

Developments in the Banking Sector

by the Banking Supervision Department

HIGHLIGHTS OF KEY TRENDS

Banking sector performance

The aggregate pre-tax operating profit of retail banks' Hong Kong offices rose by 13.9% in the first three quarters of 2017 compared with the same period last year. The improved performance was mainly due to an increase of 18.2% in net interest income and a growth of 9.8% in fee and commission income. However, these increases were partially offset by a decline of 25.6% in income from foreign exchange and derivatives operations and a growth of 9.1% in operating expenses (Table 1).

The net interest margin of retail banks widened to 1.43% in the first three quarters of 2017 from 1.32% in the same period of 2016 (Chart 1).

Bank credits expanded at a slower pace in the third quarter of 2017, with total loans of the banking sector increasing by 2.3% in the third quarter compared to 5.4% in the second quarter and 4.6% in the first quarter (Chart 4). As total loans grew faster than total deposits, the loan-to-deposit ratio of the banking sector rose further to 72.4% at the end of September from 71.4% a quarter earlier (Chart 5).

The banking sector's Mainland-related lending increased by 2% to HK\$4,073 billion (16.7% of total assets) at the end of the third quarter, from HK\$3,992 billion (16.6% of total assets) a quarter earlier (Table 2).

The loan quality of the banking sector remained healthy, with the classified loan ratio edging down to 0.79% at the end of September from 0.83% a quarter earlier (Table 3a). Similarly, retail banks' classified loan ratio fell slightly to 0.62% from 0.68% over the same period (Table 3b).

The classified loan ratio of the banking sector's Mainland-related lending decreased slightly to 0.84% at end-September from 0.88% a quarter earlier (Table 3a), while the classified loan ratio of retail banks' Mainland-related lending also decreased to 0.83% from 0.86% (Table 3b).

Results of surveys on debt securities and off-balance sheet exposures to derivatives and securitisations

The total market value of debt securities held by the surveyed authorized institutions (AIs) increased slightly by 2.7% to HK\$4,662 billion at the end of September 2017 from HK\$4,538 billion a year ago (Chart 13). Most of the non-structured debt securities were investment grade securities issued by sovereigns and banks (Chart 14 and Table 4).

The total notional amount of outstanding derivatives contracts held by the surveyed AIs rose notably by 18.9% to HK\$96 trillion at the end of June 2017 from HK\$81 trillion a year earlier (Chart 15). The rise was mainly attributable to the increase in customer-driven interest rate swap transactions. Over-the-counter (OTC) swap and forward contracts continued to account for over 90% of the total notional amount of all outstanding derivatives contracts at the end of June 2017 (Table 5). Over 98% of derivatives contracts held were foreign exchange and interest rate contracts (Table 6). The off-balance sheet securitisation exposures of the surveyed AIs remained insignificant, with the aggregate amount of exposures totalling HK\$17.4 billion at the end of June 2017.

Key performance indicators of the banking sector are provided in the Appendix.

Banking sector performance

Profitability

TABLE 1

Profitability of retail banks' Hong Kong offices

Key items	Q1 – Q3 2017 vs. Q1 – Q3 2016	
	Percentage change	Contribution to the percentage change in profitability (ppt)
Net interest income	+18.2%	+18.5
Fee and commission income	+9.8%	+4.5
Foreign exchange and derivatives operations income	-25.6%	-4.2
Total operating expenses	+9.1%	-7.0
Pre-tax operating profit	+13.9%	

