Hong Kong listed banks' 2005 results

June 2006

FINANCIAL SERVICES

The 12 banks[1] listed in Hong Kong reported good results for 2005 on the back of the continuing expansion in the local market and a robust growth in the global economy. The listed banks achieved solid bottom-line profit growth, with average net profit after tax increasing by 6.6% year-on-year, while overall operating profit before tax recorded growth of 8.2%.

A broad-based economic expansion and the return of consumer and business optimism have created generally benign credit conditions for the banks. Thanks to the revival in economic activity, the sustained recovery in property prices and brighter employment prospects, the asset quality of the banks continued to improve considerably, with the balance of non-performing loans (NPLs) decreasing further by a significant 32.9% and the average NPL ratio coming down by 60 basis points to 1.0%. As a result, the banks had only HK$587 million in loan impairment allowance charges, despite an 8.9% expansion in total loan books.

Ample liquidity forced the banks to continue to operate in a generally highly competitive market, with net interest margins remaining under considerable pressure, albeit with some recovery. However, rising interest rates and the pick up in demand for loans led to a 9.4% increase in net interest income compared with a 2.6% decrease over the same period last year. Aided by reasonable performances in wealth management and treasury activities, non-interest income continued to rise by 10.9% in comparison with 22.72% one year earlier. Furthermore, due to increasing competition for skilled staff and huge competitive business pressures from within and outside the banking sector, most of the listed banks saw a greater rise in operating expenses than in total operating income, resulting in the average cost-income ratio rising by 0.8 percentage points to 42.1%.

In addition, a number of the banks also benefited from gains on the disposal of long-term investments and the effects of the newly implemented Hong Kong Financial Reporting Standard (HKFRS) on investment properties, which led to higher property revaluation profits.

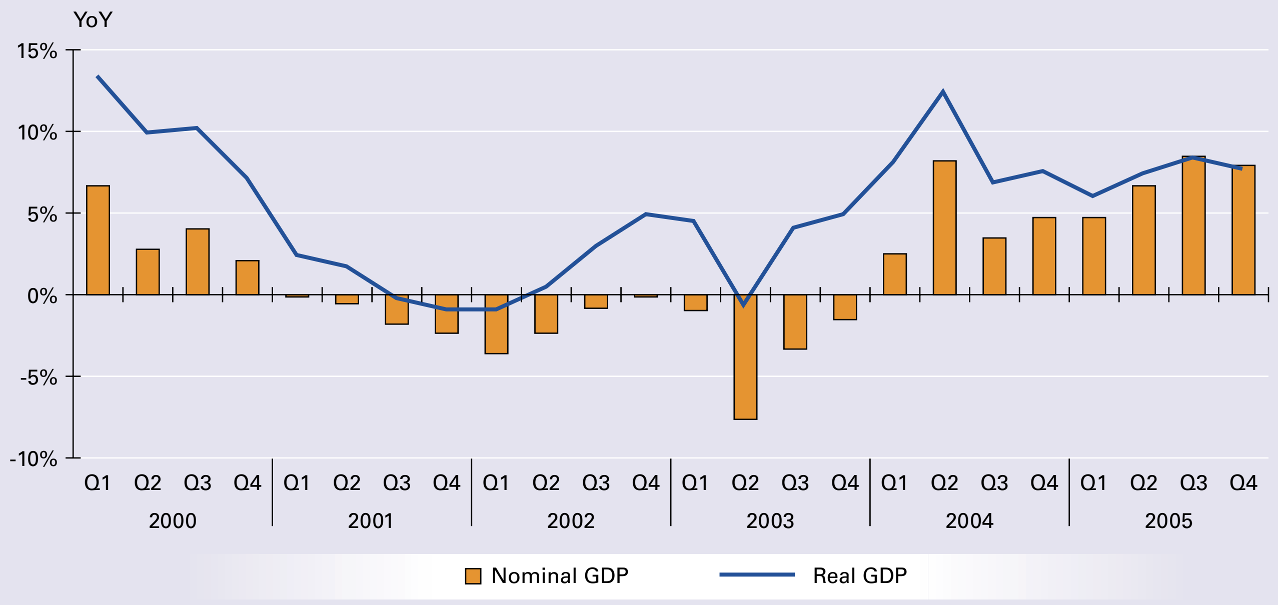
1 The 12 banks included in our analysis are: Bank of China Hong Kong (Holdings), The Bank of East Asia, CITIC International Financial Holdings, Dah Sing Banking Group, Fubon Bank (Hong Kong), Hang Seng Bank, The Hong Kong and Shanghai Banking Corporation, ICBC (Asia), Liu Chong Hing Bank, Standard Chartered Bank (Hong Kong) Limited, Wing Hang Bank and Wing Lung Bank. China Construction Bank and Bank of Communications, despite being listed in Hong Kong, have a relatively small operation in the territory, therefore, we have not included them in our analysis.

AUDIT ▪ TAX ▪ ADVISORY

Economic environment

Despite rising global energy prices and interest rates in the US and Hong Kong, the Hong Kong economy continued to register a brisk pace of growth in the second half of 2005, with the real and nominal GDP growth rates for the year as a whole rising by 7.3% and 7.0% respectively, following the strong growth of 8.6% and 4.7% recorded in 2004. The robust and broad-based economic growth in 2005 was supported by a number of favourable domestic as well as external factors, including steady economic growth in Hong Kong's major trading partners, especially mainland China, as well as a strengthening labour market and reviving domestic demand.

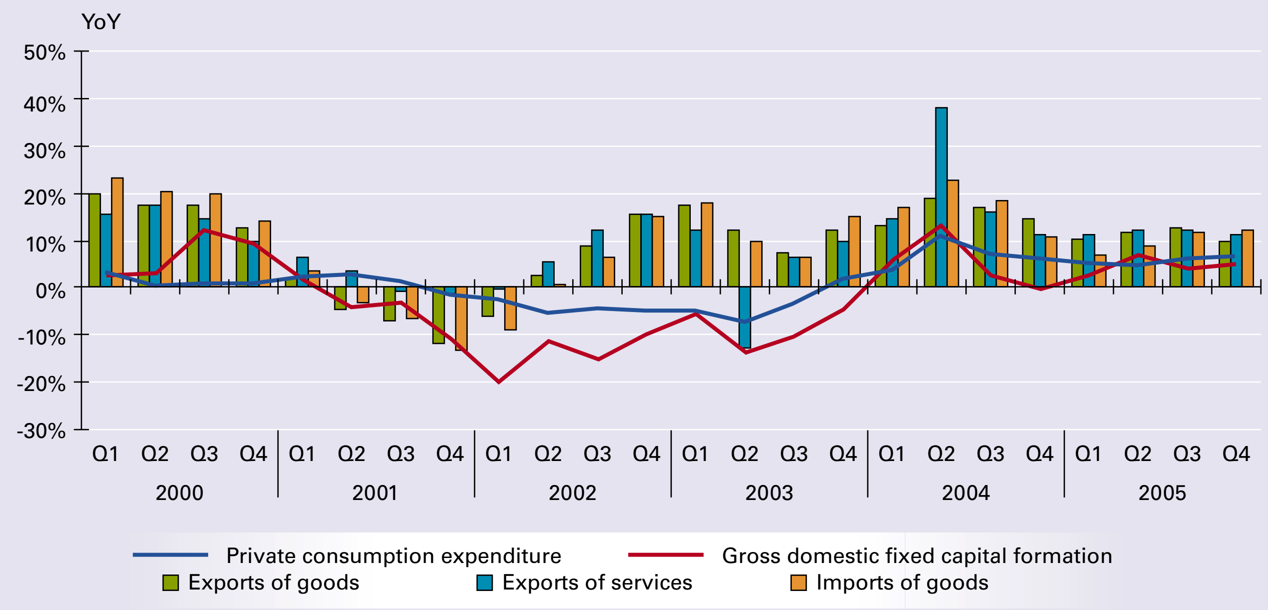
Chart 1: The economy continued its steady growth ...



Source: Census and Statistics Department

On the external front, the export of goods and services continued to be one of the main growth engines for the economy. Sustained expansion of the global economy and associated strong trade flows, particularly those emanating from the mainland, continued to benefit Hong Kong's external sectors, which saw imports and exports of goods rising by 10.1% and 11.1% respectively. In addition, a continuing influx of tourists, particularly mainland tourists, and strong external trade flows pushed up exports of services by 12.5%, compared with the 18.5% increase in 2004.

