BANKING

Listed banks in China

2009 Interim results

FINANCIAL SERVICES

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Contents

Hong Kong listed banks[1]

The operating environment remained challenging in the first half of 2009, with real GDP contracting by 3.8% year-on-year in the second quarter after a 7.8% year-on-year drop in the first quarter. Hong Kong listed banks[1] still earned a total of HKD 38.2 billion in net profit after tax for the first half of 2009, though profit fell 17.7% over the first half of 2008. A low interest rate environment paired with a more selective lending appetite resulted in a 9.4% drop in net interest income. Net fee and commission income fell by 16.5% as demand for wealth management products remained weak. Overall, total operating income was only down 3.0% due to lower investment write-downs. If we compared the first half of 2009 with the second half of 2008, we still saw a 9.1% decrease in net interest income, but net profit was almost double as investment write-downs were not repeated.

Investment impairments had less impact on the listed banks in the first half of 2009. Based on disclosed information, the banks wrote down their investments by a further HKD 2.8 billion in the first half of 2009, compared with HKD 7.7 billion and HKD 25.5 billion booked in 2007 and 2008 respectively. Most banks have now either disposed of or fully written down their toxic investments. Whether any further write-down will be required will depend on the recoverability of credit and stock markets globally.

Many listed banks were involved in the distribution of minibonds, structured products arranged by Lehman Brothers whose value and recoverability were impacted by the investment bank's bankruptcy. These listed banks together with other minibond distribution banks have reached an agreement with the regulators to repurchase these minibonds from eligible customers. Based on disclosed information, the amounts the banks will have to compensate under the repurchase arrangement is estimated at HKD 6 billion. The ultimate loss to the banks will depend on the amount they can recover from the collateral underlying the minibonds.

The economic downturn which started after the global financial crisis hit in 2008 continued to lead to some corporate failures as well as personal bankruptcies, bringing the impaired loan ratio to 1.09%, up from 0.84% at the end of 2008. Net loan impairment charges rose by 125%, with net collectively assessed charges rising by 54% and net individually assessed charges increasing by 6.9 times. While the delinquency ratios for listed banks remain low and are not accelerating quickly, lenders should still keep close contact with their loan customers and respond quickly to early signs of liquidity problems in order to minimise bad debts.

Hong Kong, as a special region of China, has been selected to participate in a pilot scheme for the use of Renminbi in settling cross-border trade transactions between the mainland and Hong Kong. The scheme will expand the role of Renminbi business in Hong Kong and thereby create more business opportunities for the banks. In the first nine months of 2009, two mainland-incorporated foreign banks sold Renminbi-denominated bonds in Hong Kong for the first time and they were both subsidiaries of Hong Kong lenders. Before the National Day on 1 October, China sovereign Renminbi bonds were made available for retail and institutional subscription in Hong Kong, marking China's first sovereign bond sale outside the mainland. The sale will strengthen the development of the offshore Renminbi business in Hong Kong.

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1 The 13 Hong Kong banks included in our analysis are BOC Hong Kong (Holdings), The Bank of East Asia, CITIC Ka Wah Bank, Chong Hing Bank, Dah Sing Banking Group, Fubon Bank (Hong Kong), Hang Seng Bank, Hongkong and Shanghai Banking Corporation, ICBC (Asia), Public Financial Holdings, Standard Chartered Bank (Hong Kong), Wing Hang Bank and Wing Lung Bank.

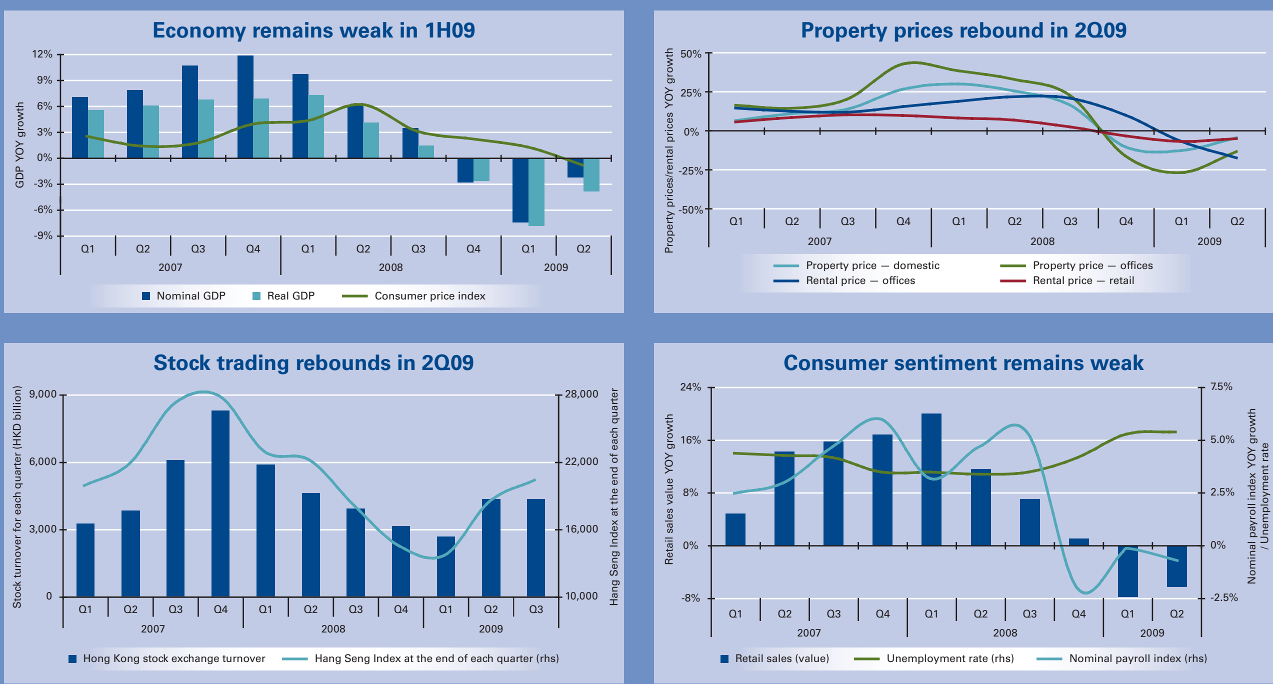
Economic environment

Economy remains weak in 1H09

The Hong Kong economy remained weak in the first half of 2009, though recent economic data indicated an improvement in the second quarter. The economic stimulus packages being implemented both locally and internationally, coupled with low interest rates and the resumption of initial public offerings (IPOs) on the Hong Kong stock market, have been supporting the domestic economy's recovery.

Real GDP contracted for three consecutive quarters, falling by 3.8% year-on-year in the second quarter, after a 7.8% drop year-on-year drop in the first quarter. Private consumption fell by 1.0% year-on-year in the second quarter, after a 6.0% dip in the first quarter. The fall in private consumption bottomed out in the second quarter as property and stock markets improved, and unemployment rates began to stabilise. On the other hand, fixed capital formation declined by 14.0% year-on-year in the second quarter, which was slightly worse than the first quarter. Weak investment sentiment was mainly due to the collapse in demand, which forced firms to postpone or cancel investment plans. Government consumption was the only category of GDP to expand in the first half of 2009. Trade figures remained dire but there were some signs of recovery. Export of goods and services fell by 12.4% and 12.7% year-on-year in the second quarter, after a 22.7% and 21.4% year-on-year drop in the first quarter. Recovery in the trade sector was partly supported by an economic rebound in the mainland. Hong Kong's exports to the mainland grew by 9.3% year-on-year in June, compared with double-digit year-on-year falls in exports to Hong Kong's other big trading partners, including the US, Japan and Germany.

Chart 1: Overview of key economic statistics for Hong Kong



Source: Census and Statistics Department, Rates and Valuation Department, Bloomberg

Property prices rebound in 2Q09

Thanks to a low interest rate regime, property prices rebounded in the second quarter of 2009, following a dive in the final quarter of 2008 and first quarter of 2009. Residential and office property prices on average fell by 5.3% and 14.2% year-on-year respectively in June 2009. We also saw some residential housing estates prices going above the levels reached just before the outbreak of the global financial crisis in late September 2008. On the other hand, office rental prices remained weak and fell 18.3% year-on-year in June 2009 as more offices began moving out of higher-rent buildings in the central business district to other districts.

Stock trading recovers in 2Q09

Fund raising in the first half of 2009 was about 35% of that for the first half of 2008. IPOs had been quiet since August 2008 and only in June 2009 did the IPO appetite pick up. Stock trading volume as well as the Hang Seng Index (HSI) plunged under the shadow of uncertainties in the first quarter but rebounded in the second quarter. The HSI rose from 14,388 at the end of 2008 to 18,379 and 20,955 respectively at the end of June and September 2009. The stock trading volume for the first half of 2009 was 33% lower than the first half of 2008, and was about the same level as the second half of 2008. Moving into the third quarter of 2009, the stock trading volume was about the same as the second quarter of 2009.

Inflationary pressure levels out

Consumer prices dropped 0.9% year-on-year in June 2009, the first decline since January 2005. The one-off subsidies on electricity charges were one of the reasons behind June's fall and excluding the one-off government relief measures, the consumer price index (CPI) would have risen 0.4%. Prices for durable goods fell by 3.6%. Offsetting these benefits, alcohol and tobacco prices increased significantly by 22.5% and rents rose by 3.7%. Consumer prices remained on an easing trend due to a weak economy but the rebound in the property market should help to prevent further significant declines in the CPI in the coming months.

Rise in unemployment rate tapers off in 2Q

The three-month period unemployment rate rose from a decade-low of 3.2% in the summer of 2008 to 5.2% in March and 5.4% in June and July 2009. This rise began to taper off in the second quarter of 2009. Although the local economy remained weak, the global economy seemed to have stabilised towards the middle of the year. The pick up in external trade and domestic economic sectors in recent months, coupled with the effect of the government's various relief measures, have helped to ease unemployment.

The latest bankruptcy data showed that more than 9,100 bankruptcy petitions were filed in the first half of 2009; 45% more than in the second half of 2008, or 73% more than the first half of 2008. Nevertheless, this was still lower than the peak in 2002 during which over 26,000 cases were filed.

Banking environment

Interest rates stay at low levels

The US Federal Reserve cut its target interest rate to almost zero by December 2008 and has kept the interest rate at a low level since then in view of the weak economy. Commercial banks in Hong Kong also cut the prime rate to 5-5.25% and trimmed the Hong Kong dollar savings deposit rate to 0.01% in late 2008.

A strong inflow of Hong Kong dollars, paired with a broad-based contraction in loans due to subdued economic activities, drove Hong Kong dollar interbank interest rates to a very low level. The average one-month HIBOR fell from 1.94% in the second half of 2008 to 0.17% in the first half of 2009. The interbank market continued to ease following various measures introduced locally and globally in response to the global financial crisis. A strong Hong Kong dollar spot exchange rate also contributed to the ample liquidity in the interbank market. The Hong Kong dollar exchange rate stayed close to 7.75 against the US dollar during the first half of 2009, and triggered the HKMA to buy US dollars and sell HK dollars to maintain the exchange-rate link during March and May 2009.

Net interest margin narrows in 1H09

The sector-wide net interest margin narrowed from 1.92% in the first half of 2008 to 1.55% in the first half of 2009 mainly due to loans being re-priced at lower interest rates and limited room for lowering fund costs in a low interest rate environment. Deposit spreads declined as a low interest rate regime offered little room for the reduction of interest rates paid to customers. Contributions from net free funds to interest margin also fell in the near-zero interest rate environment. Cautious lending in a subdued economy led to a fall in loan-to-deposit ratio. A relatively higher holding of cash and low yields debt instruments thus contributed to a narrowing of interest margins.