CHART 1

Net interest margin (year-to-date annualised) of retail banks widened further

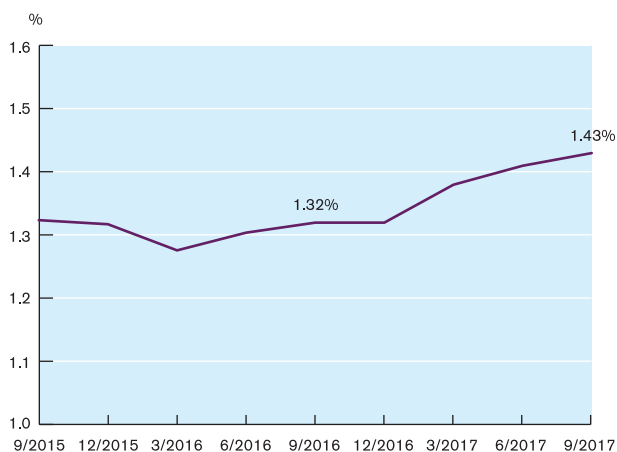


CHART 3

Cost-to-income ratio (year-to-date) of retail banks remained stable

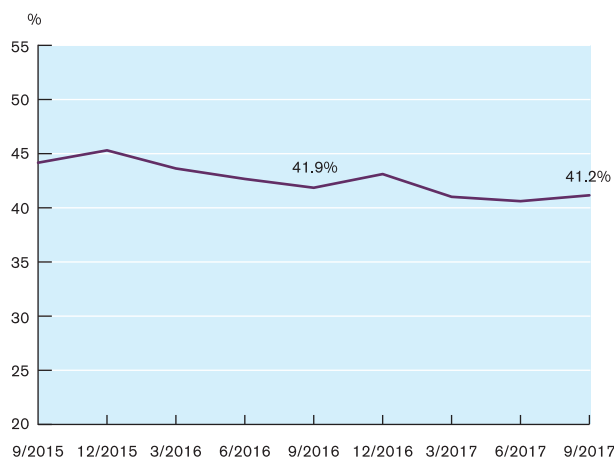
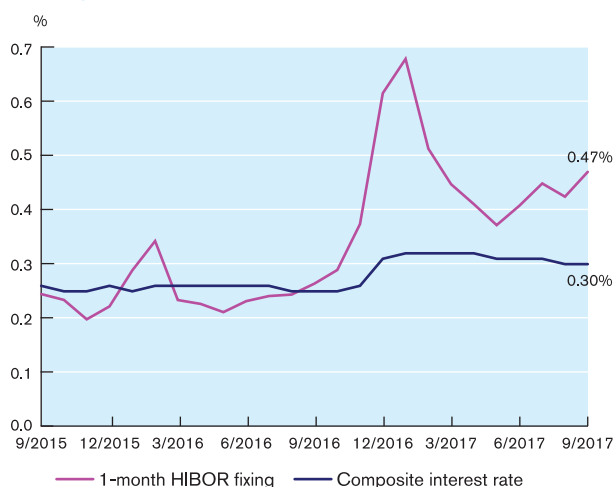


CHART 2

Hong Kong-dollar interbank interest rates increased moderately while the composite interest rate remained broadly stable



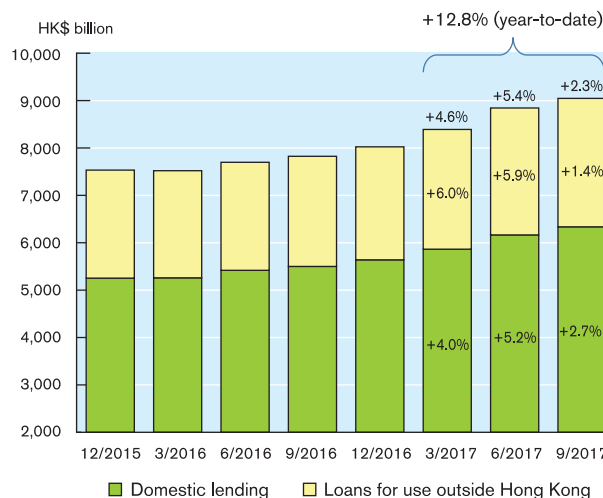
Notes:

1. HIBOR fixing (monthly average) refers to the Hong Kong Interbank Offered Rates released by the Hong Kong Association of Banks.
2. Composite interest rate is a weighted average interest rate of all Hong Kong-dollar interest-bearing liabilities of retail banks.

