

## DEVELOPMENTS IN THE BANKING SECTOR

Despite the February cut in the best lending rate, average interest rate spreads continued to widen during the March quarter. This resulted in a further increase in the net interest margin. Net interest income was further boosted by faster growth in residential mortgage lending, although growth in other types of lending remained subdued. HK dollar deposits rose at a healthy pace.

### Interest rate movements

Tracking the trend of the US interest rates, domestic interest rates continued to decline in the first three months of 1996. However, the Hong Kong dollar yield curve steepened with HIBOR decreasing further at the short end. Following the decision of the Federal Reserve to cut interest rates by 25 bp, the Hong Kong Association of Banks lowered the savings rate by 25 bp to 3.75% on 5 February. In line with this, the best lending rate declined from 8.75% to 8.50%. During the March quarter, the average 1-month HIBOR rate also fell 52 bp to 5.29% while the 1-month time deposit rate fell 55 bp to 4.67%. The equivalent 12 month figures decreased by 39 bp to 5.67% and 51 bp to 5.02% respectively.

With average funding costs decreasing faster than the best lending rate, authorised institutions enjoyed a further widening in interest rate spreads. The average spread between the best lending rate

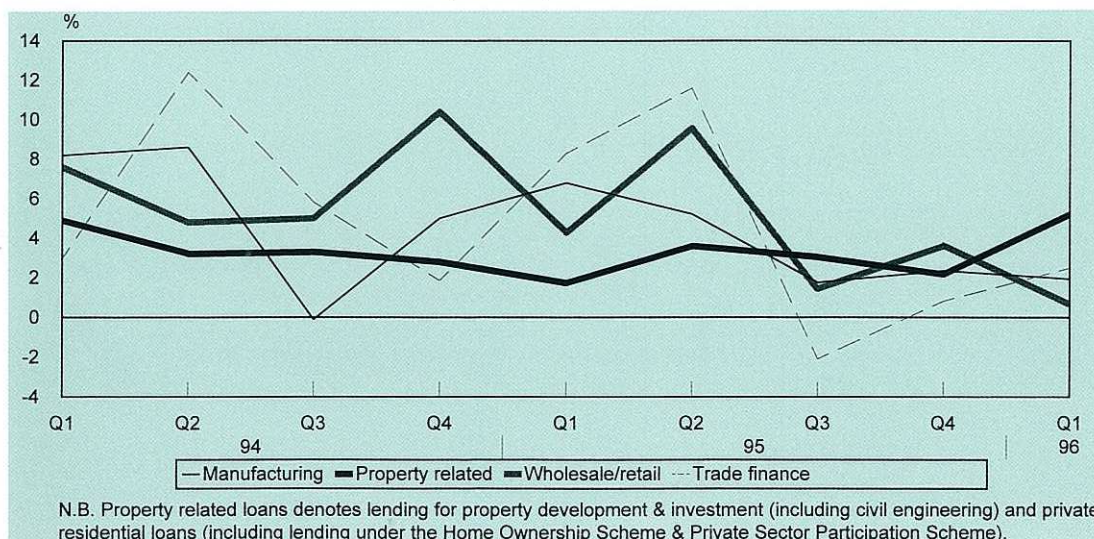
and the 1-month time deposits rate widened from 3.76% in the December quarter to 3.92% in the March quarter. The corresponding spread between the best lending rate and HIBOR also improved from 3.17% to 3.30%. As a result, the net interest margin of local banks increased from 2.49% in 1995 to 2.61% (annualised). This improvement occurred despite increased competition in the residential mortgage market as evidenced by an effective reduction of 1 percentage point in the standard mortgage rate for new loans. So far the fall in lending rates has not had a material impact on banks' profitability.

### Balance sheet development

#### Customer deposits

Despite the further softening of interest rates, the growth of total customer deposits remained relatively robust at 2.9% in the March quarter of 1996, following 2.1% growth in the

Chart I  
Loans for use in Hong Kong by selected sectors  
quarterly % change



December quarter of 1995. A higher growth rate for HK dollar deposits (adjusted to include foreign currency swap deposits) of 3.8% was recorded in the March quarter (compared with the 2.0% in the December quarter). This reflected strong growth of 6.4% in savings deposits (compared with 4.1% in the December quarter), reflecting a narrowing of the interest rate differential with time deposits and possibly an increased preference for transaction balances as the stock and property markets improved. While HK dollar time deposits also rose quite rapidly, the increase of 3.2% was below the average quarterly pace of 4.7% seen in 1995. Demand deposits rose by only 0.5% compared with 3.2% in the previous quarter. Within the quarter, both savings and demand deposits were affected by a number of seasonal factors such as the Lunar holidays and receipts of annual bonuses. However, these effects had unwound by the end of the quarter.

Growth in foreign currency deposits declined over the quarter from 2.2% to 1.8% as funds switched into HK dollar deposits and reflecting the depreciation of major currencies against the Hong Kong dollar. However, the impact of these two factors was partly offset by a notable increase in Yen time deposits placed with Japanese banks by their offshore subsidiaries. This in turn appears to have enabled some banks to reduce the need to go into the interbank market to raise funds.

