Dangerous Business Models: Bankers, Bureaucrats & Hong Kong's Economic Transformation, 1948-86

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Abstract

This paper reviews the banking response to Hong Kong's industrial take-off in the 1950s and the transition to a service economy and regional financial centre in the 1970s. Adjustments to bank business models were frequently flawed, and they were prone to self-destructive behaviour. The paper examines how the Government contributed to this mismanagement and misconduct. It failed to match its regulatory policies to the changing economic environment, and it also misunderstood the monetary system. The analysis makes extensive use of previously unpublished data and government archives.

Key words: Hong Kong, banking regulation, bureaucrats, rules, self-destructive

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Introduction

Hong Kong has been described as the first society in Asia to escape from poverty, achieving prosperity faster than any other economy in history.[2] Hong Kong was also probably unique among Third World economies on another count: it was never short of the capital required for rapid economic development in the first two decades after World War II.[3] By the end of the century, Hong Kong had become not only the most advanced city in China; it also claimed to be the world's fifth largest banking and financial centre and fifth largest foreign exchange market.

The maturity of its financial institutions was put to the test by the 1997 Asian financial crisis, when it was credited with having the most effective banking regulation in the region.[4] This impressive performance was in marked contrast to the crises which had overtaken its financial markets in the past. Between 1961 and 1965, three licensed banks closed and another six had to be rescued from imminent collapse, including, Hang Seng Bank, Hong Kong's second largest bank. Worse was to come. Between 1982 and 1986, seven licensed banks failed amid a welter of corporate collapses and scandal.

Bureaucrats and Bankers

Although there is no clear consensus among economists on the relationship between different banking models and economic modernisation,[5] this paper will argue that the problems and performance of the banking industry were shaped, in the first place, by the way in which the successive stages of Hong Kong's economic growth changed the business community's financial requirements. The paper examines how the different sectors of the banking industry adjusted their business models:

- in the 1950s, as Hong Kong switched from entrepôt to manufacturing;
- in the 1960s, when Hong Kong was a mature industrial society; and
- in the 1970s, as Hong Kong emerged as a major regional financial centre and began the transition to a service-dominated economy.

The paper also focuses on how these adjustments were helped or hindered by regulatory policies and practices. The starting point for this analysis is the way that the banking industry's business models were shaped by two 'players': the officials responsible for the financial sector ('bureaucrats') and the proprietors and senior executives of financial institutions ('bankers'). Baumol has suggested that 'at times

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[2] Gordon Redding, 'Culture and Business in Hong Kong', in Wang Gangwu and Wong Siu Lun (eds), *Dynamic Hong Kong: Business & Culture* (Hong Kong: Centre of Asian Studies, 1997), p. 102.

[3] Ronald Findlay and Stanislaw Wellisz, 'Hong Kong', in Ronald Findlay and Stanislaw Wellisz (eds), *The Political Economy of Poverty, Equity, and Growth. Five Small Open Economies* (New York: Oxford University Press, 1993), p. 47; Henry Smith, *John Stuart Mill's Other Island. A study of the economic development of Hong Kong* (London: Institute of Economic Affairs, 1966), pp. 18-21.

[4] Measured by comparative levels of non-performing loans and problem assets. Clifford D. Clark and Jung-Chao Liu, 'The media, the judiciary, the banks and the resilience of East Asian economies', in Tsu-Tan Fu *et al* (eds), *Productivity and Economic Performance in the Asia-Pacific Region* (Cheltenham: Edward Elgar, 2002), p. 61 Table 3.3, p. 52.

[5] A convenient summary of the main issues is Sanghoon Ahn and Philip Hemmings, *Policy Influences on Economic Growth in OECD Countries: An Evaluation of the Evidence* Economics Department Working Papers No. 246 (Paris: OECD, 2000), pp. 41-3.

the entrepreneur may even lead a parasitical existence that is actually damaging the economy' – which sums up the chronic problem of Hong Kong's financial markets and their regulation from 1948 to 1986. He argues that it is 'the rules of the game that determine the relative payoffs to different entrepreneurial activities'. These rules may vary according to time and place, he notes, and they can be rapidly transformed by direct action – government policies, legislation and the courts, for example.[6] Hence, a primary concern of this paper is with the bureaucrats' rules and their impact on bankers' behaviour.

Hong Kong's Industrial Takeoff

In 1948, a Banking Ordinance was enacted in response to severe political pressure from China and the ruling Guomindong.[7] This legislation established Hong Kong's first, rudimentary framework for banking regulation. Its original aim was to impose controls on the 'native Chinese banks' which flourished through gold and currency dealing and financial transactions with a war-torn Mainland, plagued by black markets and inflation for both of which the Guomindong blamed Hong Kong. In 1949, the Chinese Communist Party came to power and quickly put an end to the nation's problems of hyper-inflation, black markets, smuggling and speculation.

Thus, the new Banking Ordinance related to an economic environment that was about to disappear.

- The state-controlled economy introduced by the Chinese Communist Party ended Hong Kong's access to the Mainland's domestic markets.
- The international embargoes imposed on the new People's Republic of China halted Hong Kong's traditional entrepôt trade between the Mainland and the West.
- Hong Kong itself was building up its industrial capacity and about to become a manufacturing centre exporting to Western markets.

The officials responsible for enforcing the legislation had little awareness of the economic transformation taking place in the early 1950s and showed no anxiety about how it might affect the banking environment. Once the Guomindong had been defeated in 1949 and its political pressure to control local Chinese banks had evaporated, the colonial administration felt free to return to their traditional colonial preconceptions. The bureaucrats tended to ignore both the foreign and the China state-owned banks, as these had not been the targets of the new Banking Ordinance. The official concern was with the local Chinese banks. The bureaucrats did not believe that local Chinese banks should be forced into the world of modern corporate structures, statutory obligations to shareholders or regulatory responsibilities to depositors.[8] Indeed, they wanted to abolish the 1948 Banking Ordinance.[9] The

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[6] William J. Baumol, 'Entrepreneurship: Productive, Unproductive, and Destructive', *Journal of Political Economy* 98 (5, Part 1), October 1990, pp. 895, 899, 917.

[7] Hong Kong's negotiations with the Mainland are recorded in HKRS 163-1-403 'China Trade & Commerce Aide memoire re closer cooperation between China and Hong Kong in connection with trade and exchange control'.

[8] (33) 'Report of the Select Committee' [of the Legislative Council set up to report on the Banking Bill], 14 January 1948. HKRS 163-1-440 'Banking 1. Banking Ordinance 2. Control over the opening and functioning of Native Banks in Hong Kong'; (86) Financial Secretary, 'Memorandum to Members of the Banking Advisory Committee… Licensing Policy', 23 October 1959, HKRS 163-1-679.

bureaucrats' preference was their own informal 'rules', and later sections of this paper will discuss how these rules affected the business model of local Chinese banks.