Loans and deposits

CHART 4

Growth in both domestic lending and loans for use outside Hong Kong moderated in the third quarter of 2017

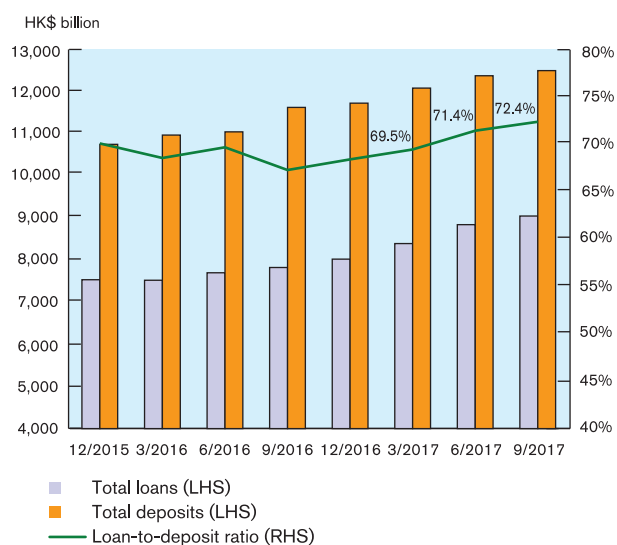


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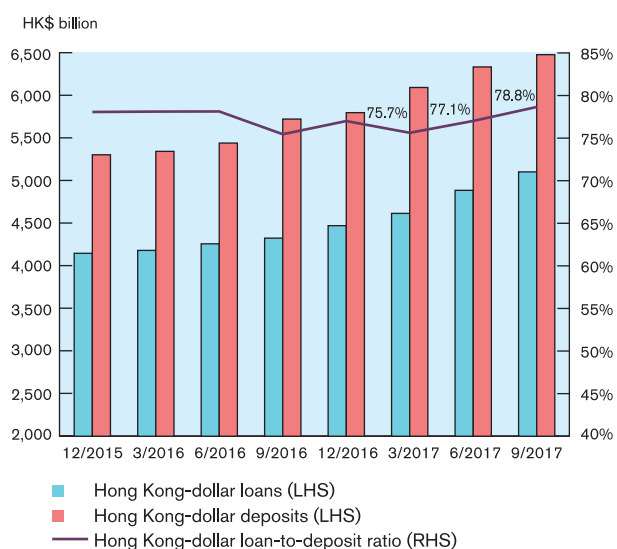
1. "Domestic lending" is defined as loans for use in Hong Kong plus trade finance.
2. "Loans for use outside Hong Kong" include "others" (i.e. unallocated).
3. Percentage denotes growth rate from prior quarter end.

CHART 5

Total loans of the banking sector expanded at a faster pace than total deposits in the first nine months of 2017

**CHART 6**

Hong Kong-dollar loans also grew faster than Hong Kong-dollar deposits in the first nine months of 2017

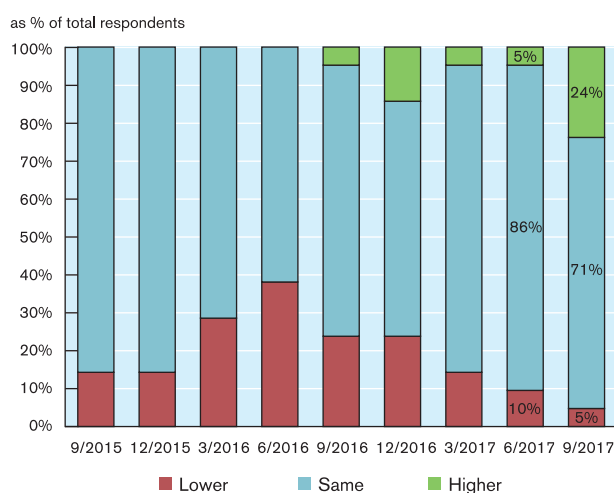


Within domestic lending, the percentage changes in the amount of credit extended to the key economic sectors in the third quarter of 2017 were:

Key items	Sep 2017 vs. Jun 2017
	Percentage change
Information technology	+6.8%
Financial concerns	+5.9%
Loans to private individuals (excluding credit card advances and residential mortgage loans)	+5.4%
Manufacturing	+4.7%
Trade finance	+4.1%
Property lending	+2.8%
Domestic lending	+2.7%

CHART 7

Majority of the respondents expected loan demand to remain stable in the next three months