Chart 2: ... driven by strong domestic as well as external factors

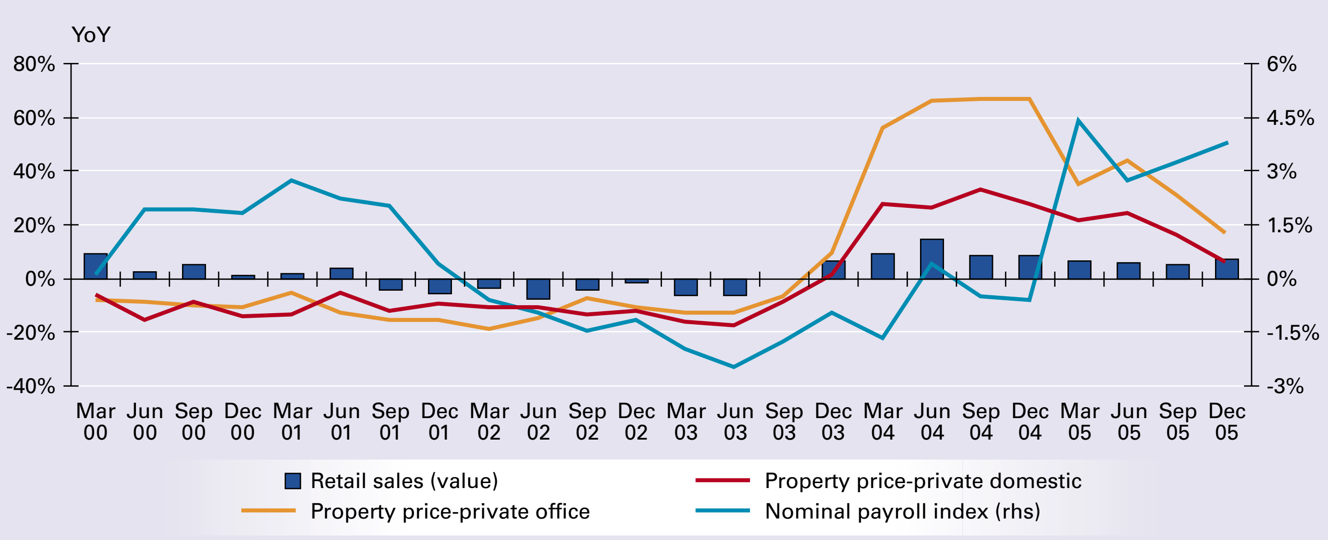


Source: Census and Statistics Department

On the domestic front, following the strong rise in the first half of the year, the property markets in Hong Kong entered into a slower but seemingly more sustainable pace of growth in the second half amid uncertainty related to interest rate increases. For the year as a whole, domestic private property prices grew by 17.9% compared with a 26.6% rise in 2004. Private office property prices rose by 33.9% year-on-year in 2005 compared with a 58.9% surge 12 months ago. The unemployment rate stood at four-year low of 5.3% in the fourth quarter of the year. After a long period of decreases since 2002, employee payroll reverted to growth in 2005 with an increase of 3.7% in the fourth quarter of 2005.

The recovery in property prices, together with salary increases, created a strong wealth effect and encouraged domestic consumption. Consequently, retail sales grew by 6.8% and 5.9% year-on-year in value and volume terms respectively. Private consumption expenditure rose by 4.8% in 2005, compared with 6.7% a year earlier. In addition, return of business optimism and a pick-up in activity stimulated a 5.1% increase in gross domestic fixed capital formation. Strong domestic demand from the household and business sectors became another driving force for growth.

Chart 3: Rising asset prices and salaries stimulated consumer spending

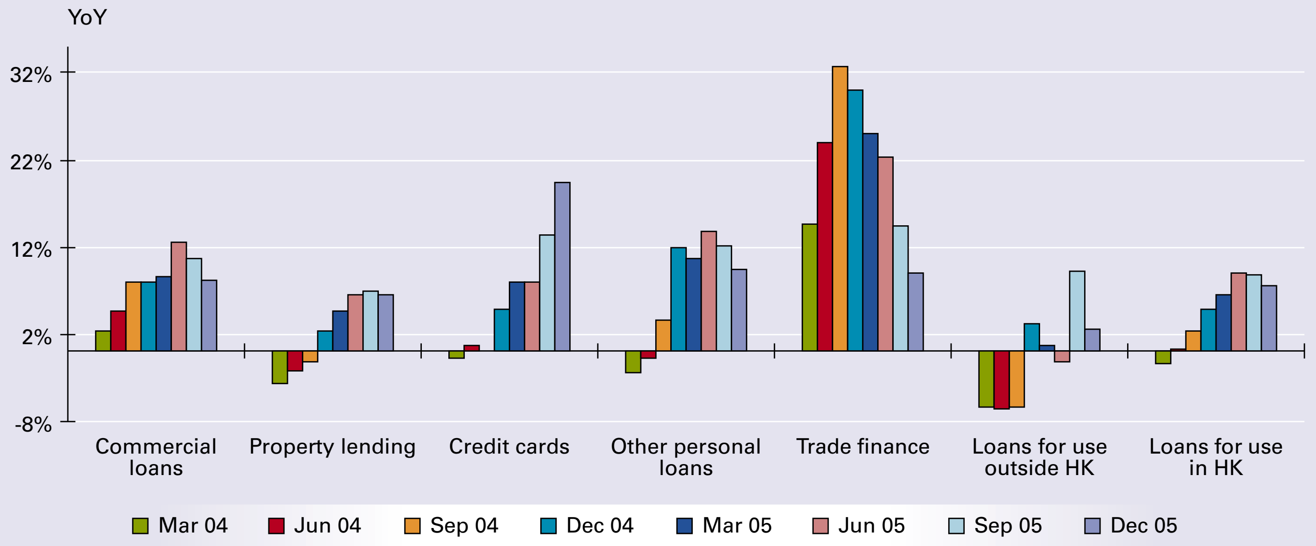


Source: Census and Statistics Department, Rating and Valuation Department

Banking environment

Banks continued to operate in a very benign market environment throughout the year such that the sector as a whole recorded another year of broad-based loan growth, although at a slightly slower pace in the second half of the year. Total loans in the banking sector increased by 7.2% year-on-year at the end of 2005 compared with an 8.7% increase at the end of June 2005 and 5.9% increase 12 months earlier. Of these, total loans for use in Hong Kong grew by 7.7% and loans for use outside Hong Kong rose by 2.4%. The two core segments of the banking sector's portfolios — commercial loans (accounting for 31% of total loan portfolios) and property lending (accounting for 45% of total loan portfolios) trended up strongly by 8.1% and 6.6% year-on-year respectively, compared with 7.9% and 2.3% respectively at the end of 2004. Stimulated by the sustained property market upturn, loans for property developments and investments grew by 18.6% year-on-year in comparison to 8.2% at the end of 2004, and the decline in mortgage loans slowed to 0.6% compared with a decrease of 0.9% in 2004. Other personal loans (ex-credit cards), which had recorded negative growth since the third quarter of 1998, recorded six straight quarters of growth to 9.3% in 2005 on the back of wealth effects and returning consumer confidence. Trade financing also maintained strong growth, thanks to the growing cross-border trade between Hong Kong and the rest of the world, particularly the mainland market, although it remained too small in size to have a significant effect on the overall portfolio trend.

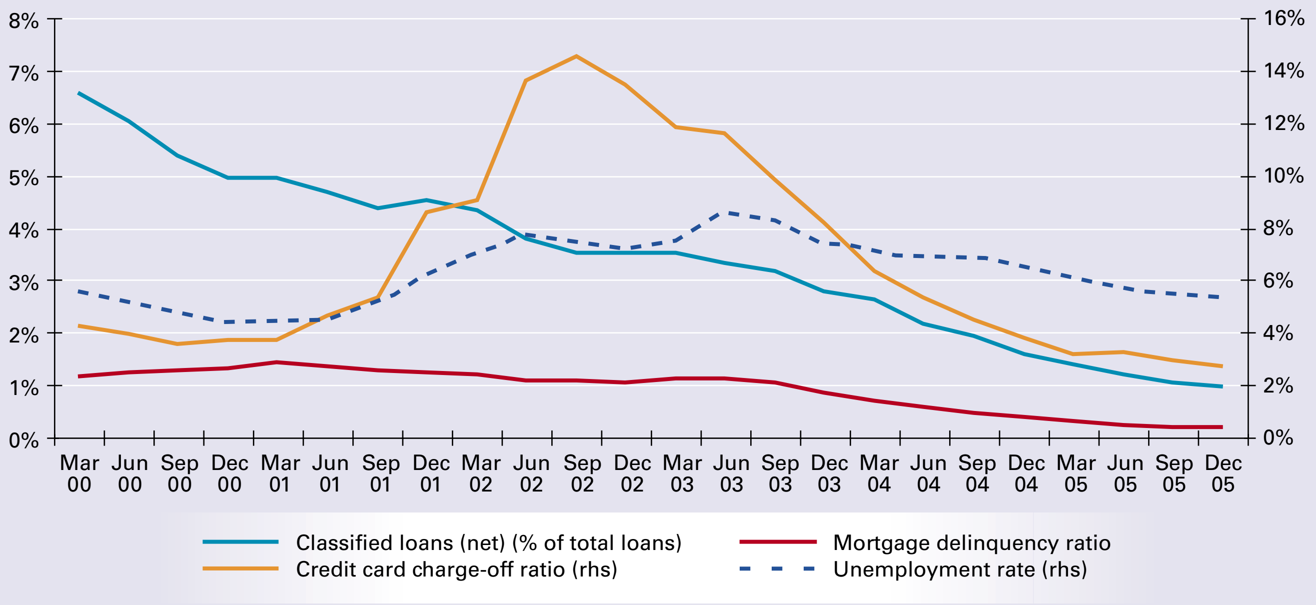
Chart 4: Broad based loan expansion, though at a slightly slower pace in 2H 2005



Source: Hong Kong Monetary Authority

Despite expanding loan books, asset quality was well maintained on the back of the recovery in property prices, and improved employment and salary prospects. The mortgage delinquency ratio decreased to 0.19% in the fourth quarter of 2005, one of the lowest in the past six to seven years. The credit card charge-off ratio continued to drop to 2.72%, the lowest in the past five years. In addition, net classified loans as a percentage of total loans decreased to an unsustainably low level of below 1% at the end of 2005, the lowest level since 1997. Furthermore, the rise in the property markets also helped to reduce negative equity mortgage loans as a percentage of total mortgage loans to 4% by the end of 2005, from 6% one year earlier.