Invisible Growth

The banking industry had confidently underwritten the reconstruction of the economy and a remarkable revival of the Mainland-related entrepôt trade immediately after World War II.[10] Nevertheless, as Hong Kong's rapid industrial take-off began in the late 1940s, even the largest banks found the experience uncomfortable. They stumbled badly when, in 1950, the Korean War led to a total United States ban on all commercial and financial transactions with the People's Republic of China which lasted till 1971 (reinforced initially by a United Nations embargo).

The banks took a gloomy view of future prospects. In 1950, they were refusing to finance imports on the grounds that local warehouses were filled with unshippable products.[11] The banks began to cut credit lines even to the biggest and most modern manufacturing plants established by refugee entrepreneurs from Shanghai. The bankers almost shut down the cotton spinning sector – the building block for Hong Kong's emergence as a major textile exporter. Catastrophe was averted by China Engineers Ltd, a trading firm, which created a formula that gave HSBC and Chartered Bank the necessary comfort to continue to finance imports of raw materials.[12] One prominent businessman, Lawrence (later Lord) Kadoorie, claimed that the credit squeeze caused more economic damage than the embargoes themselves.[13]

The bankers' pessimism was part of a general unawareness within Hong Kong about the total transformation of the economy that was underway with the rise of manufacturing. Until 1959, there were virtually no official data to demonstrate the speed with which Hong Kong was becoming dependent on exports from its own factories. Most contemporary observers focused on the total export figures, the only economic data readily available, and they seemed calamitous. A fall of 53 per cent in total exports in 1952 alone was followed by a further 17 per cent decline before starting to recover in 1955. (Table I) For over a century, the economy had been wholly dependent on entrepôt activities, so it required an enormous leap of the imagination to recognise that the value added from manufacturing would more than fill the shortfall. The Government had other trade statistics which pointed to

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[9] (8) Financial Secretary letter to Sir Man Kam Lo, 25 March 1952. HKRS 41-1-6691 'Banking Operations Legislation for control of…'.

[10] Y. C. Jao, *Banking and Currency in Hong Kong. A Study of Postwar Financial Development* (London: Macmillan, 1974), p. 17.

[11] C. G. S. Follows, Financial Secretary, *Hong Kong Hansard*, 8 March 1950. p. 46.

[12] *Far Eastern Economic Review* (*FEER* hereafter): 'Cotton Spinning in Hongkong', 21 September 1950; 'Commercial Reports', 9 November 1950; 'The Hongkong Cotton Mills Pool', 6 September 1951.

[13] (35) Note from Lawrence Kadoorie dated 30 December 1950. HKRS163-1-1376 'Industry and Production. Industrial Situation in Hong Kong'. This view was echoed twenty years later by Sir John Cowperthwaite, Financial Secretary. (26) Cowperthwaite letter to Sir Frank Figgures (United Kingdom Treasury), 19 October 1970 and 'A Preliminary Note on the International Monetary Fund with reference to dependent territories (and with particular reference to Hong Kong)', p. 11. HKRS163-9-217 '(A) Meeting of Senior Commonwealth Finance Officials 1970. Sterling Area Balance Of Payments - Developments and Prospects To Mid-1971 (B) Overseas Sterling Area Countries Statistics'.

considerable growth in the local economy, but they were not generally accessible. These unpublished data are included in Table I and reveal that domestic exports were growing by 136 per cent a year between 1950 and 1960, thanks to the breakneck expansion of local manufacturing. During the same period, re-exports fell by an annual 7 per cent.[14]

Table I: Domestic Exports & Total Exports, 1950-1960 (HKD millions)

Year	Domestic Exports	Re-exports	Total Exports
1950	197	3,518	3,715
1951	312	4,130	4,433
1952	486	2,413	2,899
1953	635	2,099	2,734
1954	682	1,735	2,417
1955	730	1,804	2,534
1956	1,115	2,095	3,210
1957	1,202	1,814	3,016
1958	1,260	1,729	2,989
1959	2,282	966	3,278
1960	2,867	1,070	3,937

Funding the Factories

Who financed this rapid expansion of manufacturing capacity implied by the growth in domestic exports recorded in Table I? The absence of adequate banking and other economic data until the 1960s makes it impossible to quantify the dynamics of Hong Kong's economic growth.[15] Certainly, the stock exchange played virtually no part in this process.[16] The colonial administration stubbornly refused to provide

[14] The data for domestic exports for 1950-52 are derived from the unpublished monthly reports in HKRS170-1-554-2/3 'Report. Department of Commerce & Industry'. The data for 1953-58 are from the serial publication, *Hong Kong Annual Departmental Report by the Director of Commerce and Industry for the Financial Year* (Hong Kong: Government Printer). Figures for subsequent years and for all total exports are from Census and Statistics Department, *Hong Kong Statistics 1947-1967* (Hong Kong: Government Printer, 1969), p. 88. Re-export data before 1959 shown here represent the difference between total exports and estimated domestic exports. The Commerce and Industry Department estimated domestic exports data up to 1958 on the basis of those items for which it had issued Imperial (later Commonwealth) Preference and Comprehensive Certificates of Origin. The former category covered the Sterling Area but not the growing markets in Western Europe. The latter covered exports to the United States but not to other dollar countries which did not ban trade with the People's Republic of China. Domestic export figures before 1959 were thus underestimated, while the residual re-export figures were over-estimated.

[15] The absence of economic statistics is discussed in Leo F. Goodstadt, 'Government without Statistics: Policy-making in Hong Kong 1925-75, with special reference to financial markets'. URL: sem_paper_0_172_Goodstadt-paper061205.pdf

[16] 'Report of the Industrial Bank Committee' (Hong Kong Government, January 1960, mimeo), p. 6. M. 10 TID to SID, 3 November 1967, HKRS1056-1-194 'Industrial Survey –Policy'. Catherine R. Schenk, 'Regulatory reform in an emerging stock market: the case of Hong Kong, 1945–86', *Financial History Review*, 11.2 (2004), pp. 5-7.

development funds. Foreign aid was negligible, equivalent to a mere 0.28 per cent of total government expenditure between 1947 and 1968.[17]

The usual explanation offered is an influx of foreign funds. [18] Flight capital from the Mainland is described as having played a major role.[19] Given the near demise of the Shanghai manufacturers at the start of the decade (mentioned earlier), the Mainland refugees' contribution must have been limited. Remittances from Overseas Chinese have been another much-canvassed source of capital, although it is hard to identify how these funds found their way into start-up factories in the 1950s.[20] It can be argued, very plausibly, that it was the bankers who financed Hong Kong's manufacturing take-off.[21] The analysis which follows will suggest that the banking industry provided the funds for the sustained momentum of industrial growth throughout the decade, including diversification from cotton spinning and weaving into garments (where local Cantonese entrepreneurs were the dominant force).

