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Legislative Council

<u>LC Paper No. CB(1)224/05-06(01)</u>

Ref: CB1/PL/FA

Panel on Financial Affairs
Meeting on 7 November 2005

Background Brief
on deregulation of interest rate rules

Purpose

This paper sets out the background of the deregulation of interest rate rules (IRRs), and summarizes the major views expressed by members when the subject was deliberated at the meeting of the Panel on Financial Affairs (FA Panel) on 1 February 1999.

Background

2. In February 1994, the Consumer Council in its report "Are Hong Kong Depositors Fairly Treated?" recommended that the interest rate caps on time, savings and demand deposits be removed. Following the partial deregulation of the IRRs undertaken in 1994 and 1995, the interest rates of more than 99% of all Hong Kong (HK) dollar fixed time deposits or around 70% of total HK dollar deposits were free to fluctuate in accordance with competitive market forces. The remaining IRRs covered time deposits with a maturity below seven days, current accounts and savings accounts deposits.

3. In early 1998, the Hong Kong Monetary Authority (HKMA) commissioned the Hong Kong Banking Sector Consultancy Study (the Consultancy Study) to examine the strategic outlook of the banking sector over the next five years and to consider the effectiveness of HKMA's approach to banking supervision. Deregulation of the remaining IRRs was one of the regulatory issues examined in the Consultancy Study, and the relevant part of the Executive Summary on the findings and recommendations of the Study issued in December 1998 is in **Appendix I**. The recommendations of the Study were released for public consultation until the end of March 1999.

4. In February 1999, HKMA briefed the FA Panel on the major findings and recommendations of the Consultancy Study. In response to the recommendations and taking into account the views received during the public consultation, HKMA developed a three-year programme for the reform and further development of the banking sector. As part of the programme to promote competition in the banking sector, HKMA adopted a two-phase approach to deregulate the remaining IRRs:

(a) Phase 1, which took effect on 3 July 2000, removed the interest rate cap on time deposits with a maturity of less than seven days and the prohibition on benefits for all deposits with the exception of HK dollar savings and current accounts; and

(b) Phase 2, which took effect on 3 July 2001, removed all IRRs on HK dollar savings and current accounts.

5. Since then, interest rates on all types of deposits have been determined by competitive market forces.

Major views expressed by members of the FA Panel

6. At the FA Panel meeting on 1 February 1999, members noted the recommendations of the Consultancy Study. On the further deregulation of IRRs, some members considered that the deregulation programme should be expedited so as to realize the benefits associated with deregulation as soon as possible and enable Hong Kong to meet international standards in this area. For details, please refer to paragraphs 44 to 50 of the minutes of the Panel meeting (http://www.legco.gov.hk/yr98-99/english/panels/fa/minutes/fa010299.htm).

References

7. A list of the relevant papers is in **Appendix II**. For the ease of reference, the following papers are also attached:

(a) HKMA's press release on "Deregulation of Interest Rate Rules" issued on 30 May 2000 (**Appendix III**);

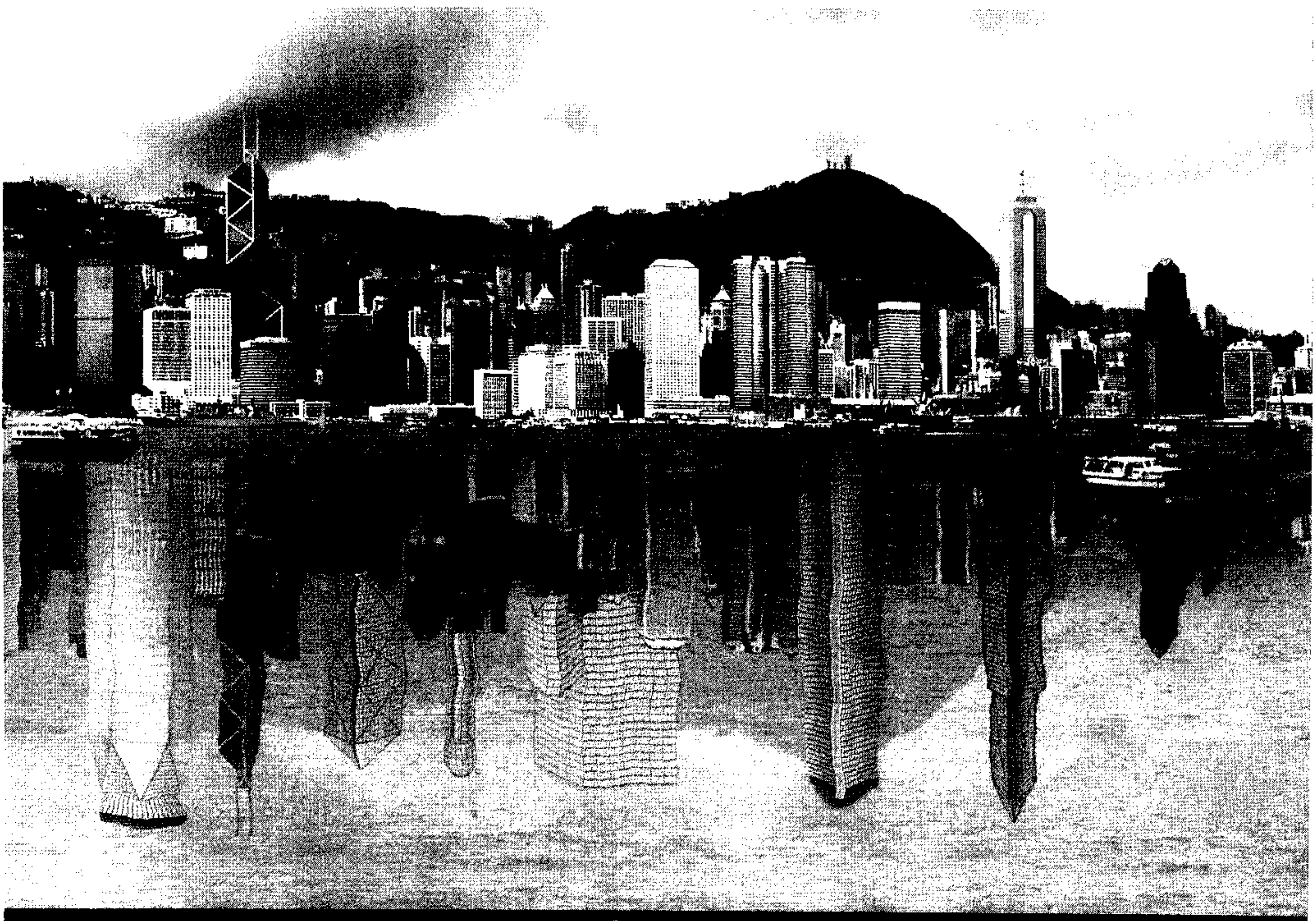
(b) An article on "Deregulation of Interest Rate Rules" published in HKMA's Quarterly Bulletin in May 2000 (**Appendix IV**); and