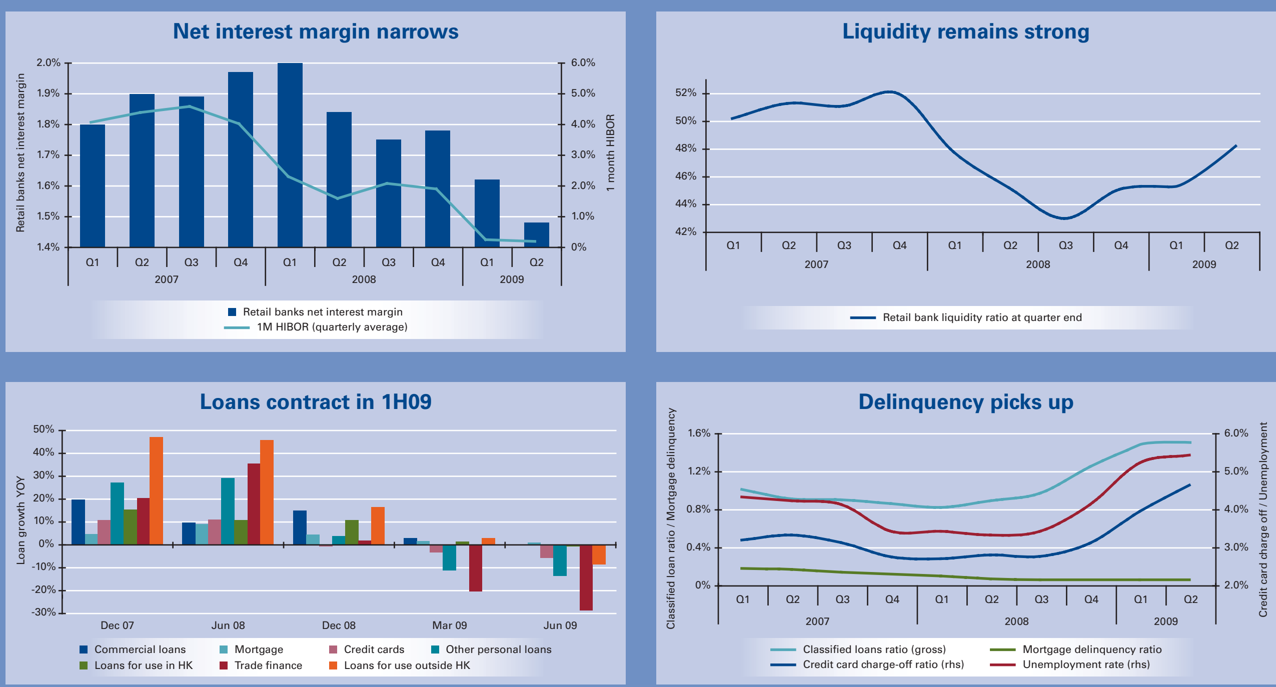
Mortgage pricing remained competitive. As residential property prices and turnover picked up in the second quarter of 2009, the mortgage battle intensified. In the third quarter, some authorised institutions (AIs) were offering mortgage rates as low as 3.25% below prime for the entire term of the mortgage. The low mortgage pricing has raised concerns at the HKMA that the intense competition might have driven some AIs to price their mortgages aggressively to such an extent that they might not have given due regard to the reputation risk, interest rate risk and liquidity risk potentially associated with their pricing. AIs were reminded to manage their Prime-HIBOR basis risk vigilantly, and price the residential mortgages reasonably so that they can be effectively used for liquidity purposes when needed. The mortgage rates should also provide a reasonable margin after taking into consideration operational and administration costs and expected loan losses.

Customer deposits remain strong

Total customer deposits in all AIs rose from HKD 6.06 trillion at the end of 2008 to HKD 6.27 trillion at the end of June 2009, up 10.0% year-on-year or 3.5% during the first half of 2009. As interbank market liquidity remained abundant, the pressure for banks to obtain funds from the retail market was reduced, keeping deposit rates at a low level. More depositors switched to demand and savings deposits, thus bringing the proportion of demand and savings deposits to 47%, compared with 40% and 37% at the end of December and June 2008 respectively. The reduction in the average maturity of deposits could potentially increase the maturity mismatch risk between assets and liabilities of the banks.

Renminbi deposits fell to RMB 54.4 billion at the end of June 2009, down 30% year-on-year or 6.3% during the first half of 2009. Hong Kong residents were converting their domestic Renminbi deposits back into Hong Kong dollars as the Renminbi appreciation flattened out around July 2008.

Chart 2: Overview of key banking statistics for Hong Kong



Source: Hong Kong Monetary Authority

Loans contract in 1H09

Authorised institutions in Hong Kong saw a drop in loans and advances to HKD 3.20 trillion in June 2009, a 4.3% year-on-year decline or a 2.5% decrease over the first half of 2009. Lending was generally more cautious in light of the deteriorating credit quality. The loan to deposit ratio also fell quickly to 51.1% from 58.7% and 54.2% at the end of June and December 2008 respectively.

Trade finance loans contracted the most at 29% year-on-year or 12.3% over the first half of 2009 as trade remained weak in Hong Kong. Demand for imports from advanced economies has not recovered yet. Loans for use outside Hong Kong also fell by 8.5% year-on-year. Exposures to non-bank mainland Chinese entities for retail banks fell slightly to HKD 635 billion or 8.3% of total assets at the end of June 2009, from HKD 644 billion or 8.4% of total assets at the end of 2008. Commercial loans remained at the same level as a year ago. In contrast, loans to stock brokerages soared 2.4 times year-on-year to HKD 49.9 billion as stock trading and IPO activity picked up in the second quarter of 2009.

Credit card loans fell by 5.7% while other personal loans fell 13.6% year-on-year, reflecting a contraction in unsecured household loans. By contrast, mortgages grew at 1.0% year-on-year as the property market picked up during the first half of 2009.

Loan quality deteriorates slightly

Loan assets have deteriorated, although the rate of deterioration slowed. Bad debts charges represented 0.16% of the total average assets for retail banks in the first half of 2009, compared to 0.05% in the first half of 2008. The gross classified loan ratio rose to 1.51% at the end of June 2009, from 0.88% and 1.24% at the end of June and December 2008.

An increase in compulsory winding-up orders for companies indicated deterioration in the corporate portfolio loan quality. The number of petitions rose by 31% in the first half of 2009 to 391 cases, compared with the same period last year, though the pace of increase was gradual.

As for the retail portfolio, unsecured lending showed signs of deterioration as observed in the rising credit card charge off ratio, which climbed from 2.68% in the first half of 2008 to 4.17% in the first half of 2009. Bankruptcy petitions rose by 73% in the first half of 2009 to 9,164 cases, compared with the same period last year while the number of petitions began to come down in the third quarter. The mortgage portfolio on the other hand remained healthy despite the economic downturn. The 3-month mortgage delinquency ratio stayed at a low level of 0.05% in June 2009, the same as in December 2008. As property prices picked up during the first half of 2009, the number of negative equity cases fell correspondingly from 10,949 in December to 3,767 in June 2009.

Tighter controls over the sale of investment products

Following the mis-selling complaints received from retail investors who suffered losses from buying structured products such as the Lehman Brothers minibond series from retail banks, the HKMA devised a range of measures to tighten the controls over the sale of investment products. In early 2009, the HKMA ruled that by October 2009 banks would be required to segregate their investment products sales from their general banking services and have appropriate signage. Banks are also required to assess the investor's risk appetite to ensure the product is suitable for them and record the sales process. In July 2009, the HKMA and the Securities and Futures Commission reached an agreement with 16 distribution banks in relation to the repurchase of minibonds from eligible customers.

The quality of retail banks' debt securities investment portfolio was relatively stable in the first half of 2009. Debt securities classified as substandard, doubtful and loss remained at 0.06% of the banks' assets at the end of June 2009 and December 2008. Debt securities investments classified as special mention declined to 0.37% of the banks' assets at the end of June 2009, from 0.39% at the end of December 2008.

Renminbi trade settlement pilot scheme

On 3 July 2009, a pilot scheme for the use of Renminbi in settling cross-border trade transactions between the mainland and Hong Kong was launched. The scheme allows cross-border trades, including re-export, to be denominated and settled in Hong Kong in Renminbi. Previously, these were settled in other currencies such as the US dollar, exposing importers and exporters to currency exchange risks. Under the pilot scheme, qualified companies in Shanghai and four cities in Guangdong province (Guangzhou, Shenzhen, Zhuhai and Dongguan) can settle trades in Renminbi with their counterparts in Hong Kong, Macau, and countries of the Association of Southeast Asian Nations.

The pilot scheme is an important breakthrough for Renminbi business in Hong Kong. Banks in Hong Kong can widen the customer base of Renminbi services to cover trade enterprises. Previously, Renminbi services were mainly offered to individuals and designated categories of local merchants only. Banks can also offer Renminbi trade finance services for trade transactions with mainland-designated enterprises. The pilot scheme saw 66 Renminbi trade settlement transactions amounting to RMB 42.8 million in the first month of operation.

Renminbi bonds

Since 2007, mainland banks have been selling Renminbi-denominated bonds in Hong Kong. During the first eight months of 2009, two mainland-incorporated foreign banks sold Renminbi-denominated bonds in Hong Kong for the first time and they were both subsidiaries of Hong Kong lenders (HSBC and the Bank of East Asia). In late September, China sovereign Renminbi bonds were also sold in Hong Kong, marking China's first sovereign bond sale outside the mainland. The sale will strengthen the development of the offshore Renminbi business in Hong Kong.

