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THE OPERATION OF THE MORATORIUM ON NEW BANK LICENSES ON THE HONG KONG BANKING SYSTEM 1965-81

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Abstract

In the mid-1960s two major institutional changes decreased the freedom for competition among banks in Hong Kong. In 1964, in response to a supposed 'interest rate war' the Exchange Banks Association (the precursor to the Hong Kong Association of Banks) was able to negotiate an Interest Rate Agreement that applied to all banks operating in the colony. Secondly, in May 1965, after two waves of banking crisis in February and April of that year, the government imposed a moratorium on new bank licenses. Both restrictions were retained (in amended form) until 2001. The longevity of both of these anti-competitive regulations in Hong Kong had a profound impact on the development of the banking system in the 36 years they were in force.

This paper investigates the operation and impact of the moratorium on the banking system of Hong Kong. It will first show how the regulation of price competition in Hong Kong led to calls from banks for further protection from non-price competition and how this became specifically aimed at foreign banks. Secondly, the paper will discuss the changes in the operation of the moratorium and how it influenced foreign acquisition. This turned out to be an inadequate solution to poor governance partly because the barriers to entry increased the bargaining power of local banks in the acquisition process. Finally, the paper assesses the moratorium's impact on the expansion of deposit taking finance companies outside the prudential regulations of the banking system, and how the regulation of these new institutions was only reluctantly introduced by the government. The general conclusions are that the moratorium and the interest rate agreement together decreased the regulatory breadth of the government, and reduced the incentives for mergers and acquisitions that might have improved governance. Evidence of fraud and poor governance immediately after the lifting of the moratorium show that it was not an effective cure for the governance problems of the Hong Kong banking system. Barriers to entry were not a substitute for effective prudential supervision.

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[1] The author would like to thank the HSBC Group Archive in London and the Hong Kong Government Records Service for access to their collections. This paper was written while the author was Visiting Research Fellow at the HKIMR.

In the mid-1960s two major institutional changes decreased the freedom for competition among banks in Hong Kong. In 1964, in response to a supposed 'interest rate war', the Exchange Banks Association (the precursor to the Hong Kong Association of Banks) was able to negotiate an Interest Rate Agreement that applied to all banks operating in the colony. Interest rate cartels were not unusual in the 1960s; similar arrangements existed in both the USA and the UK. However, these countries abandoned interest rate controls in the 1970s, while Hong Kong maintained their Interest Rate Rules in amended form until 2001. Secondly, in May 1965, after two waves of banking crisis in February and April of that year, the government imposed a moratorium on new bank licenses. The large banks had lobbied for this restriction since the banking crisis of 1961. Hong Kong finally lifted the barriers to entry of foreign banks in 2001.[2] The longevity of both of these anti-competitive regulations in Hong Kong had a profound impact on the development of the banking system in the 36 years they were in force.

The official rationale for the moratorium on new bank licenses in 1965 was to enhance stability by encouraging consolidation in the banking sector. Forty years later, the relationship between stability of banking systems and concentration is still the subject of debate.[3] On the one hand, a comparison between the historically unstable US system, with a proliferation of small banks, and the relatively stable systems of Canada and Europe, where a few large banks dominate, suggests that 'big is beautiful'. Large banks might be more stable because they are better able to diversify risk. Moreover, in a less competitive environment they might accumulate larger profits and be less prone to engage in risky behaviour. Allen and Gale have also argued that it is easier for a government to supervise and enforce prudential supervision in a system with a small number of banks.[4] On the other hand, the dominance of a few large banks might lead to a situation where they become 'too big to fail' and thus induce moral hazard. Large banks may also have complex and opaque operations that make supervision more challenging. International evidence has also suggested that systems with greater market share for small banks have more lending to SMEs.[5]

Recent empirical research suggests that barriers to entry by foreign banks do not enhance the stability of banking systems.[6] The presence of foreign banks may increase the quality of the banking system through the import of managerial and technological efficiencies. Where banks are subject to sound regulatory and supervisory jurisdictions this may also transfer to the host centre. On the other hand, foreign banks may face more information obstacles to lending to local SMEs, an issue that could have particular relevance for Hong Kong, where SMEs dominated the manufacturing sector.

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2 This paper should be read in conjunction with an earlier HKIMR discussion paper dealing with the imposition of the anti-competitive regulations in the mid-1960s. CR Schenk (2006), "The Origins of Anti-Competitive Regulation: Was Hong Kong 'over-banked' in the 1960s?" HKIMR Working Paper No.9/2006, Hong Kong Institute for Monetary Research.

3 T. Beck, A. Demirguc-Kunt and R. Levine (2003), "Bank Concentration and Crises," World Bank Policy Research Working Paper No. 3041. The G10 Working Party on Consolidation in the Banking Industry (January 2001) concluded that consolidation in the 1990s was likely to undermine systemic stability. http://www.bis.org/publ/gten05.html

4 F Allen and D Gale (2000), *Comparing Financial Systems*, MIT Press.

5 AN Berger, I Hasan and LF Klapper (2004), "Further evidence on the link between finance and growth: an international analysis of community banking and economic performance," *Journal of Financial Services Research*, 25: 169-202.

6 Beck et al., "Bank concentration and crises".

Theoretically, a moratorium could encourage consolidation through foreign acquisition (since this becomes the only method of entry to the market), but it would also decrease the incentive for horizontal consolidation if the moratorium (and the accompanying interest rate agreement) raised profits to a comfortable level. One of the goals of lifting the interest rate rules in 2001 was to encourage the merger of smaller banks in Hong Kong.[7] The HKMA also reported in 2000 that it was encouraging bank mergers through public statements and private discussions with individual institutions at the same time that barriers to entry for foreign banks were being lifted.[8] David Carse, Deputy Chief Executive of the HKMA, noted in a report to the BIS that the reasons why the banking industry had not consolidated during the 1990s had to do first with ownership structures (family control or a large proportion of minority shareholders), secondly because profits were healthy so there was no pressure for consolidation, and thirdly because large local banks did not want to increase their market share further.[9] These factors could all be reinforced by the anticompetitive regulation operating during this period.

This paper investigates the operation and impact of the moratorium on the banking system of Hong Kong. It will first show how the regulation of price competition in Hong Kong led to calls from banks for further protection from non-price competition and how this became specifically aimed at foreign banks. Secondly, the paper will discuss the changes in the operation of the moratorium and how it influenced foreign acquisition. This turned out to be an inadequate solution to poor governance partly because the barriers to entry increased the bargaining power of local banks in the acquisition process. Finally, the paper assesses the moratorium's impact on the expansion of deposit taking finance companies outside the prudential regulations of the banking system, and how the regulation of these new institutions was only reluctantly introduced by the government. This shows that the three-tiered system in place today was devised as early as 1974, although it was not introduced until 1981. The general conclusions are that the moratorium and the interest rate agreement together decreased the regulatory breadth of the government, and reduced the incentives for mergers and acquisitions that might have improved governance. Evidence of fraud and poor governance immediately after the lifting of the moratorium show that it was not an effective cure for the governance problems of the Hong Kong banking system. Barriers to entry are not a substitute for effective prudential supervision.

1. The Banking System in the 1960s

There was no central bank in Hong Kong so the duties of note issue, prudential supervision, regulation and lending of last resort were shared between the government and the commercial banks. Currency notes were issued by the HSBC, Chartered Bank and the Mercantile Bank under an effective currency board system operated by the government's Exchange Fund. Under the Financial Secretary's guidance, HSBC and Chartered Bank sometimes acted as informal lenders of last resort. A Banking Advisory

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7 D. Carse (2000), "The banking industry competition, concentration and systemic stability, the Hong Kong experience," paper prepared for a BIS meeting of central bankers in December.

8 In 2003 Dao Heng Bank merged with Kwong On Bank. In August 2004 Wing Hang Bank merged with Chekiang First Bank.

9 Carse (2000), "The banking industry," December.

Committee (made up of the Financial Secretary, the Accountant General, bank representatives and an accountant) advised the government on issues related to the banking industry. The Exchange Banks Association, led by the HSBC, set the interest rates payable on deposits under the Interest Rate Agreement. The regulatory system was underdeveloped until 1965 when a more robust Banking Ordinance was introduced including monitoring of balance sheets and limits on insider lending. A Banking Commissioner (Leo Cole until 1971, then JC Paterson) was appointed under the Ordinance, but his budget was small and his powers constrained by the Financial Secretary (Sir JJ Cowperthwaite until 1971, then Sir Philip Haddon-Cave). The change in the office of Financial Secretary and Banking Commissioner in 1971 prompted a shift in the attitude to the moratorium and we can mark its erosion from this date. Weaknesses in prudential supervision and enforcement continued, however, and contributed to the persistence of poor governance structures among many Hong Kong banks into the 1980s.

By the 1960s Hong Kong was already emerging as an important regional and global financial centre. The number of banks increased sharply from the late 1950s due to increased domestic demand from the large immigrant population, growing industry in the colony, and also flight of capital to Hong Kong from elsewhere in Asia due to political and economic uncertainty in the region. This changing environment prompted two waves of banking crisis: in 1961 and in 1965. The causes of the banking crises are beyond the scope of this paper but they are well covered in existing literature. In summary, the diagnosis was that excessive competition was encouraging risky behaviour, that Hong Kong was ‘over banked’ and that the appropriate response was restrictions on new entry to the market.

This diagnosis created a tension between the banks (who lobbied for even more anti-competitive regulation) and the state, which while agreeing that there were too many banks, hoped to promote Hong Kong as an international financial centre. This conflict was expressed in the debate over a further moratorium on bank branches in the late 1960s and in the regulation of non-bank deposit-taking companies in the 1970s.