(c) HKMA's press release on "Deregulation of Interest Rate Rules" issued on 3 July 2001 (**Appendix V**).

Council Business Division
Legislative Council Secretariat
4 November 2005

Hong Kong Banking into the New Millennium

Hong Kong Banking Sector
Consultancy Study - Executive Summary



December 1998

KPMG BARENTS GROUP LLC

1.8.8 Interest rate rules

The Consumer Council in its report *Are Hong Kong Depositors Fairly Treated?*[12] recommended that the interest rate caps on time, savings and demand deposits be removed. The HKMA's response to this report was as follows:

> *"We endorse the principle that there should be more competition in retail interest rates as it would encourage product innovation and greater efficiency. This is also in line with our conviction about the free market philosophy and the practice of it. What is equally important is the need to strike the right balance between two different, although not mutually exclusive objectives, i.e. to encourage more competition vis-à-vis the need to maintain stability in the monetary and banking systems."*

Following this, partial deregulation of the IRRs took place in two phases:

- ***Phase 1 (1 October 1994)*** -- removal of the interest rate cap on time deposits fixed for more than 1-month; and
- ***Phase 2 (3 January 1995)*** – removal of the interest rate cap on deposits fixed for more than 7-days up to 1-month.

It was intended to relax further the remaining interest rate caps on short-term time deposits, and 7-day time deposits were deregulated in November 1995.

Although the Consumer Council also proposed to release the interest rate cap on current and savings accounts, it was decided that these rules should continue for the time being. The HKMA's comments in this regard were as follows:

> *"The additional steps proposed by the Consumer Council in respect of demand and savings deposits could have much more serious consequences because of the size of these deposits. Before deciding to proceed with these measures, it would be necessary to review carefully the impact of the removal of the interest rate cap on time deposits. It is therefore premature to make a commitment to any further changes in the IRR."*

The effect of partial deregulation on consumer choice is summarised by the following table (see Table 1.8.3):

Table 1.8.3 Effect of deregulation on HK$ deposits accepted by banks

<table>
<tr><td>HK$500,000 or more</td><td></td><td colspan="5">Non-regulated</td></tr>
<tr><td>Up to HK$499,999</td><td colspan="3">IRRs regulated deposits</td><td>Phase 2</td><td>Phase 1</td><td></td></tr>
<tr><td></td><td>Current accounts</td><td>Savings accounts</td><td>Up to 6-days</td><td>7-days up to 1-month</td><td>1-month up to 15-months</td><td>Over 15-months</td></tr>
</table>

Note: Consumers could always place deposits of HK$100,000 or more with DTCs for any maturity of 3-months or more at competitive interest rates, since DTCs are not subject to the IRRs.

Source: KPMG/Barents analysis

[12] A summary and conclusion prepared by the Consumer Council Steering Group on Financial Services based on the consultants report "An Evaluation of the Banking Policies and Practices in Hong Kong -- focusing on their impacts on consumers", 28 February 1994.

Since partial deregulation, the HKMA has been monitoring the impact that this deregulation has had on the market, through a survey of the 40 authorized institutions which accept the majority of HK$ deposits. We have reviewed the findings from this survey and updated them up to June 1998. The impact of deregulation on four major areas, in particular, has been considered. These are the underlying growth of different types of deposit, the volatility of the deposit base[13], the volatility of interest rates and the overall impact that deregulation has had on bank profitability. Our conclusions in each of these areas for the 40 institutions are as follows:

- ***Deposit growth*** – deregulated time deposits have continued to grow at a far more rapid pace than the underlying growth rates of the deposit base. At the same time, the rate of growth of IRRs regulated deposits has been very low. These deposits at present account for HK$387 billion (approximately 27% of total HK$ deposits), compared to HK$372 billion (42% of total HK$ deposits) in September 1994.

- ***Deposit volatility*** – deregulation has had an impact on deposit volatility in that it increases the potential for movement of deposits between different maturities, different banks and different currencies. This potential is often realised at times of uncertainty, as has been evidenced during the Asian crisis. In contrast, prior to the Asian crisis, there had been a relatively long period of stability in banks' deposit bases, even though deposits had been deregulated. While the majority of deposit volatility (since the Asian crisis began) has occurred in deposits that were never subject to the IRRs (i.e. HK$500,000 or more), deregulated deposits have also become more volatile.