Expectation of loan demand to change in the next 3 months relative to the past 3 months

Mainland-related lending

TABLE 2

Mainland-related lending

	Jun 2017 HK\$bn	Sep 2017 HK\$bn
Mainland-related loans excluding trade finance	3,695	3,755
Trade finance	297	317
Total	3,992	4,073

Asset quality

TABLE 3a

Quality of loans and advances of the banking sector*

	Sep 2016	Dec 2016	Mar 2017	Jun 2017	Sep 2017
	% of total loans				
Special mention loans	1.80	1.82	1.74	1.45	1.41
Classified loans (gross)	0.93	0.85	0.83	0.83	0.79
of which:					
Substandard	0.31	0.24	0.22	0.23	0.21
Doubtful	0.54	0.54	0.50	0.50	0.47
Loss	0.07	0.07	0.11	0.11	0.11
Classified loans (net of specific provisions)	0.57	0.51	0.50	0.47	0.42
Overdue > 3 months and rescheduled loans	0.69	0.67	0.68	0.61	0.59
of which:					
Overdue > 3 months	0.63	0.61	0.61	0.56	0.54
Rescheduled loans	0.06	0.06	0.06	0.05	0.05
	% of Mainland-related lending				
Classified loans (gross) of Mainland-related lending**	0.85	0.80	0.78	0.88	0.84

Note: Figures may not add up to total due to rounding.

* Unless stated otherwise, figures covered all Als' Hong Kong offices, as well as locally incorporated Als' overseas branches and major overseas subsidiaries.

** Figures covered all Als' Hong Kong offices, as well as locally incorporated Als' Mainland branches and subsidiaries.

TABLE 3b

Quality of loans and advances of retail banks*

	Sep 2016	Dec 2016	Mar 2017	Jun 2017	Sep 2017
	% of total loans				
Special mention loans	1.51	1.53	1.35	1.10	1.02
Classified loans (gross)	0.81	0.72	0.70	0.68	0.62
of which:					
Substandard	0.28	0.21	0.20	0.19	0.15
Doubtful	0.49	0.48	0.47	0.46	0.44
Loss	0.04	0.03	0.03	0.03	0.03
Classified loans (net of specific provisions)	0.55	0.48	0.48	0.45	0.40
Overdue > 3 months and rescheduled loans	0.57	0.53	0.54	0.46	0.45
of which:					
Overdue > 3 months	0.49	0.44	0.45	0.39	0.38
Rescheduled loans	0.08	0.09	0.09	0.07	0.07
	% of Mainland-related lending				
Classified loans (gross) of Mainland-related lending**	0.89	0.82	0.85	0.86	0.83

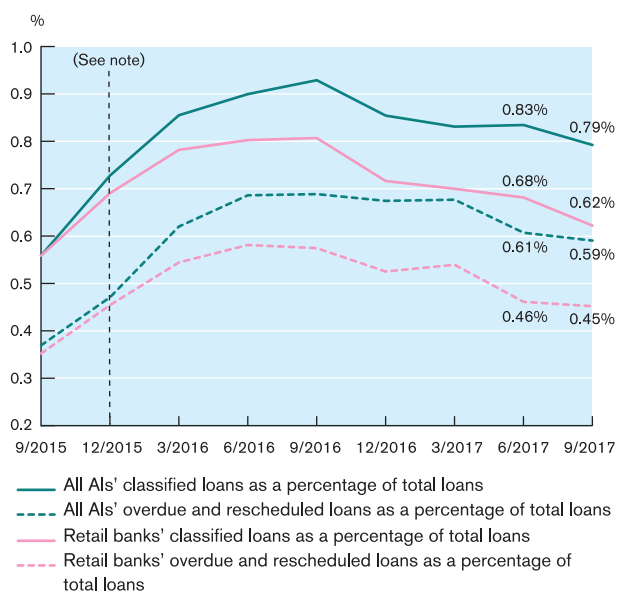
Note: Figures may not add up to total due to rounding.

* Unless stated otherwise, figures covered retail banks' Hong Kong offices, as well as locally incorporated retail banks' overseas branches and major overseas subsidiaries.