Performance of Hong Kong listed banks

Table 1: Reported results for the period ended 30 June 2009

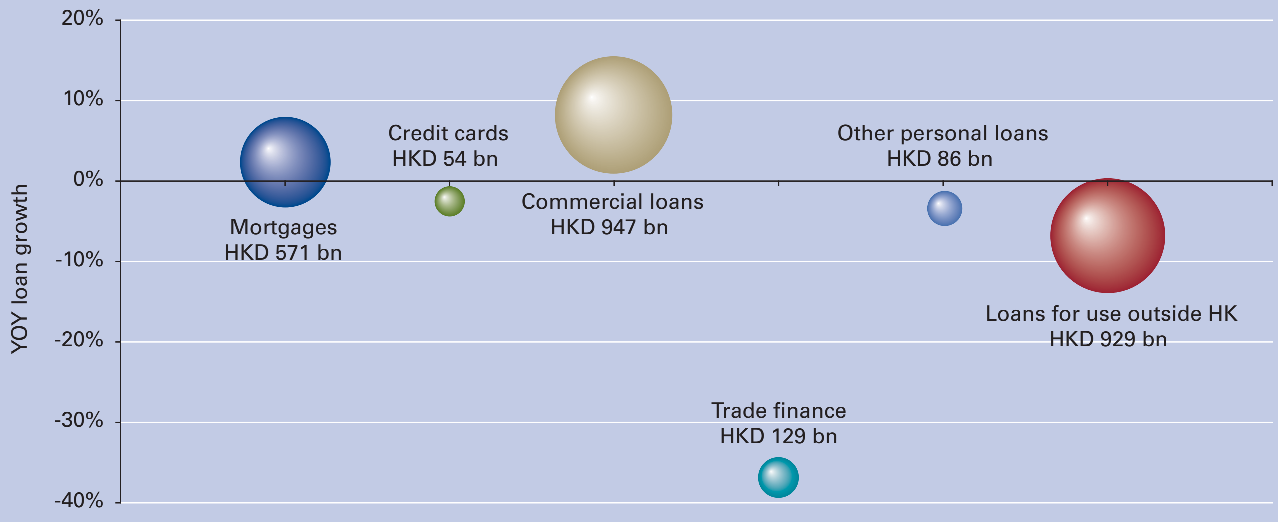
HKD millions		Net interest income	Non-interest income #	Total operating income #	Operating expenses	Operating profit before loan impairment allowances	Charge for impairment allowances on loans and advances	Other items	Profit before tax	Tax	Net profit after tax	YOY growth in net profit after tax
BOC Hong Kong (Holdings)	BOCHK	8,929	2,931	11,860	4,194	7,666	-60	518	8,244	1,369	6,875	(4.3%)
The Bank of East Asia	BEA	3,234	1,761	4,995	3,041	1,954	474	187	1,667	462	1,205	46.8%
Chong Hing Bank	CH	397	208	605	361	244	54	-1	189	28	161	53.2%
CITIC Ka Wah Bank	CKWB	795	465	1,260	597	663	220	60	503	78	425	296.4%
Dah Sing Banking Group	DSBG	1,062	407	1,469	964	505	272	83	316	9	307	(40.8%)
Fubon Bank (Hong Kong)	FBHK	600	173	773	463	310	206	11	115	14	101	(59.7%)
Hang Seng Bank	HSB	7,275	3,361	10,636	3,215	7,421	621	818	7,618	1,167	6,451	(28.8%)
The Hongkong and Shanghai Banking Corp.	HSBC	30,111	28,617	58,728	25,368	33,360	6,313	3,533	30,580	6,137	24,443	(20.9%)
ICBC (Asia)	ICBCA	1,490	544	2,034	695	1,339	225	14	1,128	198	930	1.5%
Public Financial Holdings	PFH	576	128	704	285	419	294	16	141	23	118	(53.0%)
Standard Chartered Bank (Hong Kong)	SCB	5,204	3,180	8,384	3,813	4,571	601	-733	3,237	570	2,667	(35.0%)
Wing Hang Bank	WHB	1,162	324	1,486	797	689	84	-6	599	85	514	(45.1%)
Wing Lung Bank	WLB	609	499	1,108	559	549	24	8	533	75	458	30.7%
TOTAL *		**54,169**	**39,237**	**93,406**	**41,137**	**52,269**	**8,707**	**3,690**	**47,252**	**9,048**	**38,204**	**(17.7%)**
TOTAL excl. HSBC **		**31,333**	**13,981**	**45,314**	**18,984**	**26,330**	**3,015**	**975**	**24,290**	**4,078**	**20,212**	**(17.8%)**

* HSBC's consolidated accounts include Hang Seng Bank's results, so 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 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, financial assets and investments, together with revaluation losses or impairment allowances or write-backs on held-to-maturity securities, non-trading securities, available-for-sale securities, financial assets and investments.

Source: Listed banks' financial disclosures

Balance sheet

Chart 3: Loan books contract mainly driven by trade finance and loans for use outside HK



Source: Listed banks' financial disclosures

Loan books shrank

The listed banks grew their balance sheets and customer deposits by 7.2% and 11.4% year-on-year respectively while their loan books shrank by 2.2% over the last twelve months, and rose by only 0.6% over the first half of 2009 due to weak demand for lending. The deterioration in loan quality has also reduced the risk appetite on lending. The annual decline in loan books was mainly driven by a 37% year-on-year dive in trade finance loans and a 6.7% year-on-year drop in loans for use outside Hong Kong. If we looked at the first six months, trade finance loans dropped 21% which corresponded with the setback in Hong Kong's trade sector. Commercial loans on the other hand rose 8.1% year-on-year. This was partly supported by strong loan growth in the property development and stockbroking sectors which rose by 18.3% and 6.2 times year-on-year respectively. Recovery in the property market and a resumption of IPOs in the first half of 2009 were the main contributors to this.

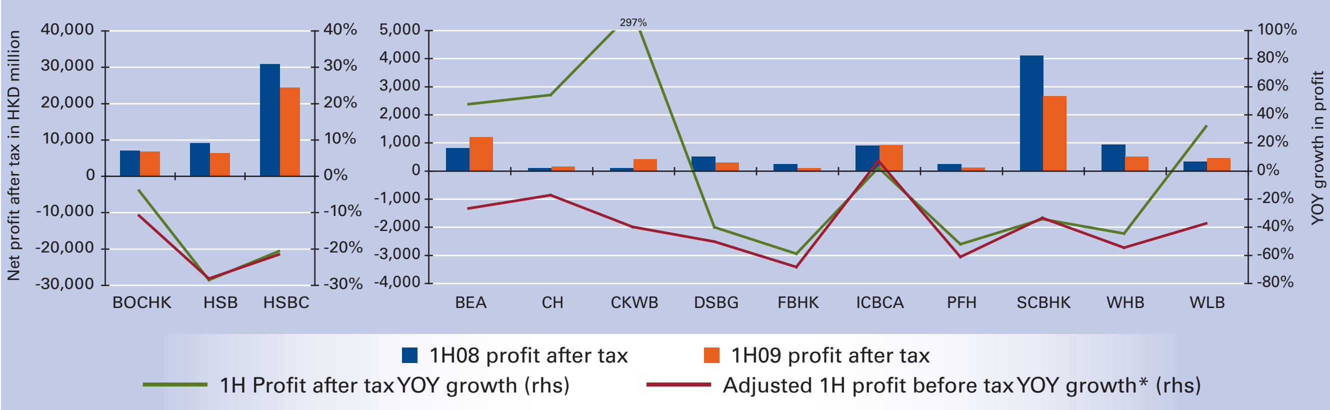
The retail portfolios were supported by an active residential property market, with mortgages growing at 2.3% year-on-year while credit cards and other personal lending fell by 2.3% and 3.4% year-on-year respectively. If we just looked at the first six months in 2009, mortgages rose 2.1% while credit card and other personal lending fell by 8.6% and 4.3% respectively. Lenders were more careful in granting unsecured loans as credit card delinquency rose. The overall loan-to-deposit ratio for the listed banks fell to 53%, from 56% and 60% at the end of December and June 2008.

Profitability

Net profit dipped, driven by lower income and higher loan impairment charges

Net profit for listed banks in the first half of 2009 fell by 17.7%. A low interest rate environment paired with a setback in lending appetite resulted in a 9.4% drop in net interest income. Fee and commission income fell by 16.5% also largely due to reduced demand for wealth management products as a result of negative market sentiment. Loan quality was affected by the economic downturn, leading to a 125% increase in loan impairment charges. All these hurt the bottom line profit of the listed banks, though they were partly offset by a smaller investment write-down in the first half of 2009. Listed banks still recorded an investment write-down of HKD 2.8 billion for the first half of 2009, but this was much lower than the HKD 8.2 billion recorded in same period last year. Excluding investment write-downs in both periods, profit before tax fell 23%.

Chart 4: Net profits suffer from margin contraction and bad debts

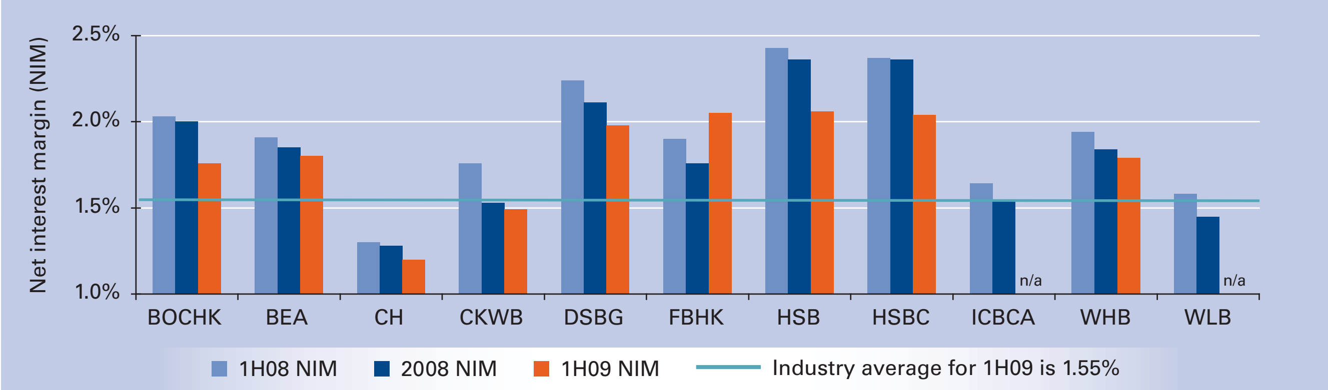


* Adjusted profit before tax refers to profit before tax, adding back impairment write-downs on equities and net losses from SIVs, CDOs and RMBS, as disclosed by the banks.
Source: Listed banks' financial disclosures

NIM narrowed in low interest rate environment

Net interest income remained the main component of income and fell by 9.4%, or 7.2% excluding HSBC, on the back of reduced margin as well as a 2.2% year-on-year fall in loans, despite the slight pick-up in loans in the first half of 2009. Most banks saw a drop in net interest income. Net interest margin (NIM) has experienced a continuous slide over the last three periods. NIM narrowed as banks were unable to lower deposit rates under the low interest rate regime while returns on assets fell as interest earning assets were repriced off a lower yield curve. Lower loan balances also lowered interest income. Contribution from net free funds also dropped as interest rates fell.

Chart 5: NIM continues to narrow in low interest rate environment

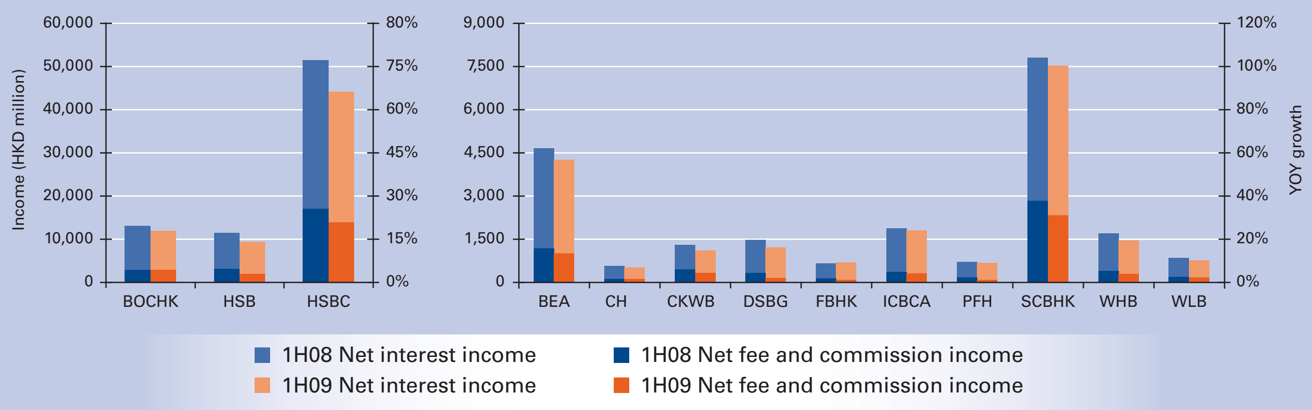


Source: Listed banks' financial disclosures

Lower fee income offset by smaller investment write-downs

Non-interest income rose 7.5% mainly due to smaller investment write-downs in the first half of 2009. If we exclude the effect of investment write-downs in both periods, non-interest income fell 5.9%. Net fee and commission income fell by 16.5% largely due to the unfavourable investment climate which dampened investor activity. Stock brokerage income fell 23%; however, excluding HSBC, which has brokerage operations outside Hong Kong, this only fell by 3.6%. Wealth management fee income fell by half, reflecting a substantial drop in demand for wealth management products against the backdrop of a weak investment climate and lower investor interest following the mis-selling of structured products. Weak demand for loans also slightly affected fee and commission income earned from credit-related activities.