- ***Interest rate volatility*** – following partial deregulation of the IRRs, banks adjusted their interest rates on the newly deregulated accounts to closely match Hong Kong Interbank Offer Rates ("HIBOR") rates. This has continued to be the situation even during the Asian crisis, although the difference between the rates quoted for deregulated deposits and HIBOR has, at times, increased and the volatility of all HIBOR-based deposit interest rates has increased substantially. Additionally, individual banks have sometimes been prepared to pay *preferential* or unquoted rates to attract deposits. In some instances, preferential interest rates have been in excess of HIBOR, which implies greater interest rate volatility than is evidenced by the quoted rates of individual banks.

- ***Bank profitability*** – increased competition for HK$ deposits during the Asian crisis (principally reflected in the volatility of deposits and interest rates) is having a significant impact on banks' profitability. In 1998, net interest margins for local banks have decreased by approximately 7% or 17 basis points, when compared with the first half of 1997[14]. Additionally, this overall fall conceals wide variations among individual banks (e.g. due to differing deposit base structures and loan portfolios).

This increased competition for deposits, coupled with declining asset quality, has raised some concerns over the stability of the sector as a whole. However, this should also be viewed in the context of the exceptional situation caused by the Asian crisis. Nevertheless, the potential impact of further deregulation of the IRRs on the profitability of the banks (and therefore increasing potential systemic risk) is one of the most important issues in the assessment of the IRRs in the current environment, and warrants in-depth and careful analysis. Our findings in this regard are summarised in the following section.

[13] Deposit volatility has been reviewed in terms of deposit movements between different maturity of deposits, deposit movements between banks and deposit movements between different currencies.

[14] *Source:* HKMA (internal)

Assessment of the IRRs

The IRRs have provided a measure of underlying stability in the retail deposit and residential mortgage markets. However, the IRRs limit competition for certain deposits and raise questions about efficient allocation of resources. In deciding whether the remaining IRRs should be deregulated, a number of issues need to be considered, principally, whether the long-term impact of restricting competition is outweighed by the need for interest rate stability.

From the perspective of consumer choice and fair returns to depositors, the argument generally used by the banks is that consumers receive other services in lieu of higher interest payments. This, however, results in inefficiency in the pricing of products and provides a subsidy to banks in the form of cheaper funding, which may discourage the forces of consolidation. This subsidy is provided at the expense of savers, which is neither efficient nor equitable. With the IRRs removed, interest costs are likely to rise and this may lead to a consolidation in the industry, as has been experienced in other countries where interest rates have been deregulated. The fewer remaining institutions will be more efficient and provide more competitive interest rates to savers.

While continuing the status quo is a reasonable regulatory decision during the current financial crisis, it is difficult to defend as a long-term stance, given the competitive reach of the global financial sector. Shielding Hong Kong banks from this process will handicap the strongest banks from effectively responding to these forces by reducing the incentive to do so in their home market. It is essential, however, that the process of further deregulation is carefully managed, to avoid potential instability in the banking sector.

Given the importance of the IRRs, two models were developed to measure the potential impact of interest rate deregulation on banking sector interest expense. Both models used interest rate and deposit data available up to the end of 1997:

- firstly, an econometric model was developed to assess the potential impact of revoking the IRRs on savings accounts and time deposits. This model reviewed the impact of the 1994-95 deregulation of time deposit accounts on deposit movements, through to the end of 1997; and

- secondly, a predictive model was developed to estimate the financial impact of interest rate deregulation (based on the results of the econometric model) for the 40 banks holding the majority of HK$ deposits[15].

As the models were designed to focus on deposit movements and interest expense, the models did not address the issue of how banks would seek to preserve net interest margins through changes in lending activities (e.g. increases in lending rates to compensate for increases in funding costs).

[15] These were the 40 institutions included in the HKMA interest rate survey.

For the predictive model, one base-case (i.e. 1997 actual data) and 10 scenarios were devised and reviewed. The scenarios were selected to show the effect of partial deregulation (e.g. only for savings accounts or current accounts) and full deregulation, under a number of different interest rate environments. The predictive model demonstrated that the impact on banks' interest expense would vary considerably, depending on the change in interest rates and the type of deregulation (e.g. whether current accounts or savings accounts or both were deregulated). The following four scenarios illustrate the impact of deregulation under differing circumstances (see Table 1.8.4):

Table 1.8.4 Impact of releasing the remaining IRRs (under four scenarios)

	Actual data for 1997	Deregulation of savings accounts		Deregulation of current accounts	Full deregulation
	Base case	Case 1	Case 2	Case 3	Case 4
Effective interest rates on:					
Current accounts	0.00%	0.00%	0.00%	4.13%	5.68%
Savings accounts	4.13%	4.71%	5.68%	4.13%	5.68%
Total interest expense (HK$million)	175,729	176,817	181,167	180,195	187,310
Increase in interest expense (HK$million)	–	1,088	5,438	4,466	11,581
Net interest margins:[1]					
Local banks	2.51%	2.42%	2.28%	2.32%	2.02%
Foreign banks	1.13%	1.10%	1.04%	1.06%	0.94%
Both local and foreign	1.66%	1.63%	1.51%	1.54%	1.35%
Decrease in net interest margin for local banks:					
% reduction	–	3.6%	9.2%	7.6%	19.5%
Basis point reduction	–	9bp	23bp	19bp	49bp

Note: [1] Net interest margins = net interest income divided by average interest earning assets
Source: KPMG/Barents analysis

Based on these numbers, full deregulation of the IRRs could have a significant financial impact on the interest expense of banks, particularly for local banks. On the assumptions set out above, and on the basis of 1997 data, the potential impact on net interest margins of local banks could be as high as 49 basis points. To put this into context, the decline in net interest margins for all local banks in the period from June 1997 to June 1998 (reflecting the impact of the Asian crisis) was only 17 basis points. Therefore, the impact of full deregulation is potentially far greater than that experienced during the Asian crisis.

