

CONSULTATION PAPER

**REVIEW OF MARKET ENTRY CRITERIA
AND THE THREE-TIER AUTHORIZATION SYSTEM**

PURPOSE

Pursuant to the recommendations contained in the Banking Sector Consultancy Study (“Consultancy Study”) commissioned by the HKMA in 1998, the HKMA has recently conducted an internal review of the market entry criteria and the three-tier authorization system. This paper reports on the results of the internal review and sets out a number of proposals in that relation for consultation with the industry. These proposals have been discussed at a recent joint meeting of the Banking Advisory Committee and Deposit-taking Companies Advisory Committee.

BACKGROUND

2. The Consultancy Study recommended, among others, that the three-tier system should be simplified and barriers to market entry should be removed, while at the same time ensuring the safety and stability of the banking sector. Notwithstanding some of its merits, the Consultants identified several problems with the three-tier system. First, the system was considered complex and there is a significant duplication of licences within banking groups. Second, the need to distinguish restricted licence banks (RLBs) and deposit-taking companies (DTCs) seemed less relevant in view of market developments. To conclude, the Consultants believed that going forward the three-tier system would likely become outdated, particularly amidst a global trend towards unitary licensing systems, coupled with the blurring of financial markets.

THE CHANGING CIRCUMSTANCES

3. The HKMA agrees with the Consultants that the present three-tier system and the associated market entry criteria are probably outdated. In fact, many features of the present system were introduced at different times for different reasons which may no longer be valid.

4. For example, the original three-tier system (banks, licensed deposit-taking companies and registered deposit-taking companies) was introduced in 1981¹ to address, inter alia, the problem of unregulated deposit-taking companies undermining the Interest Rate Rules. Within the licensed bank category, many requirements are designed to hinder entrance by foreign banks as local applicants to circumvent the branching restrictions originally embodied in the “one-building” condition. Foreign applicants are also subject to a size criterion designed to limit the number of eligible applicants due to concern about “over-banking”.

5. The Interest Rate Rules of course no longer exist. The branching restrictions have also been abolished². In keeping with its status as an international financial centre, the financial system of Hong Kong has moved on to embrace the world trend of enhanced competition with improved market discipline and transparency, a supervisory framework of international standard, and a safety net to cope with potential problems. “Over-banking” is an issue which the market today should be able to address.

¹ The two categories of licensed deposit-taking companies and registered deposit-taking companies were replaced by restricted licence banks and deposit-taking companies respectively in 1990.

² All branching restrictions on foreign incorporated banks and RLBs were abolished on 30 November 2001.

6. At the same time, the number of authorized institutions (AIs) has been dwindling in the past few years. This is partly due to the withdrawal of foreign banks, in particular Japanese and European banks, after the Asian financial crisis and partly due to the ongoing trend of consolidation which is certain to continue. While the process of consolidation produces stronger players, the number of participants and market activities decrease. This is not helpful to the breadth and depth of the financial markets of Hong Kong.

7. It is clear that the rationale for the present licensing and tiering system should be revisited and reviewed. In light of the above developments, the HKMA considers that the policy objectives of the review should be as follows:

- (a) to enhance the status of Hong Kong as an international financial centre by allowing a broad range of domestic and international institutions to participate in the Hong Kong financial markets while not compromising market stability;
- (b) to improve the market structure by removing unnecessary restrictions and distinctions between local and foreign players;
and
- (c) to increase the transparency of the licensing process by removing the more subjective entry criteria.

MARKET ENTRY CRITERIA

The Size Criteria

8. At present, an overseas-incorporated bank that wishes to set up a branch in Hong Kong must have total assets of more than US\$16 billion (for the whole banking group). This asset size criterion is intended to ensure that only substantial and reputable international banks would be admitted as full licensed banks. In other words, it is intended to provide a means for the HKMA to filter out smaller applicants. According to the Consultancy Study, the measure has provided an effective means for the HKMA to achieve this objective. The Consultancy Study therefore did not envisage any need to change this criterion.

9. As mentioned above, the circumstances have significantly changed since the Consultancy Study was conducted in 1998. The reducing number of AIs in Hong Kong calls into question the value of measures to limit the number of eligible applicants from overseas. Moreover, the presence of a size criterion in our own market does not help in persuading the Mainland authorities to relax their size criterion of US\$20 billion for foreign banks (including those from Hong Kong) to enter the Mainland market.

10. In fact, this size requirement was already recognised as inflexible in a review of the three-tier system in 1987. Accordingly, the HKMA was given the power to override the size criterion if it considered that, in doing so, it would help promote the interests of Hong Kong as an international financial centre. This discretion is however very subjective and has rarely been exercised.