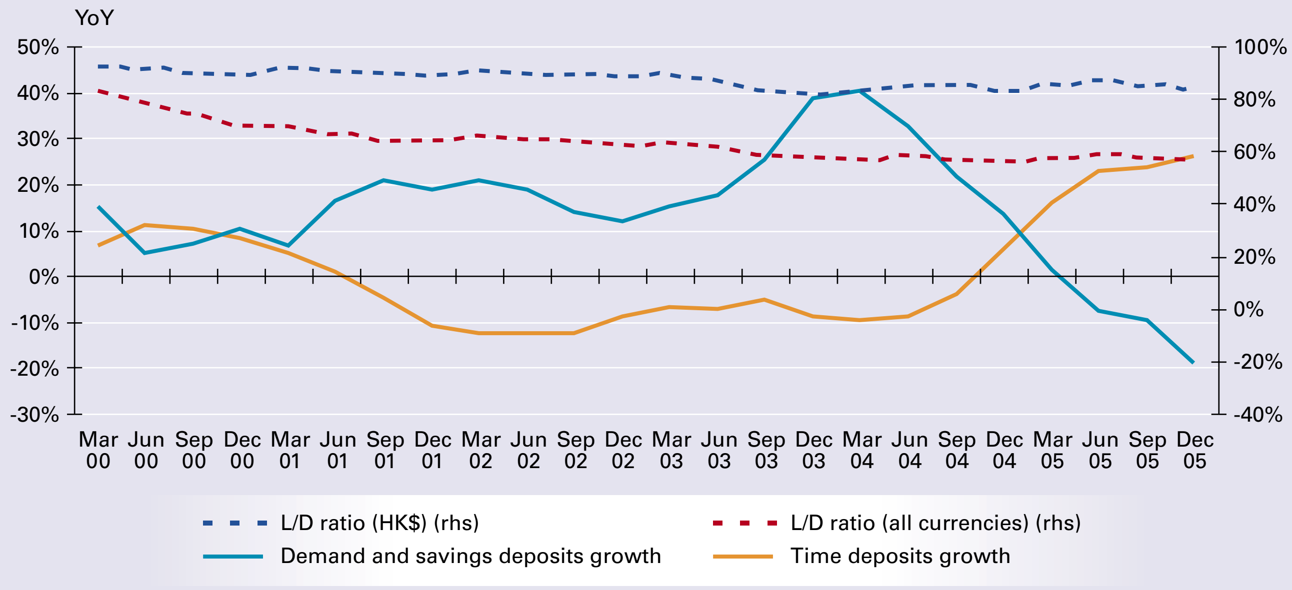
Chart 5: Classified loan ratio is now at an unsustainably low level



Source: Hong Kong Monetary Authority, Census and Statistics Department

On the liabilities side, strong and volatile capital inflows seen in 2004 subsided somewhat in 2005 due to the fading market speculation of a substantial renminbi revaluation and the implementation of the refinements to the currency board system by the Hong Kong Monetary Authority in May 2005. As a result, inter-bank liquidity gradually came down to more normal levels in 2005, though remaining high by historical standards. Total customer deposits in the banking sector continued to grow steadily by 5.2% year-on-year by the end of 2005, compared with 8.4% one year earlier. Of these, time deposits continued to regain favour amid rising interest rates, and grew by 25.9% at the end of 2005, reversing more than three years of decline, while demand and savings deposits shrank by 19.1% year-on-year, decreasing for three consecutive quarters and ending more than six years of growth. As a result, for the sector as a whole, the loan-to-deposit ratio for all currencies rose slightly to 56.8% from 55.8% a year earlier and the ratio for Hong Kong dollars increased to 84.3% from 82.6% in 2004.

Chart 6: Time deposits continued to regain favour amid interest rate rises

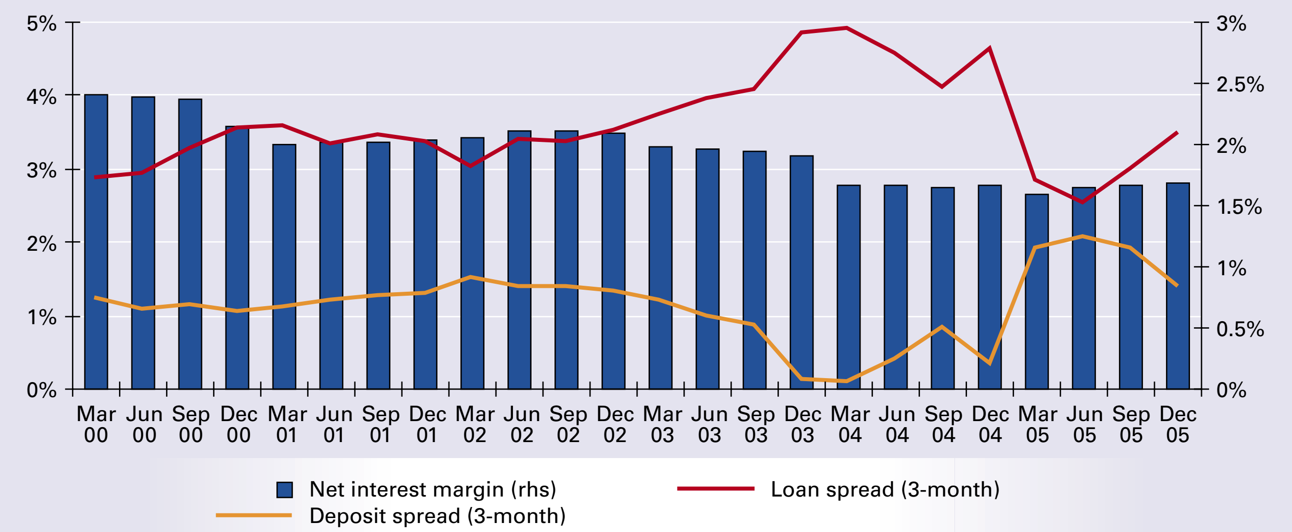


Source: Hong Kong Monetary Authority

Pick-up in loan demand, a slow down in capital inflows and pressure to realign Hong Kong dollar rates with US dollar rates led to general rises in interest rates. During 2005, banks raised prime rates eight times, compared with one brief increase in the previous year, pushing up monthly average prime rates to 7.64% in December 2005 from 5% 12 months earlier. The interest rate spread between the US dollar and Hong Kong dollar narrowed sharply. The three-month average HIBOR and average deposit rates increased to 4.15% and 2.78% respectively in December 2005, compared with 0.37% and 0.03% respectively in the previous year. Consequently, there was a moderate pick-up in total spread of 12 basis points between the first and fourth quarters of the year. The net interest margin for the sector as a whole improved to 1.68% in the fourth quarter from 1.59% in the first quarter of the year and 1.66% one year earlier. A modest return of inflation to 1.0% in 2005 from deflation of 0.4% in 2004 led to only a small offsetting effect on the real prime rate, which rose to 6.3% (monthly average) in December 2005 from 4.8% a year earlier. The rise in the real interest rate would have had only a small impact on loan demand.

In addition to significant upward movements in prime rates, a pickup in loan demand and rising funding costs have encouraged banks to raise mortgage rates significantly so that the percentage of residential mortgage loans being priced at 2.5% or more below prime rate decreased dramatically to 5.9% by the end of the year from 87.2% at the end of 2004. However, the increase in prices at the end of the year has not had a significant effect on 2005 results.

Chart 7: Net interest margin improved in 2H of the year



Source: Hong Kong Monetary Authority

Listed banks' performance

This section analyses the performance of Hong Kong's 12 listed banks in 2005 compared with 2004.

This is the first time that the banks have reported their results under the revised Hong Kong Financial Reporting Standards (HKFRS) which are now more or less fully aligned with International Financial Reporting Standards (IFRS).