Chart 6: Both net interest income and fee and commission income contract



Source: Listed banks' financial disclosures

Operating expenses remained stable

On the cost side, listed banks did well in restricting cost increases to only 1.1%. Included in the operating expenses were some top-up provisions for Lehman Brothers minibonds following the repurchase scheme. The majority of the banks saw a drop in staff costs as performance-linked remuneration was cut back, though this was partly offset by pay rises. Overall, staff costs remained at the same level as in the first half of 2008. Rental expenses in premises and equipment still recorded some growth as property prices picked up again in the first half of 2009.

The cost-to-income ratio for listed banks rose to 44% for the first half of 2009, compared with 42% in the first half of 2008. Excluding HSBC, this ratio rose to 42% from 39%. The setback in efficiency was mainly caused by lower operating income.

Ultimate loss of minibond compensation will depend on recoveries from the underlying collateral

Many listed banks which had sold minibonds to their retail customers in the past received mis-selling complaints from them following the failure of Lehman Brothers in late 2008.

In July 2009, 16 minibonds distribution banks reached an agreement with the regulators on the repurchase of these minibonds. The terms of the repurchase scheme require each bank to offer to repurchase from each eligible customer all outstanding minibonds at a price equal to 60% of the nominal value of the investment for customers below the age of 65, and 70% of the nominal value for customers aged 65 or above as at 1 July 2009. The banks will also make further payments, depending on the recoveries, to eligible customers once the underlying collateral has been recovered. Eligible customers do not include professional investors, corporate or non-individual investors, or experienced investors. Moreover, these banks have agreed to forfeit the commission income received through the distribution of minibonds. The money will be used to fund the recovery of the underlying collateral.

Based on disclosed information, the amount involved in the repurchase arrangement, including the forfeited commission income, was estimated to be approximately HKD 6 billion (excluding any future payments following recovery of any collateral). The ultimate loss to the banks on the repurchase scheme will depend on the amount they can recover from the underlying collateral.

Contribution from mainland associates remained stable

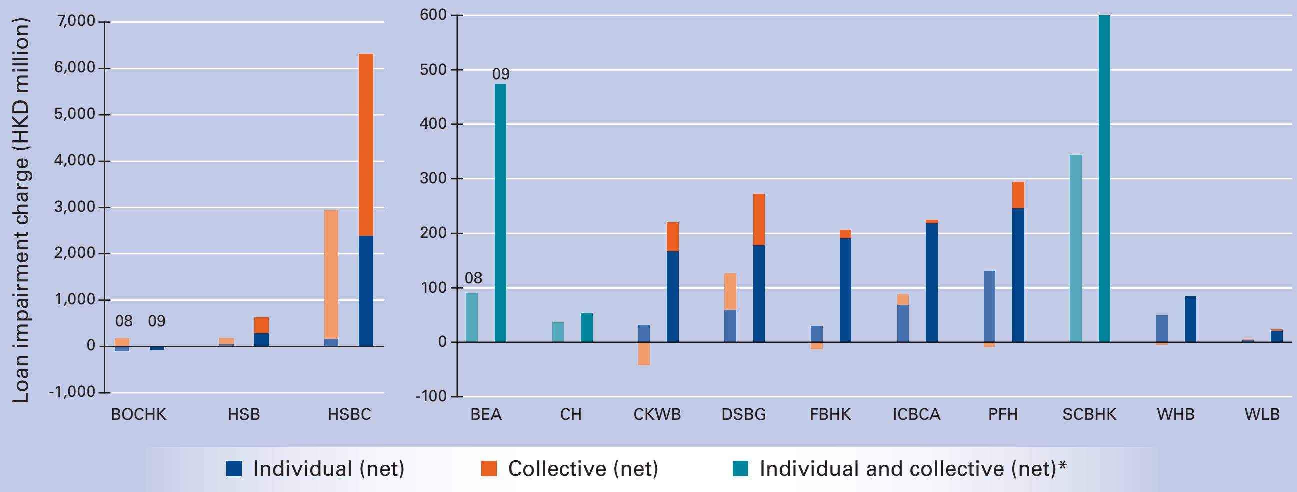
Operating profit before loan impairment allowances fell by 6.0% as costs increased, although total operating income only fell by 3.0%. Impairment charges on loans rose 125%. We still saw fair value gains on properties as property prices picked up in the first half of 2009, though this revaluation gain was 46% lower than in the previous period. Contribution from associates and jointly controlled entities went up by 4.0% to HKD 3.8 billion. Most of these were contributions from mainland associated banks. Overall, profit before tax came down by 16.6%.

Asset quality

Impairment charges doubled

Net loan impairment charges for listed banks rose by 125% and the increase was across almost all listed banks. This was a result of individual failures in the corporate and commercial books together with top-ups of collective provisions. Net individually assessed charges saw an increase of 6.9 times or 3.1 times excluding HSBC. Net collectively assessed charges rose 54% or 111% excluding HSBC. The rise in credit card delinquencies as well as historical loss rates led to higher impairment charges on the collectively assessed portfolio. The absolute level of provisions still remained at a low level, representing 16.7% of operating income before provisions and 0.32% of total loans, though these were higher than the 7.0% of operating income before provisions and 0.14% of total loans recorded in the prior period.

Chart 7: Loan impairment charges double as delinquency rises



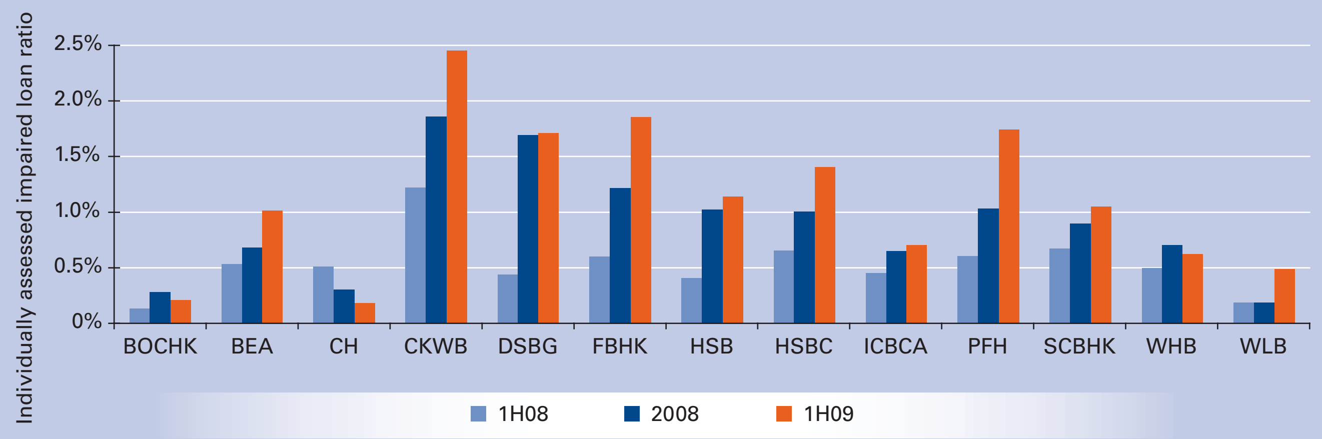
* Breakdown is not available
Source: Listed banks' financial disclosures

Loan assets continued to deteriorate

A weak economy led to more credit downgrades in the loan portfolios, bringing the impaired loan ratio to 1.09%, from 0.84% and 0.54% at the end of December and June 2008. Excluding HSBC, the impaired loan ratio was 0.86%, compared with 0.75% and 0.43% at the end of December and June 2008. Gross impaired loans surged 97% year-on-year. Based on disclosed information, the gross impaired loans for all listed banks went up from HKD 15 billion at the end of June 2008 to HKD 22.6 billion at the end of 2008 and then climbed to HKD 29.5 billion at the end of June 2009. The pace of loan deterioration in the first half of 2009 was similar to that for the second half of 2008. Though loan deterioration has not accelerated, loan officers should still follow up closely with their loan customers.

The provision coverage for impaired loans was 41% at the end of June 2009, compared with 44% and 37% at the end of December and June 2008. The slight reduction in coverage could be due to a number of factors including increased property values. Impaired loans are not 100% provided as provisions are made after taking into account collateral values and other expected recoveries. The allowance coverage for the collectively assessed portfolios was 0.41% at the end of June 2009, higher than 0.37% at the end of 2008. Excluding HSBC, this ratio was 0.29% and 0.28% at the June 2009 and December 2008 respectively.

Chart 8: Impaired loan ratio rises



Source: Listed banks' financial disclosures

Are investment write-downs coming to an end?

Investment impairment has affected the listed banks' results over the past two years. In 2007, at least HKD 7.7 billion was booked and in 2008 at least another HKD 25.5 billion was booked, of which approximately HKD 8.2 billion was booked in the first half. Moving into 2009, we saw a further write-down of HKD 2.8 billion in the first half, mainly on equities, debts and other structured products. Most listed banks holding toxic financial assets had either disposed of them or fully written them down by the end of June 2009. The net carrying value of the impaired portfolio at the end of June 2009 was at least HKD 12.4 billion but this related mainly to one listed bank. Whether the current debt and equity investment portfolio will deteriorate further will depend on the recovery of the credit and stock markets.

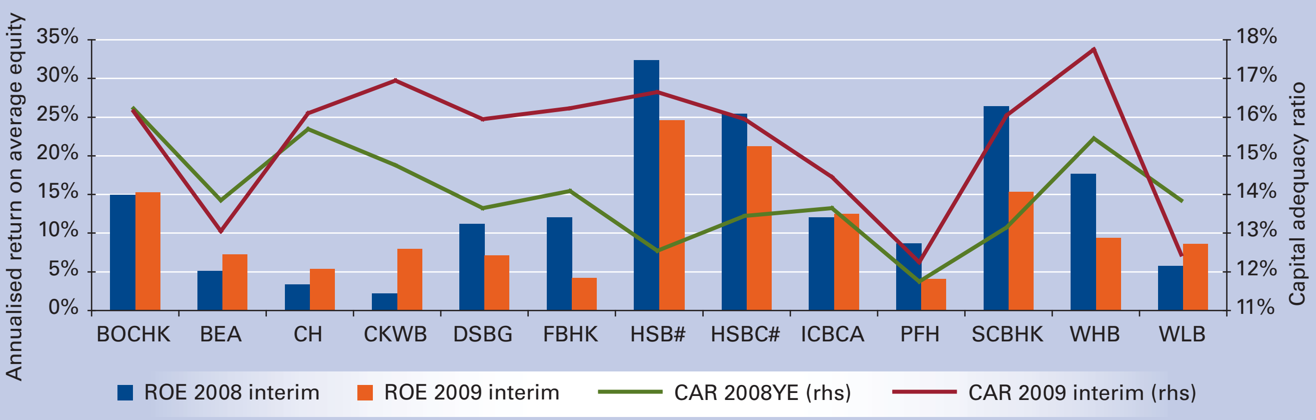
Capital strength

CAR improved while ROE came down

The overall average capital adequacy ratio (CAR) for listed banks improved to 15.6% and 15.5% excluding HSBC, compared with 14.1% and 14.4% at the end of 2008. Capital adequacy remained strong and has generally increased as banks have raised capital and, in some cases, have adopted more advanced calculation approaches. Others have reduced risk weight assets through re-allocation of assets. The lowest CAR among the listed banks stood at 12.2% while the highest was 17.7% against the legal, regulatory minimum of 8% (although the HKMA has set minimum ratios for individual banks in excess of 8%).