The historical record is confused by manufacturers' lobbying for cheap industrial finance. In this campaign which lasted from the mid-1950s until the end of the century, a crucial argument was the banks' alleged neglect of industry, particularly the smaller enterprises. In fact, the claims made in the 1950s that the banks did not supply industrial finance are refuted by the speed of Hong Kong's transition to a manufacturing centre exporting to Western markets. Even more persuasive, the banking industry's critics failed repeatedly to produce evidence that the banks had rejected any viable loan proposal from industry.[22]

After the Government began to collect comprehensive banking statistics in the 1960s, the share of total bank loans allocated to manufacturing was seen to be well below manufacturing's contribution to GDP (and it declined in the following two decades). These figures have been taken as evidence of the bankers' neglect of manufacturers' needs.[23] However, criticism based on these official statistics overlooks the particular nature of Hong Kong manufacturing and the finance that it required.[24]

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[17] The figure was so low as to be a potential political embarrassment to the United Kingdom. M.2 Acting Financial Secretary to Governor, 10 September 1968. HKRS229-1-807 'Financial Aid (Including Loans) Received from the United Kingdom and Other Governments record of…'.
[18] I. M. D. Little, *Collection and Recollections Economic Papers and their Provenance* (Oxford: Clarendon Press, 1999), p. 229.
[19] Leonard K. Cheng, 'Strategies for Rapid Economic Development: The Case of Hong Kong', *Contemporary Economic Policy*, Vol. 13. No. 1, 1995, p. 29.
[20] On refugees and remittances, see Cheng Tong Yung, *The Economy of Hong Kong* (Hong Kong: Far East Publications, 1977), p. 39.
[21] See John L. Espy, 'Some Notes on Business and Industry in Hong Kong', *Chung Chi Journal*, Vol. 11, No. 1 (April 1972), p. 178. The role of non-institutional financing in the history of Hong Kong's industrial growth was reported in L. F. Goodstadt, 'Hongkong Affairs: Profits in Pawn', *FEER*, 3-19 April 1969.
[22] The campaign for cheap government loans is summarised in Leo F. Goodstadt, *Uneasy Partners: The Conflict between Public Interest and Private Profit in Hong Kong* (Hong Kong: Hong Kong University Press, 2005), pp. 130-1, 134.
[23] Complaints about the lack of bank support began in the 1950s, before reliable bank data were available. Stephen W. K. Chiu *et al.*, *City States in the Global Economy: Industrial Restructuring in Hong Kong and Singapore* (Boulder: Westview Press, 1997), p. 34.
[24] This issue is analysed cogently in 'Report of the Industrial Bank Committee' (Hong Kong Government, January 1960, mimeo), pp. 3, 12-3.

In an economy where the manufactured product, almost always, had been pre-sold to an overseas buyer, bankers found it difficult to make a distinction between commercial and industrial loans.[25] Overwhelmingly, factory production was concentrated in the light industrial sector, which exported the bulk of its output. Few manufacturers operated on their own account until late in the last century. Most started to manufacture a product only after receiving a firm order from a foreign buyer, which allowed financing of the factory's activities through letters of credit, packing credits and other short-term facilities. Turnover, both physical and financial, was rapid. Bank lending could thus support a much higher level of production in manufacturing than in other sectors (property and construction in particular).

The headlong expansion of manufacturing thus created a secure lending environment. There was little room for speculation in the provision of trade finance and short-term capital secured against export orders largely via letters of credit, with additional income generated by import and export transactions in foreign currency. Management of credit risk was straightforward, and this was banking of the most traditional and conservative kind.[26]

Reluctant Lenders

As Hong Kong made the transition from trading port to manufacturing, bankers ought to have had no difficulty in adjusting to this new stage of economic growth. In practice, all three groups within the banking industry found it hard to adapt their business models to the rise of manufacturing. It is arguable that the criticism of banks as reluctant lenders to manufacturing can be traced back to the mixed response from bankers to the new economic environment at the start of Hong Kong's industrial take-off.

National Interest First

China state-owned banks took little part in financing the growth of manufacturing in Hong Kong. They devoted all their available resources to serving the Mainland's development needs. So much so that the Commissioner of Banking proposed the introduction of legislation in the 1960s to compel this group of banks to use a minimum share of their assets in Hong Kong.[27]

Traditional Preferences

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[25] This point was made by both HSBC and Chartered Bank in response to an official request for banking statistics in 1960. (304) A. G. Small, Chartered Bank, 2 December 1960 and R. G. L. Oliphant, HSBC, 3 December 1960. HKRS163-1-625 'Banking Statistics – 1. Supply of…to S of S 2. Policy Correspondence concerning…'.

[26] Credit policies are discussed in Jao, *Banking and Currency in Hong Kong. A Study of Postwar Financial Development*, pp. 46-9.

[27] This proposal won no support within the colonial administration. Commissioner of Banking letter to Financial Secretary, 22 March 1966; M. 14 AS(E)2 to DES and Financial Secretary, 2 May 1966HKRS163-1-3274 'Banking Statistics Various – 1966'. The new law would have covered all banks.

Local Chinese banks were accused of being happy to provide any ‘fly-by-night manufacturer’ with easy loans.[28] The evidence available about their lending practices shows no such enthusiasm for industrial borrowers.[29] In any case, the typical manufacturer was a new entrepreneur, without the sort of business background that would have created a relationship with a local banker. Furthermore, unlike personal or property loans, a local Chinese bank could not charge a premium for manufacturing facilities because alternative finance was available at least as cheaply from foreign banks (as will be explained below). Industrial loans also involved a different kind of credit, which was not secured by traditional assets in the form of gold, currency or real estate. Increasingly in the 1950s, local Chinese banks came to regard property as the growth business, particularly after the introduction of instalment terms for the sale of new multi-storey flats. Quite simply, local Chinese banks retained a deep-rooted preference for their traditional business model in which the finance of manufacturing for export to Western markets had played little part.[30]

Foreign Advantages

Foreign banks faced cultural barriers rather than business obstacles in adjusting to their new opportunities. Hong Kong’s largest bank, HSBC, was an important example of the reluctance to adapt. It was slow to abandon the tradition of the China Treaty Ports, where it had given priority to British firms and Westernised clients. It preferred to transact business with Hong Kong Chinese customers through compradors and other intermediaries. The provision of banking services to local industrialists came cautiously in the 1950s, and so did the appointment of Chinese managers.[31] There was still limited interest among the bank’s British staff in building relations with Chinese businesses or even visiting their premises in the 1960s.[32] The foreign banks, nevertheless, emerged as the dominant banking sector in financing industrial growth. Many of them had experience of financing industrial ventures in Shanghai before 1949. They all benefited from their traditional focus on commercial banking as well as from their connections in Hong Kong’s new export markets in Western Europe and North America.