It is also likely that banks would act to pass on or mitigate these such cost increases in the form higher customer fees and/or lending rates. Any increase in mortgage rates could adversely affect the property market.

Recommendations

In the longer-term, deregulation brings with it a number of benefits, including more efficient intermediation and improved product choice for consumers. However, actions taken to deregulate the remaining IRRs have the potential to increase the recent reductions in profitability of banks and also sector instability. We therefore consider that deregulation of the remaining IRRs should not occur at this particular time, when there is already increased systemic risk in the financial sector. Once this period of market volatility has subsided, we recommend the HKMA take steps to assess whether deregulation could be achieved without a significant adverse impact on systemic risk of the sector. Given the difficult operating conditions expected for banks during 1999, no deregulation is recommended next year.

In determining the timing of any further deregulation, we recommend that changes should only be introduced after a specified period of stability, characterised by relative containment of risk. The containment of risk could be measured using a wide range of monetary, financial and market indicators and monitoring of these indicators should commence during 1999. Additionally, not all banks currently have the products, systems, risk management capabilities and/or balance sheet structures that would enable them to compete in a fully deregulated interest rate environment. Consequently, if the HKMA and the HKAB move towards further interest rate deregulation, such reforms would be more prudently implemented if phased in over a period of time.

There are only three separate types of accounts or deposits that remain to be deregulated (i.e. current accounts, savings accounts and time deposits up to 6-days). In determining how and when to deregulate these types of accounts in a phased manner, we have considered the likely impact of the deregulation of each on sector stability and individual banks' ability to compete. Bearing these considerations in mind, one possible scenario is outlined below (subject to monitoring of indicators during 1999 and following each stage of deregulation):

- ***Stage 1*** – remove interest rate restrictions on time deposits with a maturity of 24-hours up to 6-days;
- ***Stage 2*** – allow interest to be paid on current accounts up to an agreed interest rate cap; and
- ***Stage 3*** – remove all remaining interest rate restrictions.

Appendix II

Deregulation of interest rate rules

List of relevant papers

(Position as at 4 November 2005)

Paper	**LC Paper No.**
Executive Summary on the "Hong Kong Banking Sector Consultancy Study: Hong Kong Banking into the New Millennium"	*(discussed at the FA Panel meeting on 1 February 1999)*
LegCo Brief on the "Hong Kong Banking Sector Consultancy Study: Hong Kong Banking into the New Millennium"	*(discussed at the FA Panel meeting on 1 February 1999)*
Paper provided by the Hong Kong Monetary Authority (HKMA) on the "Hong Kong Banking Sector Consultancy Study: Hong Kong Banking into the New Millennium"	CB(1)816/98-99(03) *(discussed at the FA Panel meeting on 1 February 1999)*
Minutes of the FA Panel meeting on 1 February 1999	CB(1)1592/98-99 *(paragraphs 44 to 50)*
HKMA's press release on "Policy Response to the Banking Sector Consultancy Study" issued on 14 July 1999	—
HKMA's press release on "Deregulation of Interest Rate Rules" issued on 30 May 2000	—
An article on "Deregulation of Interest Rate Rules" published in HKMA's Quarterly Bulletin in May 2000	—
HKMA's press release on "Deregulation of Interest Rate Rules" issued on 3 July 2001	—

Appendix III

中文

Deregulation of Interest Rate Rules

The Hong Kong Monetary Authority (HKMA) announced today (30 May 2000) that the deregulation of Interest Rate Rules (IRRs) on time deposits with a maturity of less than 7 days and the prohibition on benefits for deposits (other than Hong Kong dollar savings and current accounts) will take effect on 3 July 2000.

"We have kept the economic and financial environment under review and have concluded that it is appropriate to proceed on schedule with the planned deregulation of interest rates. This view is shared by the Banking Advisory Committee, the Deposit-taking Companies Advisory Committee and the Exchange Fund Advisory Committee. Phase 1 of the deregulation will therefore take place as scheduled on 3 July 2000," said Mr David Carse, Deputy Chief Executive of the HKMA.

This is the first of a two-phased plan to deregulate the remaining IRRs in order to promote market liberalisation and enhance competition of the banking sector. It is also part of an overall programme to reform and further develop the banking system. Under the first phase of deregulation, the IRRs on time deposits with a maturity of less than 7 days and the prohibition on benefits for deposits (other than Hong Kong dollar savings and current accounts) will be lifted. The second phase, which will remove the IRRs on savings and current accounts, is scheduled to take place 12 months after the phase 1 liberalisation, subject to the prevailing economic and financial environment at the time.

In reviewing the current economic and financial environment, the HKMA has taken into account the following indicators:

- improvement in the underlying performance of the Hong Kong economy (the economy has reported four consecutive quarters of real GDP growth);
- absence of severe strains on banking sector profitability (pre-tax operating profits for local banks rose significantly in the first quarter of 2000 compared with the same quarter last year);
- comparatively low interest rate volatility over a sustained period (the differential between HIBOR and US dollar LIBOR is close to the levels prior to the Asian financial crisis);
- improvement in the classified loan ratio of the banking sector (the classified loan ratio of local banks dropped to 9.28% in March 2000 from the peak of 10.33% in September 1999);
- maintenance of stable capital adequacy ratios (the ratio for the banking sector remained at just under 19% in the first quarter of 2000); and
- absence of foreseeable major international or regional economic upheavals.