11. An asset size criterion for foreign entrants is not commonly found in other major international financial centres. The US, Germany and Australia do not have such a criterion whereas in the UK a rather small threshold (£1 million) has been adopted. Moreover, it is now well accepted that size is not the principal measure of the strength of a bank. There are other more widely accepted measures to assess the financial soundness and international reputation of a bank. These include tier one capital, asset quality, fitness and probity of the bank management as well as its major shareholders, etc. Also, banking supervisors in developed countries have all primarily referred to the capital adequacy ratio in assessing the financial strength of banks applying for banking licences. All these have been included in the detailed minimum authorization criteria set out in the Seventh Schedule of the Banking Ordinance which should be sufficient to ensure the quality of new entrants. It should be noted that these criteria did not exist when the minimum size requirement was originally introduced.

12. It therefore appears that an asset size criterion for foreign applicants is now of less relevance. However, there may still be some advantage in retaining some balance sheet criteria for locally incorporated applicants for full licensed status. The HKMA has primary supervisory responsibility for these institutions, and it has an interest in ensuring that they have achieved sufficient critical mass to be upgraded to full licensed status. It would also be desirable to avoid a proliferation of very small local banks at a time when the HKMA is encouraging consolidation of the banking sector. Under the present licensing policy, a local applicant for a full banking licence must satisfy the size criteria of total customer deposits of not less than HK\$3 billion and total assets of not less than HK\$4 billion (in addition to other market entry criteria that apply – see subsection on Other Criteria for Locally Incorporated Applicants below). The current criteria have not been changed since 1992. The HKMA proposes to increase the current amounts to HK\$4 billion for deposits and HK\$5 billion for assets basically to

allow for inflation since the last increase³. It is also proposed that for policy consistency the same criteria be applied to foreign applicants (in relation to the bank as a whole, rather than simply its operations in Hong Kong).

13. It is unlikely that foreign applicants would find it difficult to meet these requirements. This would increase the number of foreign banks eligible to enter the Hong Kong market in full licensed form (including those already here as RLBs). It may also be helpful in our discussions with the Mainland on their own asset size criterion. The risk is that more banks of doubtful quality may try to gain access. But the HKMA's authorization criteria should be sufficient to deal with this. If it is not considered appropriate to grant a full banking licence to a small overseas-incorporated bank, it would still be open to the HKMA to authorize it as a RLB. In addition to the HKMA's own authorization powers, it can also rely to some extent on foreign supervisors to ensure that their banks are sufficiently well-equipped to set up a branch operation in Hong Kong.

14. With respect to locally incorporated RLBs and DTCs, there are not many that currently meet or are close to meeting the asset and/or deposit size criteria. However, as explained in para. 12, the HKMA believes that it is reasonable to expect them to have demonstrated this capability before being upgraded to full licensed bank status. In any case, the revised size criteria are objective and transparent targets that AIs can strive to meet if they want to upgrade. The situation should also be considered together with the proposed relaxation in the other criteria that apply to local applicants (see subsection below).

³ As of October 2001, the cumulative inflation (based on the Composite Consumer Price Index) since 1992 was 36%. The proposed increased amounts have been rounded down.

15. The HKMA would, however, welcome comments on the proposed changes to the size criteria for locally incorporated institutions. If they are increased as proposed, it is suggested that existing locally incorporated licensed banks that do not meet the criteria would continue to be grandfathered as at present.

Other Criteria for Locally Incorporated Applicants

16. A locally incorporated applicant for a full banking licence must also fulfil the following criteria:

- (a) it must have been a RLB or DTC in Hong Kong for at least 10 continuous years; and
- (b) it must in the opinion of the HKMA be “closely associated and identified with Hong Kong”.

17. These criteria were introduced to prevent foreign banks from entering the market through the local route in order to circumvent the then “one-building condition”. Since all branching restrictions on foreign banks have been abolished, the rationale for these criteria will need to be reviewed.

18. Based on the advice of the Consultants, the HKMA is making two proposed changes in relation to these criteria:

- (a) reduce the time period before upgrading of a locally incorporated RLB or DTC to full licensed status can be allowed from 10 years to 3 years. The HKMA believes that 3 years should provide sufficient time to judge the performance of an applicant for upgrading; and

- (b) remove the requirement that the AI should be “closely associated and identified with Hong Kong”. This test is largely judgmental in nature and experience has shown that it is difficult to apply consistently. This is particularly the case since many “local” institutions in Hong Kong are in fact foreign-owned. It would seem an opportune time to dispense with this relatively subjective requirement and to rely instead on the length of time that the AI concerned has been established in Hong Kong (say three years) and the extent to which it has built up customer deposits and assets.

