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23rd November, 2004

By Hand
Ms. Salumi Chan
Clerk to the Panel
Financial Affairs Panel
Legislative Council of the HKSAR
Legislative Council Building
8 Jackson Road, Central
Hong Kong

Dear Ms. Chan,

Follow-up to meeting on 1st November, 2004

Further to the letter from Ms. Connie Szeto on behalf of the Panel on Financial Affairs dated 3rd November, 2004, I have the pleasure of enclosing the attached response to the questions that arose following the briefing on the draft Citibank (Hong Kong) Limited (Merger) Bill at the meeting of the Panel on 1st November, 2004.

I would be very grateful if you would arrange for this response to be circulated to Members for their review. I am pleased to confirm that the contents of the response may also be made available to the media, and to the public through the Council's normal channels.

Should Members require any further information, both Citibank N.A. and I would be very pleased to provide all necessary assistance.

Yours sincerely,

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David K.P. Li

Encl.

c.c. Hon. Bernard Chan, JP (Chairman)
Hon. Ronny Tong, SC (Deputy Chairman)
Ms. Catherine Weir, Citigroup Corporate Officer, HK

<u>CITIBANK (HONG KONG) LIMITED (MERGER) BILL</u>

INFORMATION PAPER FOR MEMBERS OF THE PANEL ON FINANCIAL AFFAIRS LEGISLATIVE COUNCIL OF THE HONG KONG SAR

This paper seeks to address those questions to which the Legislative Council has requested a response from Citibank and myself further to the meeting of the Panel on Financial Affairs on 1 November, 2004, in relation to the Citibank (Hong Kong) Limited (Merger) Bill (**Bill**).

The Bill provides for the merger of the retail banking business of Citibank N.A., Hong Kong Branch (**Citibank N.A. Branch**) into Citibank (Hong Kong) Limited (**Citibank (Hong Kong)**), which is a wholly owned subsidiary of Citibank N.A. incorporated in Hong Kong. Unlike a number of other developed jurisdictions, Hong Kong does not have laws designed to facilitate a merger of this kind. In consequence, such merger may only be achieved by a merger-specific piece of legislation, or by business transfer. A merger effected through legislation causes the least disruption to customers and other persons doing business with the bank. Business transfers are uniquely unsuited to bank mergers in view of the potential disruption and inconvenience to customers and elements of legal uncertainty that would unavoidably arise.

Citibank (Hong Kong) already carries on a substantial part of Citibank's consumer businesses in Hong Kong, including its credit card and mutual fund businesses. The Bill will bring together the consumer businesses of Citibank in Hong Kong into a single corporate vehicle.

1. Please provide the reasons for the proposed transfer of the activities, assets and liabilities which constitute the retail banking business of Citibank N.A. in Hong Kong, currently operated through a branch in Hong Kong (Citibank N.A. Branch), to a wholly owned subsidiary within the Citibank group of companies (Citibank (Hong Kong)).

1.1 The merger provides a number of benefits for Citibank and for its customers in Hong Kong.

(a) Citibank has operated in Hong Kong for over 100 years and wishes to continue to expand its Hong Kong retail banking business. Citibank has or will open 11 new branches in Hong Kong in 2004. Citibank's immediate expansion plans include opening 10 more branches in 2005, and taking on more staff. This expansion requires substantial capital. The merger of Citibank’s consumer businesses within a single local subsidiary provides a tax-efficient way for Citibank to retain and re-invest the profits of the Hong Kong retail banking business in Hong Kong, as described below.

(b) Provided that the profits of Citibank in Hong Kong are generated in Hong Kong in a local subsidiary, it is open to Citibank to defer its liability for US taxation at a group level. Therefore, the merger will permit a greater accumulation of capital in Hong Kong devoted to local operations. Citibank conducted a bank-wide review of the legal form of its overseas operations in 2001/2002, following a US tax law change. The current initiative in Hong Kong began in earnest in 2003, as a direct result of this review.

(c) Whilst Citibank is not immediately qualified to benefit from CEPA, Citibank believes that future changes to the legal and regulatory environment in the PRC will tend to be of more direct and immediate advantage to Hong Kong-incorporated banks and their customers. Citibank intends to deploy all necessary resources in Hong Kong to ensure that both Citibank (Hong Kong) and the bank's customers are able to benefit from these potential advantages.

(d) As set out in the introduction above, Citibank (Hong Kong) already carries on a substantial part of Citibank's consumer businesses in Hong Kong, including its credit card and mutual fund businesses. Merging all Citibank's consumer businesses in Hong Kong into a single corporate vehicle will streamline the bank's relationships with its customers. Furthermore, the merged entity will be more efficient from a regulatory point of view, as it will allow regulators an integrated view of the business.

