

Developments in the Banking Sector

by the Banking Supervision Department

HIGHLIGHTS OF KEY TRENDS

Banking sector performance

Overview

- Despite the challenges posed by the COVID-19 pandemic and geopolitical tensions, the Hong Kong banking sector remained resilient, underpinned by robust capital and liquidity positions. As businesses of all sizes across different sectors were hit by the pandemic, banks' loan quality deteriorated modestly but it remained sound by historical and international standards. Retail banks recorded thinner profits alongside the low interest rate environment and the slight deterioration in loan quality. Looking forward, the highly uncertain pandemic and economic outlook could continue to weigh on banks' loan quality and profitability in the coming months.

while loans for use outside Hong Kong and trade finance declined by 0.4% and 3.6% respectively. The banking sector's Mainland-related lending increased modestly by 0.8% in the third quarter of 2020 to HK\$4,827 billion (16.6% of total assets) from HK\$4,790 billion (17.2% of total assets) in the previous quarter (Exhibit 6).

- Total deposits of the banking sector increased by 4.9% in the third quarter of 2020, partly driven by initial public offering (IPO) activities straddling the end of the quarter (Exhibit 7). Among the total, Hong Kong dollar deposits and US dollar deposits increased by 8.4% and 0.4% respectively. Excluding deposits created by the IPO loans, total deposits and Hong Kong dollar deposits would have increased by 2.2% and 3.0% respectively.

Profitability

- The aggregate pre-tax operating profit of retail banks fell by 26.1% in the first three quarters of 2020 compared with the same period last year. A drop in net interest income (-19.6%) and a surge in loan impairment charges (+83.1%) were the key drivers for the lower profitability (Exhibit 1). Retail banks' net interest margin narrowed to 1.24% in the first three quarters of 2020 from 1.64% in the same period of 2019 (Exhibit 2).

Loan quality, liquidity conditions and capital adequacy

- The pace of deterioration in the loan quality of the banking sector slowed in the third quarter of 2020. The classified loan ratio increased modestly to 0.84% at the end of September from 0.79% a quarter earlier. The asset quality of Mainland-related lending remained largely stable in the third quarter, with the classified loan ratio standing at 0.96% at end-September as compared with 0.94% at end-June 2020 (Exhibit 10). During the same period, the delinquency ratio of credit card lending decreased to 0.33% from 0.39%, while that of residential mortgage loans remained steady at 0.04% (Exhibit 13).

Balance sheet trends

- Total loans of the banking sector grew by 3.2% in the third quarter of 2020 (Exhibit 5). Among the total, loans for use in Hong Kong grew by 5.3%,

- The liquidity and capital positions of the banking sector remained sound in the third quarter of 2020, providing strong buffers against asset quality deterioration and, more broadly, the ongoing economic downturn. The average Liquidity Coverage Ratio (LCR) of category 1 institutions was 156.8% in the third quarter, well above the statutory minimum requirement of 100%. The average Liquidity Maintenance Ratio (LMR) of category 2 institutions was 55.9% during the same period, also well above the statutory minimum requirement of 25% (Exhibit 15). The total capital ratio of locally incorporated authorized institutions (AIs) stood at 20.3% at the end of September 2020, exceeding the international minimum requirement of 8% (Exhibit 17).

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 AIs¹ increased by 2.6% to HK\$5,833 billion at the end of September 2020 from HK\$5,683 billion a year ago (Exhibit 19).

The credit quality of these securities remained high, with over 96% of the debt securities holdings rated investment grade (Exhibit 20). Most of these securities were issued by sovereigns and banks (Exhibit 21).

- The total gross notional amount of outstanding derivatives contracts held by all AIs declined by 15.5% to HK\$119 trillion at the end of June 2020 from HK\$141 trillion a year earlier (Exhibit 22), in part due to reduced demand by corporate customers as the pandemic disrupted business activities. Over-the-counter (OTC) swap and forward contracts remained the majority of the contracts held, accounting for over 90% of the total notional amount of all outstanding derivatives contracts at the end of June 2020 (Exhibit 23), of which 98% were foreign exchange and interest rate contracts (Exhibit 24). The off-balance sheet securitisation exposures of AIs remained insignificant, with the aggregate amount of notional exposures totalling HK\$4.6 billion at the end of June 2020.