They had another advantage: a ‘liquidity loophole’. Although Hong Kong laid down no minimum liquidity requirements until 1964, the local Chinese banks, together with HSBC and the other two note-issuing banks, had to maintain a prudent margin of deposits over their loans in order to meet the liquidity requirements of their customers, together with an adequate cushion against sudden crises. Foreign banks, by contrast, could manage their liquidity on a global basis. Head offices could cover the liquidity requirements of their Hong Kong branches through credit facilities made available to them in London and New York. In consequence, apart from their ability

[28] R. H. Leary, interview with M. G Carruthers, HSBC Hong Kong Manager, *FEER*, 10 June 1965.
[29] See, for example, from the HKRS files on individual banks cited in this paper.
[30] The best account of local Chinese banks and their traditional business model is Catherine R. Schenk, ‘Banks and the emergence of Hong Kong as an international financial center’, *Journal of International Financial Markets, Institutions and Money*, 12 (2002), pp. 321–340.
[31] Frank H. H. King, *The Hong Kong Bank in the Period of Development and Nationalism, 1941-1984. From Regional Bank to Multinational Group* (Cambridge: Cambridge University Press, 1991), pp. 306-11, 621-5, 704-5.
[32] T J. F. Marshall, *Whereon the Wild thyme Blows. Some memoirs of service with the Hongkong Bank* (Grayshott: Token Publishing Limited, 1986), pp. 107-8, 111-4.

to borrow Hong Kong dollars, the only constraint on their branches' local lending was commercial prudence.

As a result, foreign banks could allow 'loans and advances to industry [to] far exceed … deposits', to quote a European banker in 1960. This almost unrestricted credit creation by foreign banks was, he claimed, a form of investment in Hong Kong although no funds were actually remitted to the local branch.33 Significantly, the bureaucrats refused to believe that such high ratios of loans to deposits were possible, and accused bankers of misunderstanding their own accounting practices.34 This 'liquidity loophole' was beneficial in the 1950s, and the foreign banks' liberal attitude towards credit creation helps to account for Hong Kong's remarkable freedom from capital constraints as manufacturing industry took off. It became less benign in the 1970s, as will be explained later in this paper.

Rules Replace Regulations

The local Chinese banks, as a group, failed to adapt their traditional business model to the new economic environment dominated by manufacturing. There was a price to be paid for their reluctance to change. Initially, it was the so-called 'native' banks which suffered most. In 1948, a total of 132 bank licences were issued under the new legislation: 78 to 'native Chinese banks'. By 1955, 52 'native' banks had closed, and the total number of licensed banks had fallen to 91. The distinction between 'native' and other local Chinese banks became increasingly arbitrary as the surviving 'native' banks sought the status of commercial banks.[35] By 1961, this category was regarded by the bureaucrats as no different from the rest of the local Chinese bank group.[36]

The bureaucrats had not intended the 1948 Banking Ordinance to have such drastic consequences. They had carefully adjusted their enforcement of the 1948 banking legislation to accommodate what they believed were the traditional practices of the Chinese family firm. In practice, these concessions were extended to local Chinese banks as a group, regardless of whether they were long-established family businesses or newly-licensed and incorporated. The bureaucrats' informal rules provided these local bankers with extensive immunity from their legal requirements.

- An almost total exemption from the 1948 Banking Ordinance was granted to the smaller local Chinese bank.[37]

[33] (302) P. Mardulyn, Manager Banque Belge, letter to DFS, 30 November 1960. HKRS163-1-625 'Banking Statistics – 1. Supply of…to S of S 2. Policy Correspondence concerning…'

[34] See DFS's reply to Mardulyn, (303) 3 December 1960. Also (312) Statistician memo to DES, 'Banking Statistics', 22 April 1961. HKRS163-1-625

[35] By 1960, the number of banking institutions still being identified as 'native' banks had fallen to 10 out of a total of 81 licensed banks, although some of those so labelled ought not to have been included. The statistics are from *FEER*: 'Hongkong Licensed Banks', 17 November 1948; Ricardo, 'Development of Banking in Hong Kong during 1955', 2 February 1956; Ng Kwok Leung, 'The Native Banks: Their Structure and Interest Rates', 11 February 1960.

[36] H. J. Tomkins, *Report on the Hong Kong Banking System and Recommendations for the Replacement of the Banking Ordinance 1948* (Hong Kong: Government Printer, 1962), p. 2.

[37] Deputy Financial Secretary, 'Banking Ordinance, 26 January 1950. HKRS 163-1-441 'Names and Addresses of Partners of Banks required for the Banking Ordinance 1948'.

- Scrutiny of the affairs of local Chinese banks was perfunctory. Investigation of the suitability of applicants for banking licences imposed a very low threshold of competence. The bureaucrats did not bother to enforce statutory reporting requirements with any vigour.[38]
- No pressure was imposed on local Chinese banks generally to ensure the prudent conduct of business or the protection of their depositors. The bureaucrats had little interest in their solvency and were prepared to go to considerable lengths to allow the weakest managers to trade their way out of trouble.[39]
- Only when, in exceptional cases, the bureaucrats perceived a real risk of bank instability leading to serious political protests, did they make full use of their statutory powers to scrutinise applicants and attach the maximum capital requirements to the licence.[40]

In 1961, one official noted, somewhat despairingly, 'the already dubious reputation of the Chinese banks'.[41] By this date, the banking industry as a whole had ample reason to conclude that the bureaucrats with whom the bankers dealt had little interest in prudent credit management and even less in law-enforcement, not just in terms of compliance with the 1948 Banking Ordinance but with commercial and criminal law generally.

Property Profits

Some local Chinese banks enjoyed impressive growth in the 1950s, which seemed to validate their attachment to the basic business model. Unfortunately, expansion usually came much faster than modernisation. It encouraged even the Hang Seng Bank, the biggest and best of them, to almost self-destruct by neglecting to adopt the corporate practices needed to ensure the prudent management of their operations. This danger was to be highlighted in the early 1960s by another shift in the pattern of Hong Kong's economic development: the arrival of multi-storey buildings, residential projects especially, sold to the public in advance of completion. Between 1960 and 1965, residential projects accounted for the largest share of new buildings completed by the private sector. They grew in size and complexity, driving up average construction costs by 291 per cent.[42]

The allure of property projects was considerable for local Chinese banks because they were part of their traditional business model, and foreign banks were not active

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[38] For example, HKRS41-1-3024 'The Foo Kee Bank 1. Application from…for a banking licence 2. Balance Sheet of…'.

[39] This tolerance is well illustrated in HKRS41-1-3095 'Far East Commercial Bank Ltd. Application from…for a banking licence'.

[40] HKRS41-1-3099 'The Bank of New Territories, Ltd. Application from…for a banking licence'.

[41] M. 10 AS(E) to DES, 7 October 1961. HKRS163-3-7 'The Chiu Tak Bank Ltd 1. Application from…for Banking Licence 2. Balance Sheet of…'.