Returns on equity (ROE) decreased for all the banks as a result of lower operating income and higher loan impairment charges. The average annualised ROE for listed banks was 16.6%, and 14.3% excluding HSBC, compared with 19.5% and 17.0% in the first half of 2008. As noted in the past, banks with more tightly managed CAR tend to have higher ROEs. This was less clear in the first half of 2009 as banks have raised capital.

Chart 9: Basel II capital ratio remains strong

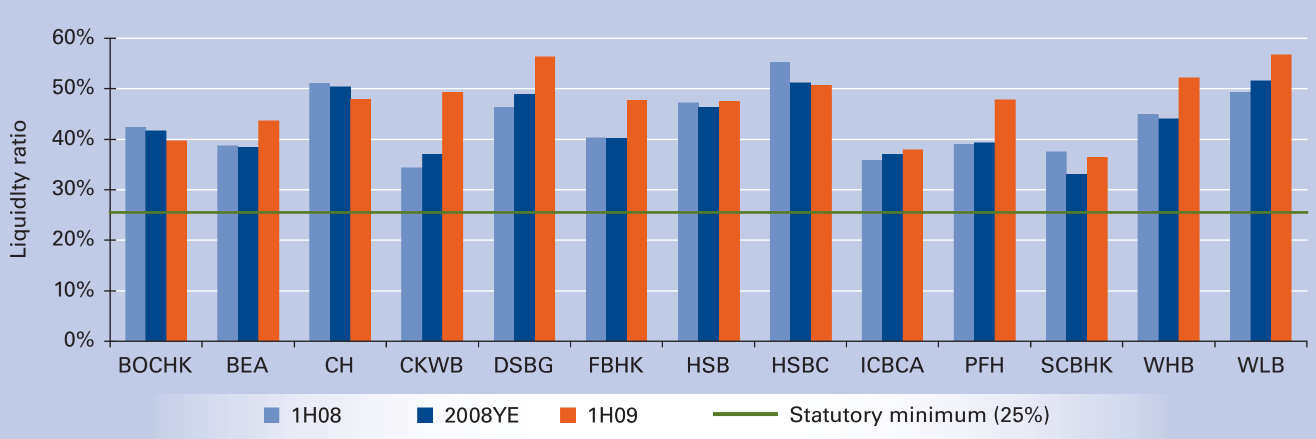


Source: Listed banks' financial disclosures
The calculation approach for CAR has been revised for June 2009, so the ratios for the two periods are not directly comparable.

Liquidity remained ample

Most listed banks saw an increase in the average liquidity ratio for the first half of 2009, compared with the year ended 2008. The interbank market remained strong with an aggregate interbank balance reaching HKD 184 billion on 30 September 2009. The lowest average liquidity ratio for listed banks was 36.5% which was still above the regulatory minimum of 25%. Substantial capital inflows into Hong Kong since the last quarter of 2008 have fuelled liquidity in the banking system.

Chart 10: Liquidity remains ample



Source: Listed banks' financial disclosures

Mainland China listed banks[2]

Mainland China listed banks recorded only a 3.1% decline in net profit after tax to RMB 226 billion despite the economic challenges. A reduction in the interest rate towards the final quarter of 2008, as well as a surge in discounting bills business which carried lower yields, put significant pressure on the interest margin, though this was partly offset by strong loan growth in the first half of 2009. Net interest income still fell 10.0%.

Non-interest income grew 39%, thanks to fee income growth as well as smaller investment write-downs. Fee income earned from bank cards, consultancy, advisory and investment banking services remained strong, offsetting the slowdown in wealth management and agency fee income. To strengthen the operation of wealth management business in the commercial banks, in July 2009 the regulator requested the banks to classify customers based on their risk tolerance and investment experience. In addition, wealth management funds are not allowed to invest in risky financial products or overly-complex structured products.

Write-downs on impaired investments had a small impact on the overall results in the first half of 2009. Based on disclosed information, listed banks in mainland China wrote down investments by at least RMB 6.4 billion in the first half of 2009, compared with at least RMB 62.5 billion and RMB 23.4 billion booked in 2008 and 2007. The net carrying value of impaired investments was at least RMB 63 billion at the end of June 2009. The recovery of the global economy as well as the credit market will determine whether these assets deteriorate further.

Impairment charges on loans fell by 7.1%. Loan quality remained healthy with an overall decline in both the NPL ratio and NPL balances over the first half of 2009. The NPL ratio for mainland listed banks came down to 1.53% at the end of June 2009 from 2.04% at year end 2008. Though the banks have not suffered significantly from the global recession in the first half of 2009, there are still uncertainties for the remainder of the year as the world economy has not recovered. Given the strong loan growth in the first half of 2009, the banks now have a bigger loan portfolio to manage. It is critical for the banks to monitor on an on-going basis whether loans are being drawn for their intended purposes and not flowing into speculative activities. The credit risk management processes at branch and head office levels and overall credit risk management remain critical.

Loan books grew by 26% over the first half of 2009. A decline in the capital adequacy ratio (CAR) among the listed banks might slow down loan growth in the remainder of the year. In September 2009, the China Banking Regulatory Commission (CBRC) proposed adjusting the calculation of CAR which would prevent banks from counting mutual holdings of subordinated bonds as part of their capital base. The proposed rule was aimed at improving the quality of the banks' capital, but is expected to put pressure on capital adequacy for the listed banks.

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2 The 14 mainland banks included in our analysis are: the H-share accounts for the six banks which are listed in both Shanghai and Hong Kong stock exchanges (Bank of China, China Construction Bank, Bank of Communications, China Merchants Bank, China CITIC Bank, and Industrial & Commercial Bank of China) and the A-share accounts for the eight banks which are listed on the Shanghai or Shenzhen stock exchanges (Bank of Beijing, Bank of Nanjing, Bank of Ningbo, China Minsheng Bank, Huaxia Bank, Industrial Bank, Shanghai Pudong Development Bank, and Shenzhen Development Bank).

Economic environment

GDP growth supported by government policy and stimulus plan

Thanks to mainland China's loose monetary policy and stimulus package, the economy saw a 7.9% year-on-year growth in the second quarter of 2009, up from the 6.1% recorded in the first quarter. During the first half of 2009, GDP expanded by 7.1%, slightly lower than the 10.4% and 9% growth seen in the first half and full year in 2008. Infrastructure, particularly in the transportation sector, was a key area of investment, soaring by 57.4% overall. Investments in railway projects surged 126.5% year-on-year, while there was a 54.7% growth in road infrastructure. Gross capital formation added 6.2 percentage points to the GDP growth during the six months.

Export revenue did not fare as well, swinging from double-digit growth in the first half of 2008 to a 22% year-on-year decline in the first half of 2009. The sharp decline in exports and stronger domestic demand led to a 2.9 percentage point drop in China's overall economic growth. Investment therefore remained the backbone of GDP growth in the second quarter, supported by government spending on infrastructure. With stronger growth in private investment and consumer spending, there are signs that China's economic recovery is becoming more broad-based.

CPI drops in 1H09

With five consecutive months of deflation, the consumer price index (CPI) dropped by 1.7% year-on-year in June 2009. On average, prices fell by 1.1% over the first six months of the year. In urban areas, consumer prices dropped by 1.3% in the first half, while in rural areas prices went down by 0.6%. The greatest decline was seen in the raw materials and fuel and power sector, which declined by 8.7%, followed by producer prices for manufactured goods, falling at 5.9%. The housing sector also took a hit, with costs falling 3.9%. The cost of transport and communications fell 2.5%, the cost of clothing fell by 2.4%, and food prices declined just 0.3%. External demand is likely to remain weak, so production overcapacity will continue to be channelled into the domestic market, which is expected to keep putting pressure on price competition.

Retail sales remain strong

Retail sales growth by value hit 15.0% in June and 15.4% in August 2009, the fastest rate since January when sales grew 18.5% during the Chinese New Year season. Propped up by government social-support programmes, rural areas saw retail sales rising by 15.5% in August, while sales in urban areas grew by 15.3%. In addition, with the government's tax incentives for sales of cars with smaller engines as well as subsidies for farm and utility vehicles, retail sales continued to be supported by demand for vehicles, which surged by 95% year-on-year in August.

Income growth is robust; fewer rural migrant workers without work

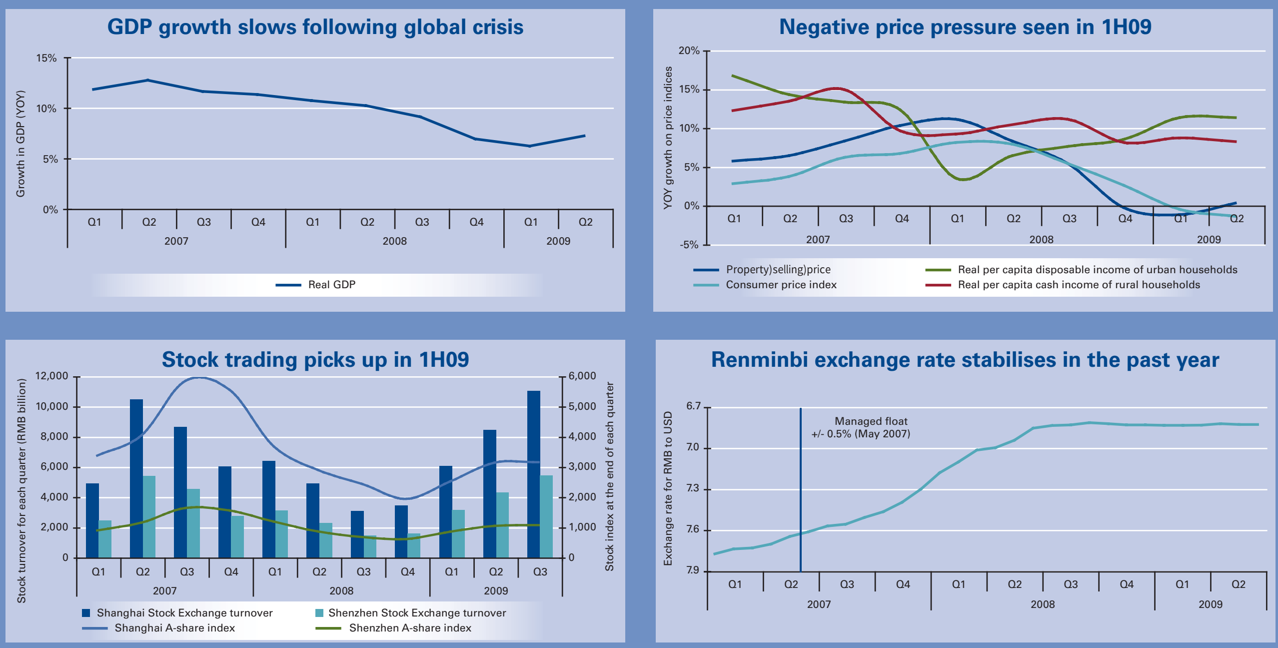
Vibrant spending has been supported by strong individual income growth. In real terms, the per capita urban residents' disposable income grew 11.2% year-on-year in June 2009. The per capita rural residents' cash income also grew by 8.1% year-on-year.

