

Developments in the Banking Sector

by Banking Supervision Department

HIGHLIGHTS OF KEY TRENDS

Banking sector performance

The aggregate pre-tax operating profit of retail banks' Hong Kong operations increased by 22.4% in the first three quarters of 2018 compared with the same period last year. The strong performance was mainly due to a 23.3% increase in net interest income and a 57.4% growth in income from foreign exchange and derivatives operations (Exhibit 1).

Retail banks' net interest margin widened further to 1.60% in the first three quarters of 2018 compared with 1.45% for the whole of 2017 (Exhibit 2).

Total loans of the banking sector decreased by 1.1% in the third quarter after increasing by 5.3% in the first half of 2018 (Exhibit 5). As total loans declined while total deposits increased, the loan-to-deposit ratio of the banking sector dropped to 74.0% at end-September 2018 from 75.7% a quarter earlier (Exhibit 6).

The banking sector's Mainland-related lending decreased by 2.1% in the third quarter to HK\$4,321 billion (16.6% of total assets), from HK\$4,414 billion (16.9% of total assets) a quarter earlier (Exhibit 9).

The loan quality of the banking sector stayed healthy, with the classified loan ratio edging down to 0.60% at end-September 2018 from 0.61% a quarter earlier (Exhibit 10). Retail banks' classified loan ratio increased slightly to 0.54% from 0.53% over the same period (Exhibit 11).

The classified loan ratio of the banking sector's Mainland-related lending increased slightly to 0.64% at end-September 2018 from 0.62% a quarter earlier (Exhibit 10). The classified loan ratio of retail banks' Mainland-related lending also increased to 0.74% from 0.70% during the same period (Exhibit 11).

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)¹ increased by 9.0% to HK\$5,081 billion at the end of September 2018 from HK\$4,662 billion a year ago (Exhibit 19). Over 96% of the debt securities holdings were investment grade (Exhibit 20). Most of the holdings were issued by sovereigns and banks (Exhibit 21).

The total notional amount of outstanding derivatives contracts held by all AIs rose notably by 14.8% to HK\$110 trillion at the end of June 2018 from HK\$96 trillion a year earlier (Exhibit 22). The rise was mainly due to increased 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 2018 (Exhibit 23). Over 97% of derivatives contracts held were foreign exchange and interest rate contracts (Exhibit 24). The off-balance sheet securitisation exposures of AIs remained insignificant, with the aggregate amount of exposures totalling HK\$3.9 billion at the end of June 2018.

The key performance indicators of the banking sector are provided in the Appendix.

¹ This survey covers all licensed banks and restricted licence banks.

Banking sector performance

Profitability

EXHIBIT 1

Profitability of retail banks' Hong Kong offices

| Key items | Q1-Q3 2018 vs. Q1-Q3 2017 | |
|---|---------------------------|---|
| | Percentage change | Contribution to the percentage change in pre-tax operating profit (ppt) |
| Net interest income | +23.3% | +24.6 |
| Income from foreign exchange and derivatives operations | +57.4% | +6.2 |
| Dividends from subsidiaries and associated companies | -46.2% | -3.1 |
| Total operating expenses | +4.9% | -3.6 |
| Pre-tax operating profit | +22.4% | |