[42] The average number of dwelling units per residential building rose from 7.3 to 27 over this period; and average construction cost per unit from HKD18,954 to HKD20,035. Figures are calculated from Census and Statistics Department, *Hong Kong Statistics 1947-1967* ,Table 10.2 Building (Private Sector): Number and Cost of Completed Buildings by Type, 1951-67, p. 171; Table 10.4 Building (Private Sector): Property Redevelopment, 1958-67, p. 173.

in this field.[43] The project was frequently undertaken within a family conglomerate, which included not just the bank but real estate and construction companies. Where the developers were not family or friends, bank proprietors and senior executives could become quasi-shareholders in their personal capacities by demanding the right to purchase units in the completed building on concessionary terms. The bank itself could expect profits from financing the construction and providing the hire-purchase facilities for the purchasers. The growth in pre-completion sales seemed to improve loan turnover, although they increased the danger of defaults if construction problems arose or property prices collapsed. The lack of distinction between personal and corporate interests meant that loans for property projects were not arm's length, and the public's deposits were treated like equity capital.

The bureaucrats faced a serious dilemma in managing the risks created by the property sector and its banking links. The Government felt very dependent on the contribution of private developers to tackling the overcrowding and squalor in which a high proportion of the population was living.[44] At the same time, the Government itself had created a real estate 'bubble' by ill-considered changes in the laws governing property development.[45] It felt unable, however, to take direct action to prevent the situation from getting out of control.[46] Inevitably, the inability of individual bankers to resist the heady profits offered by property lending became a major threat to banking stability in this decade. The developers' dependence on their bankers increased, and the exposure of local Chinese banks grew to levels which alarmed officials.[47] Catastrophe became only a matter of time in the 1960s after excessively liberal creation of credit by the banks allowed developers to launch over-ambitious property projects that proved financially unsustainable.[48]

Five who Failed

Between 1961 and 1965, five local Chinese banks were brought to the verge of collapse: Liu Chong Hing in 1961, Chiu Tai in 1963 and Ming Tak, Canton Trust and Hang Seng in 1965. The bureaucrats had failed to heed the early indicators of illegal activities and financial fragility threatening the first four of these institutions. Liu Chong Hing and Hang Seng Banks were too large to be allowed to fail, and they were rescued to prevent a general collapse in depositor confidence although in both cases, their difficulties were blamed on bank runs caused by 'unfounded' rumours. The other three were not saved from self-destruction. For all five banks, over-exposure to

[43] A good analysis of the importance of property for local Chinese banks is provided by Ng Kwok Leung, 'The Native Banks: Their Structure and Interest Rates', *FEER*, 11 February 1960. Ng records how 'native' banks had generally merged into the world of commercial banking by this date.
[44] 'It would be very shortsighted to do anything to discourage' the developer. Cowperthwaite, *Hong Kong Hansard*, 17 January 1962, p. 6.
[45] The impact of legislation on the property market is analysed by Stephen N. S. Cheung, 'Rent Control and Housing Reconstruction: The Postwar Experience of Prewar Premises in Hong Kong', *The Journal of Law and Economics*, Vol. XXII, April 1979, pp. 27-53.
[46] Cowperthwaite, *Hong Kong Hansard*, 24 February 1966, p. 55.
[47] The danger from involvement in property was in highlighted in Tomkins, *Report on the Hong Kong Banking System and Recommendations for the Replacement of the Banking Ordinance 1948*, p.6. The position was no better in 1965. (4) Banking Commissioner secret memo to Financial Secretary, 16 September 1965. HKRS163-1-3284 'Problems Affecting the Real Estate and Allied Industries'.
[48] Cowperthwaite, *Hong Kong Hansard*, 24 February 1966, pp. 54-5.

property was the precipitating factor, but each suffered from one or more management defects that imperilled their survival:

- failure to distinguish between the public's deposits and family assets,
- over-involvement in non-banking businesses, especially property speculation,[49]
- consequent fraudulent and corrupt behaviour to conceal mounting losses,[50] and
- lack of concern about cancellation of a licence or prosecution because of the bureaucrats' reluctance to act as regulators and enforce the law.[51]

These five failures did not reveal the full extent of the propensity to self-destruct. When the Canton Trust failed in 1965, bank runs followed which undermined depositors' confidence not just in Hang Seng Bank but in local Chinese banks as a group. Their total deposits fell by 30 per cent from January to September, leaving another four of them especially vulnerable.[52] When the Government arranged facilities to rescue them, some assumed that they could continue to run their affairs with small regard for prudent management and little to fear from the regulators.[53] But the regulatory environment was changing. A new Banking Ordinance had been enacted in 1964 whose principal target was the banker whose business model preferred to make loans to family, friends and their related businesses.

The Regulators Take Charge

The scandalous background to the Liu Chong Hing's near-collapse in 1961 had made it impossible to resist any longer the demands of leading bankers for professional regulators backed by adequate legislation. The bureaucrats, however, remained reluctant to force through drastic changes in traditional lending practices. Thus, the 1964 Banking Ordinance incorporated three 'strictly unorthodox banking practices', principally in respect of controls on borrowing by directors.[54] The Government stated publicly that the legislation left the boundaries between personal and public interest ill-defined, and directors' misconduct was to feature conspicuously in future scandals.[55] Nevertheless, the new law established the Banking Commission

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[49] Catherine R. Schenk, *Hong Kong as an International Financial Centre. Emergence and development 1945-65* (London: Routledge, 2001), pp. 69, 146.

[50] T. K. Ghose, *The Banking System of Hong Kong* (Singapore: Buttterworths, 1995, 2nd edition), pp. 72-3.

[51] See, for example, *Report of the Committee appointed to consider certain matters concerning the closure of the Chong Hing Mansion 1971* (Hong Kong: Government Printer, 1972), p. 9; Catherine R. Schenk, 'Banking Groups in Hong Kong, 1945–65', *Asia Pacific Business Review,* Vol. 7, No. 2, Winter 2000, pp. 145-6.

[52] (6) and (16) Commissioner of Banking memos to Financial Secretary, 19 March and 25 November 1965. HKRS163-1-3273 'Banking Statistics Various 1965'.

[53] Commissioner of Banking memo to Financial Secretary, 'Bank Loans – Dao Heng Bank Ltd and Kwong On Bank Ltd', 23 March 1966, HKRS 163-3-249 'Banking Emergency 1965 – Matters arising from…staff etc'.

[54] '… i.e. unsecured advances to directors, share dealing and property investment, under one overall limit of 55% of capital and reserves (which is the total of the three previously separate limits) and an individual limit for any one of them of 25%; thus limiting total indulgence in these practices while giving some choice as to the extent of indulgence in each one'. Cowperthwaite, *Hong Kong Hansard*, 16 September 1964, pp. 331-2.

[55] Robert Fell, *Crisis and Change. The Maturing of Hong Kong's Financial Markets* (Hong Kong: Longman, 1992), p. 180. His views carry added weight as a former Commissioner both for Securities and of Banking.

as a professional regulator with sufficient powers to start a clean-up of banking behaviour.