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

Profitability

Exhibit 1

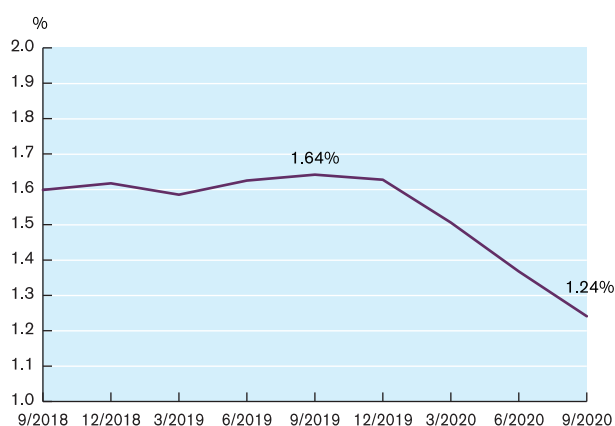
Pre-tax operating profit of retail banks' Hong Kong offices

Key items	Change of pre-tax operating profit Q1-Q3 2019 vs Q1-Q3 2020	
	Percentage change	Contribution to the percentage change in pre-tax operating profit (ppt)
Net interest income	-19.6%	-22.1
Loan impairment charges	+83.1%	-4.2
Total operating expenses	+3.5%	-2.2
Income from foreign exchange and derivatives operations	+36.8%	+3.5
Pre-tax operating profit	-26.1%	

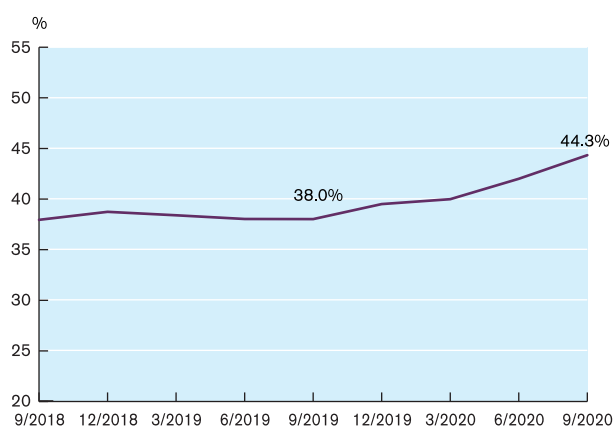
¹ This survey covers all licensed banks and restricted licence banks.

Exhibit 2

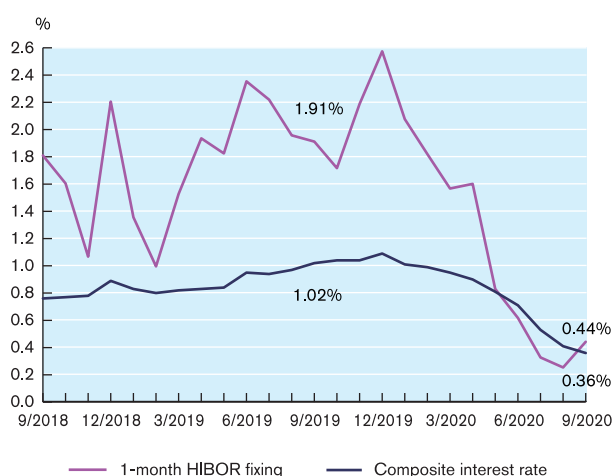
Net interest margin (year-to-date annualised) of retail banks narrowed in the first three quarters of 2020 compared with the same period last year

**Exhibit 4**

Cost-to-income ratio (year-to-date) of retail banks increased in the first three quarters of 2020 compared with the same period last year

**Exhibit 3**

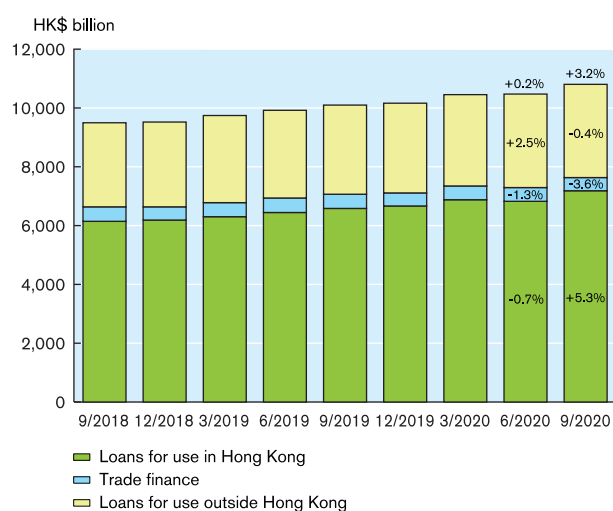
Hong Kong-dollar interbank interest rates and composite interest rate decreased to 0.44% and 0.36% respectively at end-September 2020 compared with a year ago