EXHIBIT 2

Net interest margin (year-to-date annualised) of retail banks continued to widen

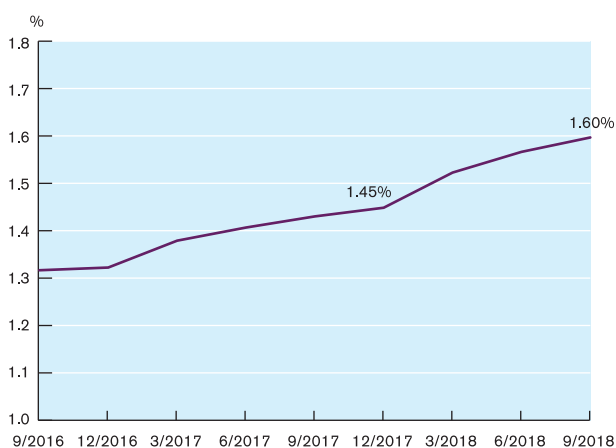


EXHIBIT 4

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

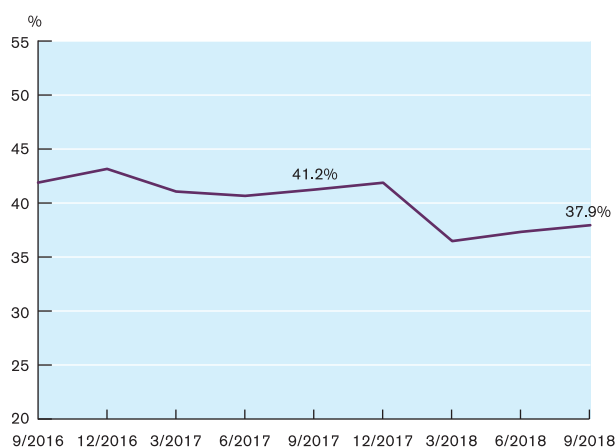
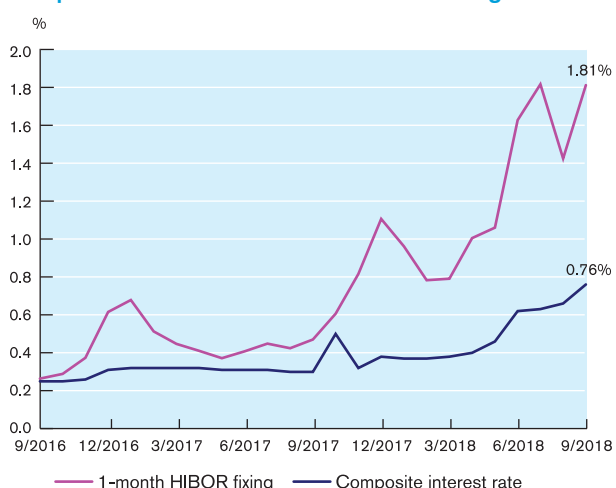


EXHIBIT 3

Hong Kong-dollar interbank interest rates and the composite interest rate continued their rising trends



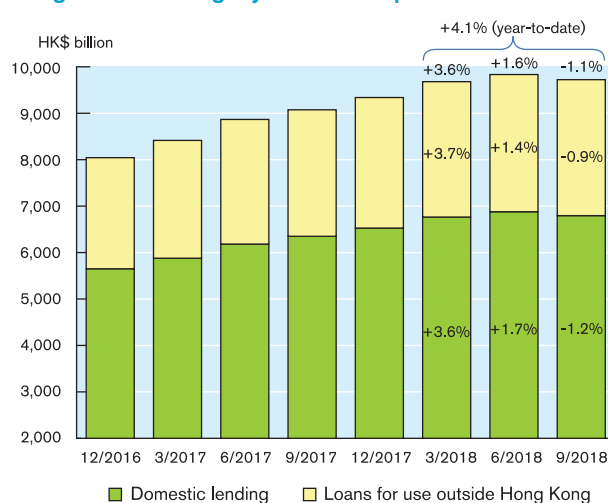
Notes:

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

Loans and deposits

EXHIBIT 5

Both domestic lending and loans for use outside Hong Kong decreased slightly in the third quarter of 2018



Notes:

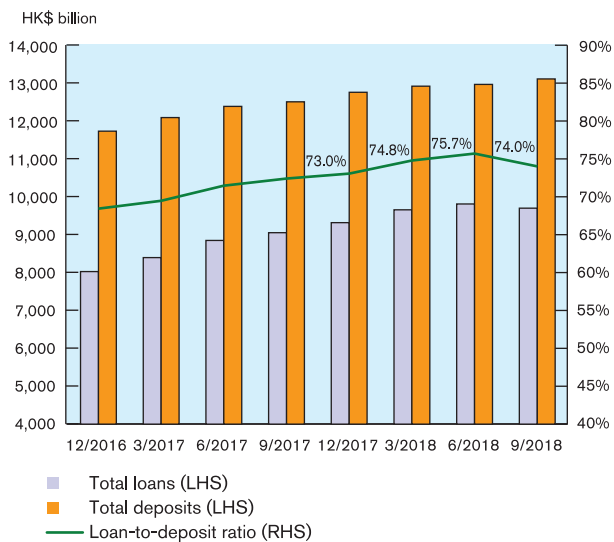
- "Domestic lending" is defined as loans for use in Hong Kong plus trade finance.
- "Loans for use outside Hong Kong" include "others" (i.e. unallocated).
- Percentage denotes quarter-on-quarter growth rate.