The registered urban unemployment rate edged up slightly from 4.2% at the end of 2008 to 4.3% at the end of June 2009. Migrant workers, who were not included in the official unemployment rate, also enjoyed a drop in unemployment numbers from 20 million early this year to 4.2 million by the end of June 2009. Most of the jobs were created in the construction and manufacturing sectors, thanks to the fiscal stimulus programme which spurred domestic labour demand.

Property prices pick up in 1H09

The government's stimulus package and increased credit helped the housing market to rebound. In March 2009, prices began to surge in major cities. Spurred by record levels of lending and higher consumer confidence, by August 2009, housing prices in the mainland's 70 biggest cities had risen at their fastest pace in 11 months. House prices rose 0.2% year-on-year and 2% year-on-year in June and August 2009 respectively, while house sales climbed 70% in the first eight months of 2009, from a year earlier. Property investment also grew by 14.7% during the first eight months of 2009.

Chart 11: Overview of key economic statistics for mainland China



Source: National Bureau Statistics of China, Bloomberg, National Development and Reform Comission, EIU Viewswire

Stock market picks up in 1H09

The stock market began to pick up in the first quarter of 2009, following a slump in 2008. IPO activity came to a halt in September 2008 and did not resume until late June 2009. Stock trading turnover in the first quarter of 2009 surpassed the last three quarters of 2009. The rising trend carried forward into the second and third quarters of 2009. The Shanghai and Shenzhen A-share indices rose 63% and 74% respectively, from 1,912 and 582 at the end of 2008, to 3,107 and 1,010 at the end of June 2009. These indices fell to 2,917 and 996 on 30 September 2009. The aggregate stock trading volume on the Shanghai and Shenzhen stock exchanges rose 31% over the first half of 2008 or 1.3 times over the second half of 2008.

RMB exchange rate is largely stable

The RMB exchange rate remained stable during the first half of 2009 and has appreciated 0.04%, 0.19% and 6.37% against the US dollar, Euro and Japanese yen respectively over the period. Since mainland China introduced the new currency exchange mechanism in 2005, the RMB has appreciated 21.14% against the US dollar, 3.87% against the Euro, and 2.73% against the Japanese yen.

Banking environment

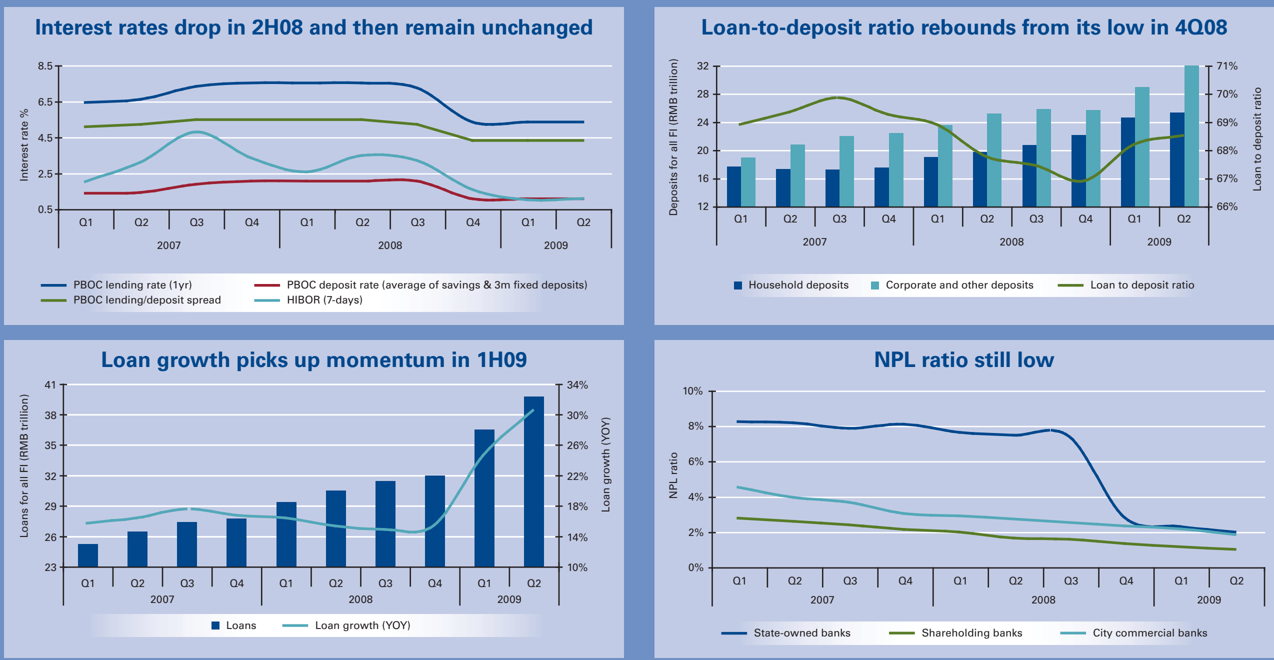
Deposit reserve ratios remained constant in 1H09

In the second half of 2008, the People's Bank of China (PBOC) cut the Renminbi deposit ratio four times to ensure sufficient liquidity in the banking system as the global financial crisis worsened. In late September 2008, the PBOC began to apply different reserve ratios for the bigger and smaller banks. The reserve ratio for small and medium-sized banks reached 13.5% while that for the larger banks was 2% higher at 15.5% by the end of 2008. Since then, the reserve ratios remained unchanged over the first nine months of 2009.

Interest rates also stayed the same in 1H09

The interest rate remained unchanged in the first eight months of 2008, but in the last four months of 2008, the PBOC lowered the benchmark interest rate five times. The one-year benchmark deposit rate was cut by a total of 189 basis points to 2.25% while the one-year benchmark lending rate was cut by 216 basis points in total to 5.31%. The savings deposit rate was cut by 36 basis points to 0.36%. Since then, interest rates have remained unchanged during the first six months of 2009. As lending rates had decreased faster than deposit rates, the cut in interest rate put significant pressure on the net spread.

Chart 12: Overview of key banking statistics for mainland China



Source: The People s Bank of China, China Banking Regulatory Commission

Liquidity still ample

Total Renminbi and foreign currency deposits rose 29% year-on-year by June 2009, or 21% for the first half of 2009 to RMB 58.1 billion. The deposit growth was broad-based across individuals and corporates. The proportion of household deposits remained at 44% of the total deposits, the same level as a year ago. The loan-to-deposit ratio initially came down from 67.8% at the end of June 2008 to 66.9% at the end of December 2009, and then rose to 68.5% at the end of June 2009 when loan growth picked up in the first half of 2009. Liquidity remained ample as financial institutions were still keeping excess deposit reserves at the central bank. The excess deposit reserve ratio maintained by the financial institutions at the end of June 2009 was 1.55%, which was lower than 5.11% at the end of 2008. The excess deposit reserve ratios maintained by state-owned banks, shareholding commercial banks and rural credit co-operatives were 1.15%, 0.95% and 4.26% respectively.

Rapid loan growth in 1H09

Total Renminbi and foreign currency loans grew by 33% year-on-year, or 24% over the first half of 2009 to RMB 39.8 trillion at the end of June 2009 on the back of the government’s stimulus plans. The government projects began to kick off in the first half of 2009, following the government stimulus package announced in November 2008. Loan growth was mostly broad-based across most financial institutions including policy banks, state-owned commercial banks, shareholding commercial banks, city commercial banks and rural financial institutions. Foreign financial institutions on the other hand saw a year-on-year contraction in their loan books.

Personal loans grew by 24% year-on-year or 19% over the first half of 2009 to RMB 6.8 trillion at the end of June 2009. The growth was partly attributable to the recent recovery in the property market. Corporate loans, including discounted bills, grew at 32% year-on-year, or 25% over the first half of 2009 to RMB 33 trillion. Short-term loans grew at 11.4% year-on-year, or 12.3% over the first half of 2009 to RMB 12.3 trillion. Short-term loans actually fell slightly over the second half of 2008 and then expanded in the first half of 2009. Discounted bills surged 1.8 times year-on-year or 88% over the first half of 2009 to RMB 3.6 trillion. Medium and long-term loans also grew strongly at 34% year-on-year or 26% over the first half of 2009 to RMB 15.4 trillion. New Renminbi medium and long term loans were mainly granted to infrastructure, leasing, commercial services and real estate industries, which accounted for 52%, 13.7% and 11.3% of these new loans.

NPL remains low

The non-performing loan (NPL) ratio of commercial banks improved to 1.77% at the end of June 2009, from 2.45% at the end of 2008 due to both rapid loan growth as well as an 8.8% decline in NPL balances over the first half of 2009. At the end of June 2009, the NPL ratios for state-owned banks, shareholding banks, city commercial banks and rural commercial banks improved to 1.99%, 1.03%, 1.85% and 3.20% respectively. On the other hand, the NPL ratio for foreign banks edged up slightly from 0.83% at the end of 2008 to 1.03% at the end of June 2009. For NPL balances, state-owned banks saw a 10.6% drop over the first half of 2009 while the others saw small increases in NPL balances.

Commercial banks continued to set aside additional allowances for loan losses. The ratio of total allowances to NPLs increased to 134.3% at the end of June 2009, from 117.9% at the end of 2008.

Performance of mainland China listed banks

Table 2: Reported results for the period ended 30 June 2009

RMB millions		Net interest income	Non-interest income #	Total operating income #	Operating expenses	Operating profit before loan provisions	Charge for impairment allowances on loans and advances	Other items	Profit before tax	Tax	Net profit after tax	YOY growth in net profit after tax
Bank of Beijing	BOB	5,118	462	5,580	1,584	3,996	299	33	3,730	807	2,923	0.7%
Bank of China	BOC	74,722	28,019	102,741	40,180	62,561	7,027	676	56,210	12,858	43,352	(2.9%)
Bank of Communications	BoCom	29,785	7,262	37,047	12,711	24,336	4,515	48	19,869	4,258	15,611	0.3%
Bank of Nanjing	BNan	1,410	296	1,706	567	1,139	226	37	950	149	801	1.6%
Bank of Ningbo	BNin	1,573	186	1,759	890	869	164	100	805	99	706	(3.2%)
China CITIC Bank	CITIC	15,014	2,095	17,109	6,528	10,581	1,176	(42)	9,363	2,311	7,052	(16.3%)
China Construction Bank	CCB	102,468	26,556	129,024	46,185	82,839	10,274	(96)	72,469	16,628	55,841	(4.9%)
China Merchants Bank	Merch	18,623	6,052	24,675	11,880	12,795	2,650	33	10,178	1,916	8,262	(37.6%)
China Minsheng Banking Corporation	Minsh	13,950	6,989	20,939	8,869	12,070	2,405	(79)	9,586	2,207	7,379	22.0%
Huaxia Bank	HX	5,600	2,154	7,754	4,046	3,708	1,404	(156)	2,148	482	1,666	(13.6%)
Industrial and Commercial Bank of China	ICBC	116,038	30,724	146,762	53,048	93,714	9,248	1,322	85,788	19,064	66,724	2.8%
Industrial Bank	IB	12,081	1,879	13,960	5,970	7,990	94	71	7,967	1,744	6,223	(4.9%)
Shanghai Pudong Development Bank	SPDB	15,137	1,536	16,673	5,796	10,877	2,085	192	8,984	2,203	6,781	6.4%
Shenzhen Development Bank	SDB	6,364	1,093	7,457	3,476	3,981	1,015	(37)	2,929	618	2,311	7.8%
TOTAL		**417,883**	**115,303**	**533,186**	**201,730**	**331,456**	**42,582**	**2,102**	**290,976**	**65,344**	**225,632**	**(3.1%)**
TOTAL — Listed in Hong Kong and mainland China		**356,650**	**100,708**	**457,358**	**170,532**	**286,826**	**34,890**	**1,941**	**253,877**	**57,035**	**196,842**	**(4.2%)**
TOTAL — Listed in mainland China only		**61,233**	**14,595**	**75,828**	**31,198**	**44,630**	**7,692**	**161**	**37,099**	**8,309**	**28,790**	**4.9%**

#: "Non-interest income" and "Total operating income" shown here may not equal the figures disclosed in annual reports as we exclude certain items in "non-interest income" which were originally included in the reported operating profits. Items we have reclassified and excluded from "non-interest income" are changes in fair value of investment properties, gain or loss on disposals of subsidiaries or associates, and gain or loss on disposals of fixed assets or other assets. Impairment allowances on investments and insurance premiums net of insurance claims are included in non-interest income.