Outline Chronology

Interest Rate Agreement	1964
Moratorium on new bank licences	1965
Lobbying for Limits on new bank branches	1966-69
Barclays Bank seeks licence	1971-1972
Amendment of Moratorium to exclude banks from countries not yet represented in Hong Kong	1972
Banks lobby for regulation of DTCs	1973-5
3-tier banking system proposed	1974
Regulation of DTCs introduced	1975
Moratorium on new bank licences lifted	July 1978
Moratorium on new bank licences re-imposed	August 1978
Moratorium on new bank licences lifted	1981

2. Pressure for Further Anti-Competitive Regulation: Restrictions on Expanding Branch Networks

The anti-competitive regulations introduced in the mid-1960s went further than most international financial centres, but they did not satisfy the desire of local banks for protection, particularly from foreign banks already operating in the colony. After price competition in bidding for funds was curtailed by the controls on deposit interest, banks had to rely on non-price competition to get access to funds, such as the provision of other services (safety deposit, foreign exchange), location, convenience, personal service, and reputation. The high profile of local branching activity in the discussions among banks suggests that this was an important form of competition both to attract local deposits and to gain local lending opportunities. A bank that could not develop a branch network had to rely on the more expensive inter-bank market to get funds, or take on exchange risk by transferring funds into the colony. Figure 1 shows the rapid growth in branch activity in Hong Kong from the early 1960s. This shows the rapid growth in the number of branches in the six years up to the imposition of the moratorium in 1965 and then an acceleration again during the boom of the early 1970s.

The rapid expansion of branch networks was also a common feature of banking in developed countries at this time. In the OECD 'practically all countries have seen a spectacular extension of the banking network in the sixties and seventies either through branching by existing banks or, in some countries, also by the setting up of new banks.' Moreover, 'a striking feature of this early phase of private customer acquisition was that price competition was hardly used as this was considered by the banks as too costly and inefficient and was moreover in conflict with current banking practice and official restrictions on deposit rates applying at that time in most countries'.[10] The most notable example was the proliferation of branches in the USA while Regulation Q (a ceiling on deposit interest payable) was in force.

On the demand side, the changing demographic situation in Hong Kong was another factor encouraging the increase in branch networks. As the large refugee population was resettled into new state housing in purpose-built sites, this increased the opportunities for new branches. In 1963, for example, the Chartered Bank applied to the Government to open a 'Squatter Bank' in the temporary squatter area of Wan Tai Sin 'realising that many of the squatters were far from penniless'.[11] Once squatters were re-housed, the opportunities were even greater. In November 1971 Hang Seng Bank asked the HSBC for permission to expand branches into the new resettlement areas to collect deposits, noting that other banks were engaged in this direction and that the Hang Seng Bank needed to follow to keep its competitive position. Although it would increase competition for HSBC itself in these areas, the bank advised Hang Seng that they could go ahead.[12]

The increase in the number of branches from 1965 prompted calls to restrict this form of competition. The arguments in favour of restricting the spread of new branches were based on a variety of premises. First, the government worried that opening branches was costly and could undermine the solvency of

10 *Competition in Banking*, OECD, 1989, pp. 24-25.

11 Government Information Service, 1963. Hong Kong Public Records Office [hereafter HKRS]365-1-105.

12 PE Hutson memo, 8 November 1971. HSBC Group Archive [hereafter HSBC] GHO322/7.

small banks that expanded too quickly. The demand for loans was falling from 1966-68 and so the cost of expansion may have caused banks to engage in more risky lending, adding to systemic risk. Secondly, the lobbying by local banks was related to continued hostility to the competition from foreign banks already operating in Hong Kong, some of whom were becoming increasingly involved in providing local services in direct competition to local banks. Thirdly, the lobbying by large local banks was related to their own international expansion, since they frequently faced barriers to entry in overseas markets and sought reciprocity as a lever to overcome these obstacles.

By 1965 there were 29 foreign banks operating in Hong Kong (excluding HSBC, which was registered locally). These included a group of overseas Chinese banks from Singapore, Malaysia and Indonesia that specialised in regional trade finance. They tended not to open branches to participate in the local credit market. The European and American banks, however, did branch more extensively after 1959. Chartered Bank had the largest network (17 branches by 1965) followed by Banque Belge pour l'Etranger with five branches in 1965. Even before the moratorium on new licences the HSBC complained particularly about the American bankers as 'fierce competitors who keep to no rules, and surely it is good policy to make things as expensive and as difficult for them as possible.'[13] In 1964 Saunders, chief manager of HSBC, observed of American banks that 'I am afraid there is no doubt that they want to dominate the financial scene in South-East Asia'.[14]

Table 1 shows the networks for different categories of bank in Hong Kong during the surge in the number of branches between 1970 and 1973. This shows the rapid expansion of foreign banks compared to local or note-issuing banks (although they increased their share of total branches only from 13% to 16%). The most prominent foreign banks were Citibank with six branches in 1970, followed by Banque Belge pour l'Etranger, Banque Nationale Paris and International Bank of Commerce (a US-owned bank) with four branches each. Citibank became a very aggressive player in the domestic system, opening 43 branches by 1981. In 1970 the two banks with by far the most extensive networks were HSBC (62) and Chartered Bank (25), both of whom lobbied vigorously for restrictions on other banks extending their networks.

In 1966 (exactly one year after the moratorium on new bank licences had been imposed), the HSBC complained to the Financial Secretary about instances when the bank was refused permission to open branches in foreign countries because the local authorities believed the area was already adequately supplied with banking services. This was the case for HSBC's application to open in San Francisco (although the Bank of America had recently opened a new branch in Hong Kong) and in Singapore.[15] The HSBC hoped that the government would retaliate by restricting the branching of banks from these countries. Carruthers of HSBC wrote to Cowperthwaite, the Financial Secretary: 'we feel very strongly

13 SWP Perry-Aldworth (Senior London Manager HSBC) to GOW Stewart (Manager, HSBC Hong Kong), 15 June 1959. HSBC Chairman's Papers Carton 4, BBME 1959.

14 JAH Saunders to A Morse, 18 September 1962. HSBC Chairman's Papers Carton 5, correspondence of A Morse.

15 MG Carruthers to DA Clinton (deputy Financial Secretary), 31 May 1966. HSBC, Chairman's Papers, BAC (BAC).

that you should seek authority to prohibit those foreign banks whose country or state imposes restrictions on branches of foreign banks from opening further branches in the colony'.[16] The HSBC's incentive, therefore, was defensive and related to their international expansion.

Cowperthwaite replied that he had been considering developing powers for the Banking Commissioner to control branching, but his motives did not match those of the HSBC. As he explained to Carruthers: 'The clause is primarily intended to give the government power to control to some extent the extension of the activities of banks which are known to be over-stretched or otherwise operating in ways contrary to the interest of the community though as a matter of general policy it could be used to prevent branch openings for other valid reasons.' He explicitly rejected the possibility of using such powers to restrict branches in areas that were over-banked, 'as this is contrary to our normal philosophy here of freedom to compete'.[17] The concern that banks might over-extend themselves may have been due to the case of the Far East Bank, which had an unusually large branch network for a local bank (13 branches) but suffered during the 1965 banking crisis from a loss of deposits and had to be nursed by the HSBC.

At the September 1966 Banking Advisory Committee meeting, the Financial Secretary agreed that the issue of reciprocity would be considered when new branches were authorised, although this could not go explicitly into the proposed revisions to the Banking Ordinance. In turn, the members of the BAC agreed that

> *the prime consideration should be whether the opening of such a branch would entail overextension of the bank's resources and that this should be the only consideration in the event of a Hong Kong bank applying to open a branch overseas. Another consideration to be taken into account might be whether the area in which the proposed branch was to be opened was already sufficiently supplied with banking facilities. Members considered that, in the case of an application from a foreign bank operating in Hong Kong to open branches in the Colony, account should be taken of whether or not Hong Kong banks would be allowed to open branches in the applicant's parent country.*[18]

The emphasis for each of the three rationales for controlling new branches was clear: stability was a 'prime consideration', competition 'might be' taken into account, and 'account should be taken' of reciprocity.

The Banking Ordinance was duly amended in 1967 to require banks to obtain approval from the Banking Commissioner to open new branches and to introduce a $1000 fee (hardly prohibitive even for the smallest bank). Debate continued, however, over the criteria under which the authority to open a new branch should be given. The *Far Eastern Economic Review* reported that some foreign banks were refused permission to open branches in 1968, although this decision had been reversed in the case of National City Bank due to the long time the bank had been represented in Hong Kong.[19] In 1968 the only

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16 MG Carruthers to Cowperthwaite, 12 April 1966. HSBC, Chairman's Papers, BAC.

17 Cowperthwaite to Carruthers, 8 June 1966. HSBC, Chairman's Papers, BAC.

18 Minutes of the BAC, 9 September 1966. HSBC, Chairman's Papers, BAC 1966.

19 *Far Eastern Economic Review*, April 17 1969. p. 184.

foreign banks to open branches (and the number) were the Chartered Bank (3), National City Bank (2) and Banque de l'Indochine (1). In addition, local banks opened 11 branches altogether (of which five were HSBC).

