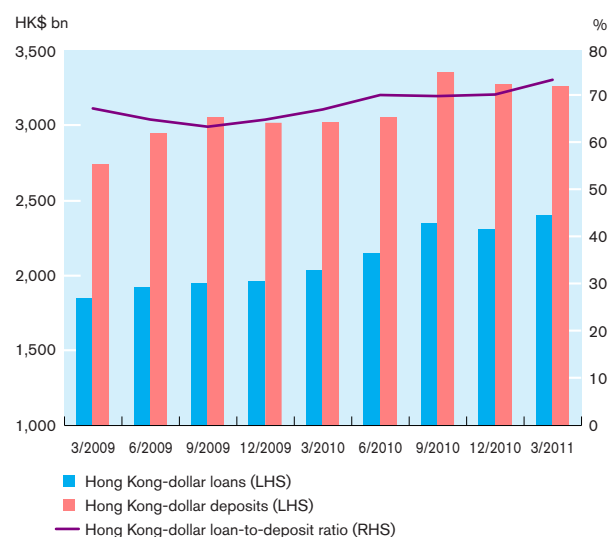
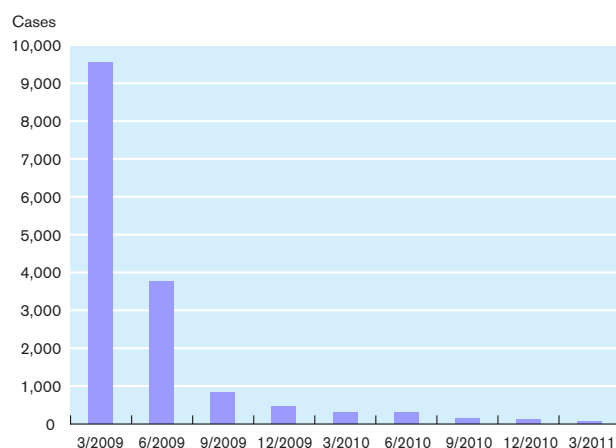


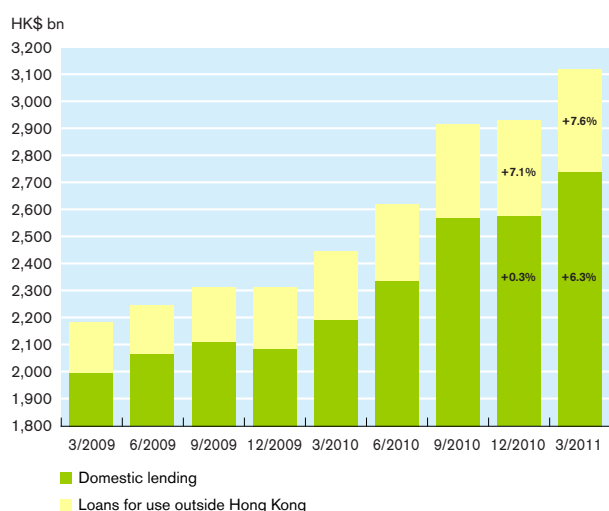
CHART 5
Residential mortgage loans in negative equity



Domestic lending and loans for use outside Hong Kong rose

Domestic lending (loans for use in Hong Kong plus trade finance) rose by 6.3% in the first quarter of 2011 after rising 0.3% in the fourth quarter of 2010 (Chart 8). The increase in domestic lending was broad-based. Loans for use outside Hong Kong continued to grow rapidly by 7.6% in the first quarter after an increase of 7.1% in the previous quarter.

CHART 8
Loans and advances of retail banks



Notes:

- 1 "Domestic lending" is defined as loans for use in Hong Kong plus trade finance.
- 2 "Loans for use outside Hong Kong" include "others" (i.e. unallocated).
- 3 Percentage denotes quarterly growth rate.

