The Operation of the Moratorium on New Bank Licenses on the Hong Kong banking system 1965-81

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Summary

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.