The banks' motivation for restricting foreign bank entry was clearly anti-competitive rather than concern for the banking system as a whole, and they found an ally in the Banking Commissioner, Leo Cole. Cole was vitriolic in his condemnation of foreign banks in the Colony. He described them to HSBC chief manager JH Saunders in May 1968 as 'parasitic invasions' that

> *contribute little or nothing in the way of support and assistance to the colony and they bring very little in. They perform no function within the colony which cannot be adequately fulfilled by the colony's own banks, apart from representation.*[20]

The charge of parasitic behaviour is difficult to substantiate. Excluding the note-issuing banks (which were not included in Cole's definition of 'foreign' in this context) the ratio of local advances to local deposits for foreign banks was 115% in 1968, implying a net inflow of funds from abroad rather than a drain. This ratio was also twice as high as the local banks (56%). The category of bank that was taking in deposits but not lending locally was the Mainland banks, whose ratio of advances to deposits was a mere 39%.[21] While the Mainland Chinese banks were foreign, they were never specifically mentioned in the debate over competition. The focus was squarely on American and European banks. More telling is the second sentence of this quotation, which refers to the competition posed by foreign banks.

Table 2 shows the distribution of deposits and advances for different category of bank. This differs from Goodstadt's analysis by separating out the note-issuing banks.[22] This breakdown shows that the competition for deposits for local banks in the mid-1960s was coming from the note-issuing banks (in particular the HSBC and Chartered Bank) and not from the foreign banks. But the note-issuing banks were the instigators of anti-competitive regulation, not the target of this lobbying. On the other hand, the foreign banks were increasing their share of advances.

In April 1968, three years into the operation of the moratorium on new licenses, 14 unauthorised local banks and 10 authorised local banks wrote to the Banking Commissioner, Leo Cole, to urge further action on branch expansion. 'Hong Kong already has too many banks, and as a result of severe competition, customers have been, and are, offered large amounts of banking facilities, thus encouraging unhealthy overtrading'.[23] At the same time, Lee Wing Heng, Sub-Manager of Hang Seng Bank complained

[20] Leo Cole to Jake Saunders, 2 May 1968. HSBC, Chairman's Papers, BAC 1968.

[21] The mainland banks channelled money to the mainland.

[22] L Goodstadt (2005), "Crisis and Challenge: The Changing Role of the Hongkong and Shanghai Bank 1950-2000," HKIMR Working Paper No.13/2005, Hong Kong Institute for Monetary Research.

[23] Letter to Cole signed by 14 unauthorised banks, 19 April 1968. HSBC GHO322/4 Hang Seng Bank Ltd 1968.

[24] The HSBC advised Hang Seng that they could increase their advances to deposit ratio to 55% from 49%, mainly through property instalment loans. Lee Wing Heng Sub-Manager, Hang Seng, memo for HSBC, 11 April 1968. Reply from OP Edwards to QW Lee (Manager Hang Seng), 25 April 1968. HSBC GHO322/4. Similar complaints were made again by Hang Seng Bank in August 1971. Report for the Chairman of HSBC by PE Hutson, 16 September 1971, HSBC GHO322/7.

that deposits had been rising but that there were few outlets for lending.[24] At a Banking Advisory Committee meeting in June 1968, QW Lee went so far as to call for local Hong Kong business to be restricted to local Hong Kong banks. Chau Kai-Yin, on behalf of the authorised local banks, agreed that foreign banks were 'interfering with domestic banking' and threatening local banks' business.[25] Cowperthwaite continued to resist extra restrictions on foreign banks, arguing that smaller local banks were feeling the pinch from large local banks as well as large foreign banks. Cole responded that the large local banks could offer support to smaller banks in time of need, whereas the foreign banks did not.

After much debate, the BAC put three views to the Governor in Council to restrict further the local activity of foreign banks.[26]

1. The majority of bank members and Leo Cole recommended that foreign banks already in Hong Kong should have one office in Hong Kong and one in Kowloon. They should be allowed to branch elsewhere provided they could demonstrate a need, and it would not affect a local bank and that the principle of reciprocity held.

2. The Financial Secretary, Mardulyn (Banque Belge pour l'Etranger) and the Registrar General preferred no restrictions on branches once a foreign bank had been allowed into Hong Kong. As a compromise (if this was not acceptable) foreign banks should be allowed to branch freely in the main business areas but not where banking is largely domestic.

3. Francis Zimmern argued that all banks applying to open a branch should have to justify need and ability to sustain it, making the policy non-discriminatory.

At this point there were applications from three foreign banks to open simultaneously a total of 12 new branches outside the Central business district of Hong Kong.[27] At the beginning of 1969 all applications for new bank branches were held in suspense while a general policy was devised.[28] The Governor, perhaps surprisingly given the weight of opinion in the BAC, opted to accept Zimmern's suggestion and avoid discriminating between foreign and local banks. The criteria for new branches of all banks were to be the resources of the bank and the need to avoid an excess of banking facilities in any particular area.[29] There was no guidance, however, on how 'an excess of banking facilities' was to be determined. The principal of reciprocity had already been agreed as a further criterion. This rubric was evidently not effectively binding since the number of bank offices increased from 274 at the end of 1968 to 326 by the end of 1970 (an increase of 19%). In 1969 alone five foreign banks opened new branches.

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[25] Minutes of the BAC, 28 June 1968. HSBC, Chairman's Papers, BAC 1968.

[26] Revised minutes of the BAC meeting of 28 June 1968. HSBC, Chairman's Papers, BAC, 1968.

[27] These included Chase Manhattan Bank in Aberdeen, Prince's Building and North Point, Banque de l'Indochine in Western district, Wanchai-Causeway Bay and Midlevels area. Minutes of the BAC, 28 June 1968. HSBC, Chairman's Papers, BAC 1968.

[28] Circular letter to all banks, 27 January 1969 from Leo Cole. HSBC, Chairman's Papers, BAC 1969.

[29] Cole to Curran (Deputy chief manager HSBC), 14 February 1969. HSBC, Chairman's Papers, BAC, 1969.

This section has shown how the moratorium on new bank licenses and the interest rate agreement together were deemed insufficient protection from competitive pressures because they encouraged non-price competition in the form of branch networks. The banks found support from the Banking Commissioner but not from the Financial Secretary or the Governor who remained focused on systemic stability as a rationale for regulation, which ruled out discrimination against foreign banks. The data show that competition from the note-issuing banks was much more keen than the competition from other foreign banks, and that foreign banks were not a net drain on the colony as was claimed. However, the note-issuing banks used the support of the local banks to press for further protection from foreign competition. In the end, without the support of the Financial Secretary, the banks were not able effectively to restrict existing foreign banks' access to the domestic market through branch expansion.

3. Operation of the Moratorium I: evolution of policy 1965-78

The moratorium was frequently challenged by applications from foreign banks, which reveal how it operated and how the policy developed. These discussions also reveal the tension between the government's goal of encouraging Hong Kong to develop as an international financial centre and the continuation of barriers to entry for foreign banks and how this was resolved.

During the early 1970s there were several applications for new licenses made on special grounds, but only one was successful in finally obtaining a license. Barclays Bank first applied for a license in August 1969 but was advised to find a local bank to acquire as a form of entry. In November 1971 they applied for a license in their own name and received the support of the Banking Commissioner.[30] He made the case to the BAC that no British banks (as opposed to British Overseas banks) had branches in Hong Kong, which was regrettable because of Hong Kong's trade relations with the UK. The prestige of hosting one of the 'Big Four' British banks was also a factor. In several other cases the prestige of the applicant bank was deemed to promise to enhance the prestige of Hong Kong as an international financial centre. Finally, Paterson expressed his belief that UK-incorporated banks had never meant to have been considered 'foreign' under the moratorium. A pencilled minute on the HSBC's copy of this document notes 'these are not in my view sound arguments. No'.

At the same time as the Barclays Bank case was recommended to the BAC, Paterson also recommended that a Swiss bank be allowed to enter the market. This has never before been noted in the historical account of the moratorium. Given the importance of the Swiss banking industry, the presence of a Swiss bank would 'contribute significantly to the Colony's prestige'. Moreover, a Hong Kong bank (HSBC in this case) was trying to open a branch in Switzerland and had been told that reciprocity in Hong Kong would help their case.[31]

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30 Memo for BAC on Review of Policy on Banking Licences, 25 November 1971. HSBC, Chairman's Papers, BAC 1971. The Big Four British banks are Natwest, Barclays, Lloyds and Midland, none of whom had branches in Hong Kong.

31 Memo for BAC on Review of Policy on Banking Licences, 25 November 1971. HSBC, Chairman's Papers, BAC 1971.

The two cases were discussed at the BAC meeting in December 1971. All were agreed that if the Swiss bank put in a formal application then it should be granted on the grounds of prestige for Hong Kong. In the end, however, a formal application was delayed and the Swiss bank did not enter until after the moratorium was lifted. The case of Barclays was much more controversial. Members were concerned about the threat of competition, and the danger of other large British banks considering this a precedent for their own cases. On the other hand, the members of the BAC were generally agreed about the prestige benefits. Sandberg of HSBC raised the danger that, if refused, Barclays would go to Singapore instead of Hong Kong, an outcome Haddon-Cave described as 'most embarrassing and politically unfortunate', although the other banks were not so concerned.[32] After considerable discussion both proposals were approved subject to the proviso suggested by Sandberg that Barclays should make one more attempt to buy a local bank. This delayed the final decision for a further few months.