Within domestic lending, the percentage changes in the amount of credit extended to the key economic sectors in the third quarter of 2018 were:

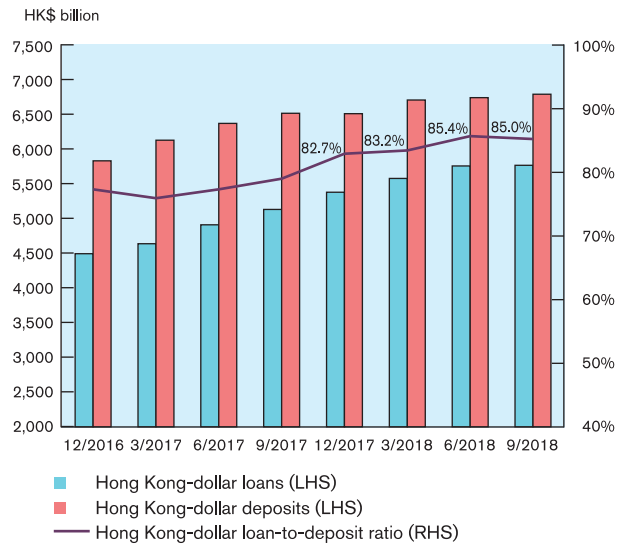
| Key items | Sep 2018 vs. Jun 2018 |
|--|-----------------------|
| | Percentage change |
| Stockbrokers | -31.0% |
| Trade finance | -8.2% |
| Financial companies (excluding stockbrokers) | -5.6% |
| Manufacturing | -4.3% |
| Wholesale and retail trade | -3.5% |
| Loans to private individuals (excluding credit card advances and residential mortgage loans) | -3.2% |
| Domestic lending | -1.2% |

EXHIBIT 6

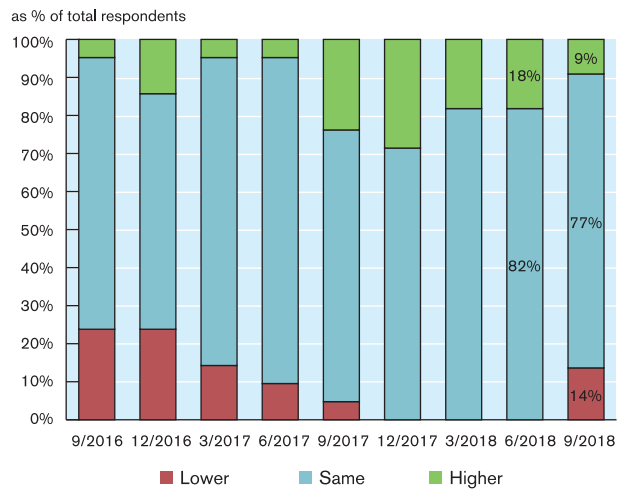
Total loans of the banking sector declined in the third quarter while total deposits continued to grow

**EXHIBIT 7**

Hong Kong-dollar loans grew slower than Hong Kong-dollar deposits in the third quarter of 2018

**EXHIBIT 8**

The majority of respondents to the HKMA Opinion Survey on Credit Condition Outlook expected loan demand to stay the same in the next three months



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

Mainland-related lending**EXHIBIT 9**

Mainland-related lending

| | Jun 2018 HK\$bn | Sep 2018 HK\$bn |
|--|--------------------|--------------------|
| Mainland-related loans excluding trade finance | 4,064 | 4,010 |
| Trade finance | 350 | 311 |
| Total | 4,414 | 4,321 |

Asset quality

EXHIBIT 10

Quality of loans and advances of the banking sector*

| | Sep 2017 | Dec 2017 | Mar 2018 | Jun 2018 | Sep 2018 |
|---|--------------------------------------|-------------|-------------|-------------|-------------|
| | <i>% of total loans</i> | | | | |
| Special mention loans | 1.44 | 1.33 | 1.28 | 1.31 | 1.31 |
| Classified loans (gross) | 0.79 | 0.68 | 0.65 | 0.61 | 0.60 |
| of which: | | | | | |
| Substandard | 0.21 | 0.21 | 0.21 | 0.20 | 0.23 |
| Doubtful | 0.47 | 0.38 | 0.38 | 0.34 | 0.31 |
| Loss | 0.11 | 0.08 | 0.06 | 0.07 | 0.07 |
| Classified loans (net of specific provisions) | 0.42 | 0.36 | 0.34 | 0.32 | 0.32 |
| Overdue > 3 months and rescheduled loans | 0.61 | 0.52 | 0.48 | 0.40 | 0.38 |
| of which: | | | | | |
| Overdue > 3 months | 0.56 | 0.47 | 0.42 | 0.36 | 0.34 |
| Rescheduled loans | 0.05 | 0.05 | 0.05 | 0.04 | 0.04 |
| | <i>% of Mainland-related lending</i> | | | | |
| Classified loans (gross) of Mainland-related lending** | 0.84 | 0.67 | 0.60 | 0.62 | 0.64 |

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.