** Figures covered retail banks' Hong Kong offices, as well as locally incorporated retail banks' Mainland branches and subsidiaries.

CHART 8

Classified loan ratios continued to decrease



Note: Figures prior to December 2015 covered Hong Kong offices and overseas branches. Starting from December 2015, the coverage was expanded to include major overseas subsidiaries.

CHART 9

Delinquency ratios of residential mortgages and credit card lending declined slightly and continued to stay at low levels

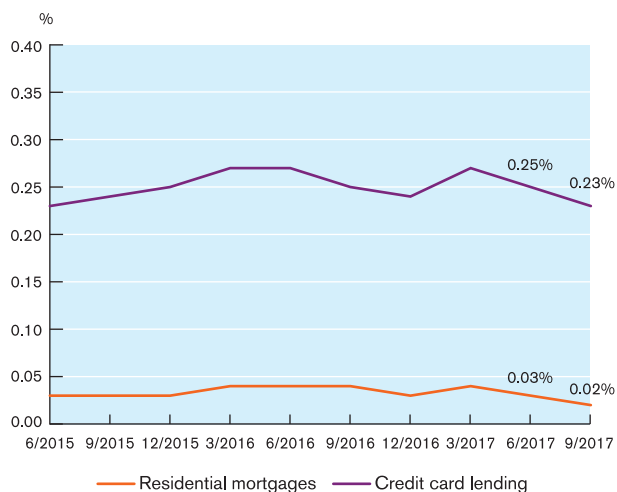
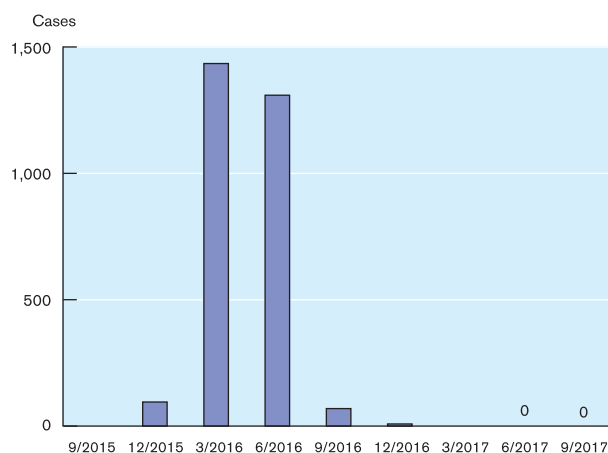


CHART 10

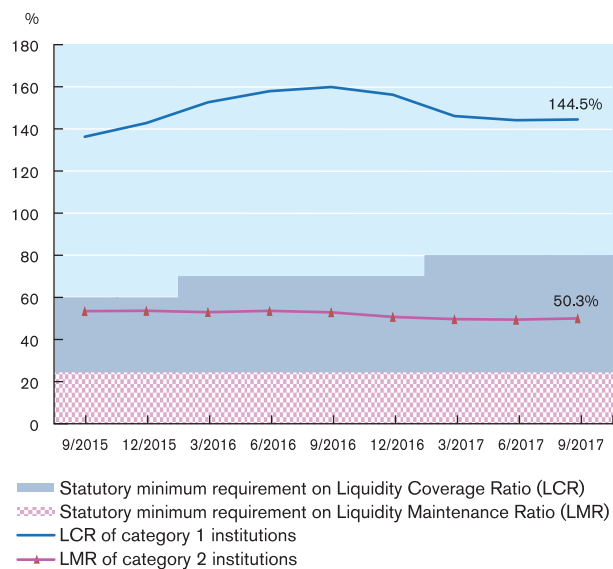
Surveyed AIs reported no residential mortgage loans in negative equity