In early February 1972, a team from Barclays visited Hong Kong and convinced Paterson that they had done all they could to take over a local bank, so they should be granted a license in their own name. The BAC meeting in April 1972 to consider this second request was more reticent, with most members arguing that Barclays should be required to make a further attempt at acquisition. After much grumbling the meeting agreed to recommend that a license be granted but that Barclays be restricted to one office only. Any branch expansion would require taking over a local bank.[33] At the last minute, Sandberg of HSBC and Millar of Chartered Bank tried to reverse this decision because there was another foreign bank in take-over negotiations with a local bank, suggesting that this might still be an option for Barclays. They were knocked back since the papers were already with the Executive Council who would be meeting in four days' time.[34] In the end, it took three more months for the Executive Council to approve Barclays' application and the office was finally opened on 3 April 1973. Barclays was restricted to operating one branch only and claimed that it intended to focus on the wholesale market, thus fulfilling the government's goal of developing the international financial centre.[35]

The Barclays case did mark a change in the attitude of the government to try to resolve the contradiction between wanting to support the development of the international financial centre in Hong Kong, but not wanting any further competition in the domestic market. They announced a limitation of the moratorium to allow consideration of banks from countries or regions that were not yet represented in Hong Kong. This encouraged more applications but did not result in any new licenses, effectively achieving the goal of showing willingness to support the IFC while not allowing further competition. In July 1973 applications from five banks were put to the BAC, but all but one were rejected. This was the Swiss bank discussed earlier and approval was agreed so long as HSBC was allowed to enter Zurich. The banks (and grounds for refusal) were BCCI (too young), Bank Bumiputra Malaysia Berhad (there was already an established

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32 Minutes of BAC, 3 December 1971. HSBC, Chairman's Papers, BAC 1971.

33 Minutes of BAC, 7 April 1972. HSBC, Chairman's Papers, BAC 1972.

34 Minutes of BAC 7 July 1972. HSBC, Chairman's Papers, BAC 1972.

35 *Far Eastern Economic Review*, 9 April 1973.

Malaysian bank in Hong Kong), and Habib Bank (already turned down in 1969; State Bank of Pakistan would object). The Bank of Tokyo wanted to transfer its license to a new wholly owned locally incorporated bank in order to increase their appeal to other Hong Kong banks and customers.[36] This proposal was rejected because it would set a precedent for other banks to do the same. In October 1973 Continental Bank applied, and in February 1974 First National Bank of Chicago applied. They were rejected on the grounds that there were already several US banks in Hong Kong, and the Continental Bank already had a wholly owned subsidiary finance company in Hong Kong (Continental Bank Illinois (HK) Ltd.) 'whose activities are at present unrestricted by law and which can and does, carry on a very extensive banking business outside the scope of the Banking Ordinance'.[37]

In March 1974, Financial Secretary Haddon-Cave mentioned in his budget speech that he was reassessing the moratorium, prompting a rush of new applications. In June 1974, six applications were put to the BAC of which three were deemed to meet the new criteria, but all were held up until a coherent policy on new licenses could be established, which in the end took a further four years.[38] One bank was allowed to enter under the name of an existing bank.[39]

When the moratorium was finally lifted in July 1978 there was an immediate rush of applications and within a year 25 new licenses had been approved. On 7 August, after 41 applications had been made, the government announced that it would not be accepting further applications for a period of at least six months to allow an evaluation of the impact of the new banks on the banking system. In the end six months turned into two years, and the suspension was only lifted in 1981. Even then, however, new foreign banks were restricted to one office to prevent them competing with existing banks in the domestic market for deposits. This was amended to three offices in 1999 and finally abandoned in 2001.

The archival evidence presented here shows that without the moratorium there would have been more foreign banks in Hong Kong and that most of them would probably have come from the USA since most of the frustrated applications were from US banks. The late 1960s was a time of dramatic expansion in US banks' multinational presence due partly to restrictions at home. From 1965-71 27 US banks opened offices in London. The pent up demand for bank licenses shows that there was still belief in the scope for profit in the market. The alternative of opening a finance company had the advantage of not being subject to the banking ordinance, but it could not trade on the international bank's name in the same

[36] There is anecdotal evidence that foreign banks were discriminated against in the inter-bank market.

[37] Memo by Banking Commissioner for the BAC, 8 October 1973. HSBC, Chairman's Papers, BAC 1973. Memo by the Banking Commissioner for BAC, 7 February 1974. HSBC, Chairman's Papers, BAC Minutes 1974.

[38] The banks were Natwest, Lloyds Bank International, Uban-Arab Japanese Finance, Bankers Trust, Chemical Bank and CIBC. The first three were deemed eligible under the new geographical criteria, the two American banks were not and the Canadian bank would be rejected because of the lack of reciprocity. Memo for the BAC, June 1974. HSBC, Chairman's Papers, BAC 1974. The issue of new licenses was suspended during the debate about introducing a Three Tiered System in 1974, which is discussed below.

[39] Underwriters Bank Inc. applied to surrender their license in February 1972 in favour of a new bank to be called Underwriters Bank (Overseas) Ltd. registered in the Cayman Islands with Manufacturers Hanover Trust as the major partner. Memo for BAC 18 February 1974. The BAC agreed in June 1974. HSBC, Chairman's Papers, BAC, Minutes 1974.

direct way as a full branch, nor could it get access to cheap retail deposits from the 'general public' or the inter-bank market. Several of the banks that applied for full licenses already had finance companies in Hong Kong, showing that they were not considered substitutes.

4. Operation of the Moratorium II: Acquisition by Foreign Banks

One of the government's aims behind the moratorium was consolidation and improvement in management and governance of local banks since foreign banks could only gain access by taking stakes in existing banks.[40] This strategy faced obstacles from the ownership and governance structures of the local Hong Kong banks so that in practice it was not easy for foreign banks to acquire stakes in local banks. Even after buying an interest in a local bank, the transfer of managerial expertise and re-organisation could be problematic. The goal of consolidation and improvement in management, therefore, was not achieved by the moratorium. There were also only a few horizontal mergers among local banks, e.g. the HSBC took over Mercantile Bank in 1960 and Hang Seng Bank in 1965 in the wake of the bank crisis of that year. The only other exception was in 1973 when the Overseas Trust Bank (a Singapore based bank with 18 branches) in a period of aggressive expansion took a controlling interest in Hong Kong Industrial and Commercial Bank of Hong Kong (seven offices). OTB, however, later proved that its governance structures were weak.

The obstacles to merger included healthy profits and family ownership. Figure 2 shows that profitability increased on average for banks in Hong Kong after the moratorium was imposed, which would undermine the pressure for mergers. There is no sign here that the entry of 41 foreign banks in 1979 immediately affected the profitability of existing banks. After the moratorium was lifted in 1981, however, when more comprehensive data are available, it is clear in Figure 3 that profitability declined.

There was no relationship between the size of a bank and its profitability. Small banks were not, therefore, more susceptible to take-over because of low profits. The relationship between size and profitability in 1977 is shown in Figure 4. Even the slightly positive relationship is only driven by the Hang Seng Bank. The correlation coefficient excluding Hang Seng is -.02.

Some indication of the obstacles to foreign acquisition can be seen from the case of Barclays Bank, which made four unsuccessful attempts before asking to open a branch in their own name in 1971. The main obstacles were that the principal shareholders (often the family of the founder) could not in the end agree to relinquish control, and that banks had unrealistic views of their value due to the moratorium. Thus Barclays described how one deal fell through in March 1971 'because the principal shareholder could not bring himself to give us more than a very small interest for several years, and our ideas as to price were a long way apart.' In May 1971 a team flew out from London for negotiations with another bank 'but it became clear that there was dissent among the shareholders as to the policy of bringing in outsiders' although discussions continued to January 1972. A final attempt failed in November 1971 when 'it became clear that the vendors valued their business at very nearly double our starting offer,

[40] Cole made this explicit in 1968. Leo Cole to Jake Saunders, 2 May 1968. HSBC, Chairman's Papers, BAC 1968.

and we were asked to give a yes-or-no decision within 24 hours.' Paterson, then Banking Commissioner, noted that this last bank had carried on negotiations with no less than nine overseas banks but none of them successfully.[41] Another of the banks approached by Barclays had been approached by at least five other foreign banks.[42] This level of activity certainly suggests a healthy appetite for local Chinese banks among the international banking community, but the obstacles were also high. Barclays wearily concluded that 'our inability to get involved with a local bank in Hong Kong has not been for want of trying.'[43]

Even if successfully concluded, foreign take-overs were not always a solution to poor governance, as is shown in the case of Far East Bank. This case also shows the intransigence of ownership and governance standards that was encouraged by the increased bargaining power of the local banks because of the moratorium. Deacon Chiu, a theatre owner in the New Territories, applied successfully for a bank license in 1959 but by 1961 the bank was already under investigation by the Deputy Economic Secretary and then the Financial Secretary. At the end of 1960 the accounts showed HK$3.9m in deposits, $2.9m in loans and $3.9m in investments, of which 70% was in land in Tsuen Wan, most of which was held in Chiu's own name rather than that of the bank.[44] During the Chinese New Year of 1961 the bank was overdrawn on its clearing account at HSBC by $200,000. After meeting with Chiu, Cowperthwaite noted 'I think we will have to continue to watch this bank very carefully. Mr. Chiu gives his manner of thought away when he says 'I' instead of 'the bank'. I read him a lecture about keeping banking business and other business strictly separate, but I am afraid the lesson will require constant repetition.'[45] In the end, the lesson was perhaps not repeated constantly enough.