**Notes:**

1. HIBOR fixing (monthly average) refers to the Hong Kong Interbank Offered Rates released by the Hong Kong Association of Banks.
2. The composite interest rate is a weighted average interest rate of all Hong Kong-dollar interest-bearing liabilities of retail banks.
3. Since June 2019, the composite interest rate has been calculated based on the new local "Interest rate risk in the banking book" (IRRBB) framework. As such, the figures are not strictly comparable with those of previous months.

Loans and deposits**Exhibit 5**

Credit grew by 3.2% in the third quarter of 2020

**Notes:**

1. "Loans for use outside Hong Kong" include "others" (i.e. unallocated).
2. Percentage denotes quarter-on-quarter growth rate.

Within loans for use in Hong Kong, the percentage changes in the amount of credit extended to the key economic sectors in the third quarter of 2020 were:

Key items	Change of loans for use in Hong Kong in the third quarter of 2020	
	Percentage change	Contribution to the percentage change in loans for use in Hong Kong (ppt)
Stockbrokers	+296.5%	+3.6
Non-stockbroking companies and individuals for the purchase of shares	+133.8%	+1.8
Property lending (including residential mortgage loans and loans for property development and investment)	+0.6%	+0.3
Loans for use in Hong Kong	+5.3%	

Mainland-related lending

Exhibit 6

Mainland-related lending

	Jun 2020 HK\$bn	Sep 2020 HK\$bn
Mainland-related loans excluding trade finance	4,463	4,523
Trade finance	326	304
Total	4,790	4,827

Exhibit 7

Total loans increased at a slower rate than total deposits in the third quarter of 2020

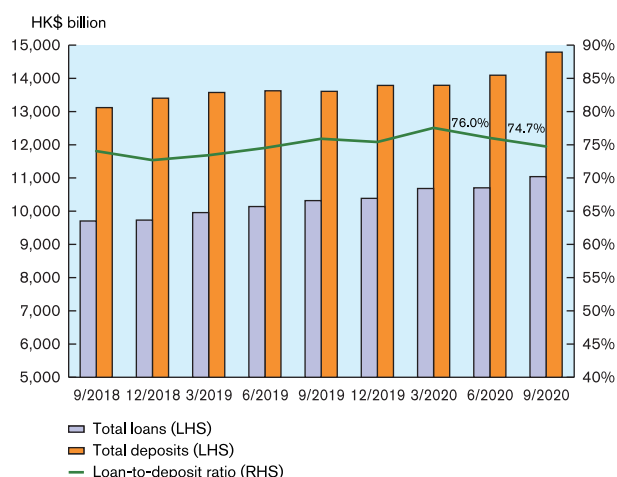


Exhibit 8

Hong Kong-dollar loan-to-deposit ratio decreased in the third quarter of 2020

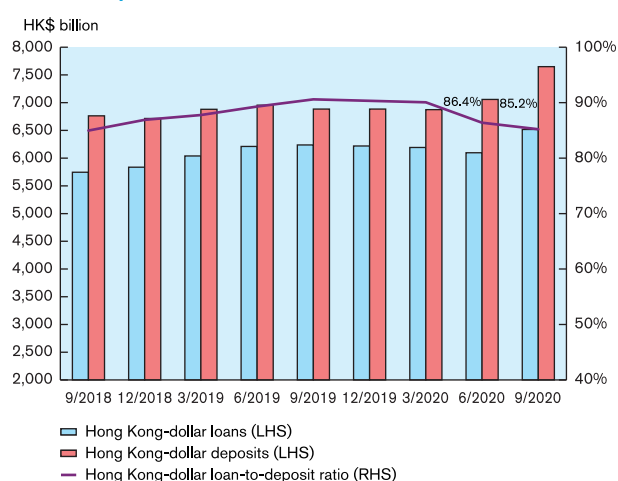
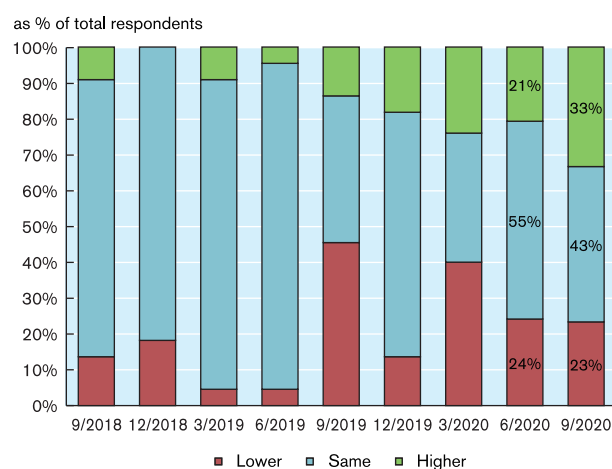