EXHIBIT 11

Quality of loans and advances of retail banks*

| | Sep 2017 | Dec 2017 | Mar 2018 | Jun 2018 | Sep 2018 |
|---|--------------------------------------|-------------|-------------|-------------|-------------|
| | <i>% of total loans</i> | | | | |
| Special mention loans | 1.02 | 0.98 | 1.09 | 1.06 | 1.09 |
| Classified loans (gross) | 0.62 | 0.56 | 0.55 | 0.53 | 0.54 |
| of which: | | | | | |
| Substandard | 0.15 | 0.18 | 0.19 | 0.18 | 0.20 |
| Doubtful | 0.44 | 0.35 | 0.33 | 0.31 | 0.31 |
| Loss | 0.03 | 0.03 | 0.03 | 0.04 | 0.04 |
| Classified loans (net of specific provisions) | 0.40 | 0.36 | 0.35 | 0.33 | 0.34 |
| Overdue > 3 months and rescheduled loans | 0.45 | 0.40 | 0.39 | 0.31 | 0.35 |
| of which: | | | | | |
| Overdue > 3 months | 0.38 | 0.34 | 0.32 | 0.26 | 0.29 |
| Rescheduled loans | 0.07 | 0.06 | 0.07 | 0.06 | 0.05 |
| | <i>% of Mainland-related lending</i> | | | | |
| Classified loans (gross) of Mainland-related lending** | 0.83 | 0.75 | 0.68 | 0.70 | 0.74 |

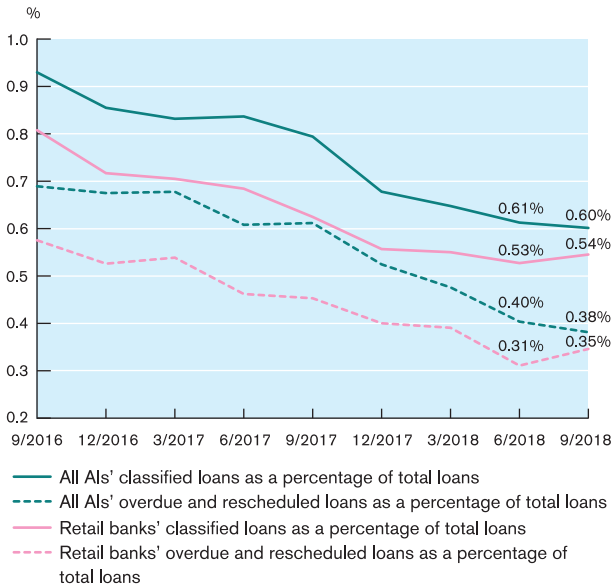
Note: Figures may not add up to total due to rounding.

* 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.

EXHIBIT 12

Loan quality remained good



Note: Figures covered Hong Kong offices, overseas branches and major overseas subsidiaries.

EXHIBIT 13

Delinquency ratios of residential mortgages and credit card lending remained at low levels

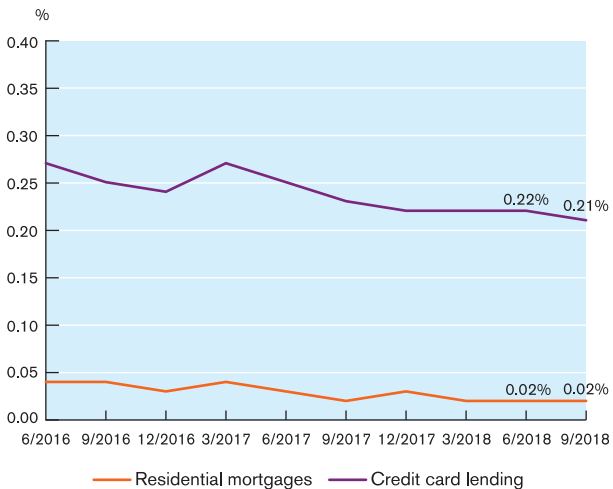
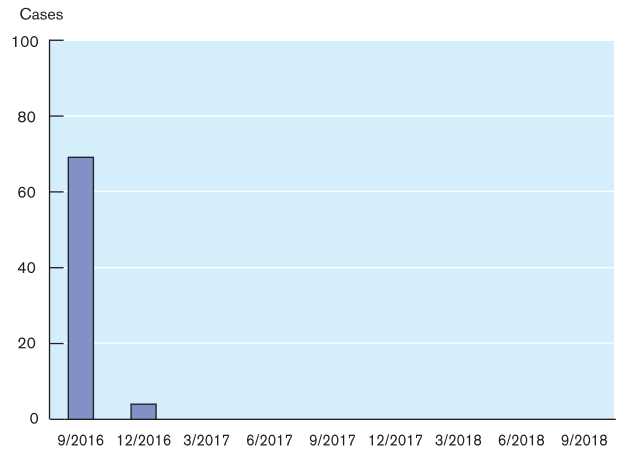