Liquidity conditions

CHART 11

Liquidity positions of AIs were generally sound

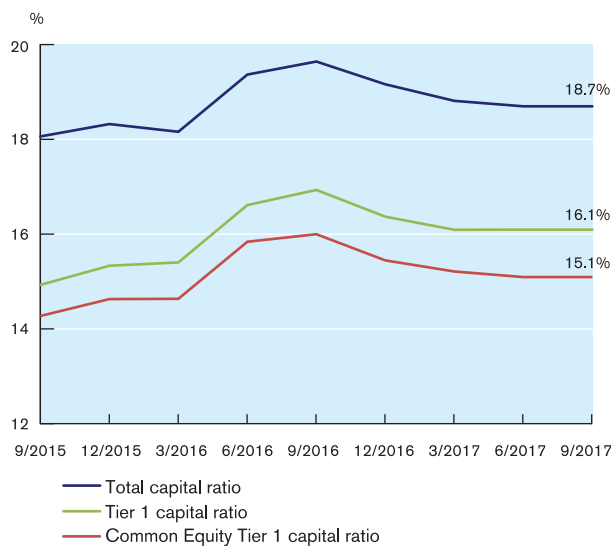


Note: For a category 1 institution, the statutory minimum requirement of the LCR applicable for 2017 is 80%. A category 2 institution must maintain an LMR of not less than 25% on average in each calendar month.

Capital adequacy

CHART 12

The consolidated capital adequacy ratios of locally incorporated AIs continued to stay at high levels



Results of surveys on debt securities and off-balance sheet exposures to derivatives and securitisations

Debt securities held¹

CHART 13

Surveyed AIs reported a small increase in their holdings of non-structured securities while holdings of structured securities remained insignificant

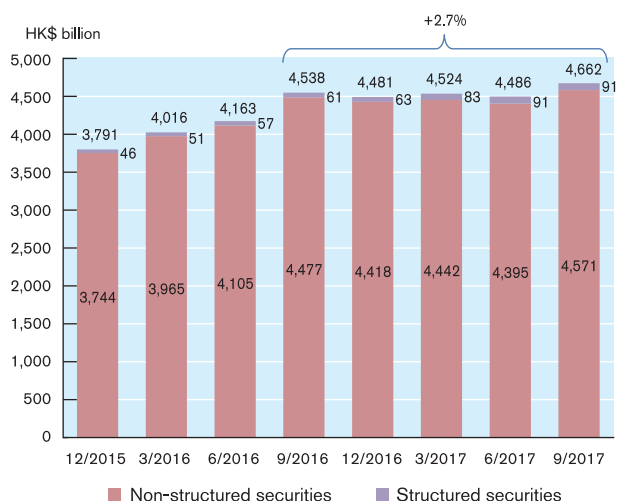


CHART 14

Non-structured debt securities held by surveyed AIs were predominantly investment grade securities

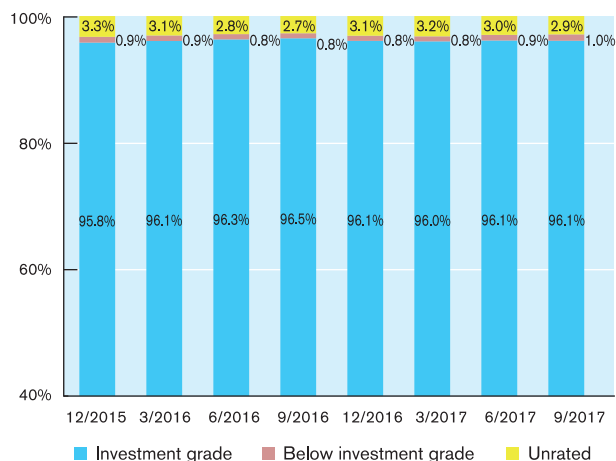


TABLE 4

Most of the non-structured debt securities were issued by sovereigns and banks

(% of total)	All surveyed AIs							
Issuer or reference entity	Dec 2015	Mar 2016	Jun 2016	Sep 2016	Dec 2016	Mar 2017	Jun 2017	Sep 2017
Sovereigns	56.7%	57.2%	54.1%	53.6%	51.7%	48.9%	47.2%	48.3%
of which:								
Exchange Fund bills and notes	24.1%	23.9%	24.1%	22.9%	23.4%	23.8%	24.2%	24.6%
US Treasury bills, notes and bonds	11.8%	10.5%	8.6%	8.2%	8.6%	7.8%	7.1%	7.5%
Public sector entities	5.9%	6.7%	6.6%	6.1%	5.9%	6.2%	6.1%	5.8%
Banks	24.5%	23.0%	25.3%	26.3%	27.6%	29.1%	30.5%	30.1%
Corporates	10.2%	10.2%	11.0%	10.6%	10.9%	11.2%	11.4%	11.0%
Others	2.7%	2.9%	3.0%	3.5%	3.9%	4.7%	4.8%	4.7%