"Although the first phase of the deregulation is relatively modest in itself, it brings the system one step closer to the complete liberalisation of interest rates in Hong Kong. The HKMA will continue to monitor closely the impact on the banks and developments in the market ahead of the final stage of deregulation due next year," Mr Carse added.

Attachment

An advanced copy of the article on the Deregulation of Interest Rate Rules, which will be published in the Quarterly Bulletin (May Issue) tomorrow, is attached with this press release.

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Hong Kong Monetary Authority

30 May 2000

TOP

DEREGULATION OF INTEREST RATE RULES

As part of the Banking Sector Reform Programme to promote competition in the banking industry, the Hong Kong Monetary Authority (HKMA) undertakes to deregulate the remaining interest rate rules in two phases. Phase 1 of the deregulation, which is scheduled for July 2000, will remove the interest rate cap on time deposits with a maturity of less than 7 days and the prohibition on benefits for all deposits with the exception of Hong Kong dollar savings and current accounts. An analysis by the HKMA of the prevailing economic and financial conditions indicates that the environment is not unfavourable for this phase of the deregulation to take place. With the support of the Exchange Fund Advisory Committee, the Banking Advisory Committee and the Deposit-taking Companies Advisory Committee, the HKMA and the banking industry agree that Phase 1 of the deregulation should proceed on 3 July 2000. This article explains the considerations behind this decision.

Background

Following the deregulation undertaken in 1994 and 1995, the interest rates of more than 99% of all HK dollar fixed time deposits or around 70% of total HK dollar deposits are now free to fluctuate in accordance with competitive market forces. The remaining interest rate rules (IRRs) cover time deposits with a maturity below 7 days, current accounts and savings accounts deposits (which amounted to 0.1%, 5.9% and 27.7% of total HK dollar deposits respectively as at 31 December 1999).

In 1998, the HKMA commissioned the Banking Sector Consultancy Study to examine the strategic outlook of the banking sector over the next five years. Deregulation of the remaining IRRs was one of the regulatory issues examined in the Study. In response to the recommendations of the Study, the HKMA has developed a three-year reform programme to further develop the Hong Kong banking sector. As part of the programme to promote competition in the banking sector, the HKMA has proposed to deregulate the remaining IRRs in two phases:

Phase 1
- Removal of interest rate ceilings on time deposits less than 7 days
- Removal of prohibitions on benefits for deposits[1]

Phase 2
- Removal of all current and savings account interest rate rules

Provided that the prevailing economic and financial conditions are not unfavourable, Phase 1 of the deregulation will take place in July 2000 and Phase 2 will take place 12 months after the Phase 1 relaxation. In this connection, a set of monitoring indicators has been developed to gauge whether the prevailing economic and financial environments are not unfavourable for deregulation.

Assessment of the Prevailing Economic and Financial Environment

The set of monitoring indicators comprises both quantitative and qualitative factors. They correlate closely with stable conditions for banking. Specific and objective criteria have been set out for the quantitative factors. As for the qualitative factors, the HKMA will monitor for the absence of

1 During Phase 1 of the deregulation, the prohibitions on benefits for all HK$ and foreign currency deposits will be removed **except in the case of HK$ current and savings accounts**. This is to avoid banks competing to offer benefits for the latter two types of deposits, which would effectively bring forth Phase 2 of the deregulation.

foreseeable significant international or regional economic upheavals which might create unstable conditions. The performance of the monitoring indicators are discussed in the following paragraphs.

Two Consecutive Quarters of Real GDP Growth

The HKMA has proposed that deregulation should be carried out in a stable economic environment to avoid compromising the stability of the banking sector. Two consecutive quarters of positive GDP growth would generally indicate that the economy is in the process of recovery and the environment would be more favourable for deregulation to take place.

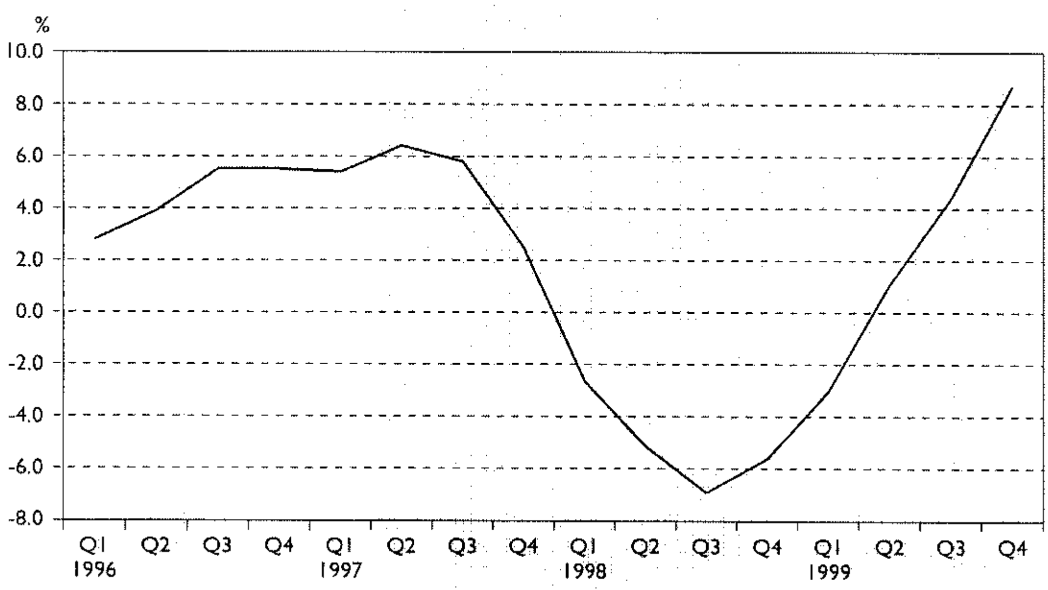
As a result of the Asian financial crisis, the Hong Kong economy suffered from five consecutive quarters of economic contraction (see Chart 1). It was not until the second quarter of 1999 that the economy returned to positive growth (1.1%) on the back of an improved global economy and a rebound in private consumption and external trade. The economic recovery gathered further momentum in the third and fourth quarter of 1999 as GDP growth accelerated to 4.4% and 8.7% respectively. Up to now, three consecutive quarters of positive GDP growth have been recorded. Looking forward, it is likely that the macro-economic environment will continue to improve. Market economists generally forecast that the economy will grow by around 5% in 2000.