19. It is also proposed to allow foreign banks with existing operations in Hong Kong in branch form to subsidiarise these operations. As the Bank of China (BoC) merger has demonstrated, there could possibly be occasions when foreign banks would wish to do this. In the case of BoC, this could be effected because the branch operations were merged into an existing locally incorporated bank. For other cases, a foreign bank is in practice currently prohibited from subsidiarising its Hong Kong operations through a new locally incorporated company. This is because a new company cannot meet the requirement of having operated as a locally incorporated RLB or DTC for the designated period (although the bank may have operated in branch form in Hong Kong for many years). It is proposed that the Seventh Schedule of the Banking Ordinance should be revised to allow such subsidiarisation, subject to the following conditions which are consistent with those proposed for other local applicants:

- (a) the foreign AI in question has been established in Hong Kong for at least three years; and
- (b) all its customer deposits and assets are transferred to the new locally incorporated bank and amount to at least HK\$4 billion and HK\$5 billion respectively.

20. Although a reasonably large number of foreign AIs currently in branch form would be eligible under the criteria specified in the preceding paragraph, in practice the HKMA thinks that very few are likely to avail themselves of the opportunity, particularly since they are no longer subject to any branching restriction. However, the important point is to offer such AIs the flexibility to make a choice, which they do not have at present. From a supervisory point of view, there is no reason why such a change should be discouraged.

Maintenance of Representative Offices

21. At present the HKMA adopts a general administrative policy of requiring foreign banks to maintain a representative office in Hong Kong for one or two years before they can be authorized as AIs. This is to allow them to acquire sufficient experience in the local banking environment before they can be considered for authorization. However, it is not clear that this adds much value to the system in practice. In keeping with the other measures to facilitate entrance by foreign players, it is proposed that this requirement be dispensed with as a general policy, though it could be applied in particular cases.

Paid-up Capital Requirement

22. The current rules require locally incorporated licensed banks to have a minimum absolute amount of paid-up share capital (including share premium account) of HK\$150 million⁴. The equivalent figures for RLBs and DTCs are

⁴ This is separate from the need to maintain a capital adequacy ratio. A paid-up capital requirement is considered to be useful since it demonstrates the commitment of shareholders to make a reasonably sizeable initial investment in the bank as well as reinforcing the permanence of at least part of the capital base (since paid-up capital cannot be distributed). A minimum absolute amount of capital is recommended by the Basel Committee as part of compliance with the Core Principles for Effective Banking Supervision.

HK\$100 million and HK\$25 million respectively. In the two latter cases, the requirement applies to both locally incorporated and foreign incorporated AIs. The last revision of the paid-up capital requirements took place in 1989. The Consultancy Study recommended that the HKMA should consider increasing the minimum capital requirement to take account of inflation since then.

23. The HKMA therefore proposes that the minimum paid-up capital of licensed banks should be increased from \$150 million to \$300 million. This is slightly ahead of the figure that would be required to allow simply for inflation since the last increase⁵. This is intended to strike a balance between on the one hand making it easier for locally incorporated institutions to upgrade to full licensed status (by removing the subjective “associated with Hong Kong” test) while on the other hand avoiding a multiplicity of small, locally incorporated banks which, as noted earlier, would arguably run counter to the objective of achieving consolidation. Coupled with the proposed minimum figures for deposit and asset size, the intention is to set objective tests which institutions with a reasonable critical mass should be able to meet, provided their shareholders are prepared to make the necessary capital investment. The proposed minimum capital requirement implies an equity to assets ratio of 6% in relation to the proposed minimum asset size of HK\$5 billion, which does not seem unreasonable.

24. Should the revision in the paid-up capital requirement be effected as proposed, it is estimated that all locally incorporated licensed banks should be able to meet the new requirement, although a few of them would have to capitalise existing reserves into share capital⁶.

⁵ As of October 2001, the cumulative inflation (based on the Composite Consumer Price Index) since 1989 was 82%.

⁶ Based on September 2001 figures.

25. However, the HKMA does not propose any increase for RLBs and DTCs. This is because to increase the paid-up capital requirement in line with inflation would entail injection of capital for a number of AIs in these two categories. This may not be appropriate in the current economic environment. Moreover the changes to the market entry criteria may cause significant structural shift of institutions among the three tiers (see section on The Three-tier Structure below). It would be opportune to review the paid-up capital requirements of RLBs and DTCs after all the changes have bedded down and the economic environment has improved.