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

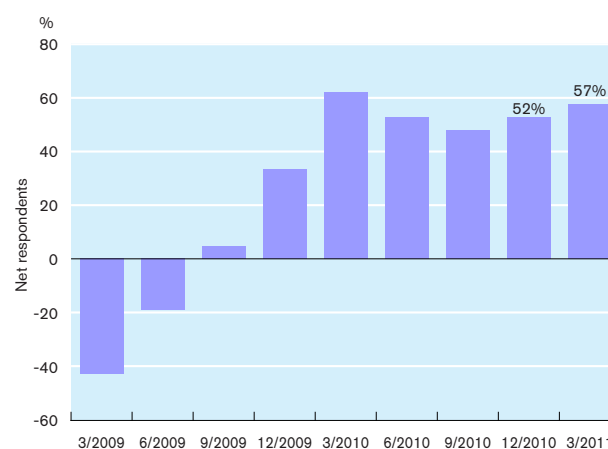
Wholesale and retail trade	+19.1%
Manufacturing	+7.4%
Trade finance	+13.3%
Property lending	+3.7%

Retail banks' total non-bank China exposures¹ rose to HK\$1,268.4 billion (13.4% of total assets) at the end of March from HK\$1,156.5 billion (12.9% of total assets) at the end of 2010. For the banking sector as a whole, non-bank China exposures increased to HK\$1,799.4 billion (12.3% of total assets) from HK\$1,620.5 billion (11.6% of total assets) in the same period.

Als remained optimistic about loan demand

Surveyed Als remained optimistic about the loan demand in the coming three months (Chart 9). According to the enhanced HKMA Opinion Survey of Credit Condition Outlook in March 2011, the majority of surveyed Als reported that loan demand is expected to increase in sectors such as trade finance, lending to non-bank Mainland entities, and wholesale and retail trade. On the other hand, surveyed Als expected demand for residential mortgage lending to be somewhat lower. In addition, Als expected that liquidity conditions will be an increasingly important factor in their review of credit loans and facilities, as the cost of funding is expected to be somewhat higher in the next three months.

CHART 9
Expectation of loan demand in the next three months



Note:

Net respondents refer to the percentage of respondents expecting loan demand to increase minus the percentage expecting loan demand to decline.

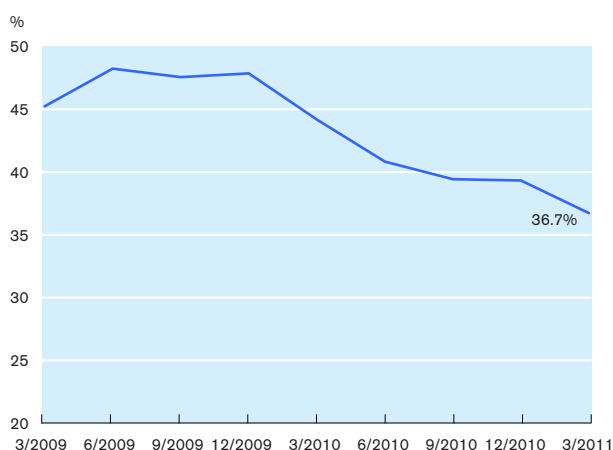
¹ Including exposures booked in the retail banks' banking subsidiaries in Mainland China.

Average liquidity ratio declined but above statutory minimum

The quarterly average liquidity ratio of retail banks fell to 36.7% in the first quarter of 2011 from 39.3% in the previous quarter, but was still above the minimum of 25% (Chart 10). The continuing upward trend in loan growth led to pressure on liquidity, which was evidenced by a reallocation of more liquid assets such as debt securities and interbank claims into generally less liquid assets like loans and advances.