Differential between HIBOR and US dollar LIBOR has Stabilised and is Close to the Pre-crisis Levels

The differential between Hong Kong dollar interest rates (i.e. HIBOR) and United States dollar rates (i.e. US dollar LIBOR) is the premium demanded by the market for holding Hong Kong dollars. It is indicative of market confidence in the Hong Kong dollar.

During the economic boom between 1996 and Q1 1997, the interest rate level in Hong Kong was generally close to the level in the U.S. (see Chart 2). The quarterly average differential between HIBOR and LIBOR (from 1-month to 6-month) was in the range of 3 to 19 basis points during this period. After the advent of the Asian turmoil in July 1997, the differential between HIBOR and US dollar LIBOR (again from 1-month

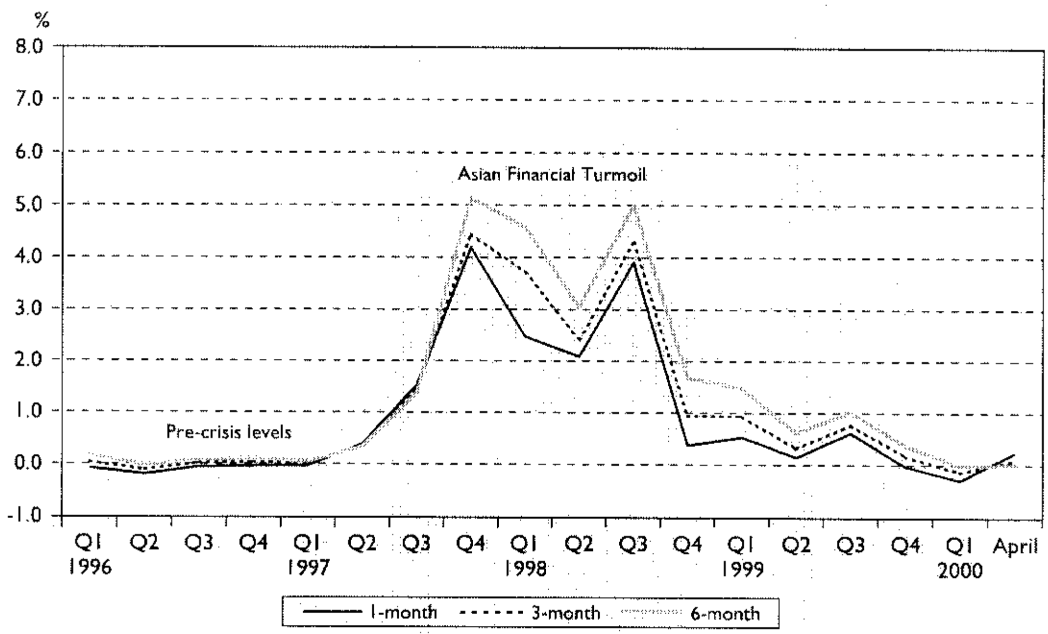
Chart 1
GDP (year-on-year rate of change in real terms)



Source: Census & Statistics Department

Chart 2

Quarterly Average Differential between HK$ and US$ Interest Rates #



Source: Bloomberg

 # Quarterly average of differential between daily HIBOR fixing and US$ LIBOR fixing

to 6-month) widened to an average level of 200 to 500 basis points due to the repeated attacks on the Hong Kong dollar.

Since the seven technical measures were introduced to strengthen the currency board system in Q3 1998, the differential between HIBOR and US dollar LIBOR has trended downwards. As the economy gradually recovers, the differential has further narrowed and has returned to the pre-crisis level. In Q1 2000, the 1-month, 3-month and 6-month HIBOR rates were on average below the corresponding LIBOR rates. While the HIBOR rates for April 2000 were slightly higher than the corresponding LIBOR rates, the differentials were still at a level comparable to the pre-crisis level. This indicates that market confidence in the Hong Kong dollar has already returned on the back of a better economic outlook for Hong Kong.

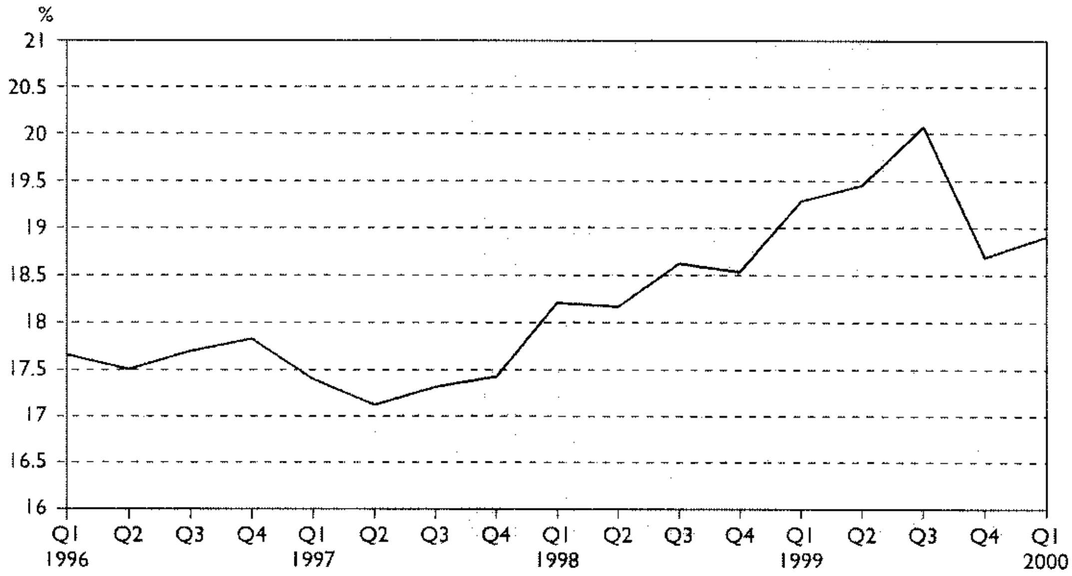
Capital Adequacy Ratio of the Banking Sector Remains at Traditionally High Levels