1.2 There are a number of matters that relate to the merger which, though not of themselves reasons for the merger, help to illustrate the business context in which Citibank's decision has been made.

(a) The merger reflects Citibank's confidence in Hong Kong as one of the leading and best regulated banking/financial markets in the Asia Pacific. As stated above, prior to embarking on the merger, Citibank carried out a careful evaluation of the business environment in Hong Kong. This study concluded that Hong Kong's respected regulatory regime and its growth as a regional financial centre, in particular in the years following 1997, made the Hong Kong Branch a leading candidate for local incorporation. The merger thus re-affirms Citibank's commitment to Hong Kong, its customers and employees. Only one other local branch was identified as suitable for local incorporation at the same time as Hong Kong: Singapore.

(b) There is a rising trend worldwide for international financial institutions to transfer their local retail banking business to local subsidiaries. From a regulatory point of view, a locally incorporated bank is seen as more manageable than the branch of an overseas bank. New Zealand is a good example. In October this year, the Reserve Bank of New Zealand ("RBNZ") introduced the "Local Incorporation Policy". This requires that certain "important banks" be incorporated in New Zealand. RBNZ provides the following rationale: with local incorporation, "there would be more legally certain and rapid access to the assets and liabilities of the New Zealand bank. Local incorporation also facilitates more effective governance, given that a locally incorporated bank has a local board of directors with a duty to act in the best interests of the New Zealand bank. In addition, local incorporation facilitates more meaningful and complete disclosure of the affairs of the bank in New Zealand".

(c) The merger is intended to be tax neutral as far as Hong Kong taxation is concerned.

2. Please confirm whether Citibank has conducted similar transfer exercises for its retail banking business in other places; if it has, please provide details of the exercises; if it has not, please provide the reasons for conducting such a transfer for its retail banking business in Hong Kong

2.1 Citibank operates retail banking businesses in many countries around the world outside the United States. Citibank's retail banking business already operates through subsidiaries in Australia, Korea, Malaysia, most major European countries including Germany and the United Kingdom, and also in a number of Latin American countries. Citibank is also in the process of transferring its Singapore retail banking business to a Singapore incorporated subsidiary. In this context, the proposed merger under the Bill is part of a wider reorganization process in relation to Citibank's businesses outside the United States.

3. Please set out the impact of the proposed transfer, in particular the transfer of liabilities, on the existing customers of Citibank N.A. Branch, and explain how customers' interests would be protected after the proposed transfer.

3.1 Citibank believes that (i) the merger will have no negative impact on customers and (ii) operating via a local subsidiary serves to enhance the protection of customers in their dealings with the bank.

(a) There will be no changes to accounts, approved credit lines or other products and services provided to the customers of the retail business.

(b) Customers' contractual rights will remain unchanged as a result of the passing of the Bill, save that their claims will be against Citibank (Hong Kong) rather than Citibank N.A. Branch. The principal recourse today for Hong Kong customers of Citibank Branch is in Hong Kong courts, because the Hong Kong Branch is the obligor of the deposit. When a customer opens an account with a local subsidiary, the local subsidiary will become the principal obligor, and the customer recourse will continue to be in Hong Kong courts.

(c) Citibank (Hong Kong) is a fully licensed bank subject to direct supervisory regulation by the Hong Kong Monetary Authority. As a locally incorporated bank, Citibank (Hong Kong) is required, among other things, to establish a local board of directors and to appoint 3 independent non-executive directors. Corporate governance of the local subsidiary will thus be enhanced following the merger.

(d) With the merger, a new Hong Kong retail bank will emerge which, in accordance with the requirements of the Hong Kong Monetary Authority, will be capitalised to reflect the extent of its business in Hong Kong and the risks to which it is subject. It is estimated that the capital of Citibank (Hong Kong) will be increased from less than US$100 million to between US$700 and US$1,000 million as part of the transfer exercise. This represents a commitment of capital to Hong Kong which will be available solely to creditors of Citibank (Hong Kong).

(e) Citibank (Hong Kong) will be required to maintain a Capital Adequacy Ratio (**CAR**)[1] at a level specified by the Hong Kong Monetary Authority. It will be higher than the statutory minimum and comparable to other locally incorporated banks in Hong Kong. The level will in fact be substantially higher than the CAR of its parent bank, which was 12.56% at end of 2003.

[1]This is expressed as the capital adequacy ratio which is the ratio of the bank's capital base (i.e., paid-up capital plus other recognized core and supplementary capital items) over its risk-weighted exposures (on-balance assets and selected off-balance sheet exposures).

