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LEGISLATIVE COUNCIL BRIEF

Banking Ordinance
(Chapter 155)

BANKING ORDINANCE (AMENDMENT OF SEVENTH SCHEDULE) NOTICE 2002

INTRODUCTION

At the meeting of the Executive Council on 30 April 2002, the Council ADVISED and the Chief Executive ORDERED that the Banking Ordinance (Amendment of Seventh Schedule) Notice 2002 (the Notice), at Annex A, should be made under section 135(1) of the Banking Ordinance to implement the proposed relaxations set out in paragraph 10 below.

BACKGROUND AND ARGUMENT

Existing Market Entry Criteria

2. Under section 16(1) of the Ordinance, the Monetary Authority (MA) has a general discretion to grant or refuse an application for authorization to carry on a business of banking or taking deposits. Under section 16(2), the MA is required to refuse an application for authorization if any one or more of the criteria specified in the Seventh Schedule are not fulfilled with respect to the applicant.

3. Most of the authorization criteria in the Seventh Schedule aim at ensuring that only institutions which are managed in a prudent and competent manner can gain access to the Hong Kong market. They are consistent with the generally accepted features of a prudent licensing system as set out in the Basel Committee's Core Principles for Effective Banking Supervision.

4. Apart from the general prudential criteria, an applicant seeking authorization must also satisfy various market entry criteria in the Seventh

Schedule. In particular, paragraph 13 of the Schedule provides that a locally incorporated applicant for a banking licence must in the opinion of the MA be “closely associated and identified with Hong Kong” and must have been a deposit-taking company (DTC) or a restricted licence bank (RLB) for not less than 10 continuous years. In addition, it must have total deposits of not less than HK$3 billion and total assets of not less than HK$4 billion. As for a foreign incorporated applicant, the total assets of the whole banking group of which the applicant is a part must be more than US$16 billion.

5. These market entry criteria were introduced at different times against different backgrounds. However, they were intended to achieve a common objective, which is to limit the number of eligible applicants with a view to avoiding “over-banking” in the industry.

Review of the Market Entry Criteria

6. Pursuant to the recommendations of the Banking Sector Consultancy Study[1], the Hong Kong Monetary Authority (HKMA) has recently completed a review of the market entry criteria for the banking sector. The results of this review are detailed in Annex B.

7. It was noted that the banking environment has changed substantially since these criteria were introduced. Many of these criteria, for example, were designed to avoid circumvention of the branching restrictions on foreign banks, which have been abolished[2]. In keeping with its status as an international financial centre, 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.

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[1] The Study was commissioned by the Hong Kong Monetary Authority (HKMA) in 1998. The main objective was to develop an appropriate strategy to effectively supervise and regulate the banking sector over the next five years. In response to the recommendations of the Study, the HKMA announced in 1999 a three-year programme to reform the banking sector.

[2] Foreign incorporated banks licensed since 1978 were previously subject to a branching restriction (i.e., the one-building condition), which was completely abolished in November 2001. Most of the market entry requirements applicable to a locally incorporated applicant are designed to hinder entrance by foreign banks as local applicants so as to circumvent this branching restriction.

8. At the same time, the number of authorized institutions (AIs) has been dwindling in the past few years[3]. 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. 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 in Hong Kong.

9. In the light of the above developments, we consider that some of the existing market entry criteria can be relaxed. This would help to enhance the status of Hong Kong as an international financial centre without compromising banking stability. Some improvements can also be made to remove certain unnecessary restrictions and distinctions between local and foreign incorporated applicants in the present system.

The Proposed Changes

10. The proposed changes to the market entry criteria are summarised below (please see Annex B for the arguments supporting such changes):

(a) replacing the US$16 billion asset size criterion for foreign bank applicants by the size criteria for local bank applicants, which are at present HK$3 billion for deposits and HK$4 billion for assets. These lower size requirements should apply to the foreign incorporated institution as a whole;

(b) increasing the minimum capital requirement for locally incorporated banks from HK$150 million to HK$300 million and extending this requirement to foreign incorporated banks (in respect of the bank as a whole). All existing licensed banks should be given a grace period of two years to comply with the new requirement;

(c) reducing the period of operation as an RLB or DTC from ten to three years and dispensing with the "association with Hong Kong" requirement for locally

[3] As of December 2001, the total number of AIs in Hong Kong was 245. This compares with a peak of 382 in June 1995.

incorporated applicants seeking to upgrade to licensed bank status; and

(d) allowing foreign banks to subsidiarise their Hong Kong operations if such banks have been established in Hong Kong for at least three years and their Hong Kong operations meet the deposit and asset size criteria applicable to local bank applicants as set out in item (a) above.

11. The above proposals, if adopted, would allow a broader range of domestic and international institutions to participate in the Hong Kong financial markets as full licensed banks. This would help to enhance the status of Hong Kong as an international financial centre. A possible downside is that more banks of doubtful quality may try to gain access. But the prudential authorization criteria in the Ordinance, which include capital adequacy, asset quality, fitness and probity of bank management, etc., which remain unchanged, should be sufficient to guard against this.