EXHIBIT 14

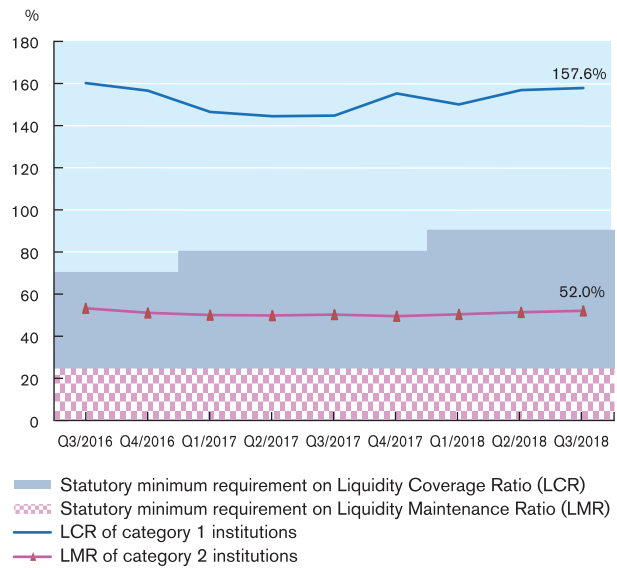
Surveyed AIs continued to report no residential mortgage loans in negative equity



Liquidity conditions

EXHIBIT 15

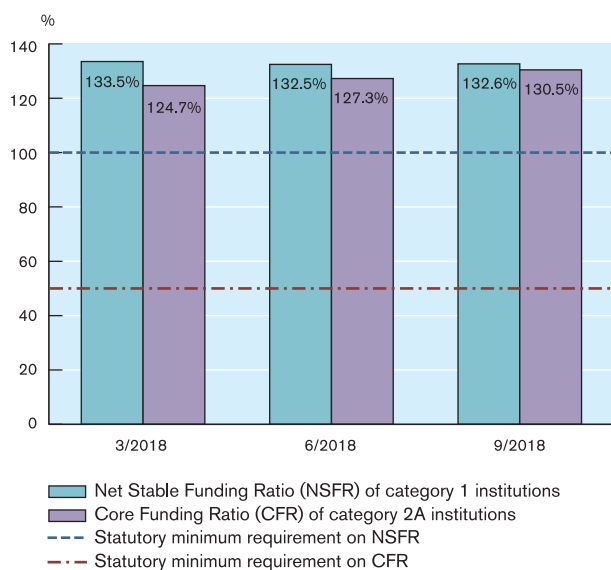
Liquidity positions of AIs remained robust



Note: For a category 1 institution, the statutory minimum requirement of the LCR applicable for 2018 is 90%. A category 2 institution must maintain a LMR of not less than 25% on average in each calendar month.

EXHIBIT 16

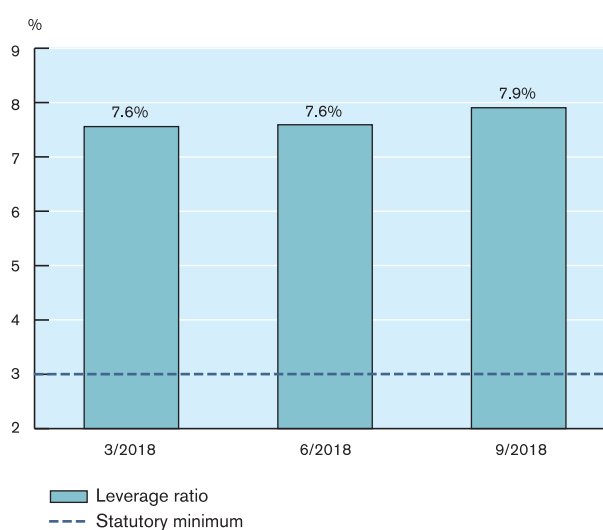
Funding positions of AIs continued to be stable



Note: For a category 1 institution, the statutory minimum requirement of the NSFR is 100%. A category 2A institution must maintain a CFR of not less than 50% on average in each calendar month during 2018.