In the event, the 1965 bank runs created an opportunity for the new regulators to show the difference that they could make. Their performance was impressive. For the first time, government decisions did not have to be based on business anecdotes and media gossip.[56] The Banking Commission had started to collect monthly statistics from all licensed banks from December 1964. The first returns provided a basic profile of the solvency of individual banks and the extent to which they were trading prudently and complying with their statutory obligations. As a result, the Government was able to monitor the impact on individual banks of changes in depositor confidence and to identify the institutions which required immediate injections of liquidity. It also mounted an emergency audit programme which demonstrated that the regulators could not be lulled into complacency as the bureaucrats had been in past. The systems established by the new Banking Commission were to prove of special importance in 1966 when anti-colonial disturbances broke out and even more so in the following year when Mao Zedong's Cultural Revolution spilled over into Hong Kong with bombs and riots. The banking industry came through these political crises unscathed.

Mature Manufacturers

Hong Kong's booming textile industry led Western countries to impose increasingly severe quotas and other restrictions on its exports from 1959. Paradoxically, these created a new development track for Hong Kong's manufacturing sector which proved more stable and more lucrative. The colonial administration administered these controls in a way that favoured existing producers and exporters and imposed a heavy premium on new entrants, which reduced price competition among local manufacturers. At the same time, Hong Kong could only expand exports significantly through increasing the value of local products, which forced manufacturers to move up-market. In parallel, because Hong Kong's access rights in Western countries were based on past performance, new entrants from lower-cost Third World nations were unable to enjoy equal access to these markets, which restricted the competition Hong Kong manufacturers faced on world markets.[57]

These improved prospects in export markets during the 1960s had little impact on the business models that the three banking groups had developed during the earlier stage of manufacturing development in the 1950s. Unpublished data from the Banking Commission are available for 1969-72, when Hong Kong had become a mature manufacturing economy and when its emergence as a regional financial centre was about to start. Table II identified the lending patterns of the three banking groups.

- Chinese state-owned banks lent virtually nothing to manufacturing, and their assets were concentrated overwhelmingly in trade.

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[56] An example of such false rumours was the allegation that China state-owned banks had aggravated the situation, which the *Far Eastern Economic Review* had to retract in 'Editorial: Post Mortem', 25 February 1965.

[57] Hong Kong *Report for the Year 1969* (Hong Kong: Government Press, 1970), p. 50; Henry Wai-chung Yeung, *Transnational Corporations and Business Networks. Hong Kong firms in the Asian Region* (London: Routledge, 1998), pp. 130, 206-7.

- Lending by local Chinese banks to manufacturing lagged behind foreign banks. Local banks enjoyed a larger share of the market personal loans (‘professional and private individuals’) than the foreign banks and attached a relatively high priority to the property sector (‘building and construction’).
- It was left to the foreign and note-issuing banks to finance local industry. They provided the bulk of the loans to manufacturers and also for foreign (and wholesale) trade transactions. This group was able to change lending priorities very rapidly, as indicated by the sharp increase in personal loans and lending to property in 1972.

Table II: Loans & advances by Bank Group and Purpose, 1969-72 (HK$ millions)[58]

Year-end	**Banks**	**Manufacturing**	**Import, export & wholesale trade**	**Retail trade**	**Building & construction**	**Stock brokers**	**Professional & private individuals**	**Total**
1969	All banks	1,490	2,666	179	803	63	1,004	7,884
	China state-owned	55	329	30	47	-	49	570
	Local Chinese	303	552	35	307	33	706	2,263
	Foreign & note-issuing	1,132	1,785	114	449	29	249	5,051
1970	All banks	1,860	3,527	217	649	143	1,367	9,670
	China state-owned	56	387	41	38	-	60	645
	Local Chinese	450	735	53	315	105	962	3,003
	Foreign & note-issuing	1,354	2,135	123	296	38	345	6,022
1971	All banks	1,979	3,961	228	723	249	1,862	11,836
	China state-owned	69	394	33	61	-	82	752
	Local Chinese	538	912	65	392	196	1,347	3,915
	Foreign & note-issuing	1,372	2,655	130	270	53	432	7,169
1972	All banks	2,233	4,770	340	1,090	736	3,746	17,726
	China state-owned	84	424	60	68	5	105	858
	Local Chinese	630	1,025	106	403	533	2,360	5,686
	Foreign & note-issuing	1,515	3,321	175	619	199	1,281	11,182

Note: The 'Total' column includes items not otherwise listed in the table.

The Rise of Financial Services

[58] Derived from Enclosures 76, 116, 157 and 186. HKRS163-3-12.

Hong Kong was now on the verge of a second economic transformation. Manufacturing for export continued to grow throughout the 1970s, and domestic exports rose by an annual 19 per cent, compared with an annual growth of 17 per cent in the previous decade. But services were increasing in importance. Exports of services grew by almost 17 per cent per annum in the 1970s, compared with an annual growth of 12 per cent in the previous decade. Hong Kong would emerge in the 1970s as a regional financial centre. By 1980, the value of output from manufacturing and from ‘financing, insurance, real estate and business services’ was almost equal, both contributing some 23 per cent of GDP.[59]

The banking legislation, however, was still focused on commercial banking for a predominantly manufacturing economy. Neither the policy-makers nor the professional regulators had the experience or the expertise either to supervise the increasingly complex activities of merchant bankers or to oversee a banking industry in which growth opportunities would come from in the wholesale rather than the retail sector.

Thus, the potential for a new banking crisis was created. The lessons of the recent past were forgotten. The bureaucrats’ aversion to regulation had not been dispelled by the Banking Commission’s performance since 1965. Senior officials remained unconvinced by the evidence in their own files demonstrating that it was the misconduct of bankers rather than commercial misjudgements which led to bank failures. The bureaucrats preferred to believe that the chief cause of banking instability was too many banks. The result, they insisted, was excessive competition which drove local bankers into imprudent lending to cover the premiums they had to pay to attract deposits. Instead of expanding the operations of the Banking Commission to improve bankers’ behaviour, the remedy adopted to prevent future bank runs was an anti-competition policy.

- The Government in 1965 decided to endorse a cartel organised originally by HSBC to set rates for interest on deposits, and which was to last until 2001.[60]
- It maintained there was an almost continuous moratorium on new bank licences from 1965 until 1981.[61]

In Place of Competition

The anti-competition policies created new and powerful incentives for banks to escape from the restrictions imposed by their licensed status, and these policies rewarded financial institutions which set up deposit-taking companies (DTCs) to operate outside the regulatory constraints imposed on the banking industry.

[59] Census and Statistics Department, *2003 Gross Domestic Product* (Hong Kong: Hong Kong SARG, 2004), pp. 14-5, 78-9. Figures for earlier years and more detailed breakdowns are not available.

[60] The Government has no records of how this decision was reached. M. D. Cartland, Secretary for Financial Services, *Hong Kong Hansard*, 27 April 1994, p. 3477. The cartel was put on a statutory basis in 1981 by the Hong Kong Association of Banks Ordinance (Cap. 364), section 12(1). Previously, the Association had imposed its decisions through informal means.