The Far East Bank was a victim of the 1965 banking crisis (deposits fell from HK$60m in 1964 to HK$22m by the end of 1965 but then recovered by 1968), and was helped by the HSBC until a longer term solution could be found. In 1969, during the moratorium on new licences, Citibank took a controlling interest (76%) of the bank leaving 24% in the control of the founder, Deacon Chiu. Citibank retained control of Chiu's share for several years, however, until he repaid debts to the bank. The avidity of the American bank to take part in the Hong Kong banking market is evident in the terms of the acquisition, which included in Clause 11 that:

> *Chiu shall continue as a Director and Chairman of the Board during his lifetime and City Bank agree and undertake that he shall not during his lifetime be removed from the position of Director and Chairman of the Board unless he shall be adjudicated, bankrupt, certified insane or shall be convicted of a serious offence which affects adversely his integrity or moral standing in the Colony of Hong Kong.*[46]

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[41] Zimmern suggested to the BAC that the moratorium encouraged local banks to increase their price. Minutes of BAC, 7 April 1972. HSBC, Chairman's Papers, BAC 1972.

[42] Comment by Paterson, Minutes of BAC, 7 July 1972. HSBC, Chairman's Papers, BAC 1972.

[43] Anonymised letter from Barclays Bank circulated to the BAC, 22 February 1972. HSBC, Chairman's Papers, BAC, 1972.

[44] See correspondence in HKRS934-7-104.

[45] Note by JJ Cowperthwaite of a meeting with D Chiu, 10 March 1961. HKRS934-7-104.

[46] Quoted in Judgement of Justice. McMullen, in the High Court of Hong Kong, 21 May 1979. HCA000931/1979.

Citibank soon had cause to regret this concession as Chiu became dissatisfied with the management of the Far East Bank. In 1978 and 1979 relations broke down to the extent that they were transferred to the High Court. On 15 February 1979 the board met acrimoniously and Chiu and his two sons left the meeting. Meanwhile, the remaining members of the board voted to hold an EGM to delete the clause that allowed Chiu to remain as Chairman.[47] Chiu subsequently took members of the Far East Bank board to court to prevent this and won his case since he was not dead or demonstrably insane. In 1982 Citibank extricated themselves from Far East Bank in an agreement by which they took over 11 out of 25 branches of the bank, amounting to 70% of total loans and 56% total deposits. In November 1988, Chiu was arrested on charges of false accounting dating back to 1983 and involving $210m of credit facilities to companies in Hong Kong and the Philippines. The case was then delayed by appeals and judicial review and finally dismissed in 1993 due to Chiu's apparent ill health.

Despite this evidence of obstacles, the effort to promote consolidation was partially successful and there were a number of important foreign acquisitions in the late 1960s and early 1970s, mainly of medium sized banks. Unlike the acquisitions in the 1980s these were not the result of the failure of the local bank and the subsequent match-making of the banking commissioner. The government did not nationalise failed banks until the crisis of 1982. Nevertheless, governance problems persisted and two of the banks that acquired a foreign interest in the 1970s were under investigation for corruption by the ICAC by the early 1980s (Ka Wah and Overseas Trust Bank). Hong Kong Industrial and Commercial bank was also caught up in the 1982 crisis. As noted in the case of the Far East Bank, these subsequent events show that foreign acquisition was not itself the solution to the problem of poor governance. The banking commissioner's hope that the foreign banks would do his job of external supervision did not come to fruition. The major acquisitions of local banks are shown in Table 3 which shows that almost all the acquisitions were in the boom years of the early 1970s, before the downturn of 1974.

Figure 5 shows the movement in published net profits as a percent of total assets for some of these banks, which shows a rising trend from 1965 until 1973 close to the average performance of our sample of 15 banks.[48] From 1973, however, by which time most acquisitions had taken place, almost all of the banks underperformed the average until the end of the decade. This is not a full sample and is based on published balance sheets, which reported profits only after transfers to inner reserves, but it does give a plausible indication that many of the banks with foreign interest underperformed the average after they were taken over but not before.

The failure to learn the lessons of the 1960s is clear in the evidence that new local banks after the moratorium still showed the same weaknesses in the 1980s as in the 1960s despite foreign participation. The first Hong Kong registered bank to gain a license after the lifting of the moratorium was the Sun Hung Kai Bank in February 1982 (applied in Nov 1981). The Sun Hung Kai Finance Co Ltd, a registered DTC, made the application in November 1981, changed its name to Sun Hung Kai Bank Ltd and started

47 Ibid.

48 The banks included with foreign interests are Wing Lung, Overseas Trust, Shanghai Commercial, Ka Wah, Kwong On, Dao Heng, Commercial Bank of Hong Kong.

offering full banking services at the end of March 1982, shifting its non-banking business to a subsidiary.[49] The major shareholders of the bank were Paribas (25%), Merrill Lynch (15%) and Fung King Hey, founder and chairman (42%). The bank immediately opened a new head office (at a cost of $300m absorbing 70% of shareholders' funds),[50] added two branches and moved two other branches to ground floor premises to be closer to retail customers. The experience as a bank, however, was not a happy one. By October 1983 the major shareholders had to make special deposits of HK$288m as indemnity against bad loans (the total bad loans in the end amounted to $339m) and the search began for an external saviour. Meanwhile HSBC acted as a lender of last resort and the government allowed the Exchange Fund to place deposits with the bank to enhance liquidity. The agreement for the sale of the bank to Arab Banking Company was concluded March 1985 and completed in May 1985, whereby Fung retained only 25% of the ordinary shares and ABC the remaining 75%. In July 1985 losses of HK$229.4m were eliminated by cancelling $78.1m ordinary shares and cancelling the share premium account $151.3m. Fung died the following month.

The moratorium was not a direct cause of the governance problems, but nor was it the solution that the government had been hoped it would be. The cost of the failure to resolve the governance problems in the Hong Kong banking system was high for depositors, many of whom lost money from the bank failures of the 1980s, but it was also high for the government and taxpayers. The total cost to the Exchange Fund related to helping seven banks during these years was HK$3.8b.[51]

5. Regulating the DTCs

One outcome of the barriers to entry was an increase in non-bank finance companies. These finance companies did not fall into the local definition of 'banking' because they did not use the word 'bank' in their title, and did not serve 'the general public' by offering current accounts or checking accounts. This meant that they were outside the regulatory and supervisory purview of the Banking Ordinance and outside the Interest Rate Agreement. The narrow definition of banks as institutions taking deposits from the public and providing cheque clearing services increased the contestability of the financial system. The perverse impact of anti-competitive regulation, therefore, was an increase in the provision of unregulated and unsupervised financial services that further threatened the stability of the banking system. Many local licensed banks established subsidiaries to operate in this sector. Others were formed by foreign banks that could not gain entry into the retail banking market.

The banks became keenly aware of this competition during the boom of 1973, and in early July the banking members of the BAC called for regulation to restrict the activities of these finance companies. The financial secretary Haddon-Cave was dismissive, arguing that they were not all weak or imprudent companies and that the public interest rationale for regulation was not clearly evident. Any legislation

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49 The information on the Sung Hung Kai Bank is drawn from its published annual reports.

50 TK Ghose (1995), *The Banking System of Hong Kong*, 2ed., Butterworths: 90.

51 Ibid.: 96.

would have to be detailed and complex and (with the difficulties experienced devising the Securities Bill in mind) he concluded that he 'felt such a task to be beyond the present resources available to government.'[52] This set the stage for a running battle between the 'official' (government) and 'unofficial' (banking) members of the BAC.

Two weeks later, on 18 July 1973, local businessman Ann Tse-Kai challenged Haddon-Cave publicly in the Legislative Council over whether he intended to regulate finance companies 'to protect the interests of the general public' and Haddon-Cave was more forthcoming. He revealed that he was investigating the status quo but admitted that 'we have not yet built up a very clear picture of the number of institutions involved and the range of their activities'. He was considering a 'Protection of Depositors Bill' to restrict the minimum size of deposit such companies could accept.[53] He dismissed the complaints from banks that the DTCs were at a competitive advantage because they did not need to conform to minimum capital or hold specified liquid assets, by remarking that 'some would argue that the banks could effectively protect their deposit base from the competitive inroads of the finance companies if they raised deposit rates and/or the gap between borrowing and lending rates was narrowed'.[54]

At the beginning of 1974 Sandberg tried to frighten Haddon-Cave into action by threatening that the Interest Rate Agreement was likely to collapse because of the competition from DTCs. This, in turn, would mean higher interest on loans to Hong Kong's industry. Haddon-Cave didn't take up the bait, remarking that the government did not have responsibility for the interest rate structure and that 'there is no doubt that the IRA has worked well and it provides a useful code, though some would query why the price mechanism shouldn't be allowed to determine the price of money as for other commodities'. On the threat of higher interest rates for industrial loans, he suggested that this might be a necessary evil given high interest rates internationally. Rather than abandoning the IRA, he recommended a two-tiered system for large deposits and small deposits. The banks and DTCs could then compete directly for large deposits. Overall, his view was that

> *the finance companies are now an integral part of Hong Kong's financial sector and they are making a measurable contribution towards our international stature as a financial centre. As far as I can see, it is not within the government's power, nor anyone else's for that matter, to freeze them out.*[55]

Moreover, Haddon-Cave 'would prefer that the financial community resolve its own affairs without further government intervention', going so far as to suggest any further intervention would lead inexorably to the establishment of a central bank for Hong Kong, and 'to put it mildly, I am not convinced that this is

52 Minutes of BAC, 5 July 1973. HSBC, Chairman's Papers, BAC, 1973. On the difficulties introducing regulation of the stock market see CR Schenk (2004), "Regulatory Reform in an Emerging Stock Market: the case of Hong Kong 1945-86," *Financial History Review*, 11(2): 139-63.

53 Hong Kong Legislative Council Hansard, 18 July 1973, p. 956-7. Such a bill had been recommended in June 1973 by the Companies Law Revision Committee.