Table 1: Reported results for the year ended 31 December 2005

HK$ millions		Net interest income	Non-interest income#	Total operating income#	Operating expenses	Operating profit before impairment charges	Loan impairment charges	Other items	Profit before tax	Net profit after tax	YoY growth in net profit after tax
BOC Hong Kong (Holdings)	BOCHK	12,874	4,926	17,800	5,730	12,070	-2,645	1,653	16,368	13,658	12.7%
The Bank of East Asia	BEA	3,760	2,165	5,925	2,988	2,937	141	417	3,213	2,786	17.5%
CITIC International Financial Hldgs	CIFH	1,099	870	1,969	1,095	874	-58	284	1,216	1,103	22.0%
Dah Sing Banking Group	DSBG	1,333	699	2,032	925	1,107	131	182	1,159	981	-12.5%
Fubon Bank (Hong Kong)	FBHK	504	309	813	603	210	-25	39	274	241	-19.7%
Hang Seng Bank	HSB	11,068	5,622	16,690	4,546	12,144	618	1,832	13,358	11,563	-0.1%
The Hong Kong and Shanghai Banking Corp.	HSBC	41,799	31,926	73,725	31,814	41,911	2,068	5,406	45,249	37,198	1.8%
ICBC (Asia)	ICBC	1,316	783	2,099	890	1,209	6	5	1,208	981	29.1%
Liu Chong Hing Bank	LCH	753	265	1,018	493	525	68	13	470	398	10.6%
Standard Chartered Bank (HK) Ltd	SCB	7,285	3,652	10,937	4,638	6,299	827	0	5,472	4,541	22.8%
Wing Hang Bank	WHB	1,729	883	2,612	976	1,636	54	34	1,616	1,351	15.7%
Wing Lung Bank	WLB	1,135	571	1,706	576	1,130	20	196	1,306	1,109	7.5%
TOTAL *		**73,587**	**47,049**	**120,636**	**50,728**	**69,908**	**587**	**8,229**	**77,550**	**64,348**	**6.6%**
TOTAL excl. HSBC **		**42,856**	**20,745**	**63,601**	**23,460**	**40,141**	**-863**	**4,655**	**45,659**	**38,713**	**9.3%**
TOTAL excl. BOCHK & HSBC**		**29,982**	**15,819**	**45,801**	**17,730**	**28,071**	**1,782**	**3,002**	**29,291**	**25,055**	**7.6%**

*: As HSBC's consolidated accounts include Hang Seng Bank's results, Hang Seng Bank has been deducted from this total to avoid double-counting.

**: Hang Seng Bank is included in this total.

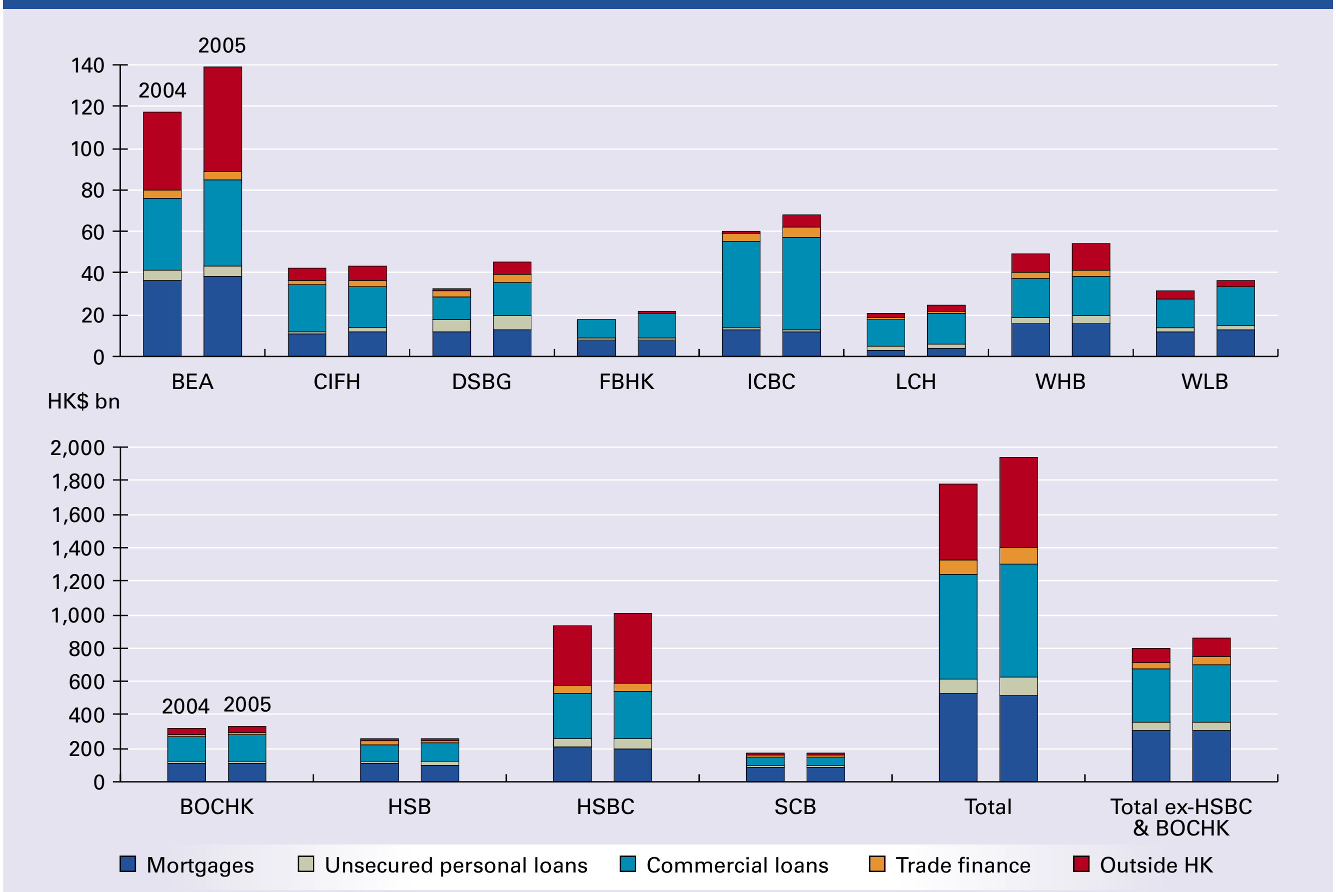
#: "Non-interest income" and "Total operating income" shown here may not equal the figures disclosed in annual reports as we added back certain items to "non-interest income", which were originally excluded in the reported operating profits. Items we have reclassified and included in non-interest income are net gain or loss on disposal of various securities, impairment allowance/losses written back on held-to-maturity securities, impairment losses on non-trading securities, reversal of impairment losses on held-to-maturity securities, impairment losses on available-for-sale securities.

Source: Listed banks' financial disclosure

Balance sheet developments

Overall, the listed banks reported an average 7% and 8.9% growth in their balance sheets and loan books, respectively, compared with the growth of 1.5% and 7.2% for the sector as a whole. Commercial loans, a core segment of the banks' Hong Kong business grew by 7.8%, similar to 2004, while mortgage loans, another core lending segment, decreased by 1%, compared with a rise of 0.9% a year earlier. Loans for use outside Hong Kong grew by 20.6% in 2005, compared with a 22.7% increase in 2004. Though accounting for a relatively small proportion of total loans, high-yielding consumer loans and credit card advances, underpinned by strong revival of consumer confidence, recorded increases of 15.6% and 18.6% year-on-year, in comparison to increases of 7.9% and 7% in 2004.