Three-tier Authorization System

12. In conjunction with the review of the existing market entry criteria, the HKMA has also evaluated the need to simplify the present three-tier authorization system into a two-tier system as previously suggested in the Banking Sector Consultancy Study.

13. Moving to a two-tier structure is not itself a simple process since it would involve reconciling the different deposit taking restrictions that currently apply to RLBs and DTCs. On the other hand, it is believed that the proposed relaxations of the market entry criteria would enable more RLBs to upgrade to full licensed bank status and eventually lead to a natural simplification of the three-tier system. In view of this probable development, it is recommended that no change to the current three-tier system of authorization should be introduced at this stage. The need for revisions to the three-tier structure can be revisited when the proposed relaxations of the market entry criteria have bedded down and worked their way through the system.

THE NOTICE

14. Under section 135(1) of the Ordinance, the Chief Executive in Council may, by notice in the Gazette, amend the Seventh Schedule.

15. The Notice amends paragraphs 1, 6 and 13 of the Schedule in order to effect the proposals set out in paragraph 10 above.

LEGISLATIVE TIMETABLE

16. The legislative timetable for the Notice will be –

Publication in the Gazette	10 May 2002
Tabling at the Legislative Council for negative vetting	15 May 2002

BASIC LAW IMPLICATIONS

17. The Department of Justice advises that the Notice is consistent with the Basic Law.

HUMAN RIGHTS IMPLICATIONS

18. The Department of Justice advises that the Notice has no human rights implications.

BINDING EFFECT OF THE NOTICE

19. The Notice does not affect the current binding effect of the existing provisions of the Ordinance.

FINANCIAL AND STAFFING IMPLICATIONS

20. There will be additional workload on the HKMA as some RLBs and DTCs will seek to upgrade to full licensed status and more foreign banks will apply for authorization after the proposed relaxations take effect. This can be absorbed by the HKMA through redeployment of

existing resources. There are no other financial or staffing implications for the Government.

ECONOMIC IMPLICATIONS

21. The proposed changes to the market entry criteria would broaden the scope of Hong Kong's banking sector by attracting more foreign banks to operate here, along with new employment opportunities. A greater number of participants in the sector would help to promote greater competition in the banking industry. This would be conducive to maintaining the status of Hong Kong as an international financial centre.

22. It is expected that all existing banks should be able to comply with the increased minimum capital requirement, although a few of them would have to capitalise existing reserves into share capital. A two-year grace period has been provided in this respect.

SUSTAINABILITY IMPLICATIONS

23. The proposals in the Notice do not have significant sustainability implications.

PUBLIC CONSULTATION

24. We have consulted the Banking Advisory Committee, the Deposit-taking Companies Advisory Committee, the Hong Kong Association of Banks and the DTC Association. All of them support the proposed relaxations of the market entry criteria.

25. The DTC Association has offered a number of suggestions on how the three-tier system should be re-structured. These suggestions will be taken into account when the three-tier system is reviewed in the future.

PUBLICITY

26. A press release will be issued on 10 May 2002. A Government spokesman will be available to handle media enquiries.

OTHERS

27. For enquiry on the content of this brief, please contact Ms Kinnie Wong, Assistant Secretary (Banking and Monetary) of the Financial Services Bureau, at 2527 3974.

Financial Services Bureau
10 May 2002

BANKING ORDINANCE (AMENDMENT OF SEVENTH SCHEDULE) NOTICE 2002

(Made by the Chief Executive in Council under section 135(1) of the Banking Ordinance (Cap. 155))

1. Minimum criteria for authorization

The Seventh Schedule to the Banking Ordinance (Cap. 155) is amended –

(a) in paragraph 1(6), by repealing "13(b)(ii)(A)(VI) and (VII)" and substituting "13(a)(i)(F) and (G)";

(b) in paragraph 6(a) -

(i) by repealing "incorporated in Hong Kong";

(ii) by repealing "$150,000,000" and substituting "$300,000,000";

(c) by repealing paragraph 13 and substituting –

"13. Where the company is seeking authorization to carry on banking business in Hong Kong -

(a) it has (or, where subparagraph (b)(ii)(B) is applicable, will have) –

(i) total customer deposits of not less than $3,000,000,000, or an equivalent amount in any other approved currency, excluding any deposits by –

(A) any authorized institution;

(B) any bank incorporated outside Hong Kong which is not an authorized institution;

(C) any controller or director of the company;

(D) any relative, within the meaning of section 79, of any such controller or director;

(E) any firm, partnership or body corporate in which the company, any controller or director of the company or any relative, within the meaning of section 79, of any such controller or director, is interested as director, partner manager or agent;

(F) any holding company, subsidiary or associated company of the company;

(G) any subsidiary or associated company of any such holding company; and

(ii) total assets (less contra items) of not less than $4,000,000,000 or an equivalent amount in any other approved currency; and

(b) in the case of –

(i) a company incorporated outside Hong Kong, either –

(A) there is, in the opinion of the Monetary Authority, an acceptable degree of reciprocity in respect of banks incorporated in Hong Kong seeking to carry on banking business in the place where that company is incorporated; or