54 Ibid., p. 958. Haddon-Cave reiterated these views in Legco six months later in response to a question from GM Sayer of HSBC on 9 January 1974.

55 Haddon-Cave personal letter to Sandberg, 19 January 1974. HSBC, Chairman's Papers, Papers for BAC 1974.

what Hong Kong needs or wants'. He referred Sandberg instead to concurrent proposals to restrict deposits of three-months and below to licensed banks under a new protection of depositors' bill. This, he argued would effectively give banks the monopoly on the retail business as well as protecting small depositors through the prudential supervision of the Banking Ordinance.

Sandberg replied that he did not want to restrict competition for its own sake, but just eliminate 'fly-by-night finance houses' that threatened systemic stability. For this, minimum capital requirements were needed (he suggested $10m or half of that of banks), a restriction on their activities to deposits of 12 months or over (rather than Haddon-Cave's suggestion of three months), and equal competition with banks.[56]

Sandberg quickly set about organising other banking members of the BAC. Several members met in March 1974 to write to the Financial Secretary jointly, calling for a change in the definition of banking by deleting the phrase related to taking deposits 'from the general public' since it was inoperable. They did not think that the minimum deposit requirements in the proposed Protection of Depositors Bill would be sufficient. They wanted to set the minimum length of deposit for finance companies at 12 months, require these companies to register, and require them to have a minimum paid-up capital of at least half that of banks (HK$10m). They did not call for minimum liquidity or inspections because the case was too urgent and this would take time, but they wanted the finance companies to have to report to the Banking Commissioner.[57]

Haddon-Cave's response was to ask Ockendon, the new Banking Commissioner, to consult with bankers and financiers and write a general review of the bank licensing situation to include reviewing the banking ordinance, regulation of finance companies, and developments in the foreign exchange and money markets.[58] One of the first outcomes of Ockendon's investigation was an attempt to encourage the finance companies to form their own organisation that would establish some self-regulation. In June 1974 the Banking Commissioner convened a 'somewhat confused meeting' of finance companies at which there was little agreement, mainly due to the diversity of institutions represented ranging from subsidiaries of large international banks to small sole-operators.[59] Ockendon's report was finally completed in June and led to a reassessment of the moratorium on new licenses as well as the regulation of DTCs.

One of the difficulties was the lack of information on the activities or even number of finance companies operating in Hong Kong. In August 1974, the Banking Commissioner held a list of 104 companies (unlikely to be exhaustive), which gave annual returns with amounts of nominal, issued and paid-up

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[56] Reply to Haddon-Cave from Sandberg, 30 January 1974. HSBC, Chairman's Papers, Papers for BAC 1974.

[57] Letter to Haddon-Cave signed by LW Gordon, KC Jay, QW Lee, Li Fook-wo, P Mardulyn, DL Millar, MGR Sanberg, F Zimmern, 28 March 1974. HSBC BAC Papers 1974.

[58] Letter Haddon-Cave to AD Ockenden, Bank Commissioner, 23 April 1974. HSBC BAC Papers 1974

[59] RHL Bacon to Sandberg, 7 June 1974. HSBC BAC Papers 1974. Haddon-Cave also hoped to encourage self-regulation of the stock exchanges at this time.

capital, loans received and number of shareholders. The breakdown of share capital is presented in Table 4, which shows that 65% would not meet the banks' preferred limit of minimum paid-up capital of $10m, and that 36% would not meet the limit finally agreed of $2.5m.

Ockendon revealed his recommendations for a three-tiered banking system of Full Licensed Bank, Limited Licensed Banks and Registered Finance Companies at the June 1974 meeting of the Banking Advisory Committee.[60] His scheme included the proviso that 'it was not expected that any new full licences would be granted in the foreseeable future'. In essence, the proposals continued the moratorium on new retail bank licenses but allowed an opportunity for new banks to enter the wholesale market. Only the retail market for small deposits repayable within three months would be fully controlled by the existing licensed banks. They would have to compete with new Limited Licensed Banks for large deposits even at short term. The fully licensed banks, with their higher minimum capital and liquidity ratios would also compete directly with Registered Finance Companies for three-month deposits over $50,000. The proposal to reserve all deposits less than three months for the existing banks had prompted 'forceful representations that the proposed amendment would unfairly alter the ground rules which finance companies had carefully studied before establishing themselves here; that it would have a most serious effect on their business; and that it would destroy an orderly and efficient inter-company money market which has built up over the years, and diminish the expertise available in various other financial areas.'[61] Having established themselves in advance of any guidelines, the finance companies had become entrenched enough to protect their position.

Table 5 shows an outline of the scheme, which left the licensed banks with the administratively relatively expensive small deposit sector while the more profitable wholesale market was opened up for competition. This structure is very close to the one eventually introduced in 1981 and still in place in 2005. The difference is that in the current structure the RLBs do not have a lower minimum deposit on terms over three months and the minimum deposit for DTCs was $50,000 (now $100,000) rather than $500,000.

Compared to the 1974 scheme, this reduced the competition between banks and RLBs for longer term deposits and increased competition between banks and DTCs. In 2005 the minimum limits are still $500,000 despite the decreased purchasing power of this sum since 1974. Ghose has suggested that a main rationale for the introduction of the three-tiered system in 1981 was the need to enforce the interest rate agreement, given that interest rates were a more important monetary tool once the exchange rate was floating.[62] This was clearly not the rationale for the development of the scheme in the summer of 1974 when the exchange rate was fixed and Haddon-Cave was critical of the interest rate agreement.

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60 Minutes of the BAC, 28 June 1974. HSBC Minutes of BAC 1974.

61 Draft Memo for Executive Council, 8 August 1974. HSBC BAC Papers 1974.

62 TK Ghose (1995), *The Banking System of Hong Kong*, 2nd ed., Butterworths, Hong Kong: 80-1. In 1990 the names of the categories were changed to licensed bank, restricted license bank, and deposit taking company. In 1998 KPMG recommended collapsing the system to a two-tiered structure after the AFC, but this was not implemented. Instead, in May 2002, the transition from RLB or DTC to fully licensed bank was made easier. It was expected that this would allow a 'natural simplification' of the system rather than imposing the changes. Legislative Council Brief, Banking Ordinance (amendment of seventh schedule), Notice 2002.

In August 1974 Haddon-Cave circulated the BAC with draft proposals for the Executive Council based on Ockendon's report. These caused considerable indignation and resistance among the banks. Haddon-Cave's draft was particularly critical of the anti-competitive impact of the moratorium, noting that the restriction had been imposed at a time of weakness, but

> *now, the banking system is strong and healthy and less in need of protection in return for the obligations imposed on it. In principle, protection from competition discourages innovation by those protected and keeps charges unnecessarily high, while its more beneficial effects may become eroded by the diversion of regulated business into unregulated channels.*[63]

The unofficial members of the BAC objected to this interpretation, claiming perversely that Hong Kong's reputation could be impaired by a rapid expansion in the number of banks that the government had responsibility to supervise. They claimed there was strong and healthy competition and 'it is unappropriate [sic] and demeaning to use a loaded expression such as 'protection from competition....'.[64]

The draft memo went on to conclude that there were probably enough retail banks, but there was room for entry in the wholesale sector. The unofficial members of the BAC responded that the banks had already seen an erosion of their ability to attract funds because of the competition from DTCs not subject to the same restrictions as the banks were (liquidity margins and reporting requirements). The problem, therefore, was not the entry of new banks (who would be subject to the same restrictions as existing banks) but the operation of non-bank institutions outside the regulations that were competing with banks for short-term deposits.

The memo set out a choice between control and supervision of DTCs to protect depositors and preserve the stability of the financial system *or* to impose liquidity requirements and other controls to protect banks from competition. The memo then rejected the second option since 'such control and supervision would require an army of inspectors and could never be fully effective'. Instead, the memo recommended the three-tiered system of full license banks, limited licensed banks, and registered finance companies.

The unofficial members of the BAC called for the limited license proposal to be shelved because the disarray in the international monetary and financial system made such a major re-organisation dangerous to stability.[65] Instead, they called for the immediate introduction of registration for DTCs, minimum paid-up capital of $2.5m and minimum deposits for them of $200,000.[66] In the meantime, they wanted a broadened redefinition of banking in order to protect their market for deposits under three months. Since the new minimum deposits and paid-up capital would threaten to put many of the existing DTCs out of business, the banks' sensitivity to the overall financial situation in Hong Kong seems to be an excuse to sideline the Restricted License proposal rather than a genuine concern.

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63 Draft Memo for Executive Council, 8 August 1974. HSBC, BAC Papers 1974.

64 Draft response to the Exco draft by unofficial members of the BAC, 24 August 1974. HSBC, BAC Papers 1974.

65 The HK$ was under considerable pressure in the Autumn of 1974 and was floated from 26 November 1974.

66 Response to the Exco draft by unofficial members of the BAC, 2 September 1974. HSBC, BAC Papers 1974.

At the September 1974 meeting of the BAC to discuss the draft for the ExCo, no agreement could be achieved. The official view was that the bankers' proposals for minimum deposits for DTCs 'would be harmful to the present condition of our financial sector as well as being unacceptable to those operating in our markets at present (including those of international repute).'[67] The government was not willing to close down the activities of these institutions through regulation. However, the Financial Secretary still sought a compromise and was eventually ready to accept the banks' request for registration of DTCs, and minimum paid-up capital but with lower minimum deposit requirements, and no immediate redefinition of banking. The proposals for limited licensed banks (i.e. new competition for short-term deposits) could be shelved for the moment.