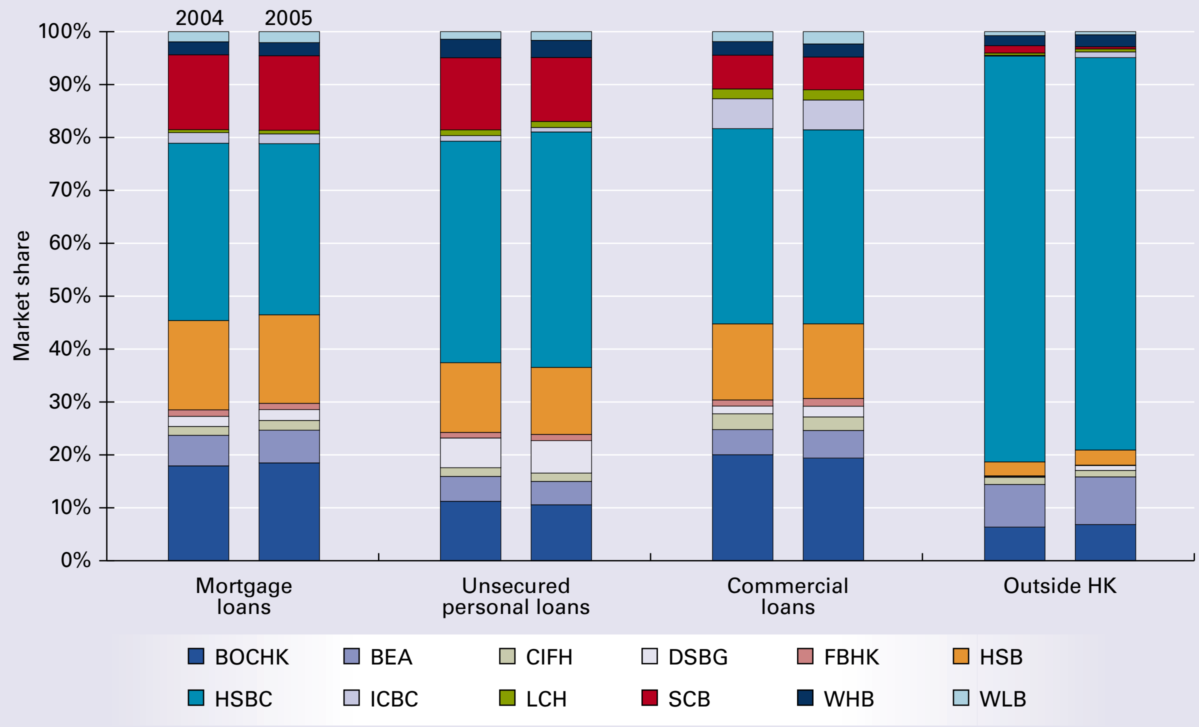
Chart 8: Significant structure difference in loan portfolios among the banks



Source: Listed banks' financial disclosure

With regard to portfolio composition, mortgages as a percentage of total loans decreased to 27% from 29% in 2004, while loans for use outside Hong Kong increased by 3 percentage points to 28%, and the share of unsecured personal loans (including credit cards) rose to 6% from 5% a year earlier. The proportions of commercial loans and trade financing in total loan portfolios remained flat at 35% and 5% respectively at the end of 2005. Excluding the largest bank, HSBC, the share of mortgage loans and commercial loans rose to 35% and 42% respectively, while the share of loans for use outside Hong Kong fell to 12%, reflecting rather different portfolio structures and market focuses across the banks, and strong dominance of the larger banks in business outside Hong Kong.

Chart 9: Domestic markets saw intense competition



Source: Listed banks' financial disclosure

The deployment of increased customer deposits, which rose by 2.1% (up by 5.3% ex-HSBC and BOCHK) and the shifting of funds from inter-bank placings to higher yielding debt securities led to an overall strong increase in investments in securities of 13%, compared with 7.1% in 2004. Overall, investments in securities accounted for 26% of total assets, rising by 2 percentage points from a year earlier. Excluding HSBC and BOCHK, the proportion of securities to total assets stood at 15%.

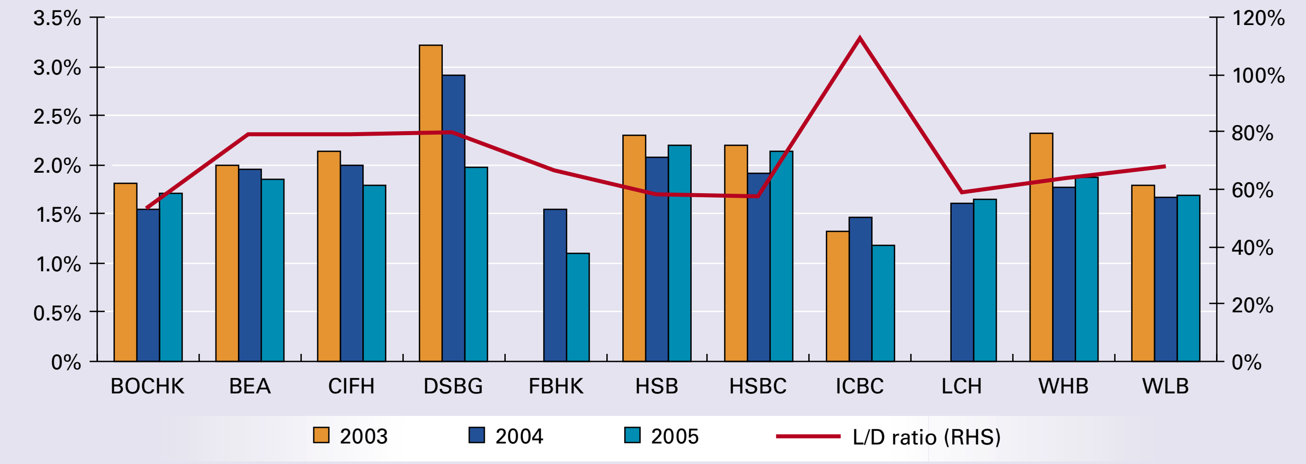
Amid the rise in interest rates, time deposits continued to reverse the declining trend seen previously and recorded a significant 24.4% increase in 2005, compared with a decrease of 6.6% in demand and savings deposits. Excluding HSBC, the banks reported a 33.1% increase in time deposits and a 24.4% decrease in demand and savings deposits, reflecting the difficulties which smaller banks had in attracting cheap customer funds as time deposits are mostly HIBOR linked.
The significant variations in the composition of deposits among the banks led them to weathering the impacts of the interest rate rises quite differently as we will see in the next section. For the listed banks as a whole, time deposits accounted for 31.8% of total customer deposits, while the ratio increased to 58.2% if excluding HSBC.

Profitability

Thanks to strong and positive domestic and external factors, the listed banks had good, though somewhat variable, bottom-line results in 2005, with net profit after tax growing by 6.6%, compared with an increase of 32.8% one year earlier, due partly to a low comparison base for 2004. Excluding the two largest banks, HSBC and BOCHK, the growth in net profit after tax stood at 7.6%.

The pick-up in loan demand and rising interest rates helped the banks to achieve an overall 9.4% increase in net interest income, compared with a 2.6% decrease reported in 2004. Excluding HSBC and BOCHK, the listed banks achieved only a 3% increase in net interest income, reflecting the fact that rising interest rates, particularly prime rates and HIBOR, benefited large, core-deposit funded banks at the cost of smaller ones. Furthermore, the overall net interest margin situation remained challenging. Of 11 listed banks which disclosed information, six saw their net interest margin higher than 12 months earlier, but all of them remained below 2003 levels. Given the fact that HIBOR rose faster than customer deposit rates and prime rates in 2005, and time-deposits are largely HIBOR-linked, it is not surprising to see the larger and core-deposit funded banks having done better than their smaller rivals, which had to rely on the inter-bank market for much of their funding. Hence, funding structure continued to be one of the key factors affecting banks' financial performance.

Chart 10: Core-deposit funded banks managed better recovery in net interest margin