EXHIBIT 18

Leverage ratio stayed at a healthy level

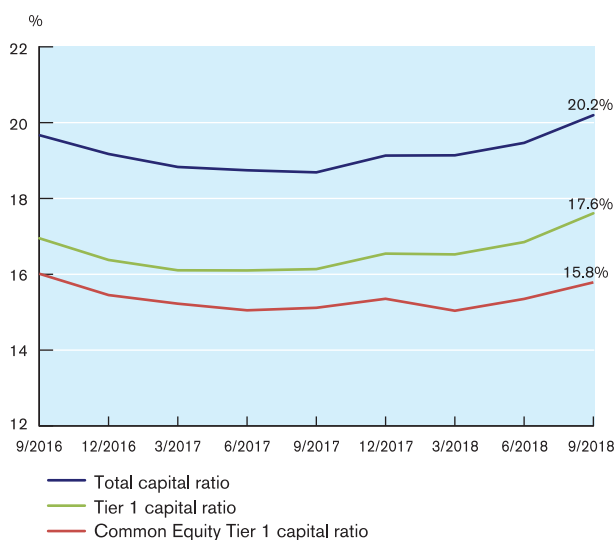


Note: All locally incorporated AIs are required to maintain leverage ratios of not less than 3%.

Capital adequacy

EXHIBIT 17

Capital positions of locally incorporated AIs remained strong



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

Debt securities held²

EXHIBIT 19

Surveyed AIs reported a moderate increase in their holdings of debt securities

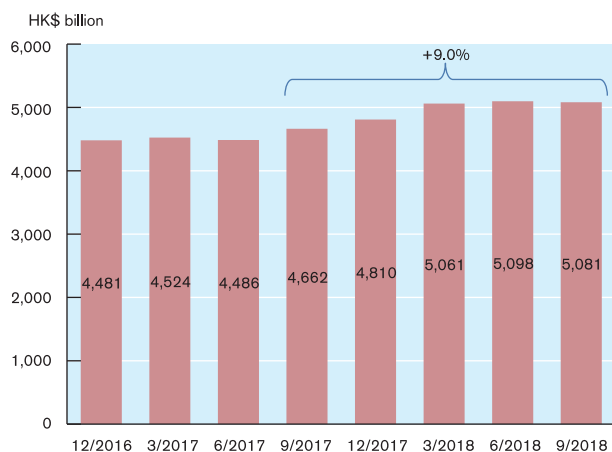


EXHIBIT 20

Debt securities held by surveyed AIs were predominantly investment grade securities

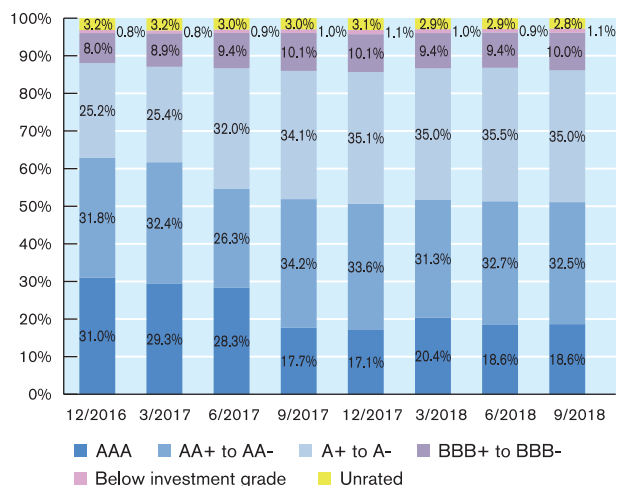


EXHIBIT 21

Most of the debt securities were issued by sovereigns and banks

| (% of total) | All surveyed AIs | | | | | | | |
|---|------------------|----------|----------|----------|----------|----------|----------|----------|
| | Dec 2016 | Mar 2017 | Jun 2017 | Sep 2017 | Dec 2017 | Mar 2018 | Jun 2018 | Sep 2018 |
| Part 1: Debt securities other than securitisation products³ | | | | | | | | |
| Sovereigns, of which: | 50.9% | 48.0% | 46.2% | 47.3% | 47.6% | 49.1% | 49.5% | 47.2% |
| Exchange Fund bills and notes | 23.1% | 23.3% | 23.7% | 24.2% | 23.8% | 22.9% | 22.6% | 22.4% |
| US Treasury bills, notes and bonds | 8.4% | 7.7% | 6.9% | 7.3% | 6.6% | 8.3% | 8.4% | 8.2% |
| Public sector entities | 5.9% | 6.1% | 6.0% | 5.7% | 5.3% | 5.8% | 5.6% | 5.7% |
| Banks | 27.3% | 28.6% | 29.8% | 29.5% | 29.5% | 27.6% | 27.7% | 29.7% |
| Corporates | 10.7% | 11.0% | 11.2% | 10.8% | 10.8% | 11.0% | 10.6% | 10.6% |
| Others | 3.8% | 4.6% | 4.7% | 4.6% | 4.8% | 4.7% | 4.7% | 4.7% |
| Part 2: Securitisation products | | | | | | | | |
| Total securitisation products | 1.4% | 1.8% | 2.0% | 2.0% | 1.9% | 1.8% | 2.0% | 2.1% |

² This section presents the results of the Survey on Debt Securities Held of all licensed banks and restricted licence banks. The results cover the banking book and trading book positions of surveyed AIs' Hong Kong offices and their overseas branches. Figures shown may not add up to total due to rounding.