Finally, in November 1974, noting that after informal discussion between official and unofficial members of the BAC since September, 'official members now accept that present conditions are unsuitable for a radical reshaping of Hong Kong's financial sector', the Banking Commissioner submitted the compromise proposals for the Executive Council.[68]

1. The proposals for issue of limited banking licences and consequent redefinition of banking business would be left under review.
2. No further bank licenses would be issued until more settled finance conditions prevailed and until better information was available on the scale of operations of finance companies.
3. Some measures to protect smaller depositors will be implemented.

Only banks were to take deposits less than $50,000, all DTCs would have to register and all must after two years have minimum capital of $5m ($2.5m paid up), provide annual audited accounts available for inspection by the public and displayed at the place of business, and they would pay an annual fee to cover administration of the new rules. The Banking Commissioner reserved the right to call for further information to check compliance. DTCs were also prevented from lending more than 25% of paid-up capital and reserves to any one person or company, and they had the same requirements as banks over lending to directors and relatives. The proposals were duly put to the Executive Council and then to the Legislative Council in January 1975.

The banks lost their battles over the minimum size of deposit, and minimum duration, which were much lower than they had wished. On the definition of banking, the memo for the BAC advised that 'the submission to Executive Council would record that strong representations have been made by unofficial members of the Committee to the effect that the Banking Ordinance should be amended so as to provide that deposits of a shorter term than three months should not in any circumstances be accepted other than by licensed banks. These representations would not, however, be supported by the Administration, which would wish to provide for controlled participation in such deposit-taking, in large sums, by companies which could be subjected to the obligations of the Banking Ordinance.'[69] Haddon-

[67] Haddon-Cave to Sandberg, summarising discussion on 4 September. 13 September 1974. HSBC, BAC Papers 1974.

[68] Memo for BAC, November 1974, HSBC, Chairman's Papers, BAC 1974.

[69] Memo for the BAC, November 1974. HSBC, BAC Papers 1974.

Cave's view was that protection of the public required restricting the minimum size of deposit new institutions could accept. Any restriction on the duration of these deposits merely protected the existing banks.

What had seemed at the outset to be a simple matter of Protection of Depositors in July 1973 grew into a prolonged and bitter battle between Haddon-Cave and the banks over the protection of the banking market in Hong Kong. It took 18 months for agreement in principal to be achieved and a further year for the bill to become law in January 1976 when 176 DTCs were registered. Prudential supervision of DTCs was enhanced at the end 1978 by requiring monthly returns, just after a run on Sun Hung Kai Finance Co. in November of that year required lines of credit from HSBC and Paribas.[70] The implementation of physical inspections, however, did not begin until January 1980, delayed by the recruitment and training of staff. In June 1980 the Banking Commissioner Colin Martin warned that he had no discretion over who successfully registered a DTC so long as they complied with the basic legal requirements, and so it was up to customers to assure themselves of the quality of the DTCs they did business with.[71] The Three-Tiered System was finally introduced in 1981, seven years after it was first proposed.

Figure 6 shows that the DTCs outside the supervision of the banking commissioner had total assets equivalent to 28% of the total bank and non-bank assets by 1978, when data first become available. Figure 6 also shows the rise in the value of assets of non-bank financial institutions relative to banks until the DTC crisis in 1982 and then the precipitous decline from the banking crisis of 1986. In September 2005 non-bank authorised institutions had only 3% of total assets, suggesting that operating a DTC is not as attractive as operating a fully licensed bank.

6. Conclusions: Was the Moratorium Effective in Improving the Stability of the Banking System?

The tension between wanting to host an international financial centre but also trying to restrict competition in the domestic banking market led to ongoing conflict between the banks and the government. In the case of restrictions on branches, the local banks lost the battle for further protection from foreign banks' activities. But they did gain considerable protection from the strict operation of the moratorium, which they were able to influence administratively through the Banking Advisory Committee. Even once the rules were changed to allow some foreign banks to bolster the IFC, only one new license was granted. The government's reluctance to regulate deposit-taking companies reflected the Financial Secretary's separation of retail and wholesale banking and an effort to promote the latter while protecting the local banks' retail operations.

[70] Confidence in SHK Finance was rocked by losses reported by its sister company SHK Securities. The company was advised by the Banking Commissioner to cease releasing time deposits before they became due to sustain liquidity. Paribas had a 17% interest in SHK Securities.

[71] 'Caveat Emptor', Speech by Commissioner of Banking at the Rotary Club of Hong Kong on 10 June 1980. This was reported also in the press.

The fact that there was no banking crisis until after the moratorium was finally lifted in 1981 might suggest that the moratorium did work to improve the stability of the banking system. The account based on archival evidence presented in this paper, however, suggests that the moratorium failed in many of its goals, particularly the improvement of governance. The main results were increased non-price competition, increased profits, and a rise of institutions outside prudential supervision. The problems of poor governance that had plagued the banking system in the early 1960s continued. Many of the banks involved in the scandals that led to the crisis of 1982-86 had foreign partners but this did not resolve their governance problems and they continued to be controlled by families with inter-linking business groups.[72] This left the banking system vulnerable to contagion from unsupervised non-banks as well as to asset market shocks, particularly property values that were a precipitating factor in the 1982-86 crises.

While the banks (large and small) supported the moratorium for anti-competitive reasons, the government supported it in order to encourage foreign banks to do the job that prudential supervision and regulation was meant to do, i.e. improve management and governance. The protection afforded to small banks by the moratorium and the IRA, however, worked against this outcome. Higher profits and greater franchise value improved the bargaining power of banks targeted by foreign banks for acquisition and reduced the incentive for horizontal mergers. At the same time the moratorium reduced the regulatory space by prompting the rise of non-bank financial institutions that ultimately threatened systemic stability through their links to banks and through contagion. The fact that owners of banks did not themselves view DTCs as a substitute for fully licensed banks, and that once the moratorium was lifted the market share of DTCs dropped away suggests that if the moratorium had not been in place there would have been more banks within the supervisory realm of the government. The moratorium therefore did not achieve its goal of solving the underlying weaknesses of governance in the Hong Kong banking system that resurfaced in the crises of 1982-86.

[72] On the detail of the bank failures of 1982-1986 see YC Jao (1989), "Recent Banking Crises in Hong Kong and Taiwan," in MK Nyaw and CY Chang eds., *Chinese Banking in Asia's Market Economies*, Chinese University of Hong Kong: 21-56 and TK Ghose (1995), *The Banking System of Hong Kong*, 2ed., Butterworths: 82-96.

Table 1. Branch Networks - totals exclude head office

	Branches 1970	Branches 1973	Percent Change
Foreign	39	64	64
Local	116	168	36
Note Issuing	89	111	25
Mainland Chinese	45	61	36
TOTAL	289	404	40

Note: note-issuing banks are HSBC, Chartered Bank and Mercantile Bank

Table 2. Share of Total Deposits and Advances of the Banking System (Percent)

	Share of Deposits 1964	Share of Deposits 1968	Share of Deposits 1972	Share of Advances 1964	Share of Advances 1968	Share of Advances 1972
Foreign Banks	16	12	13	22	25	30
Local Banks	34	31	35	35	30	32
Note Issuing Banks	40	45	44	36	38	33
Mainland Chinese Banks	10	11	8	7	7	5

Source: HKRS 163-1-3273, 163-1-3277, 163/9/371

Table 3. Foreign Interest in Hong Kong Banks 1969-79

Parent	Majority Interest	Minority Interest
First National City	76% Far East Bank (1969)	
National and Grindlays	50% Dao Heng (1970)	
Hawaii Thrift and Loan Co. CS Low Investment Ltd	80% Ka Wah (1970) Ka Wah (1974)	
Security Pacific National Bank	Bank of Canton (1971)	
International Consolidated Investments Ltd/ Toronto Dominion Bank	Overseas Trust Bank (1970)	
	Hong Kong Industrial and Commercial Bank (1970)	
Irving Trust	Wing Hang (1973)	
Fuji Bank	55% Kwong On Bank (1973)	
BCCI	Hong Kong Metropolitan (1979)	
Tokai Bank		10% Commercial Bank of Hong Kong (1972)
Bangkok Bank		Commercial Bank of Hong Kong (1966)
Chartered Bank		Wing Lung Bank (1973)
Wells Fargo		10% Shanghai Commercial Bank (1969)
Mitsubishi Bank		25% Liu Chong Hing Bank (1973)
Daiichi Kangyo Bank		30% Chekiang First Bank (1962)

Table 4. Share Capital of Finance Companies Reported to the Banking Commissioner 1974

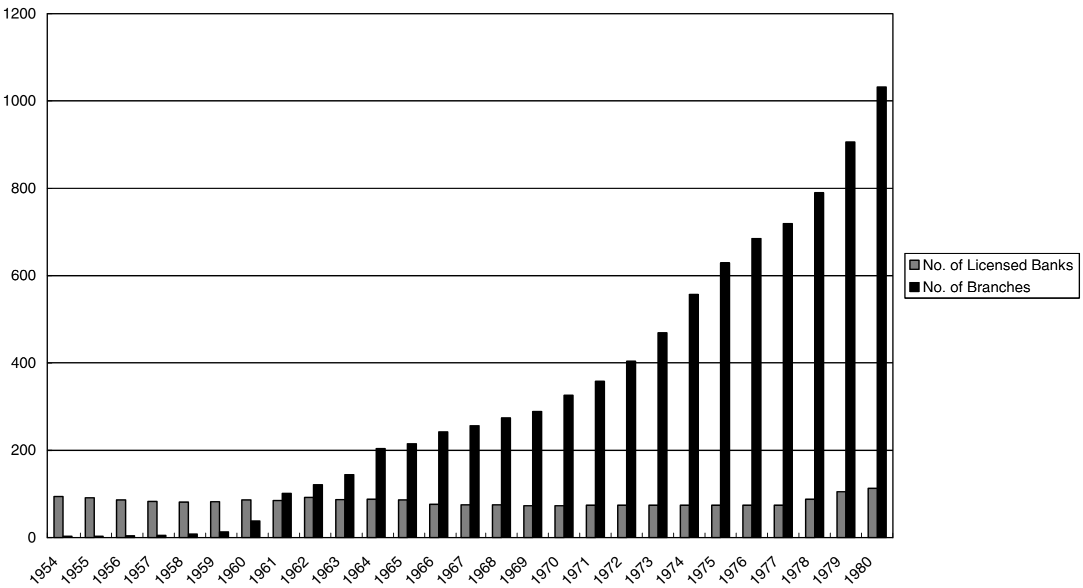
Less than $1m	29
$1m - $2.5m	8
$2.5m -$10m	31
$10m-$25m	20
Over $25m	13
Not Recorded	3
TOTAL	104

HSBC Group Archive, Chief Manager's Files, Banking Advisory Committee Minutes 1974.