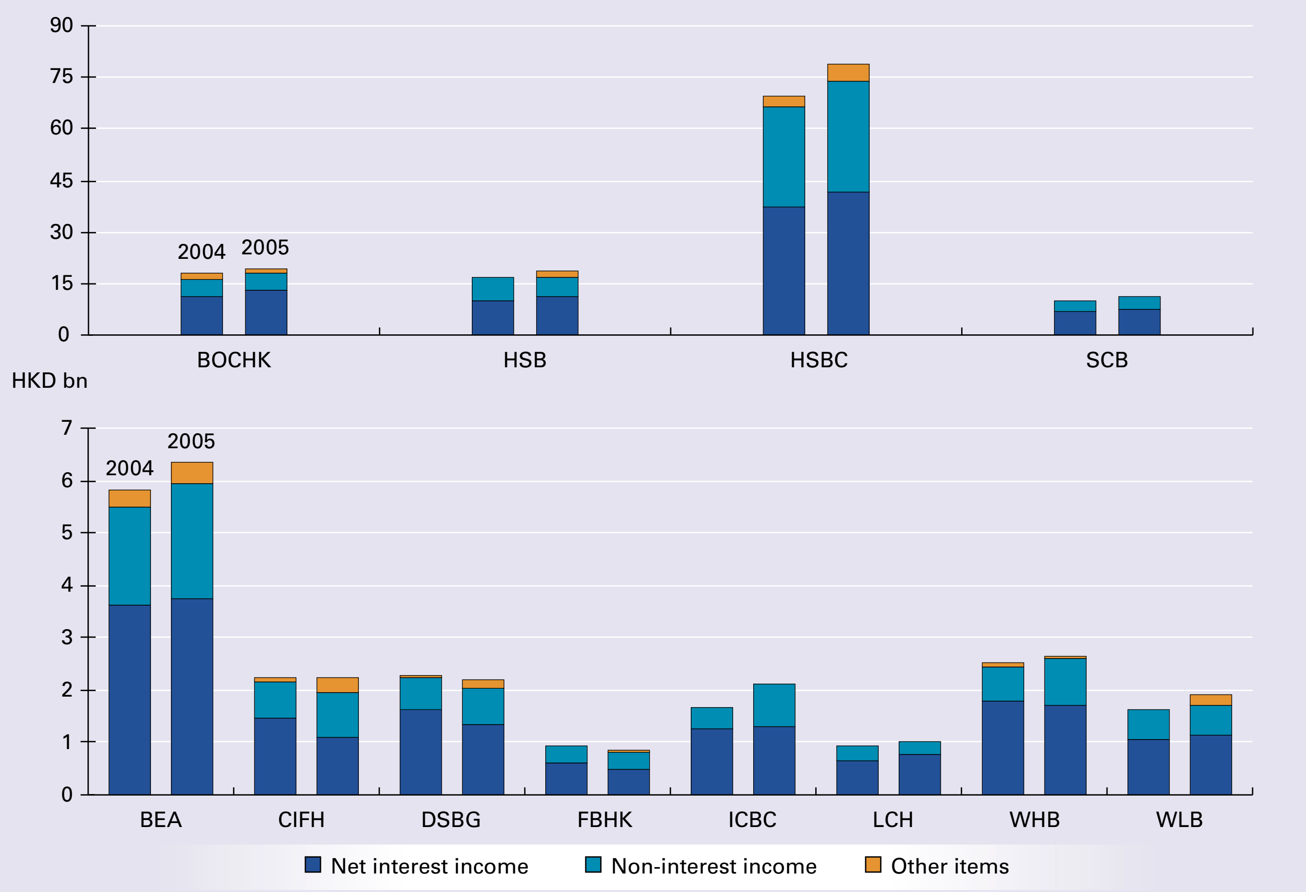


Source: Listed banks' financial disclosure

As seen in the last few years, banks have been proactively exploring alternative sources of income to make up for the decreasing contribution from traditional lending business. However, rising interest rates, changes in investors' risk-return preferences, and severe market competition led to a significant slow-down in non-interest income, which rose by 10.9% in 2005, compared with the 22.7% increase reported in 2004. Excluding HSBC, the growth rate was 5.6%. As a percentage of total operating income, non-interest income remained flat at 39.0%.

Overall, the recovery in net interest income and the slower growth of non-interest income resulted in 10.0% growth in total operating income, compared with the 5.8% rise in 2004. However, not all of the banks are as well placed to take advantage of the market pick-up, as total operating income was up only by a more modest 3.9%, if HSBC and BOCHK are excluded, with three of the listed banks actually recording shrinking total operating income.

Chart 11: Strong growth in net interest income compensated the slower growth in non-interest income

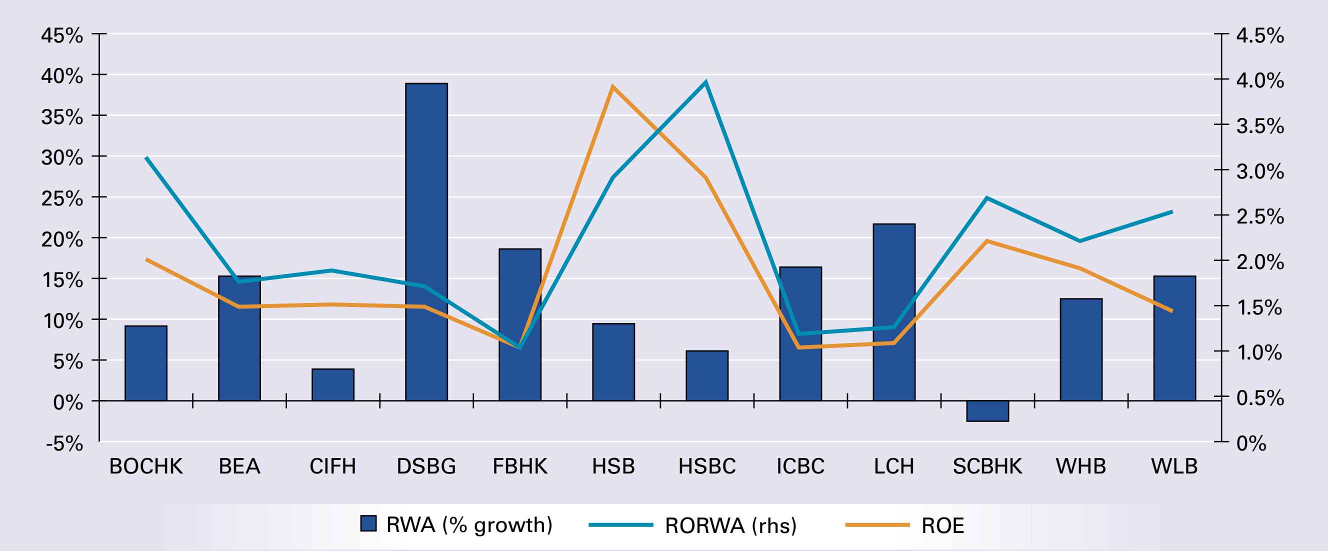


Source: Listed banks' financial disclosure

Further analysis of non-interest income shows considerable variation between the various components. Based on disclosed information, net fee and commission income (the core components, accounting for 57% of non-interest income) increased by 8.6%. Income from treasury dealing activities[2] (accounting for 31% of non-interest income) was up by 18.7%. Insurance activities (accounting for 7% of non-interest income) only grew by 1.6%. Of net fee and commission income, income from securities and asset management and insurance businesses rose by 11% and 15.9%, respectively, while income from bills and loans commissions was down by 9%. On the other hand, fee income from credit card business increased by 20.9%. Among the listed banks, large banks generally appeared to have done better in terms of fee and commission income. Excluding HSBC, total net fee and commission income decreased by 2.1%.

Furthermore, revenue generation capability, measured by the ratio of total operating income to total assets, has been under pressure in the past couple of years and showed large variations among the banks, with the highest ratio standing at 3.24% while the lowest was only 1.63%. The average ratio stood at 2.6%, 10 basis points higher than that in 2004. Excluding HSBC and BOCHK, the average ratio was 2.7%, 10 basis points lower than that in 2004. The results also highlighted the increasingly polarised market with a wide range of operating incomes and returns on assets being achieved. Notably, eight out of 12 banks showed lower ratios, demonstrating major pressure and inability of some banks to increase non-funds income as quickly as assets. This is also a symptom of excess liquidity being channelled into non-core, lower-yielding assets.

Chart 12: Banks focusing on non-interest income achieved better return



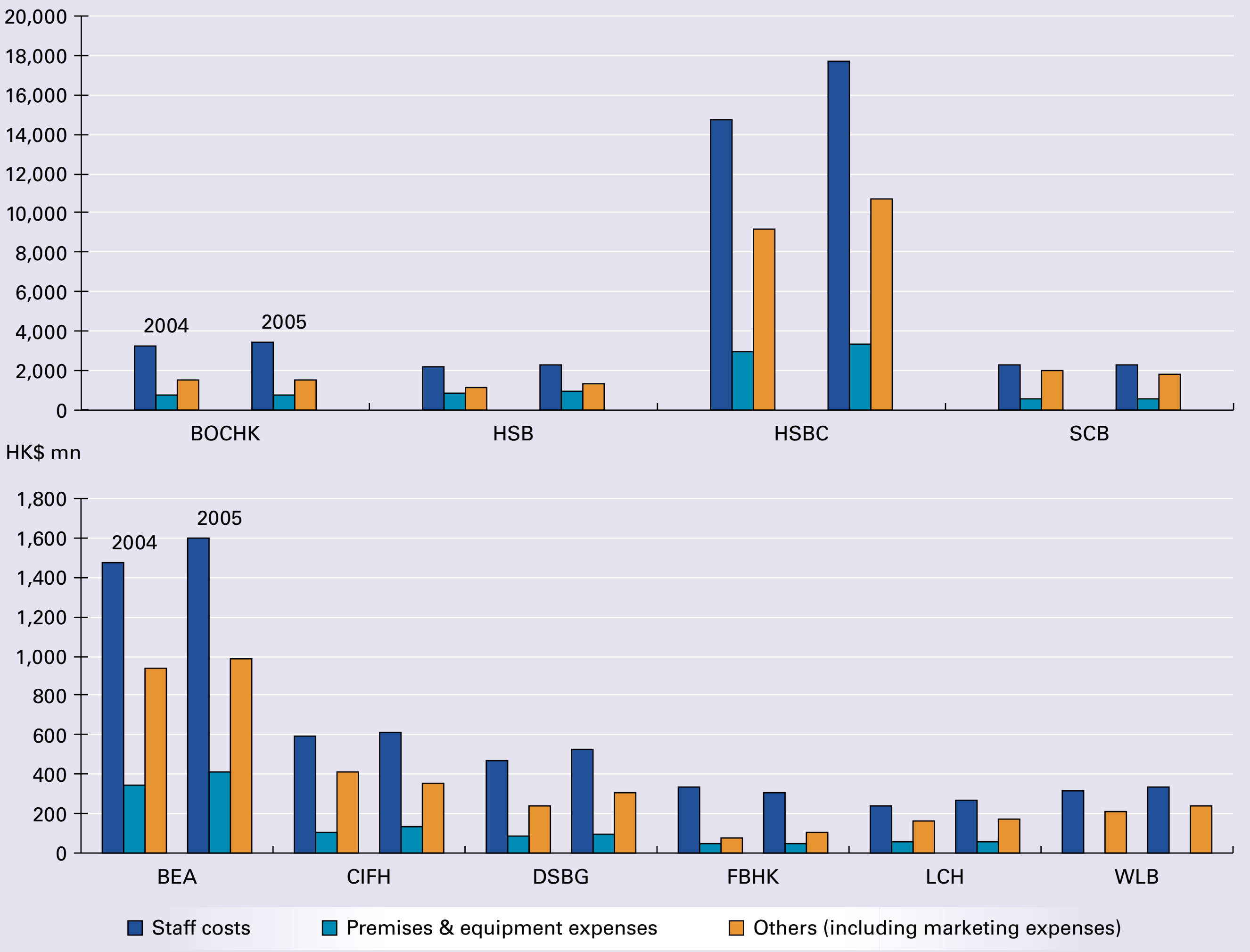
Source: Listed banks' financial disclosure