Source: Listed banks' financial disclosures

Balance sheet

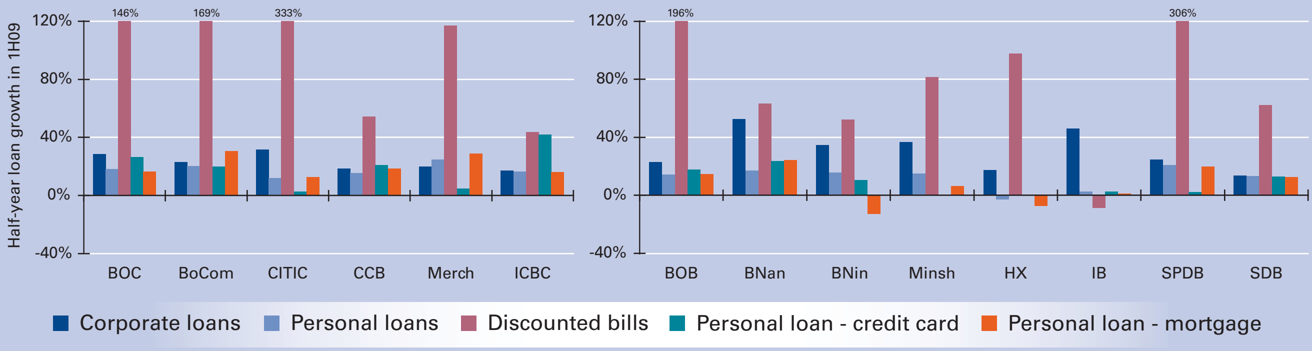
Corporate loan growth seen in 1H09; discounted bill growth steady over the last 12 months

The mainland listed banks achieved balance sheet and loan growth of 29% and 34% year-on-year to reach RMB 41.7 trillion and RMB 21.8 trillion respectively. Corporate loans and personal loans grew by 27% and 22% while discounted bills surged 215%. Most of the loan growth actually happened in the first half of 2009, growing at 26% over the previous year end balance. Corporate loans and personal loans grew by 23% and 16% while discounted bills surged 94% over the first half of 2009, thanks to government's stimulus plans. At the end of June 2009, corporate loans accounted for 71.8% of the total loans. A major part of the new corporate loans were granted to key national infrastructure projects under the government's economic stimulus package. Most listed banks have expanded their discounted bills business over the last 12 months and they now account for 9.5% of total loans.

Mortgage growth expands in 1H09

Personal loans account for 18.7% of total loans and the growth was mainly supported by mortgage lending which grew by 22% over the last 12 months. Similar to corporate loans, most of the growth in mortgage books took place in the first half of 2009 where mortgages grew by 17% over the last six months. Other personal loans also displayed a similar trend, growing by 17.8% over the last 12 months, or 14.5% over the last six months. On the other hand, credit card loan growth was less concentrated in the first half of 2009, growing by 66% on year-on-year basis, or 15.6% over the last six months. Credit cards still account for less than 1% of the total loans in the mainland.

Chart 13: Very strong loan growth in the first six months



Source: Listed banks' financial disclosures

Deposits with central bank generally stay the same in 1H09

Deposits with central banks, which mainly comprise statutory, surplus and fiscal deposits reserves with the PBOC, rose by 18.3% over the last 12 months but fell 0.9% over the first half of 2009. Those banks listed in China only saw a bigger drop of 4.3% over the first six months of 2009. The statutory deposit reserves with the PBOC actually went up 19.7% over the first half of 2009 to match with a 21% rise in customer deposits whilst the PBOC has kept the statutory deposit reserve ratios unchanged since the end of 2008. On the other hand, the surplus deposit reserves with the PBOC came down by 48%. As demand for lending was strong in the first half of 2009, more banks were trimming down the voluntary deposits at the PBOC.

Loan to deposit ratio improves in 1H09

Customer deposits rose 32% year-on-year to RMB 33.2 trillion at the end of June 2009. Savings deposits accounted for 48% of total deposits, the same as at the end of 2008. The loan to deposit ratio improved to 65.6% at the end of June 2009, up from 63.1% at the end of 2008.

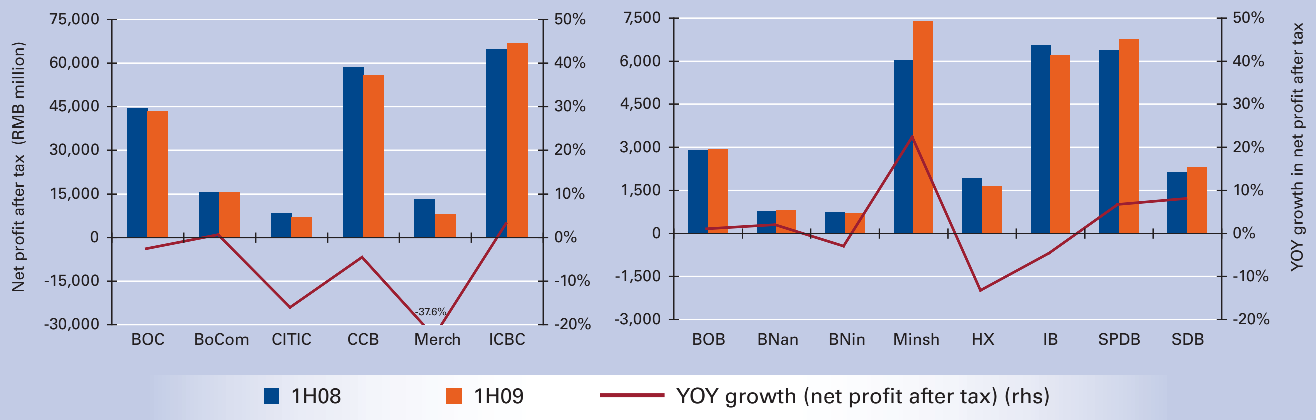
Profitability

Profit fell slightly despite narrowing of interest spread

The mainland listed banks continued to post strong results, with net profit after tax dropping by 3.1% to RMB 226 billion due to narrowing of interest spread though partly offset by strong loan growth. Lower investment write-downs together with fee income growth also helped to offset the decline in net interest income. Operating profit before loan impairment allowances fell by 3.7%.

In 2007 and 2008, at least RMB 23.4 billion and RMB 62.5 billion in investment write-downs were booked as the global financial crisis deepened. As we moved into 2009, investment write-downs decreased. About RMB 6.4 billion of investment impairment was booked in the first half of 2009, smaller than the RMB 18.3 billion booked in the first half of 2008. Most of the write-downs were made by a few large listed banks.

Chart 14: Profit is strong despite challenging environment

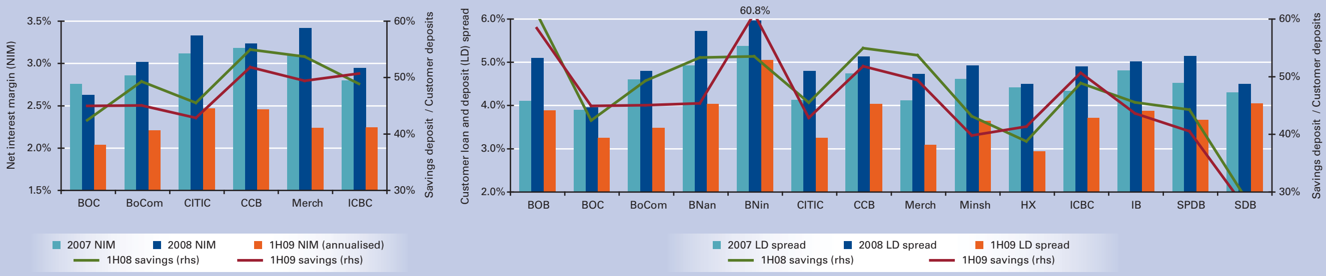


Source: Listed banks' financial disclosures

Cuts in interest rate put significant pressure on net interest income

Net interest income fell by 10.0% to RMB 418 billion despite strong loan growth. Yields on customer loans and deposits narrowed due to the cumulative effect of interest rate cuts towards the fourth quarter of 2008. The benchmark savings deposit rate, which remained very low by historical standards, had much less room for rate cuts. The savings deposit rate was cut from 0.72% to 0.36%. As the proportion of savings deposits was relatively large (close to half of the total deposits), the average funding cost decreased at a slower pace than the loan interest yield when interest rates came down. On average, the lending yields and deposit yields for the first half of 2009 fell by approximately 1.8% and 0.5% respectively, compared with first half of 2008. Based on disclosed information, the average annualised net interest margin came down to 2.30% in the first half of 2009, compared with 3.00% for full year of 2008 and 3.13% for the first half of 2008. A surge in discounted bills lending, which usually carries a lower lending yield, lowered the average interest margin of the banks.