The capital adequacy ratio of the banking sector was consistently higher than 17% during 1996 and 1997. This was well above the minimum standard of 8% set by the Basel Committee on Banking Supervision.

Despite the impact of the regional turmoil, banks in Hong Kong remained very well capitalised. As a result of banks adopting cautious lending policies and the subdued demand for loans, the risk weighted exposures of the banking sector have fallen since the start of the Asian crisis. With capital base remaining roughly stable, this has resulted in a steadily rising trend in the capital adequacy ratio until Q3 1999 (see Chart 3). The decline in the capital adequacy ratio in Q4 1999 was due to a large local banking group distributing a special dividend out of its reserves to its parent company. As of 31 March 2000, the aggregate capital adequacy ratio of all locally incorporated institutions stood at 18.91%, compared with 17.83% as of 31 December 1996. With this high level of capital adequacy ratio, the banking sector has a sufficient cushion to absorb any negative impact of deregulation, which is in any case unlikely to be significant for the first phase of deregulation.

Chart 3

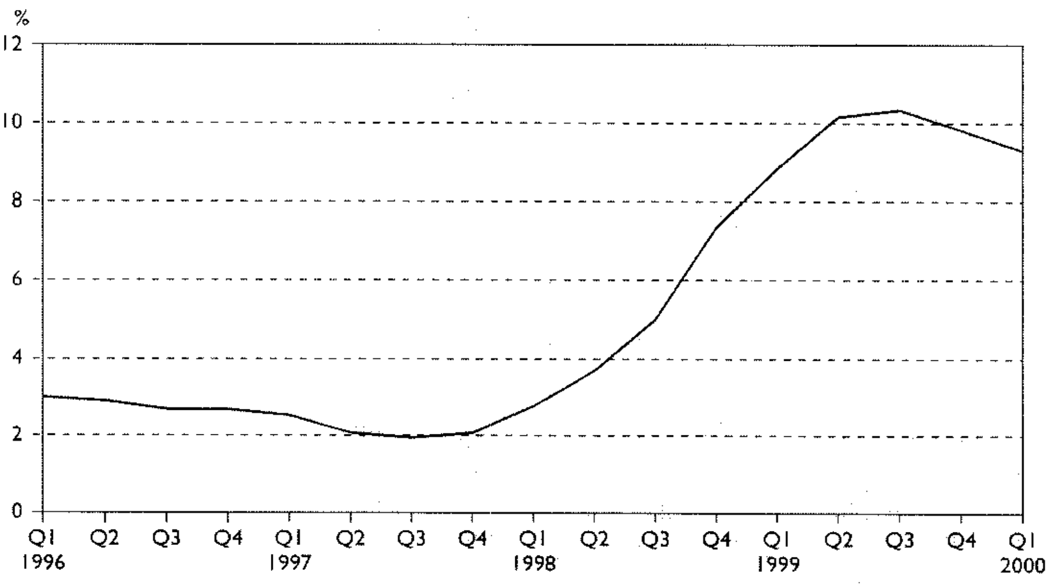
Capital Adequacy Ratio (all local AIs - consolidated position)



Source: HKMA Banking Statistics Section

Chart 4

Classified Loan Ratio (all local banks)



Source: HKMA Banking Statistics Section

Signs of Improvement in the Classified Loans Ratio for the Sector

Asset quality of the Hong Kong banking sector deteriorated sharply during 1998 and 1999. The classified loans ratio of the local banks, which is the ratio of loans classified as Substandard or below to total loans outstanding, reached 10.14% in the second quarter of 1999 (see Chart 4) compared with 2.08% at end-June 1997. Although the ratio rose slightly further to 10.33% in the third quarter, it fell back to 9.81% at end-December 1999 and further down to 9.28% at end-March 2000. Other measures of asset quality such as the overdue loans ratio and the rescheduled loans ratio also improved. As the economy continues to revive and the problem associated with lending to Chinese enterprises gradually subsides, the reversing trend in classified loans ratio is likely to be sustained. Banks generally expect bad debt provisions to fall sharply in 2000.