³ Securitisation products include asset-backed securities, mortgage-backed securities, collateralised debt obligations, notes issued by structured investment vehicles, asset-backed commercial papers, and other similar structured credit products.

Exposures to derivatives⁴

EXHIBIT 22

Total notional amount of all outstanding derivatives contracts increased notably

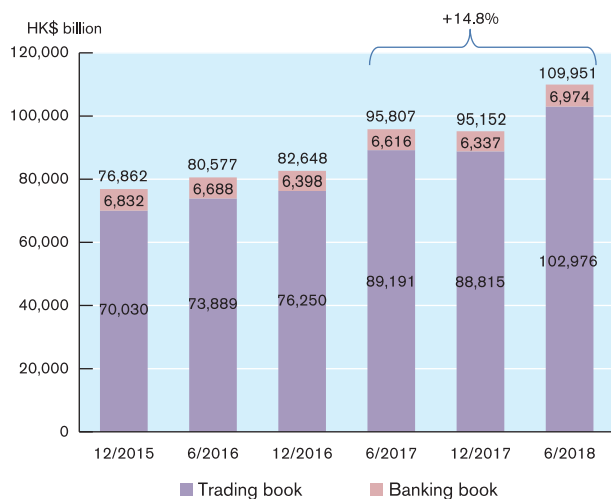


EXHIBIT 25

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

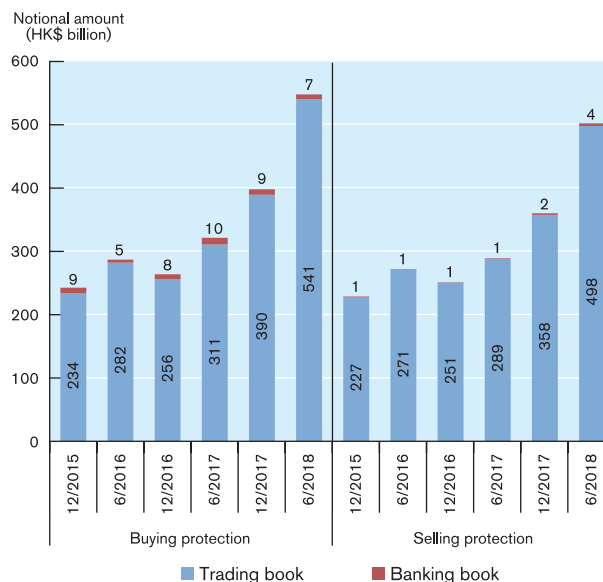


EXHIBIT 23

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

| (% of total) | All AIs | | | | | |
|-----------------------------|--------------|--------------|--------------|--------------|--------------|--------------|
| | Dec 2015 | Jun 2016 | Dec 2016 | Jun 2017 | Dec 2017 | Jun 2018 |
| Derivatives product | | | | | | |
| Exchange-traded derivatives | 1.5% | 1.7% | 2.1% | 2.7% | 2.0% | 1.8% |
| OTC derivatives | 98.5% | 98.3% | 97.9% | 97.3% | 98.0% | 98.2% |
| of which: | | | | | | |
| Forwards | 34.4% | 35.4% | 32.2% | 32.0% | 28.6% | 27.7% |
| Swaps | 57.5% | 57.3% | 60.4% | 60.0% | 64.0% | 64.1% |
| Options | 5.1% | 4.1% | 3.9% | 3.8% | 3.6% | 3.8% |
| Credit derivatives | 0.6% | 0.7% | 0.6% | 0.6% | 0.8% | 1.0% |
| Others | 0.9% | 0.7% | 0.8% | 0.9% | 1.0% | 1.7% |