26. There is an additional issue to be addressed. As indicated, the minimum capital requirement is presently applicable to foreign incorporated RLBs and DTCs (though all existing DTCs are locally incorporated) but not to foreign incorporated licensed banks. For the sake of policy consistency, it is proposed that the capital requirement should also be applied to licensed banks which are incorporated overseas. The imposition of this requirement is unlikely to pose any difficulties for foreign banks wishing to seek entry to the Hong Kong market⁷.

⁷ According to *The Banker July 2001*, the 1000th largest bank (in terms of capital strength) has US\$135 million tier one capital, and the 500th largest bank has US\$500 million tier one capital.

THE THREE-TIER STRUCTURE

27. The above proposals should, in principle, make it easier for foreign banks to enter the Hong Kong market in branch form as full licensed banks and for RLBs (and possibly DTCs) to upgrade to full licensed status in either branch or locally incorporated form.

28. This has implications for whether it is necessary to change the three-tier structure, for the time being at least. One reason for change, as suggested by the Consultants, was to simplify the current arrangements. But moving to a two-tier structure is not itself a simple process since it would involve reconciling the different restrictions on deposit-taking that currently apply to RLBs and DTCs. It would also involve changes to the Banking Ordinance, which would take time to implement.

29. Another reason for change would be to make the RLB category more attractive and thus perhaps encourage more entrants. One possibility that the HKMA has considered would be to allow RLBs to offer current accounts, which a number of RLBs would find useful for business purposes. But this would erode one of the principal distinctions between licensed banks and RLBs, calling into question whether there is any purpose in keeping the two categories separate. It would also require primary legislation.

30. A more practical approach might therefore be to make it easier to become a licensed bank, as proposed in the previous section on market entry criteria. This would allow existing RLBs (and new entrants) to have access to the full range of banking business and would reduce the need to tinker with the current restrictions on RLBs (and DTCs).

31. The need for revisions to the three-tier structure could be looked at again when the changes induced by the current proposals have worked their way through the system. It is for example possible that the banking sector might move to a de facto two-tier system of licensed banks and DTCs (doing finance company and other specialised types of business), with perhaps a rump of RLBs in the middle. In due course, the legislation could be changed to accommodate such a situation.

32. There is, however, one change that could currently be made that would improve slightly the situation of locally incorporated RLBs. These are presently not allowed to use a banking name, even if they are a subsidiary of a bank. This is less flexible than the treatment afforded to foreign incorporated RLBs. It is proposed therefore that the HKMA should revise the policy to the effect that a locally incorporated RLB would be able to incorporate the name of its banking parent in the name under which it conducts business in Hong Kong. This would mean, for example, that a RLB subsidiary of ABC Bank could describe itself as ABC Bank (Asia) Ltd. This would be subject to the condition that the name is used in immediate conjunction with the term “restricted licence bank”, which is the same condition that currently applies to foreign incorporated RLBs.

SUMMARY

33. The recommended changes are summarised in the table below:

Table: Proposed changes to the market entry criteria for the banking sector
(changes shaded)

	Licensed Banks (LBs)		RLBs	DTCs
	Locally incorporated banks	Overseas-incorporated banks		
<i>Size criteria</i>	Total assets: HK\$4b → HK\$5b Total deposits: HK\$3b → HK\$4b	To adopt the same criteria as for local LBs	No size criteria	
<i>Capital requirement</i>	HK\$150m → HK\$300m	To be subject to same requirement as local LBs: HK\$300m	No change	No change
<i>Time period</i>	Must have been a RLB or DTC for 10 yrs → 3 yrs	Remove general requirement for foreign banks to have maintained a local representative office in HK		
<i>Association with Hong Kong</i>	Remove the requirement	Not applicable		
<i>Branch subsidiarisation</i>	Not applicable	Conditions: (a) Branch established in HK for at least 3 years (b) Meet customer deposits and assets criteria of HK\$4b and HK\$5b respectively	Not applicable	
<i>Use of banking name</i>	No restriction		To relax restrictions for local RLBs operating as a subsidiary of another bank	Not allowed

34. The HKMA believes the above changes will help to rationalise the authorization and market entry system in Hong Kong and will also enhance the position of Hong Kong as an international financial centre.

WAY FORWARD

35. Subject to the results of consultation with the industry, the HKMA would proceed to implement the recommended changes. As noted, some of the changes can be effected by administrative measures while others will entail amendments to the Seventh Schedule of the Banking Ordinance.

36. The HKMA will monitor market developments after the recommendations are implemented and consider the need for legislation to change the three-tier system when the need arises.

The Hong Kong Monetary Authority

11 December 2001