Exhibit 9

A higher share of respondents to the Hong Kong Monetary Authority Opinion Survey on Credit Conditions Outlook expected loan demand to strengthen in the next three months



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

Loan quality

Exhibit 10

Quality of loans and advances of the banking sector*

	Sep 2019	Dec 2019	Mar 2020	Jun 2020	Sep 2020
	% of total loans				
Special mention loans	1.32	1.33	1.59	1.74	1.74
Classified loans (gross)	0.56	0.57	0.62	0.79	0.84
of which:					
Substandard	0.19	0.22	0.20	0.30	0.34
Doubtful	0.28	0.30	0.37	0.45	0.45
Loss	0.09	0.04	0.04	0.05	0.05
Classified loans (net of specific provisions)	0.25	0.28	0.31	0.43	0.47
Overdue > 3 months and rescheduled loans	0.40	0.34	0.43	0.49	0.56
of which:					
Overdue > 3 months	0.37	0.32	0.40	0.46	0.53
Rescheduled loans	0.03	0.03	0.03	0.03	0.03
	% of Mainland-related lending				
Classified loans (gross) of Mainland-related lending**	0.71	0.75	0.73	0.94	0.96

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

* Unless otherwise stated, 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 2019	Dec 2019	Mar 2020	Jun 2020	Sep 2020
	% of total loans				
Special mention loans	1.16	1.27	1.60	1.67	1.61
Classified loans (gross)	0.52	0.48	0.55	0.71	0.75
of which:					
Substandard	0.19	0.19	0.18	0.29	0.34
Doubtful	0.28	0.27	0.32	0.37	0.37
Loss	0.05	0.03	0.04	0.04	0.04
Classified loans (net of specific provisions)	0.27	0.25	0.29	0.39	0.43
Overdue > 3 months and rescheduled loans	0.33	0.32	0.36	0.41	0.47
of which:					
Overdue > 3 months	0.30	0.28	0.32	0.37	0.43
Rescheduled loans	0.04	0.04	0.03	0.04	0.04
	% of Mainland-related lending				
Classified loans (gross) of Mainland-related lending**	0.86	0.79	0.74	0.87	0.92

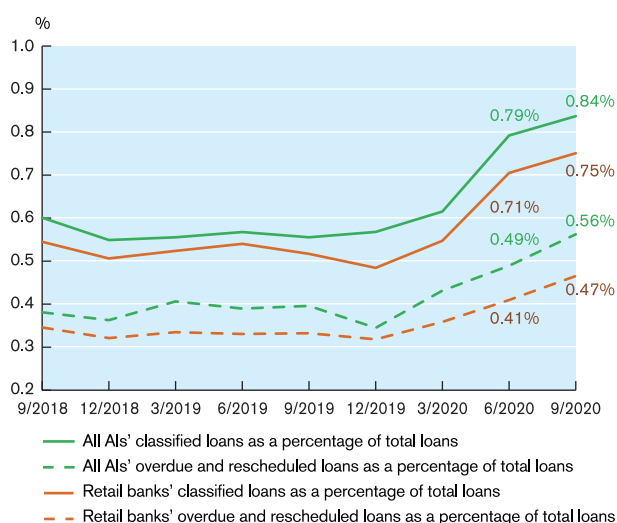
Note: Figures may not add up to total due to rounding.