[61] Lifted temporarily in 1972, again between 1975 and 1978 and then substantially relaxed in 1981 covering applications from Hong Kong for the first time. T. K. Ghose, *The Banking System of Hong Kong* (Singapore: Butterworths, 1987), pp. 76-8; Sir Philip Haddon-Cave, Financial Secretary, *Hong Kong Hansard*, 27 May 1981, pp. 893-5.

- The interest-rate cartel applied only to licensed banks and prevented them from competing for deposits on price. Thus, banks wishing to expand their lending rapidly were constrained by their licensed status and had a strong incentive to shift at least part of their operations outside the regulated system.
- The moratorium on new licences meant that new entrants to the banking industry had to operate outside the regulated banking system. Freedom from regulation lowered their costs because they did not have to comply with the statutory liquidity requirements.
- To remain competitive against these new 'non-bank' rivals, licensed banks had an additional incentive to transfer operations outside the regulated system.
- When the parents of these non-bank vehicles were licensed, either locally or overseas, the public regarded the vehicles themselves as having the same status as the parent banks was concerned. Thus, a new banking sector was created, unlicensed and, at best, regulated only indirectly.

The anti-competition measures, in effect, invited the banking industry to escape from the regulators' oversight and, in particular, to avoid the statutory obstacles to imprudent lending.

The impact of anti-competition policies was reinforced by the 'liquidity loophole' which had proved benign in the 1950s when it had helped to finance the highly conservative business of lending to manufacturers against their export orders. This special advantage of the foreign banks continued even after the introduction of minimum statutory liquidity ratios under the 1964 Banking Ordinance because they were permitted to comply with the law's requirements through 'window-dressing' transactions with their head offices.[62] The result was that a foreign bank (from the United States, for example) could operate on extremely profitable terms with almost no local capital, maintaining a far higher loan-to-deposit ratio than local Chinese or the note-issuing banks. Until 1972, enforcement of the exchange controls would have ended this practice, but the colonial administration preferred to protect Hong Kong's free currency market.[63] A modern central bank would have made it possible to remove this anomaly, but the bureaucrats were adamantly opposed to any such institution.

Regional Ambitions

At the start of the decade, Hong Kong was 'one of the cheapest sources of short-term funds in the world', commented an official, and foreign merchant banks had been attracted in droves. The Government noted a curious implication of the liquidity loophole: 'It does seem rather odd that a foreign bank can in fact increase its own business in Hong Kong basically with funds lent to it by local banks – thus taking

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[62] These arrangements are described in Y. C. Jao, 'Monetary system and banking structure', in H. C. Y. Ho and L. C. Chau (eds), *The Economic System of Hong Kong* (Hong Kong: Asian Research Service, 1988), p. 45. The Government argued unconvincingly that these arrangements were conventional deposits rather than 'window dressing'. Haddon-Cave, *Hong Kong Hansard*, 11 April 1979, pp. 706-7.

[63] Exchange Controller memo to Financial Secretary, 'Foreign Banks in the Colony', 26 October 1968; Commissioner of Banking memo to Financial Secretary, 'Foreign Banks in Hong Kong', 12 March 1969. HKRS163-3-369 'Foreign Banks in Hong Kong Capitalization Requirements'.

away business from local banks with their own funds'.[64] It was this arrangement that enabled foreign banks to allow their loan portfolios to surge in line with share and property market booms because their lending was not constrained by minimum liquidity ratios.

The bureaucrats regarded this situation without concern became in the 1970s, they were anxious to promote a new economic role for Hong Kong which they identified publicly for the first time as a 'regional financial centre'. They attributed this development to the licensed foreign banks whose ample funding was propelling the liquidity loophole and to the merchant banks drawn to Hong Kong by the surge in financial activity during a stock market boom.[65]

The Government seemed to think that these overseas institutions arrived with ready-made portfolios. In fact, they came in search of the business which Hong Kong, uniquely in the region, could facilitate because of its freedom from trade and currency controls and the absence of restrictions on foreign participation in domestic transactions. But they did not come to escape from prudential supervision or statutory regulation, to which they were accustomed in their home countries. An additional attraction to set up in the Hong Kong market was access to regional business. The sophistication of Hong Kong's wholesale banking attracted Asian governments as they started to issue overseas bonds. Furthermore, by the end of the decade, Hong Kong's ability to respond to Deng Xiaoping's 'open door' policies by providing the Mainland with external financing had added a new dimension to the market.[66]

Because of ambitions to develop the financial services sector, the bureaucrats resisted demands to close the liquidity loophole and for tighter regulation generally throughout the 1970s. But they were also handicapped by an inability to understand the monetary system.

- The Government was nervous about tackling the secondary banking sector for fear of imperilling Hong Kong's new-found role as a regional financial centre, in which non-bank DTCs were viewed as important players. Officials feared that with a world oil crisis and the depressed local share and property markets in the mid-1970s, an extension of banking regulation to DTCs would force many of them into liquidation.[67]
- The growth of an unregulated financial system appeared to involve no serious political risks for the colonial administration. The licensed banks had emerged from a 1973 stock market crash without crisis or scandal. The public seemed to accept that neither stockbrokers nor DTCs could be held to the same standards of integrity or stability as licensed banks.
- The bureaucrats misunderstood how Hong Kong's switch to a floating exchange rate in 1974 affected the process by which money was created and the role played

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[64] M. 9 AS(E3) to DES, 21 August 1972; M. 11 Exchange Controller to DES, 23 August 1972. HKRS163-3-12 'Banking Statistics /1. Supply of to S. of S. Policy concerning…'.

[65] Sir Murray MacLehose, Governor, *Hong Kong Hansard*, 17 October 1973, pp. 25-6; Haddon-Cave, *ibid*., 29 November 1973

[66] Josephine M. Chesterton and Tushar K. Ghose, *Merchant Banking in Hong Kong* (Hong Kong: Butterworths Asia, 1998), pp. 29-32.

[67] Haddon-Cave, *Hong Kong Hansard*, 8 January 1975, p. 340.

> by the banks in this process.[68] The inflation which resulted financed a new surge in speculative share and property activities from 1978. Not until 1979 did the Government begin to realise that without first bringing the liquidity generated within the banking system under control, it could not stabilise the money supply.[69]

By the end of the decade, the Government was rejecting complaints from local Chinese banks that foreign banks used their inter-bank facilities to fund irresponsible lending.[70] Nevertheless, the colonial administration could no longer take it for granted that foreign banks would be the conservative backbone of the banking industry, as following sections will recount. The bureaucrats' reluctance to close the liquidity loophole had encouraged foreign financial institutions to adopt a riskier business model than in previous decades.

Boom and Bust

The importance of the liquidity loophole surfaced early in the 1970s when a stock market boom was fuelled by the banks (Table III). The foreign banks (except for the note-issuers) were especially active, thanks to their relative freedom from the constraints of statutory liquidity ratios, as Table IV illustrates. The Hang Seng Index rose to a record high of 1775 early in 1973. It then crashed, falling to 400 at year-end and stood at 150 in December 1974. [71] Turnover was HKD48 million in 1973 but only HKD11 million the following year. Full recovery did not come until the end of the decade (Table V).