¹ This section presents the results of the Survey on Selected Debt Securities Held. The results cover surveyed AIs' Hong Kong offices plus their overseas branches, with both banking book and trading book being included. Figures shown may not add up to total due to rounding.

Exposures to derivatives²

CHART 15

Total notional amount of all outstanding derivatives contracts increased notably

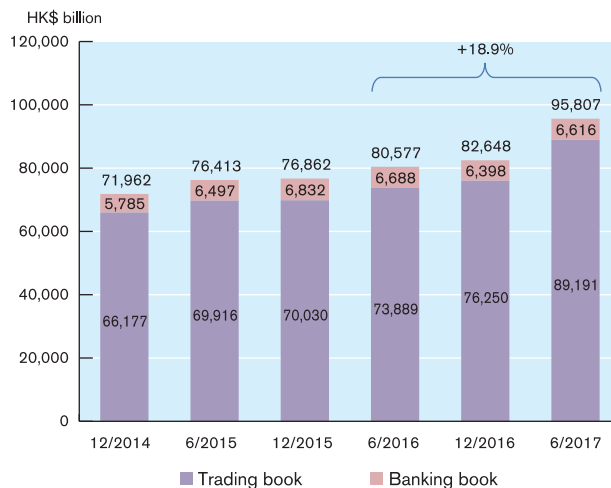


CHART 16

The notional amount of credit derivatives contracts increased but continued to account for a small share of total derivatives contracts held

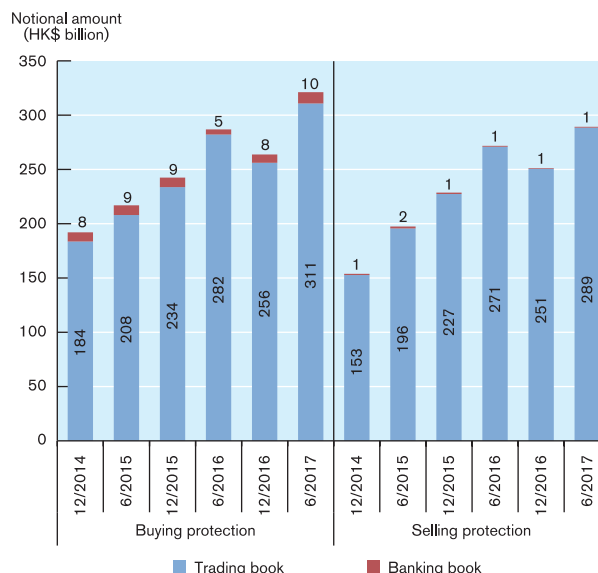


TABLE 5

OTC swap and forward contracts continued to account for about 90% of total derivatives contracts held by surveyed AIs

(% of total)	All surveyed AIs					
Derivatives product	Dec 2014	Jun 2015	Dec 2015	Jun 2016	Dec 2016	Jun 2017
Exchange-traded derivatives	2.0%	2.3%	1.5%	1.7%	2.1%	2.7%
OTC derivatives	98.0%	97.7%	98.5%	98.3%	97.9%	97.3%
of which:						
Forwards	31.7%	32.4%	34.4%	35.4%	32.2%	32.0%
Swaps	58.4%	56.9%	57.5%	57.3%	60.4%	59.9%
Options	6.9%	7.2%	5.1%	4.1%	3.9%	3.8%
Credit derivatives	0.5%	0.5%	0.6%	0.7%	0.6%	0.6%
Others	0.5%	0.6%	0.9%	0.7%	0.8%	0.9%

TABLE 6

Derivatives contracts held were predominantly foreign exchange and interest rate contracts