(f) It is in Citibank N.A.'s strong interest that Citibank (Hong Kong) meets its financial obligations at all times. It is Citibank N.A.'s policy to provide its subsidiaries with such support and assistance as may be required to ensure that they maintain capital and liquidity levels to enable them at all times to meet their obligations in conformity with standards of prudence generally accepted for their field of business, provided that the subsidiary is not precluded from meeting such obligations due to compliance with the laws to which it is subject.

(g) Citibank (Hong Kong) will participate in the deposit insurance scheme, which will be introduced in 2006. The fact that the Deposit Protection Scheme premium is risk-based solely on the Hong Kong operation imposes a strong financial incentive on the local entity to be recognized as sound in all aspects, and to earn the top ranking from the Hong Kong Monetary Authority.

3.2 Members raised the question of a possible claim against Citibank (Hong Kong) for an amount greater than the level of assets and capital available to meet the claim, and suggested that customers might be better protected by having a continued relationship with Citibank N.A. Branch. In relation to such possible claim, Citibank would note that:

(a) Citibank (Hong Kong) is a wholly owned subsidiary of Citibank N.A., and is integrated within Citibank's worldwide business for operational purposes in exactly the same way as Citibank N.A. Branch;

(b) As stated above, it is in Citibank N.A.'s strong interest that Citibank (Hong Kong) meet its financial obligations at all times. Thus practical considerations relevant to any very large contractual claim made against Citibank's Hong Kong retail banking business, whether before or after subsidiarization, are substantially the same;

(c) In each case of claim, the ultimate issue is the prudential regulation of capital requirements by the Hong Kong Monetary Authority. Banking supervisors do not measure capital adequacy of banks by the absolute amount of capital they are holding. Rather, they use capital adequacy ratio (CAR), which measures the size of a bank's capital against the size of its risk assets. It is the intention of Citibank (Hong Kong) to maintain a CAR that is above or in line with the average for locally incorporated authorized institutions; and

(d) Citibank N.A.'s capital may be subject to claims arising from operations in a number of jurisdictions and from a number of different businesses, and is likewise exposed to a wide variety of economic risks. In contrast, the capital of Citibank (Hong Kong) is effectively reserved for claims by customers and other creditors of Citibank (Hong Kong), while being subject to the regulatory supervision of the Hong Kong Monetary Authority.

3.3 Members have also asked whether Citibank is somehow seeking to limit its potential liabilities to customers by operating through a Hong Kong subsidiary.

Citibank is very clear that this is not one of Citibank's objectives for the reasons below.

(a) Citibank (Hong Kong) is a locally incorporated entity and has obtained a full banking licence issued by the Hong Kong Monetary Authority. The consequence of this is that the level of regulation and governance to which Citibank's Hong Kong retail operations will be subject after the transfer to Citibank (Hong Kong) will in fact be increased. Such regulation and governance have the primary objective of safeguarding the interests of customers.

(b) The new requirements on capital adequacy to which Citibank's Hong Kong retail banking operation will be subject when it is merged into Citibank (Hong Kong), and Citibank N.A.’s continual support to Citibank (Hong Kong) going forward are described in 3.1(f) above.

4. Please confirm whether the existing customers of Citibank N.A. Branch have been consulted on the proposed transfer; if they have, please provide the outcome of the consultation; if they have not, please provide the reasons

4.1 Given the large number of retail banking customers, it is difficult to seek the affirmative consent of all customers. However:

(a) Citibank has conducted surveys of local customers, which indicated that nearly 90% of those customers had no objection to the merger;

(b) When Citibank (Hong Kong) received its full banking licence on 28th October 2004, a public announcement was made. At the same time, it was also announced publicly that the retail banking business would be merged with Citibank (Hong Kong). Customers did not raise any concerns with Citibank;

(c) Customers will be given written notice in advance of the specific details of the merger, and provided with information about the effect of the merger upon them. In addition, a bi-lingual help line will be set up for customers if they have queries, and further public announcements will be made; and

(d) Customers who do not wish to maintain accounts with Citibank (Hong Kong) will have the option of closing their accounts (subject to settlement of amounts owed by them to Citibank (Hong Kong)), and Citibank will assist them to transfer their accounts to another bank.

5. Please confirm whether the existing staff members of Citibank N.A. Branch have been consulted on the proposed transfer; if they have, please provide the outcome of the consultation; if they have not, please provide reasons.

Employees affected by the transfer have affirmatively consented to the transfer of their employment. This has taken place already. There has been no reduction in staff numbers. In fact, Citibank (Hong Kong) has taken on more than 300 additional local staff in 2004 and plans to take on more local staff in 2005. All staff are already employed by Citibank (Hong Kong) on terms no less favourable than those which applied prior to the transfer. Staff will not be affected by the enactment of the Bill.

Dr. Hon. David Li Kwok-po, GBS, JP
22 November 2004