### Negotiable instruments

The market in negotiable certificates of deposit (NCDs) continued to expand during the quarter although at a more modest rate. The total amount of NCDs issued and outstanding increased by 6.7% to reach \$141 bn as at the end of March. While this was higher than the previous quarter's growth rate of 6.0%, it was nevertheless relatively modest compared with the average growth rates seen during the past two years. The preference for floating rate instruments remained; such issues accounted for 60% of new issues in the quarter.

Total holdings of NCDs by authorised institutions increased by 5.4% during the quarter, taking the amount held by the banking sector to over 50% of the total as of end-March. Holdings of other negotiable debt instruments by authorised institutions increased by 1.9%.

### Lending

Total loans and advances fell by 1.0% in the March quarter (compared with an increase of 0.3% in the December quarter and a fall of 3.3% in the September quarter of 1995) reflecting a significant decline of 4.3% in offshore lending. The latter was caused by the combined effect of the further depreciation of yen against the Hong Kong dollar and a fall in Euroyen activities during the quarter. This appears to indicate some scaling back by some Japanese banks of their involvement in the interbank and offshore markets. In contrast, loans for use in Hong Kong picked up, growing by 3.4% against 0.5% in the previous quarter. Trade finance also recovered, with growth of 2.5% (compared with 0.8%).

The growth in domestic lending was supported by the continued revival in the property market. With HK dollar deposits continuing to grow at a healthy rate and with the demand for other types of loans relatively subdued, authorised institutions have been competing more aggressively for new mortgage business. At the same time, end-user demand for residential properties has revived. Reflecting these factors, residential mortgage loans (excluding those under the Home Ownership Scheme and Private Sector Participation Scheme) grew by 4.6% in the March quarter of 1996 (compared with 3.4% and 3.7% in the December and September quarters of 1995 respectively). Apart from the effective reduction in the standard mortgage rate already referred to, the marketing campaigns launched by institutions so far include options that allow borrowers to defer a portion of their regular monthly instalments during the initial period of the loan; bridging loans to enable borrowers to purchase a new property pending sale of the existing residence; and the provision of other "fringe" benefits such as the waiving of the fire insurance premium during the first year. So far these initiatives have represented healthy competition, though authorised institutions will also need to take into account the longer term effects on their financial position of an over-aggressive "price war". It is also essential that prudential lending criteria – including particularly the maximum loan to value ratio and debt service ratio – are not allowed to slip under competitive pressure.

Table I:  
HK Dollar Deposit Mix

Amount (HK\$ bn)

	Deposits				
	Demand	Savings	Time*	Swap	Time @
Mar/95	103.4	263.8	615.4	71.2	686.5
% growth	3.3	-4.0	14.5	-31.4	7.0
Jun/95	99.7	278.9	666.6	63.0	729.6
% growth	-3.6	5.7	8.3	-11.5	6.3
Sep/95	97.2	288.8	705.4	56.9	762.4
% growth	-2.5	3.5	5.8	-9.6	4.5
Dec/95	100.3	300.7	720.8	49.8	770.6
% growth	3.2	4.1	2.2	-12.5	1.1
Mar/96	100.8	320.0	750.2	44.9	795.1
% growth	0.5	6.4	4.1	-9.8	3.2

Note: % growth denotes the quarter-on-quarter growth of the deposits  
\* excludes swap deposits  
@ includes swap deposits

Lending for property development and investment (excluding civil engineering) rebounded by 6.6% during the quarter following a small decline in the December quarter. As a result, total property lending as a proportion of loans for use in Hong Kong increased from 39.1% in the previous quarter to 39.9%.

Growth in other lending for use in Hong Kong remained relatively modest, growing by 2.0% in the March quarter compared with 3.2% in the previous quarter. In particular, growth in the lending to manufacturing (1.9%), the wholesale & retail sector (0.7%), financial concerns (1.0%) and credit card balances (0.8%) all slowed. However, with the sustained stock market recovery, share financing loans rose by 10.0% during the quarter.

#### Loan to deposit ratio

As the growth in HK dollar loans exceeded the increase in HK dollar deposits, the Hong Kong dollar loan-to-deposit ratio for the banking sector as a whole increased slightly from 105.6% at end-1995 to 105.9% at end-March. For the locally

incorporated banks, the ratio increased from 70.2% at end-1995 to 71.3% at end-March.

#### Profitability

The sector has made a solid start to 1996 with strong growth in net interest income on the back of the widening of margins discussed above. However, the level of provisions for bad and doubtful debts increased over the quarter. For locally incorporated banks such provisions, expressed as a percentage of total assets, rose from 0.08% in 1995 to 0.16% (annualised) in the March quarter of 1996. Such an increase would be expected in view of the financial strains on some corporate borrowers caused by the credit squeeze in China, slower retail sales in Hong Kong and the delayed impact of the higher interest rates in 1994/95. While the asset quality of banks in Hong Kong remains high by international standards, some further deterioration is likely to occur during the rest of this year. Banks will therefore need to step up their credit monitoring in order to detect problem loans at an early stage. ❁

— prepared by the Banking Policy Department