* Unless otherwise stated, 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

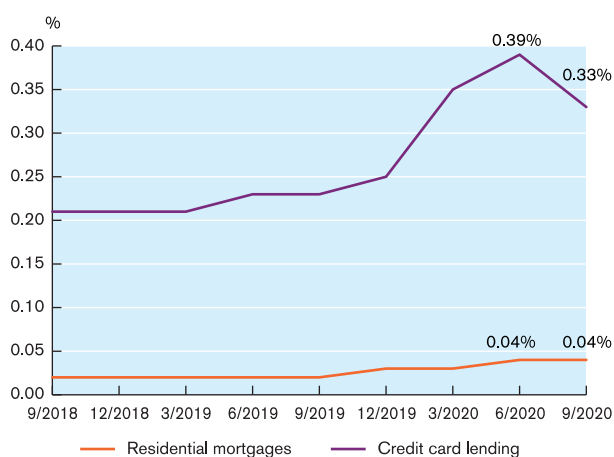
Classified loan ratios and overdue and rescheduled loan ratios deteriorated slightly in the third quarter of 2020



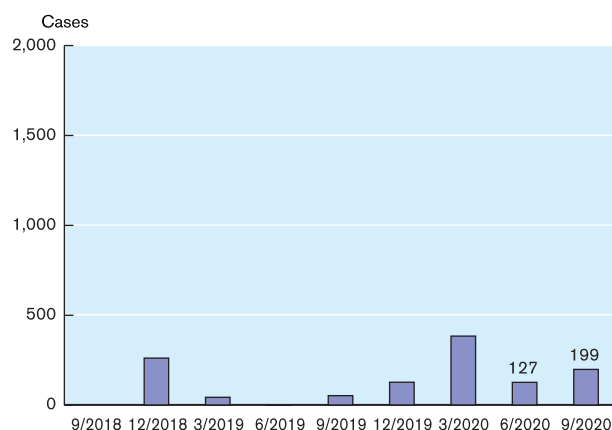
Note: Figures covered Hong Kong offices, overseas branches and major overseas subsidiaries.

Exhibit 13

Delinquency ratio of residential mortgages remained stable; delinquency ratio of credit card lending decreased

**Exhibit 14**

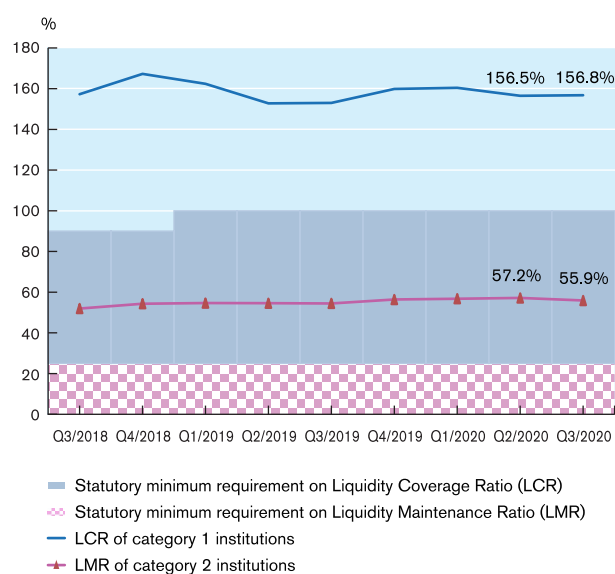
The number of negative equity cases increased to 199 at end-September 2020, mostly housing loans offered by banks to their employees and residential mortgage loans under the mortgage insurance programme