Another negative trend in the past 12 months was the continued rise in costs as overall operating expenses increased by 11.9%, compared with a 10.1% increase in 2004, and this outpaced the rise in total operating income. Only three banks managed to reduce their operating expenses. The rise in operating expenses is attributable to the significant increase in staff costs, technology expenses, and marketing expenses associated with business expansion and a tight labour market. It is also due to significant compliance related expenditure for projects including the new financial reporting standards and Basel II implementation. As a result, the average cost-income ratio increased by 0.8 percentage points year-on-year to 42.1%. With banks continuing to compete for experienced staff, we would expect continued pressure on staff related costs, and Basel II implementation is still to come.

As a result, operating profit before provisions increased by a modest 8.6%. Excluding HSBC and BOCHK, profits before provisions grew by only 4.2%. For four of the listed banks, the combined impact of squeezed interest margins, a tougher environment for wealth management, and higher operating expenses resulted in lower profits before provisions in 2005. Modest growth in operating profit before provisions in some of the banks demonstrates the challenges faced by some banks in income generation and cost control.

2 Income from treasury dealing activities includes net gains from investments in securities, net gains from foreign exchange activities, and net gains from other dealing activities.

Chart 13: Staff costs and marketing costs both trended up significantly

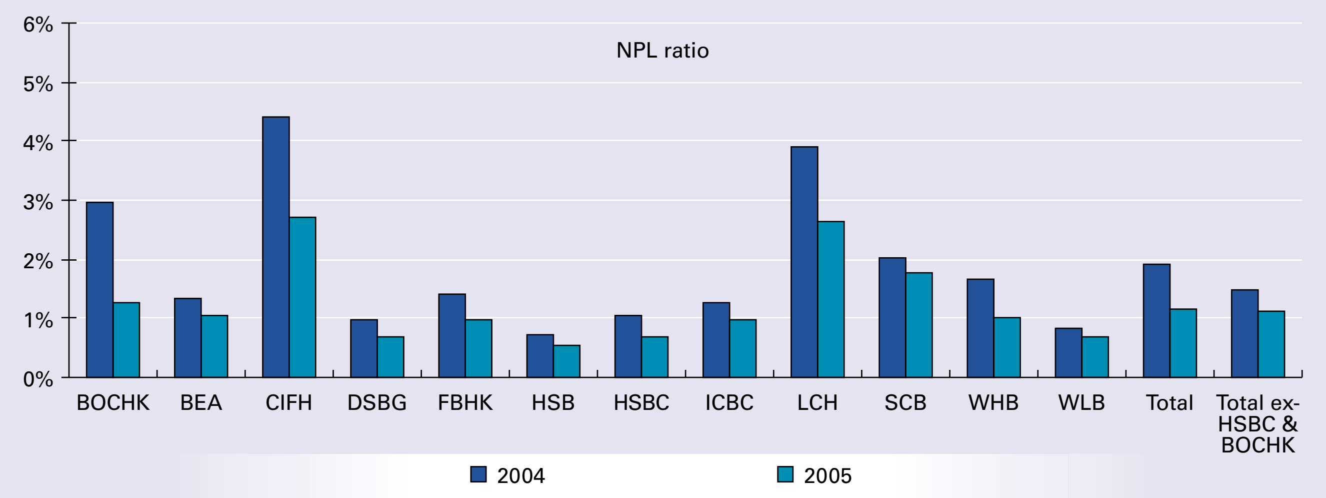


Source: Listed banks' financial disclosure

Asset quality

2005 saw continuing improvements from an already very low non-performing loans (NPLs) position. Total non-performing loans (NPLs) decreased by 32.9%, driving the average NPL ratio down by 0.6 percentage points to 1.0%, with the lowest NPL ratio of the listed banks standing at only 0.5%. Excluding HSBC and BOCHK, NPLs decreased 18.9%. In addition, rescheduled loans in the listed banks also fell sharply by 40.2%. Although there were large variations, all but one bank reported a decrease in NPLs.

Chart 14: NPLs continued to reduce substantially across the board



Source: Listed banks' financial disclosure

Despite the fall in NPLs, the net write-back of provisions achieved in 2004 was not repeated. In 2005, there was a net charge of HK$587 million, compared with write-backs of HK$1 billion in 2004. Of these, the overall new impairment charges stood at HK$8.0 billion, compared with HK$8.4 billion a year earlier, and the overall write-back of impairment allowances was HK$7.4 billion vis-a-vis HK$9.4 billion in 2004. There were significant write-backs in BOCHK in both 2005 and 2004 and the overall position was not as favourable if these are excluded. Excluding BOCHK, the overall net charge was HK$3.2 billion, vis-a-vis a charge of HK$615 million in 2004. Average net credit costs, measured by the ratio of impairment charges to gross loans increased marginally to 0.03% from a negative 0.06% in 2004. Five of the banks reported lower credit costs. It is worth noting that the reported figures for impairment charges were also somewhat affected by HKAS 39 implementation, with some banks releasing collective impairment provisions during the period. The reported effect of implementing new accounting standards is discussed in more detail below.

In Chart 15, we have analysed the provisions between collective and individual impairment charges. We can see that movements in the collective impairment provisions now have a significant effect. As loan books have expanded, some banks have been increasing collective impairment provisions. However, there is not a consistent trend across the banks as this depends on the individual banks' portfolios.

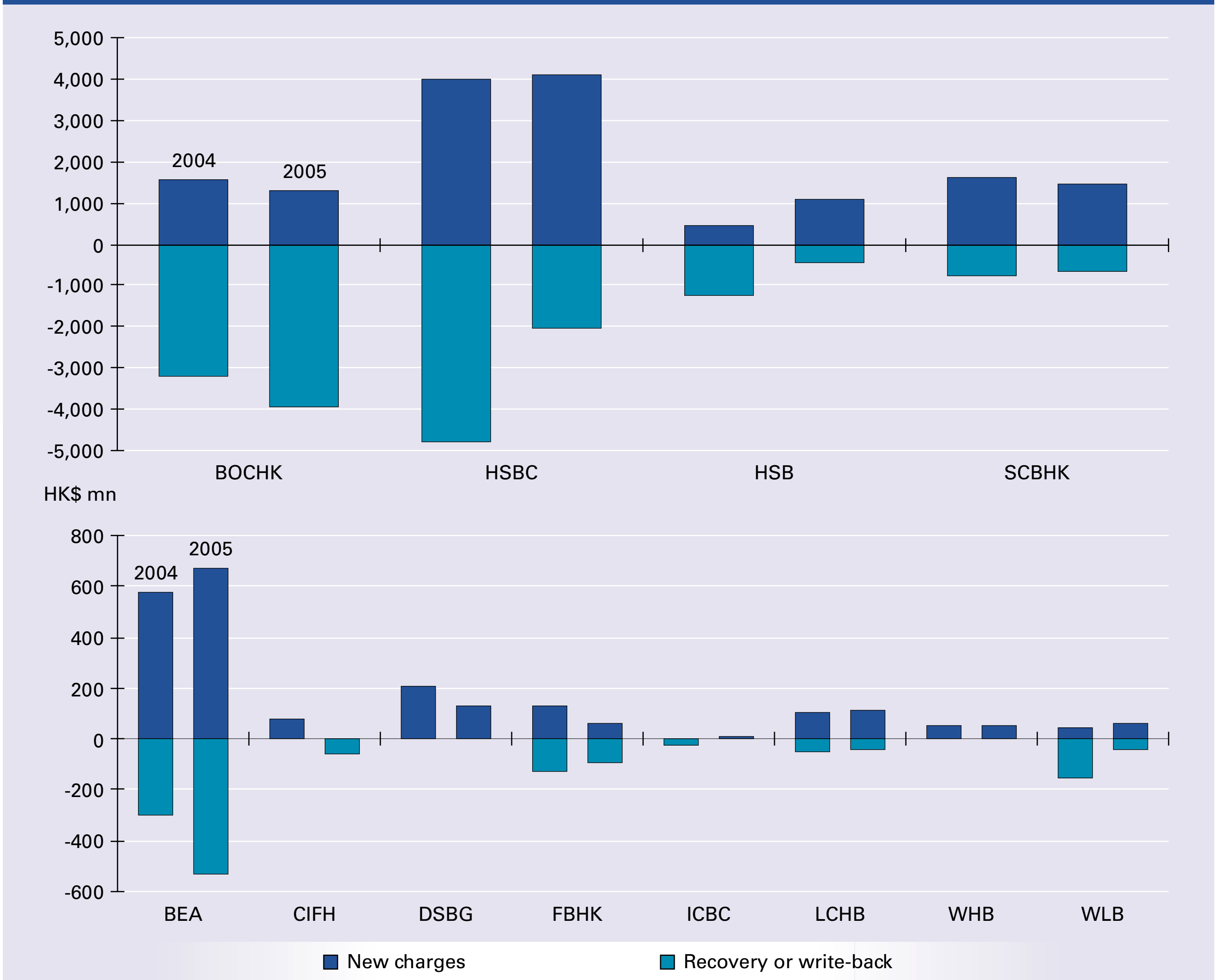
Chart 15: Some banks incurred new charges for expanded loan books