CHART 10

Liquidity ratio of retail banks (quarterly average)



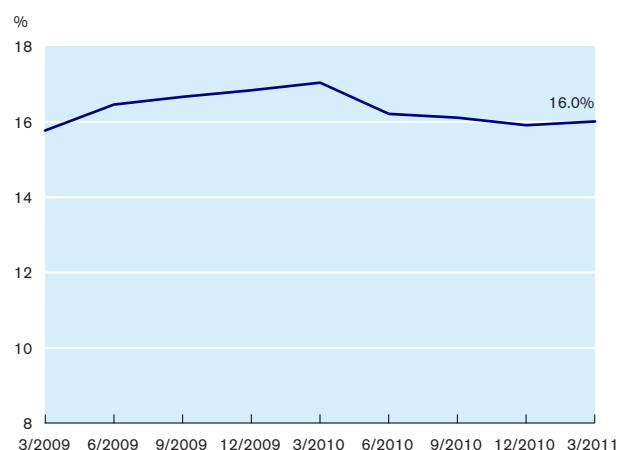
Als remained well capitalised

The consolidated capital adequacy ratio of locally incorporated Als edged up slightly to 16.0% at the end of March compared with 15.9% at the end of 2010 (Chart 11). The ratio remained well above 8%.

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

CHART 11

Capital adequacy ratio of locally incorporated Als



APPENDIX

KEY PERFORMANCE INDICATORS OF THE BANKING SECTOR¹ (%)

	Mar 2010	Dec 2010	Mar 2011
Interest rate			
1-month HIBOR ² (quarterly average)	0.07	0.22	0.16
3-month HIBOR (quarterly average)	0.13	0.29	0.23
BLR ³ and 1-month HIBOR spread (quarterly average)	4.93	4.78	4.84
BLR and 3-month HIBOR spread (quarterly average)	4.87	4.71	4.77
Composite interest rate ⁴	0.12	0.21	0.24
Retail banks			
Balance sheet developments⁵			
Total deposits	0.5	1.9	2.3
Hong Kong dollar	0.4	-2.2	-0.5
Foreign currency	0.8	8.4	6.4
Total loans	5.8	1.1	6.4
Domestic lending ⁶	5.2 ^r	0.3 ^r	6.3
Loans for use outside Hong Kong ⁷	11.4 ^r	7.1 ^r	7.6
Negotiable instruments			
Negotiable certificates of deposit (NCD) issued	17.3	28.5	39.8
Negotiable debt instruments held (excluding NCD)	2.4	0.0 ^r	-3.7
Asset quality⁸			
As a percentage of total loans			
Pass loans	97.08	97.95	98.17
Special mention loans	1.72	1.28	1.17
Classified loans ⁹ (gross)	1.20	0.77	0.66
Classified loans (net) ¹⁰	0.78	0.45	0.39
Overdue > 3 months and rescheduled loans	0.79	0.60	0.52
Profitability			
Bad debt charge as percentage of average total assets ¹¹	0.04	0.03	0.01
Net interest margin ¹¹	1.34	1.32	1.23
Cost-to-income ratio ¹²	48.2	49.9 ^r	46.0
Liquidity ratio (quarterly average)	44.2	39.3	36.7
Surveyed institutions			
Asset quality			
Delinquency ratio of residential mortgage loans	0.03	0.01	0.01
Credit-card lending			
Delinquency ratio	0.32	0.20	0.19
Charge-off ratio — quarterly annualised	2.39	1.56	1.55
— year-to-date annualised	2.39	1.91	1.55
All locally incorporated AIs			
Capital adequacy ratio (consolidated)	17.0	15.9	16.0

Notes:

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

² With reference to the Hong Kong-dollar 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 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 on the HKMA website.

⁵ Quarterly change.

⁶ Loans for use in Hong Kong plus trade finance.

⁷ Including "others" (i.e. unallocated).

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

⁹ Classified loans are those loans graded as "substandard", "doubtful" or "loss".

¹⁰ Net of specific provisions/individual impairment allowances.

¹¹ Year-to-date annualised.

¹² Year-to-date figures.

^r Revised figure.