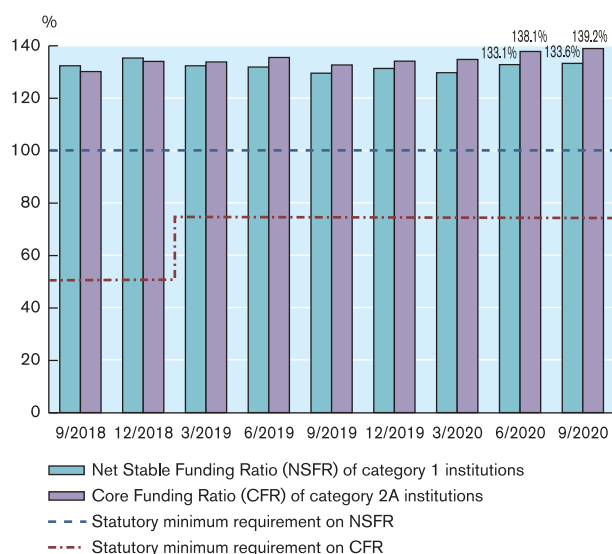
Liquidity conditions

Exhibit 15

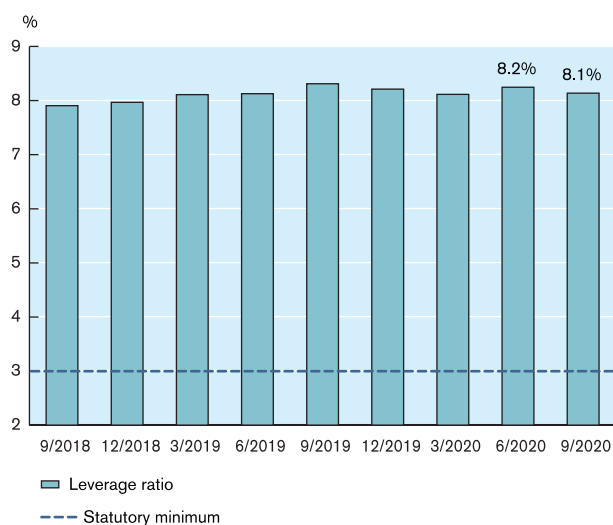
Liquidity positions remained sound



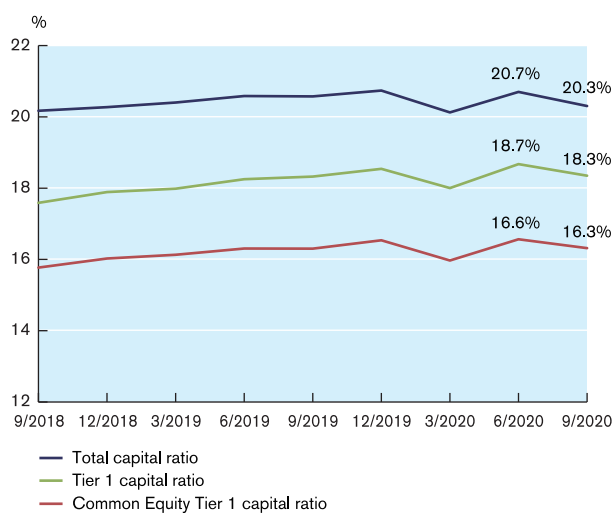
Note: For a category 1 institution, the statutory minimum requirement of the LCR applicable for 2019 onwards is 100%. A category 2 institution must maintain a LMR of not less than 25% on average in each calendar month.

Exhibit 16**Funding positions of AIs remained 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. The minimum CFR rose to 75% starting from 1 January 2019.

Exhibit 18**Leverage ratio stayed at a healthy level**

Note: Leverage ratio is defined as the ratio of Tier 1 capital to an exposure measure, where the exposure measure includes both on-balance sheet and off-balance sheet exposures. All locally incorporated AIs are required to maintain a leverage ratio of not less than 3%.

Capital adequacy**Exhibit 17****Capital positions of locally incorporated AIs continued to be 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 compared with a year ago

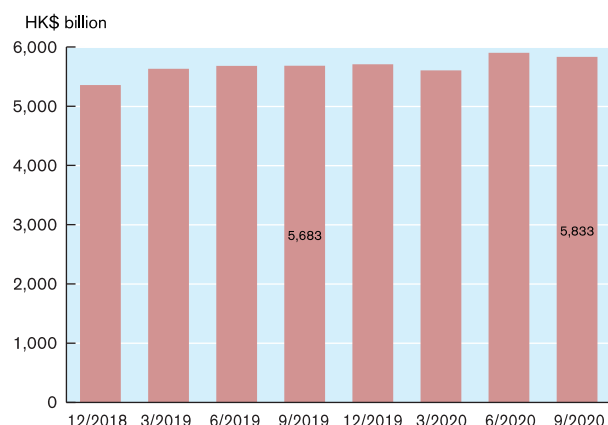


Exhibit 20

Debt securities held by surveyed AIs were predominantly investment grade securities