Source: Listed banks' financial disclosure

For the banks which disclosed the breakdowns, individual impairment charges were a credit of HK$15 million, compared with charges of HK$737 million in 2004. Collective impairment charges were HK$1.2 billion, vis-a-vis a credit of HK$2.7 billion a year earlier. As we expected previously, there was little room for the banks to continue write-backs of provisions as the overall credit costs have already been at a very low and unsustainable level of 0.03%.

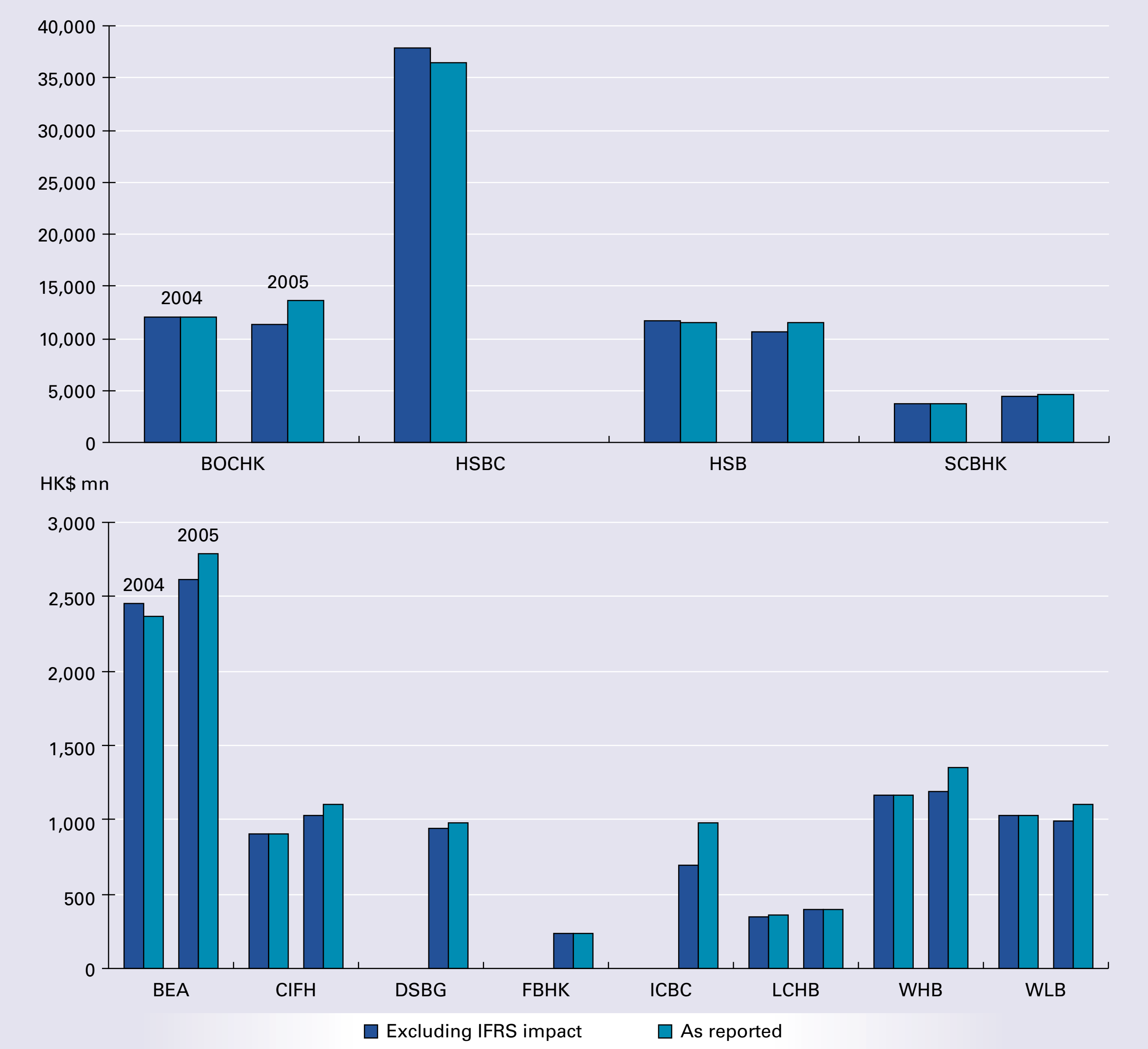
Benefiting from the rebound in property prices, the listed banks recorded property revaluation profits of HK$3.1 billion in 2005, compared to a profit of HK$2.1 billion 12 months earlier. This effect was particularly significant in some of the larger banks which had booked substantial property valuation losses before 2004. Profits on the sale of fixed assets and long-term investments increased to HK$5.1 billion, compared to HK$4.1 billion in 2004, due partly to the effects of HKAS 40 (the accounting standard on Investment Property) implementation. Consequently, operating profit before tax rose by 8.2%.

Chart 16: Five banks reported lower new loan impairment charges, only three had higher recoveries



Source: Listed banks' financial disclosure

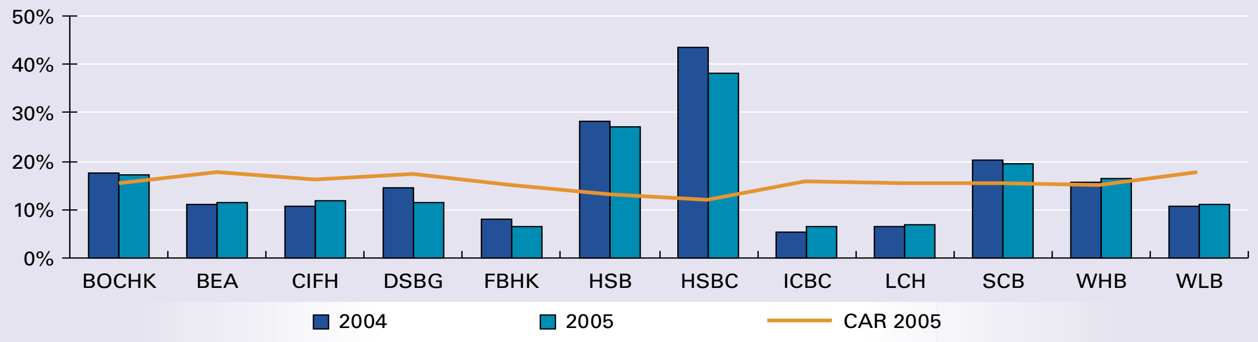
Chart 17: IFRS had only marginal impacts on results



Source: Listed banks' financial disclosure

Looking at the impacts of new financial reporting standards, whilst they have been painful to introduce, the effect on results has not generally been very significant. Although new accounting standards increased average profits by 12.0% in 2005, this is distorted by one large reported effect on the collective impairment allowance in one of the large banks. Excluding this, average profits were inflated by a smaller amount of 8.4%. Another key factor is the requirement to report changes in sales of investment properties through the profit and loss account as discussed above. Other than these items, and changes in presentation, the new standards generally had little impact.

Chart 18: ROEs across the sector varied considerably



Source: Listed banks' financial disclosure

Overall, the combined effect of the small recovery in net interest margin, higher operating costs, and pressure on wealth management led to a modest 6.6% increase in profit after tax, which resulted in a decrease of 1.8 percentage points in the return on equity (ROE) to 22.5% in 2005. However, despite the overall reduction in ROE, six of the 12 listed banks managed to deliver higher returns to their shareholders. Considerable variations in ROE across the banks as shown in the chart above reflected differences in the efficiency and effectiveness of the banks in using their capital as the banks capital adequacy ratios ranged from as high as 17.6% to as low as 12% against the legal, regulatory minimum of 8% (although the HKMA has set minimum ratios for individual banks in excess of 8%).

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