EXHIBIT 24

Derivatives contracts held were predominantly foreign exchange and interest rate contracts

| (% of total) | All AIs | | | | | |
|------------------------|----------|----------|----------|----------|----------|----------|
| | Dec 2015 | Jun 2016 | Dec 2016 | Jun 2017 | Dec 2017 | Jun 2018 |
| Underlying risk | | | | | | |
| Interest rate risk | 35.0% | 35.3% | 38.9% | 40.9% | 45.4% | 43.8% |
| Foreign exchange risk | 63.2% | 62.9% | 59.4% | 57.4% | 52.6% | 54.2% |
| Equity risk | 1.2% | 1.1% | 0.9% | 1.0% | 1.1% | 0.9% |
| Commodity risk | 0.1% | 0.1% | 0.1% | 0.1% | 0.1% | 0.1% |
| Credit risk | 0.6% | 0.7% | 0.6% | 0.6% | 0.8% | 1.0% |
| Other risks | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |

⁴ This section presents the results of the Survey on Off-balance Sheet Exposures in Derivatives and Securitisation Transactions. The results cover the banking book and trading book positions of all AIs' Hong Kong offices and their overseas branches. Figures may not add up to total due to rounding.

APPENDIX

KEY PERFORMANCE INDICATORS OF THE BANKING SECTOR¹ (%)

| | Sep 2017 | Jun 2018 | Sep 2018 |
|---|----------|----------|----------|
| Interest rates | | | |
| 1-month HIBOR fixing ² (quarterly average) | 0.45 | 1.23 | 1.68 |
| 3-month HIBOR fixing (quarterly average) | 0.76 | 1.68 | 2.00 |
| BLR ³ and 1-month HIBOR fixing spread (quarterly average) | 4.55 | 3.77 | 3.32 |
| BLR and 3-month HIBOR fixing spread (quarterly average) | 4.24 | 3.32 | 3.00 |
| Composite interest rate ⁴ | 0.30 | 0.62 | 0.76 |
| All AIs | | | |
| Balance sheet developments⁵ | | | |
| Total deposits | 1.0 | 0.4 | 1.1 |
| Hong Kong dollar | 2.3 | 0.5 | 0.7 |
| Foreign currency | -0.4 | 0.2 | 1.6 |
| Total loans | 2.3 | 1.6 | -1.1 |
| Domestic lending ⁶ | 2.7 | 1.7 | -1.2 |
| Loans for use outside Hong Kong ⁷ | 1.4 | 1.4 | -0.8 |
| Negotiable instruments | | | |
| Negotiable certificates of deposit (NCDs) issued | 0.9 | -2.5 | -1.1 |
| Negotiable debt instruments held (excluding NCDs) | 4.5 | 1.1 | -1.5 |
| Asset quality | | | |
| As a percentage of total loans ⁸ | | | |
| Pass loans | 97.77 | 98.07 | 98.09 |
| Special mention loans | 1.44 | 1.31 | 1.31 |
| Classified loans ⁹ (gross) | 0.79 | 0.61 | 0.60 |
| Classified loans (net) ¹⁰ | 0.42 | 0.32 | 0.32 |
| Overdue > 3 months and rescheduled loans | 0.61 | 0.40 | 0.38 |
| Classified loan ratio (gross) of Mainland related lending ¹¹ | 0.84 | 0.62 | 0.64 |
| Liquidity ratios (consolidated) | | | |
| Liquidity Coverage Ratio — applicable to category 1 institutions (quarterly average) | 144.5 | 156.6 | 157.6 |
| Liquidity Maintenance Ratio — applicable to category 2 institutions (quarterly average) | 50.2 | 51.3 | 52.0 |
| Net Stable Funding Ratio — applicable to category 1 institutions | n.a. | 132.5 | 132.6 |
| Core Funding Ratio — applicable to category 2A institutions | n.a. | 127.3 | 130.5 |
| Retail banks | | | |
| Profitability | | | |
| Loan impairment charges as a percentage of average total assets (year-to-date annualised) | 0.06 | 0.02 | 0.03 |
| Net interest margin (year-to-date annualised) | 1.43 | 1.57 | 1.60 |
| Cost-to-income ratio (year-to-date) | 41.2 | 37.3 | 37.9 |
| Surveyed institutions | | | |
| Asset quality | | | |
| Delinquency ratio of residential mortgage loans | 0.02 | 0.02 | 0.02 |
| Credit card lending | | | |
| Delinquency ratio | 0.23 | 0.22 | 0.21 |
| Charge-off ratio — quarterly annualised | 1.95 | 1.65 | 1.64 |
| — year-to-date annualised | 1.91 | 1.60 | 1.59 |
| All locally incorporated AIs | | | |
| Capital adequacy (consolidated) | | | |
| Common Equity Tier 1 capital ratio | 15.1 | 15.3 | 15.8 |
| Tier 1 capital ratio | 16.1 | 16.8 | 17.6 |
| Total capital ratio | 18.7 | 19.4 | 20.2 |
| Leverage ratio | n.a. | 7.6 | 7.9 |

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.