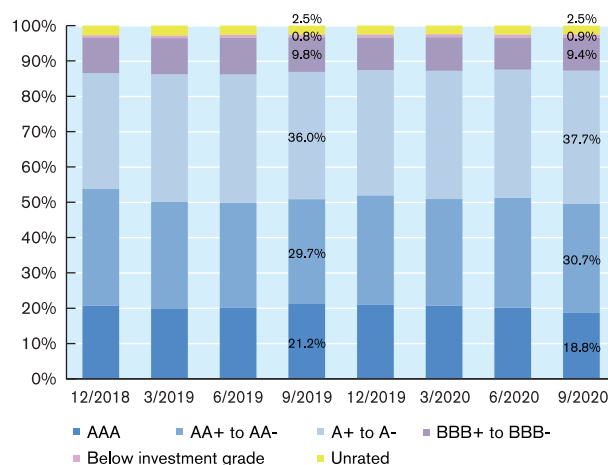


Exhibit 21

Most of the debt securities were issued by sovereigns and banks

(% of total)	All surveyed AIs							
Types of instrument and issuer	Dec 2018	Mar 2019	Jun 2019	Sep 2019	Dec 2019	Mar 2020	Jun 2020	Sep 2020
Part 1: Debt securities other than securitisation products³								
Sovereigns, of which:	49.4%	48.0%	47.3%	48.4%	49.6%	47.2%	48.0%	47.2%
Exchange Fund bills and notes	22.2%	20.4%	20.5%	20.9%	21.3%	21.4%	20.7%	20.1%
US Treasury bills, notes and bonds	9.8%	9.3%	9.2%	9.8%	9.3%	7.8%	7.4%	6.8%
Public sector entities	5.5%	5.6%	5.6%	5.8%	5.5%	5.6%	5.7%	5.8%
Banks	28.2%	28.8%	28.7%	26.9%	26.1%	27.0%	26.6%	27.0%
Corporates	10.2%	10.7%	11.1%	11.5%	11.5%	12.2%	12.5%	12.9%
Others	4.6%	4.7%	4.7%	4.9%	4.7%	5.2%	4.7%	5.0%
Part 2: Securitisation products								
Total securitisation products	2.1%	2.2%	2.7%	2.6%	2.6%	2.8%	2.5%	2.1%

² This section presents the results of the Survey on Debt Securities Held by 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 decreased

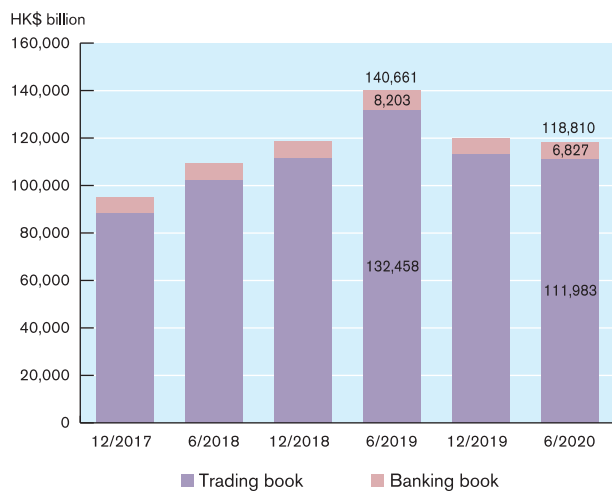


Exhibit 23

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

(% of total)	All AIs					
Derivatives product	Dec 2017	Jun 2018	Dec 2018	Jun 2019	Dec 2019	Jun 2020
Exchange-traded derivatives	2.0%	1.8%	1.5%	1.0%	0.7%	0.6%
OTC derivatives	98.0%	98.2%	98.5%	99.0%	99.3%	99.4%
of which:						
Forwards	28.6%	27.7%	26.0%	24.8%	25.1%	24.2%
Swaps	64.0%	64.1%	67.7%	69.0%	68.7%	68.5%
Options	3.6%	3.8%	3.0%	3.1%	2.9%	3.5%
Credit derivatives	0.8%	1.0%	0.9%	0.9%	0.7%	0.8%
Others	1.0%	1.7%	0.9%	1.3%	1.9%	2.4%

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.

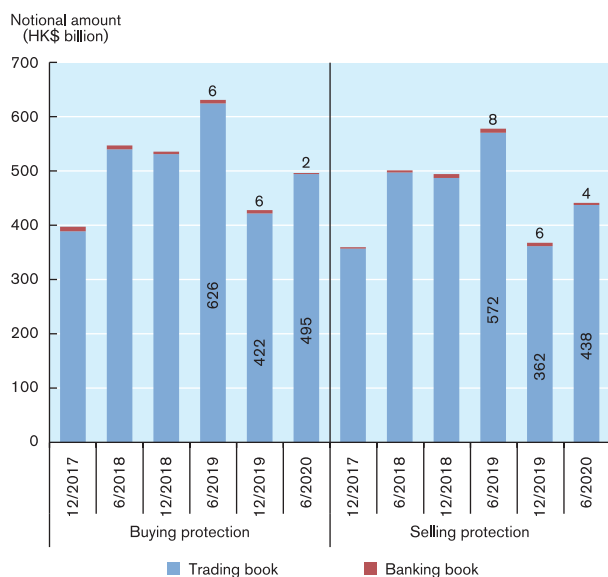
Exhibit 24

Derivatives contracts held were predominantly foreign exchange and interest rate contracts