(% of total)	All surveyed AIs					
Underlying risk	Dec 2014	Jun 2015	Dec 2015	Jun 2016	Dec 2016	Jun 2017
Interest rate risk	38.6%	36.9%	35.0%	35.3%	38.9%	40.9%
Foreign exchange risk	59.0%	60.6%	63.2%	62.9%	59.4%	57.4%
Equity risk	1.8%	1.9%	1.2%	1.1%	0.9%	1.0%
Commodity risk	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%
Credit risk	0.5%	0.5%	0.6%	0.7%	0.6%	0.6%
Other risks	0.1%	0.0%	0.0%	0.0%	0.0%	0.0%

² This section presents the results of the Survey on Off-balance Sheet Exposures in Derivatives and Securitisation Transactions. The results cover surveyed AIs' Hong Kong offices plus their overseas branches, with both banking book and trading book being included. Figures may not add up to total due to rounding.

APPENDIX

KEY PERFORMANCE INDICATORS OF THE BANKING SECTOR¹ (%)

	Sep 2016	Jun 2017	Sep 2017
Interest rates			
1-month HIBOR fixing ² (quarterly average)	0.25	0.40	0.45
3-month HIBOR fixing (quarterly average)	0.57	0.83	0.76
BLR ³ and 1-month HIBOR fixing spread (quarterly average)	4.75	4.60	4.55
BLR and 3-month HIBOR fixing spread (quarterly average)	4.43	4.17	4.24
Composite interest rate ⁴	0.25	0.31	0.30
All AIs			
Balance sheet developments⁵			
Total deposits	5.2	2.4	1.0
Hong Kong dollar	5.2	4.0	2.3
Foreign currency	5.3	0.9	-0.4
Total loans	1.6	5.4	2.3
Domestic lending ⁶	1.5	5.2	2.7
Loans for use outside Hong Kong ⁷	1.9	5.9	1.4
Negotiable instruments			
Negotiable certificates of deposit (NCDs) issued	3.9	8.1	0.9
Negotiable debt instruments held (excluding NCDs)	6.6	-1.7	4.5
Asset quality			
As a percentage of total loans ⁸			
Pass loans	97.27	97.71	97.80
Special mention loans	1.80	1.45	1.41
Classified loans ⁹ (gross)	0.93	0.83	0.79
Classified loans (net) ¹⁰	0.57	0.47	0.42
Overdue > 3 months and rescheduled loans	0.69	0.61	0.59
Classified loan ratio (gross) of Mainland-related lending ¹¹	0.85	0.88	0.84
Liquidity ratios (quarterly average, consolidated)			
Liquidity Coverage Ratio — category 1 institutions	159.9	144.2	144.5
Liquidity Maintenance Ratio — category 2 institutions	53.2	49.7	50.3
Retail banks			
Profitability			
Loan impairment charges as a percentage of average total assets ¹²	0.07	0.08	0.06
Net interest margin ¹²	1.32	1.41	1.43
Cost-to-income ratio ¹³	41.9	40.7	41.2
Surveyed institutions			
Asset quality			
Delinquency ratio of residential mortgage loans	0.04	0.03	0.02
Credit card lending			
Delinquency ratio	0.25	0.25	0.23
Charge-off ratio — quarterly annualised	2.14	2.08	1.95
— year-to-date annualised	2.02	1.93	1.91
All locally incorporated AIs			
Capital adequacy (consolidated)			
Common Equity Tier 1 capital ratio	16.0	15.1	15.1
Tier 1 capital ratio	16.9	16.1	16.1
Total capital ratio	19.6	18.7	18.7

Notes:

1. Figures are related to Hong Kong offices only except where otherwise stated.
2. The Hong Kong Interbank Offered Rates are 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 are related to all Als' Hong Kong offices, as well as locally incorporated Als' overseas branches and major overseas subsidiaries.
9. Classified loans are those loans graded as "substandard", "doubtful" or "loss".
10. Net of specific provisions/individual impairment allowances.
11. Figures are related to all Als' Hong Kong offices, as well as locally incorporated Als' Mainland branches and subsidiaries.
12. Year-to-date annualised.
13. Year-to-date figures.