Table 5. Three Tiered Scheme Proposed in July 1974

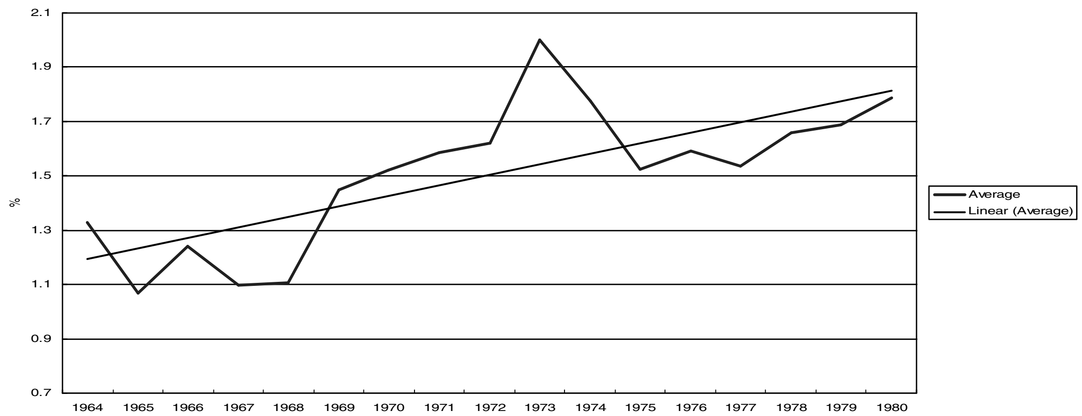
	Minimum Deposit less than 3 months	Minimum Deposit over 3 months	Minimum Paid-Up Capital
Tier I Licensed Bank	$1	$1	$25m
Tier II Restricted License Bank	$500,000	$50,000	$25m
Tier III Registered Finance Co.	n/a	$500,000	$5m

Figure 1. Expansion of Bank Officers in Hong Kong 1954 - 1980



Source: HKIMR Historical Database https://www.hkimr.org/history_database.asp

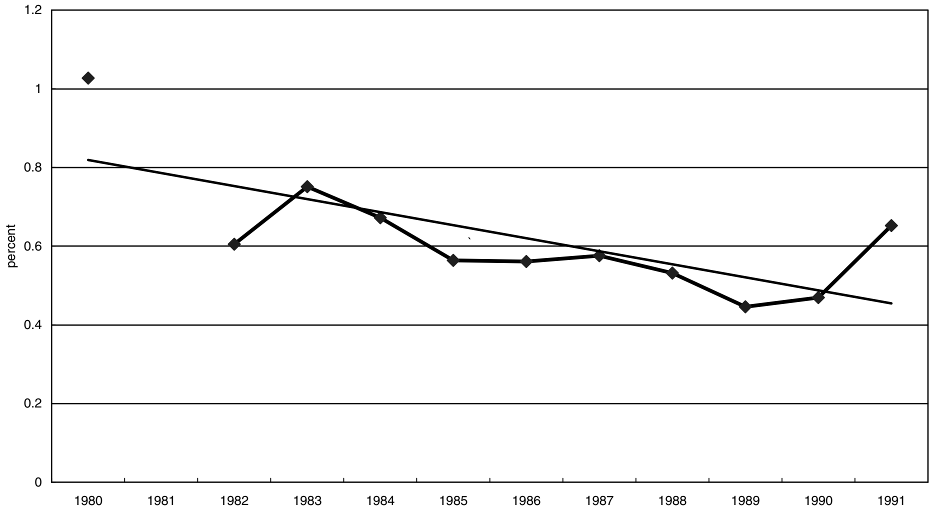
Figure 2. Net Profit as Percent of Assets for a Sample of 15 Hong Kong Banks 1964 - 1980



Source: Published balance sheets for 13 banks.[72] Chartered Bank archives, Guildhall Library. King (1991) for HSBC.

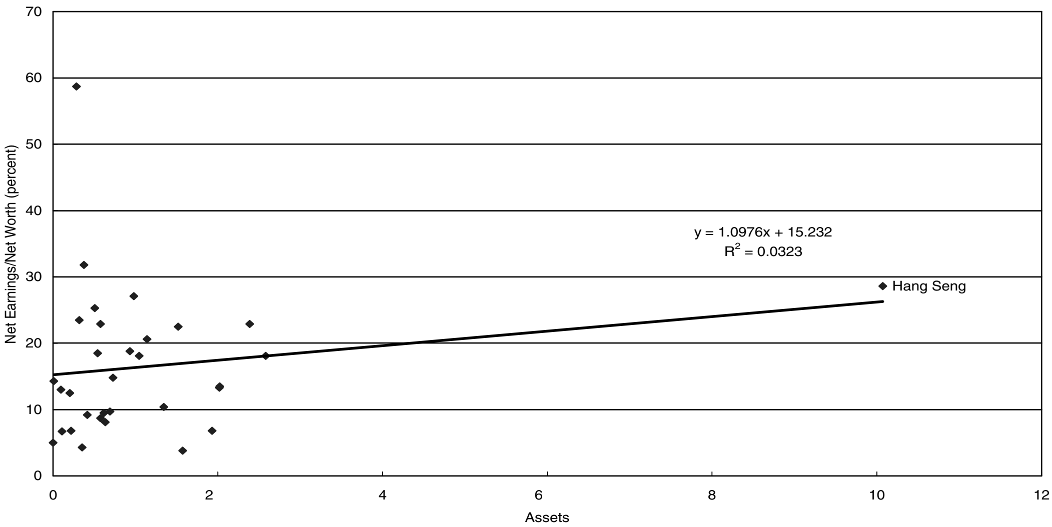
[72] On the detail of the bank failures of 1982-1986 see YC Jao (1989), "Recent Banking Crises in Hong Kong and Taiwan," in MK Nyaw and CY Chang eds., *Chinese Banking in Asia's Market Economies*, Chinese University of Hong Kong: 21-56 and TK Ghose (1995), *The Banking System of Hong Kong*, 2ed., Butterworths: 82-96.

Figure 3. Return on Assets of Licensed Banks in Hong Kong (income-costs/assets)



Source: *Census of Storage, Communications, Financing, Insurance and Business Services*, Census and Statistics Department, Hong Kong.

Figure 4. Size of Total Assets and Net Earnings/Net Worth: 1977



Source: SGV-Sun Hung Kai Ltd., *A Study of Domestic Commercial Banks in Hong Kong*, December 31, 1978.

Figure 5. Comparison of Average Profits for 15 Hong Kong Banks and 7 Banks with Foreign Participation

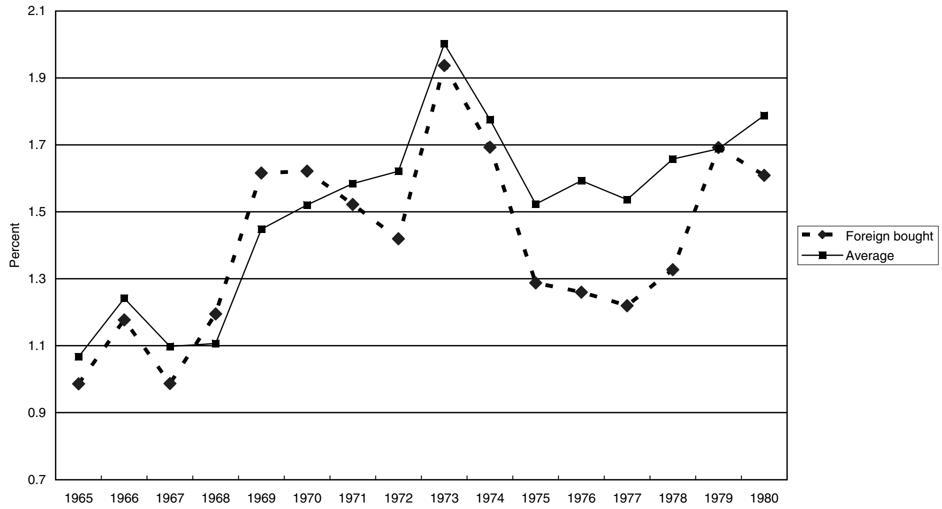


Figure 6. DTC+RLB Share of Total Bank and Non-Bank Assets