(% of total)	All AIs					
Underlying risk	Dec 2017	Jun 2018	Dec 2018	Jun 2019	Dec 2019	Jun 2020
Interest rate risk	45.4%	43.8%	44.7%	49.1%	47.5%	47.4%
Foreign exchange risk	52.6%	54.2%	53.7%	49.2%	51.1%	50.9%
Equity risk	1.1%	0.9%	0.6%	0.7%	0.7%	0.8%
Commodity risk	0.1%	0.1%	0.0%	0.1%	0.0%	0.0%
Credit risk	0.8%	1.0%	0.9%	0.9%	0.7%	0.8%
Other risks	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%

Exhibit 25

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



APPENDIX

KEY PERFORMANCE INDICATORS OF THE BANKING SECTOR¹ (%)

	Sep 2019	Jun 2020	Sep 2020
Interest rates			
1-month HIBOR fixing ² (quarterly average)	2.03	1.02	0.34
3-month HIBOR fixing (quarterly average)	2.32	1.35	0.53
BLR ³ and 1-month HIBOR fixing spread (quarterly average)	3.10	3.98	4.66
BLR and 3-month HIBOR fixing spread (quarterly average)	2.81	3.65	4.47
Composite interest rate ⁴	1.02	0.71	0.36
Balance sheet developments⁵	All AIs		
Total deposits	-0.1	2.2	4.9
Hong Kong dollar	-1.0	2.7	8.4
Foreign currency	0.8	1.8	1.5
Total loans	1.7	0.2	3.2
Domestic lending ⁶	1.9	-0.8	4.7
Loans for use outside Hong Kong ⁷	1.4	2.5	-0.4
Negotiable instruments			
Negotiable certificates of deposit (NCDs) issued	-5.7	-0.7	-0.1
Negotiable debt instruments held (excluding NCDs)	1.2	5.2	0.1
Asset quality			
As a percentage of total loans ⁸			
Pass loans	98.13	97.47	97.42
Special mention loans	1.32	1.74	1.74
Classified loans ⁹ (gross)	0.56	0.79	0.84
Classified loans (net) ¹⁰	0.25	0.43	0.47
Overdue > 3 months and rescheduled loans	0.40	0.49	0.56
Classified loan ratio (gross) of Mainland related lending ¹¹	0.71	0.94	0.96
Liquidity ratios (consolidated)			
Liquidity Coverage Ratio — applicable to category 1 institutions (quarterly average)	153.0	156.5	156.8
Liquidity Maintenance Ratio — applicable to category 2 institutions (quarterly average)	54.5	57.2	55.9
Net Stable Funding Ratio — applicable to category 1 institutions	129.9	133.1	133.6
Core Funding Ratio — applicable to category 2A institutions	132.9	138.1	139.2
Profitability	Retail banks		
Loan impairment charges as a percentage of average total assets (year-to-date annualised)	0.06	0.13	0.11
Net interest margin (year-to-date annualised)	1.64	1.37	1.24
Cost-to-income ratio (year-to-date)	38.0	42.0	44.3
Asset quality	Surveyed institutions		
Delinquency ratio of residential mortgage loans	0.02	0.04	0.04
Credit card lending			
Delinquency ratio	0.23	0.39	0.33
Charge-off ratio — quarterly annualised	1.76	2.82	2.53
— year-to-date annualised	1.58	2.18	2.28
Capital adequacy (consolidated)	All locally incorporated AIs		
Common Equity Tier 1 capital ratio	16.3	16.6	16.3
Tier 1 capital ratio	18.3	18.7	18.3
Total capital ratio	20.6	20.7	20.3
Leverage ratio	8.3	8.2	8.1

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-rate-sensitive liabilities, which include deposits from customers, amounts due to banks, negotiable certificates of deposit and other debt instruments, and all other liabilities that do not involve any formal payment of interest but the values of which are sensitive to interest rate movements (such as 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.