(B) the place where that company is incorporated is, or is part of the territory of, a member of the World Trade Organization;

(ii) a company incorporated in Hong Kong, either –

(A) it has been a deposit-taking company or a restricted licence bank (or any combination thereof) for not less than 3 continuous years; or

(B) it is a subsidiary of a bank incorporated outside Hong Kong or a subsidiary of a holding company of such bank and that –

(I) the bank has been authorized to carry on banking business in Hong Kong for not less than 3 continuous years; and

(II) the Monetary Authority is satisfied that the bank will transfer, and is capable of transferring, as soon as reasonably practicable after the company is authorized, from its principal place of business in Hong Kong or any local branch or local office (within the meaning of this Ordinance as amended by the Banking (Amendment) Ordinance 2001 (32 of 2001)), to the company amounts of customer deposits and assets not less than the respective amounts specified in subparagraph

(a)(i) and
(ii).".

2. Transitional

Where an authorized institution is a bank immediately before the commencement of section 1(b), then, for the purposes of paragraph 2 of the Eighth Schedule to the Banking Ordinance (Cap. 155) -

(a) paragraph 6(a) of the Seventh Schedule to that Ordinance as in force immediately before that commencement shall apply to the institution until the 2nd anniversary of that commencement; and

(b) paragraph 6(a) of the Seventh Schedule to that Ordinance as in force after that commencement shall not apply to the institution until the 2nd anniversary of that commencement.

Clerk to the Executive Council

COUNCIL CHAMBER

2002

Explanatory Note

This Notice amends the Seventh Schedule to the Banking Ordinance (Cap. 155) to –

(a) increase the minimum paid-up capital requirement from $150 million to $300 million for a company, whether incorporated in or outside Hong Kong, seeking authorization to carry on banking business in Hong Kong;

(b) unify the amounts of total customer deposits and total assets required to be held by an applicant company to not less than $3,000,000,000 and $4,000,000,000 respectively;

(c) delete the "closely associated and identified with Hong Kong" requirement for an applicant company which is incorporated in Hong Kong;

(d) reduce the number of years of operation as a deposit-taking company or a restricted licence bank from not less than 10 continuous years to not less than 3 continuous years required of an applicant company;

(e) enable a company incorporated in Hong Kong which is a subsidiary of a bank incorporated outside Hong Kong to seek authorization based on the operations of, and the deposits and assets to be transferred from, that bank.

ANNEX B

REVIEW OF MARKET ENTRY CRITERIA

The Size Criteria

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.

2. However, 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.

3. 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.

4. 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.

5. 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 below). The HKMA notes that although the cumulative inflation since the size criteria were last adjusted in 1992 has been 36%, the total amount of deposits taken by the RLB and DTC sectors as a whole has fallen by 28% over the same period. It seems reasonable to maintain the balance sheet criteria at their current levels so as not to make it more difficult for RLBs and DTCs to seek to be upgraded.

6. For the sake of policy consistency, it is proposed that the same criteria should be applied to foreign applicants (in respect of the applicant as a whole). 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. A possible downside 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.

7. With respect to locally incorporated RLBs and DTCs, there are not many that currently meet or are close to meeting the asset and deposit size criteria. However, as explained above, the HKMA believes that it is reasonable to expect them to have demonstrated this capability before being upgraded to full licensed bank status.

Other Criteria for Locally Incorporated Applicants

8. 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".

9. 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.

10. 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.

11. 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) the amounts of customer deposits and assets that will be transferred to the new locally incorporated bank should be at least HK$3 billion and HK$4 billion respectively.

12. 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.

Paid-up Capital Requirement

13. 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 million[1]. The equivalent figures for RLBs and DTCs are 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.

14. 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 increase[2]. 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 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.

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[1] 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.

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

15. 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 capital[3].

16. 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.

17. 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 (in respect of the bank as a whole). The imposition of this requirement is unlikely to pose any difficulties for foreign banks wishing to seek entry to the Hong Kong market[4].

Summary

18. The recommended changes can be summarised in the following table:

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**		
Size criteria	Total assets: HK$4b (Unchanged) Total deposits: HK$3b (Unchanged)	To adopt the same criteria as for local LBs	No size criteria	
Capital requirement	HK$150m → HK$300m	To be subject to same requirement as local LBs: HK$300m	HK$100m (Unchanged)	HK$25m (Unchanged)
Time period	Must have been a RLB or DTC for 10 yrs → 3 yrs	Not applicable		

[3] Based on September 2001 figures.

[4] 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.

	Licensed Banks (LBs)		RLBs	DTCs
	Locally incorporated banks	**Overseas-incorporated banks**		
Association with Hong Kong	Remove the requirement	Not applicable		
Branch subsidiarisa-tion	Not applicable	Conditions: Branch established in HK for at least 3 years Meet customer deposits and assets criteria of HK$3b and HK$4b respectively	Not applicable	

Hong Kong Monetary Authority
April 2002