Chart 15: Net interest margin and spread narrow following interest rate cuts

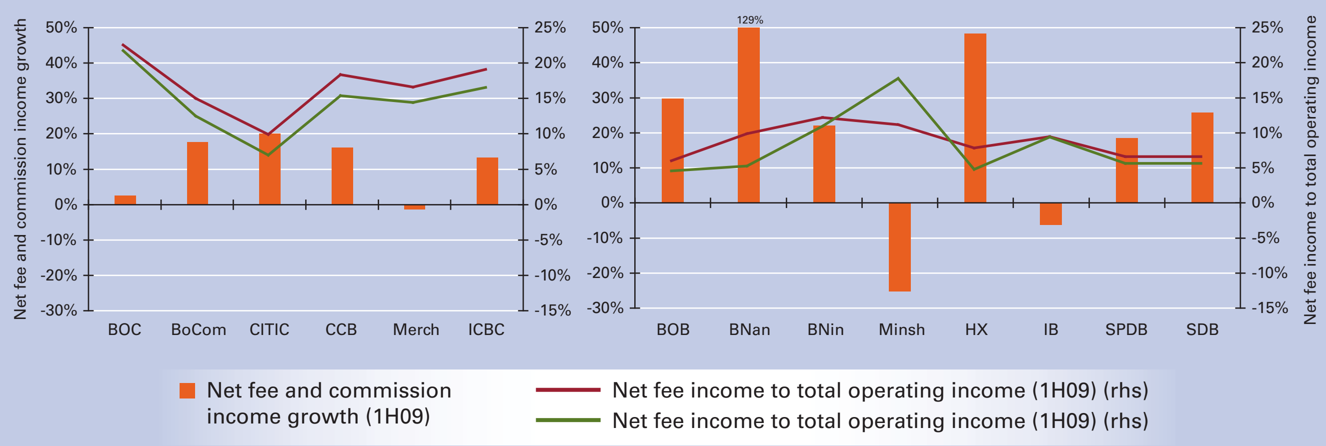


Source: Listed banks' financial disclosures

Fee income grows on the back of loan growth

Net fee and commission income rose 9.5% to RMB 92 billion. Bank card fees rose 34% as the banks continued to expand the number of bank cards. Consumer spending through bank cards and transactions through self-service facilities continued to increase. Consultancy, advisory and investment banking fees, mainly earned by state-owned banks, rose 48% partly due to the expansion of investment banking and financial advisory services. On the other hand, agency services fees declined. Fees earned from fund agency services shrank as the domestic capital markets were still recovering from the global downturn.

Chart 16: Net fee and commission grows on the back of loan growth and expansion in consultancy services



Source: Listed banks' financial disclosures

Efficiency ratio generally similar to last year

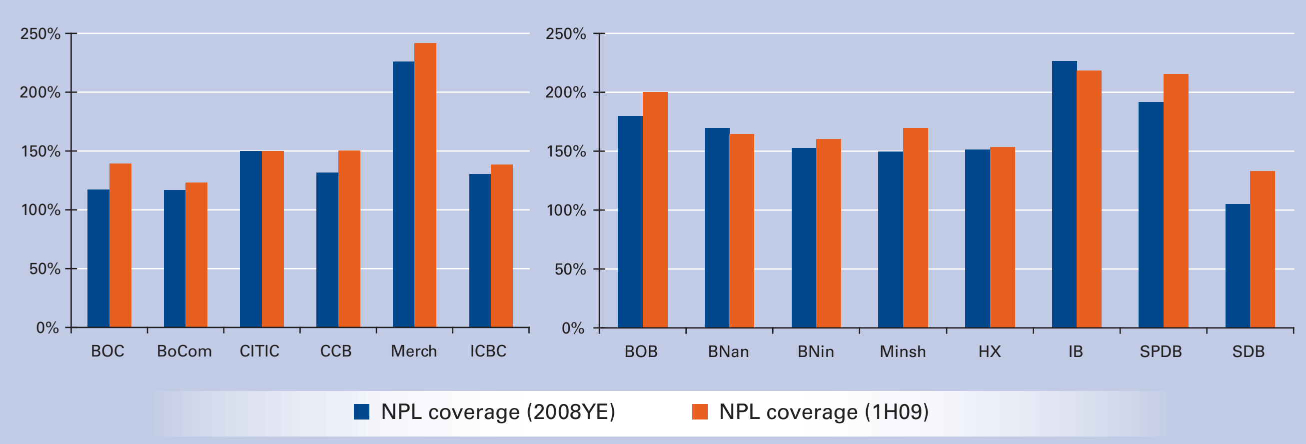
Operating expenses fell by 0.5% to RMB 202 billion, within which staff costs fell by 6.7% while premises- and equipment-related expenses rose about 17%. The cost to income ratio was 38% for the first half of 2009, slightly higher than 37% for the first half of 2008. The cost to income ratio for banks listed only in China was at 41% for the first half of 2009, down from 42% for the first half of 2008.

Asset quality

Loan impairment charges surge; loan allowance coverage increases

Loan impairment charges fell by 7.1% to RMB 43 billion partly due to an overall decline in both NPL balances and the NPL ratio. Net individually assessed charges fell by 71% partly because additional loan provisions were made in last year's first half following the Sichuan earthquake. Net collective charges rose 6.5% as banks continued to set aside adequate provisions in view of the global slowdown and raised the NPL coverage ratio. At the end of June 2009, the provision coverage ratio reached 148%, up from 134% at the end of 2008. For banks listed in mainland China only, the provision coverage ratio reached 184% at the end of June 2009, up from 171% at the end of 2008.

Chart 17: Loan allowance coverage continues to build up in most banks



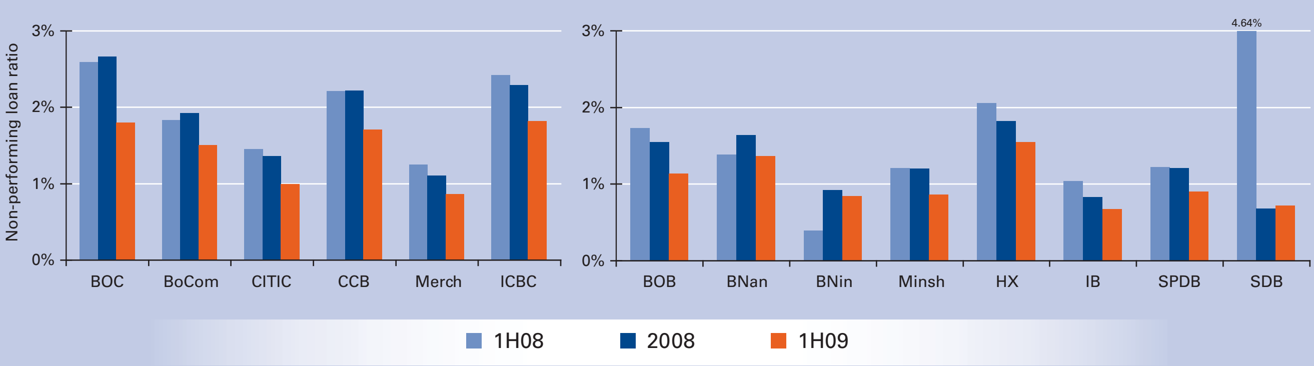
Source: Listed banks' financial disclosures

NPL ratio remains low

NPL ratio continued to improve on the back of loan growth and lower gross NPLs, dropping to 1.53% at the end of June 2009 from 2.04% at the end of 2008. The decline in NPL ratio was observed across almost all banks and by the end of June 2009 all listed banks achieved an NPL ratio of less than 2%. Gross NPLs also fell by 4.8% year-on-year, or 5.7% over the first half of 2009, although the decline was more apparent at the bigger banks. Banks listed in mainland China only saw an 18.6% year-on-year decline in gross NPLs, or a 2.5% increase during the first half of 2009.

The special mention loan ratio for all listed banks improved to 3.2% at the end of June 2009, from 4.5% at the end of 2008. Gross special mention loans also fell 1.1% year-on-year, or 10.4% over the first half of 2009.

Chart 18: Non-performing loan ratio remains low



Source: Listed banks' financial disclosures

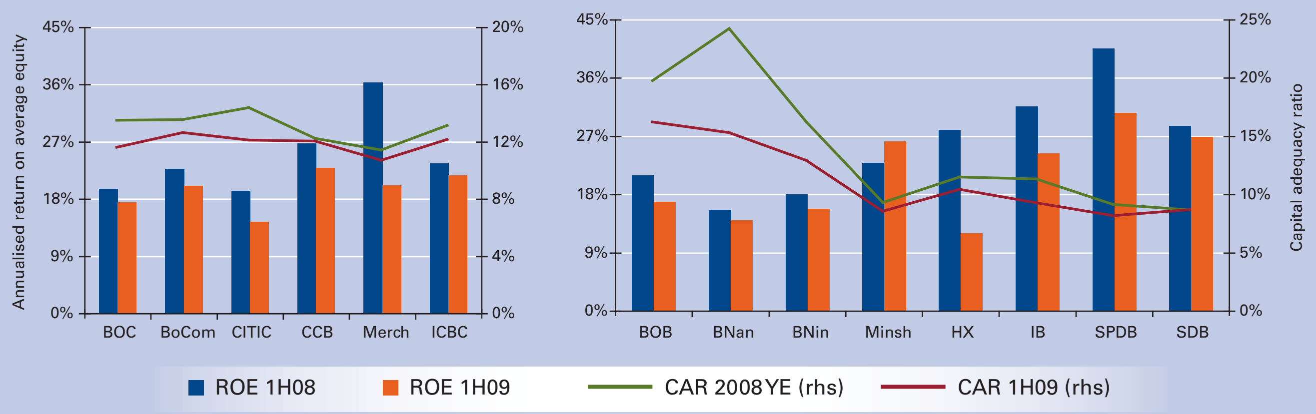
Banks remain cautious on rising credit risk

In response to the slowdown in the global economy, the Chinese government announced a RMB 4 trillion stimulus package in November 2008 under which the banks were encouraged to help finance projects to build railways, toll roads, power grids and other infrastructure. China is likely to maintain a relatively loose monetary policy as the global financial crisis is not yet over. The government has expressed concern over the rapid loan growth and has asked the banks to watch out for projects with insufficient capital, to monitor bills discounting, the property sector and lending concentration risks. For fixed-asset investment projects, banks should ensure that the funds are being used for their intended purposes, monitor the revenue stream of the project and investigate unusual fund flows. The same applies to short-term bill financing where banks should ensure that the funds were used for genuine short-term working capital needs rather than for speculation. For second home mortgages, banks should comply with the down-payment and lending rate requirements on second homes and also monitor property loan risks. To help reduce concentration risks, banks were encouraged to arrange more syndicated loans.

Impact of the global financial crisis is relatively small to the sector as a whole

The global financial crisis which started in 2008 continued to impact the investment portfolios of the listed banks, mostly their debt securities investments. Based on disclosed information, RMB 6.4 billion in investment impairments was booked in the first half of 2009. Those banks listed in Hong Kong, which tend to be the bigger and more international banks, suffered relatively more as they had higher exposure to overseas toxic assets. The remaining net book value of the impaired investment portfolio at the end of June 2009 was at least RMB 63 billion, based on disclosed information. The recovery of the global economy as well as the credit market will determine whether these assets deteriorate further and whether more assets will become impaired in the second half of the year.

Chart 19: Loan growth puts pressure on CAR



Source: Listed banks' financial disclosures

CAR stays above 8%; active planning for fund raising in 1H09

All listed banks were well capitalised, having all achieved the minimum CAR standard of 8%. The average CAR of all listed banks fell to 11.5% at the end of June 2009 from 12.6% at the end of December 2008 as loan growth put pressure on capital ratios. Listed banks have been actively planning to raise funds in 2009 to strengthen their capital bases. The annualised ROE for listed banks was 21% for the first half of 2009, lower than 24% for the first half of 2008.

There were no initial public offerings (IPO) for banks in the first half of 2009 as investment sentiment proved unfavourable. A number of listed banks have received regulatory approvals to raise funds in 2009, including subordinated debt, private placements, rights issues and also listing in Hong Kong. A total of RMB 150 billion was raised from issuing subordinated debt during the first nine months of 2009, of which RMB 40 billion was raised in the first half and another RMB 110 billion in the third quarter.

KPMG directory

KPMG International's network of member firms has established focused industry groups covering areas in which we have particular knowledge. Financial Services is one such area. In China we have a wide range of capabilities in our Financial Services group. Feel free to contact the following individuals with your particular banking and finance queries.

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