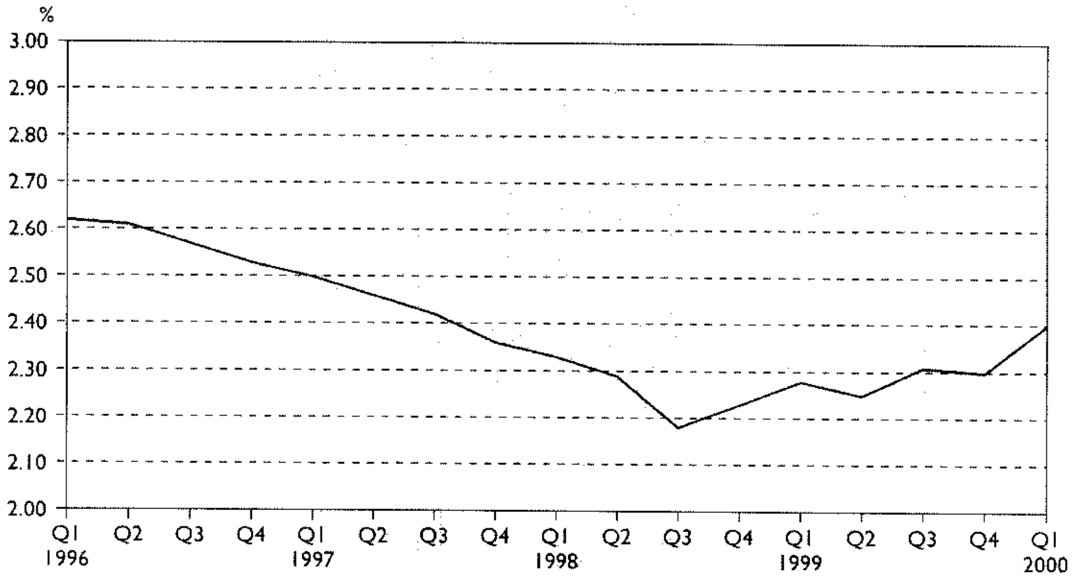
Absence of Significant Narrowing of Net Interest Margins of the Banking Sector Similar to that Experienced During the Period of the Asian Crisis

The Asian crisis put the profitability of the banking sector under considerable stress. The impact was evidenced by a sharp fall of 24 basis points in the net interest margin of local banks between Q3 1997 and Q3 1998 (see Chart 5). Since the introduction of the seven technical measures to strengthen the currency board system in September 1998, the funding cost of the sector stabilised and was on a declining trend during 1999, reflecting the ample liquidity in the banking system. This has offset the impact on the banks of the downward pressure on lending margins and the impact on interest income of non-accrual loans. As a result, the net interest margin of local banks has gradually recovered from 2.18% in Q3 1998 to 2.30% in Q4 1999 and widened further to 2.40% in the first quarter of the year. Looking ahead, lending margins remain under pressure for the time being, but this may be alleviated as economic recovery gathers momentum.

Absence of Severe Strains on the Profitability of a Significant Proportion of the Local Banking Sector

After an extremely difficult year in 1998, the operating environment for local banks has gradually improved. Although performance of individual banks has varied, pre-tax operating profits of the 31 local banks as a whole increased by 14.8% in

Chart 5
Net Interest Margin (all local banks)



Source: HKMA Banking Statistics Section

1999 compared with 1998. The recovery was attributable to growth in interest-bearing assets, slight improvement in the net interest margin and reduction in operating expenses.

Looking forward to 2000, the banks are expecting further improvements in profitability, largely driven by the reduction in bad debt charges.

Absence of Foreseeable Significant International or Regional Economic Upheavals

The global economy improved further in 1999. Both the U.S. and the Euro area recorded healthy growth last year. Despite higher interest rates and the recent correction in US asset prices, there is still no clear moderation in the growth momentum of the U.S. and Europe. In the Asian region, while the latest economic indicators in Japan revealed mixed performance, most other Asian economies have reported strong and broad-based recovery in the second half of 1999. Growth in Mainland China has also continued at a steady rate of 7-8% per annum. Exchange rates for the regional currencies further stabilised, indicating that capital flows in and out of the region are getting less volatile. In summary, there does not appear to be any signs of major international or regional economic threats.

Conclusion

The above analysis shows that the banking sector has been gradually recovering from the Asian financial crisis. Although the amount of problem loans remains high by historical standards, signs of improvement have already emerged. The domestic and external environment has also become more favourable to the banks. On the whole, the monitoring indicators seem to suggest that the outlook for the banking sector in 2000 is more optimistic and there does not appear to be significant unfavourable factors which would call for a slow down of the first stage of the deregulation process. The initial stage is in any case unlikely to have a major impact on the behaviour of interest rates given that it affects directly only a very small proportion of the deposit base.

In light of the above analysis, the HKMA's assessment is that the prevailing economic and financial environments are not unfavourable for Phase I of the deregulation of remaining IRRs to proceed as planned in July 2000. This view is endorsed by the Exchange Fund Advisory Committee, the Banking Advisory Committee and the Deposit-taking Companies Advisory Committee. The HKMA and the banking industry therefore agree that Phase I of the deregulation should proceed on 3 July 2000 unless there is any major economic or financial upheaval in Hong Kong or elsewhere before the date of deregulation.

- Prepared by the Banking Development Division

Appendix V

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Deregulation of Interest Rate Rules

As scheduled, the final phase of interest rate deregulation covering Hong Kong dollar savings and current accounts takes effect today (3 July 2001). From now onwards, interest rates on all types of deposits, including savings account deposits, will be determined by competitive market forces. The prohibition of interest on current accounts is also lifted at the same time.

"Deregulation will allow banks to compete for deposits freely on the basis of price and product innovation. This will enhance the efficiency and the competitiveness of our banking sector," said Mr David Carse, Deputy Chief Executive of the Hong Kong Monetary Authority (HKMA).

The HKMA notes that different banks have been responding to deregulation in different ways with regard to their charging policy for account services, minimum balance requirements and tiering of interest rates. Customers therefore have a choice as to how they access banking services and at what cost. However, as a greater diversity of banking products and services is available in the market, consumers should be prepared to shop around to look for the services that suit them best.

Mr Carse added that the HKMA would be monitoring the impact of deregulation closely.

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Hong Kong Monetary Authority
3 July 2001

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