Table III: Bank Lending against Shares Compared with Total Loans & Advances and Total Deposits (percentages)[72]

	December 1970	**December 1971**	**March 1972**	**June 1972**	**September 1972**	**December 1972**
Percentage of total loans & advances	8.2	10.96	12.03	14.57	17.46	18.06
Percentage of total deposits	5.3	6.91	7.47	9.03	11.54	13.39

[68] A defective monetary policy encouraged excessive lending, but the Financial Secretary misunderstood the connection between inflation and both budget surpluses and currency in circulation until the end of the decade. Haddon-Cave, *Hong Kong Hansard*, 16 November 1978, pp. 208-9; 28 February 1979, p. 548.

[69] The Financial Secretary remained muddled about Hong Kong's monetary system even after he began to link macro policies to banking operations. Haddon-Cave, *Hong Kong Hansard*, 12 April 1979, pp. 762-3; 9 December 1981, pp. 236-7.

[70] Haddon-Cave, *Hong Kong Hansard*, 15 November 1979, p. 217.

[71] Frederick Ma, Secretary for Financial Services and the Treasury, *Government Information Services*, 18 November 2002.

Table IV: Ratio of Loans to Deposits for Selected Banks (percentages)[73]

Year-end	1970	1971	1972
Chartered Bank	50	51	55
HSBC	49	43	54
Hang Seng Bank	54	53	54
Bank of East Asia	59	61	49
Bank of China	28	34	17
Bank of Communications	33	35	47
Bangkok Bank	217	165	114
Belgian Bank	127	103	103
Bank of America	302	299	284
First National City	138	108	246
Chase Manhattan	270	167	255

Table VI: Share Prices & Stock Exchange Turnover, 1970-80[74]

	1970	1971	1972	1973	1974	1979	1980
Hang Seng Index (1964=100)	187	282	489	786	305	620	1,121
Total Annual Stock Exchange Turnover (HKD millions)	5.99	14.79	43.76	48.22	11.25	25.63	95.68

Note: The Hang Seng Index figures are the 'average of indexes as at end of each month' in each year.

The Government publicly deplored the market malpractices and the reckless speculation which had caused this spectacular crash, and which the banking industry

[72] Reproduced from Leo F. Goodstadt, 'Crisis and Challenge: The Changing Role of the Hongkong & Shanghai Bank, 1950-2000', *HKIMR Working Paper No.13/2005*, July 2005, p. 26

[73] Reproduced from Goodstadt, 'Crisis and Challenge: The Changing Role of the Hongkong & Shanghai Bank, 1950-2000', p. 26

[74] Derived from *Hong Kong Annual Digest of Statistics* (Hong Kong: Government Printer), 1978 and 1982 editions.

ought to have resisted.[75] The licensed banks, for their part, had lobbied unsuccessfully for the introduction of controls on the 1,500 unregulated financial firms which had sprung up during the boom. These were mostly under-capitalised and facilitated the small client who could not obtain margin facilities from other sources. Their freedom from statutory constraints gave them an edge in competing for deposits, which banks countered by setting up their own deposit-taking companies (DTCs) outside the regulatory system.[76]

Responsibility Repudiated

Although the stock market was not to recover fully until 1980, the boom in 1972 and 1973 had lasted long enough to start a major transformation of the corporate environment. The family firms which had done well out Hong Kong's first post-war economic transformation had begun to restructure themselves into modern corporations, as Sun Hung Kai, New World and Henderson all did in 1972. A pattern of publicly-quoted but tightly-held public companies was created which has dominated the Hong Kong securities market ever since.[77]

A real estate boom in the second half of the 1970s accelerated the momentum of the wholesale banking market. The new Chinese-owned corporations embarked on major property acquisitions and development projects which required jumbo-scale financing. The syndicated loan business grew rapidly. This process continued throughout the 1970s, enabling Chinese entrepreneurs, like Li Ka-shing and Sir Yue-kong Pao, to overtake British family firms like Jardine Matheson, Hutchison and Wheelock Marden that had prospered in the past with the help of colonial privileges.[78]

Bankers had adopted a new business model which, although highly aggressive and competitive, had much in common with the traditional business practices of Hong Kong banking before the 1964 Banking Ordinance. The bureaucrats, however, had still not grasped that allowing financial institutions the opportunity to lend depositors' funds on the basis of personal connections led almost inevitably to self-destructive behaviour. These loans were exempt from proper scrutiny and, when they went sour, led to criminal behaviour in a desperate effort to conceal the damage done to the bank's balance sheet.[79]

In the 1950s, as this paper has already discussed, the bureaucrats tried to avoid responsibility for the prudent conduct of licensed banks and the protection of their depositors. As a result, the rules which replaced enforcement of the relevant laws

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[75] For example, two thirds of all public listings were by way of private placements, to the alarm of the Government. Haddon-Cave, *Hong Kong Hansard*, 25 February 1976, p. 501.

[76] Philip Bowring, 'Hongkong's Banks: Newcomers squeeze the Establishment', *FEER*, 1 April 1974; Y. C. Jao, *Banking and Currency in Hong Kong. A Study of Postwar Financial Development* (London: Macmillan, 1974), p. 96.

[77] Note Yen-P'ing Hao, 'Themes and Issues in Chinese Business History', in Robert Gardella et al (eds), *Chinese Business History. Interpretative Trends and Priorities for the Future* (Armonk: M. E. Sharpe Inc., 1998), p. 135.

[78] This process is summed up by Lau Chi Kuen, *Hong Kong's Colonial Legacy* (Hong Kong: Chinese University Press, 1997), pp. 88-93.

[79] Philip Bowring in Philip Bowring, *et al.*, 'Symposium on Prudential Supervision of Financial Institutions in Hong Kong', *Hong Kong Economic Papers*, Vol. 1985 No. 16 (1985 Dec), p. 98.

meant that bankers could choose to operate outside the law with very little risk. In the 1970s, the Financial Secretary's policy decisions had much in common with the informal measures taken by the bureaucrats in the 1950s to avoid supervising the licensed banks.[80]

- The Government publicly repudiated all responsibility for ensuring 'complete safety for depositors' or even securing 'the prudent conduct of business' by DTCs.
- It introduced registration of DTCs in 1975 and prescribed some prudential controls over lending. But there was no effective regulation or inspection to ensure compliance with the statutory requirements.
- In March 1978, as speculation in shares and property became rampant once again, the Government finally recognised that self-regulation of the secondary banking market was ineffective.
- In the following year, DTCs were made subject to 'a system of prudential supervision broadly similar to that applied to all licensed banks' including minimum liquidity ratios. The regulators, however, were not provided with adequate resources to achieve this goal.[81]

The inference easily drawn by less scrupulous proprietors and executives was the same in the 1970s as it had been before the 1964 Banking Ordinance: the colonial administration had low standards when it came to either stability or integrity and was not much interested in law enforcement.

Clash of Cultures

The consequences for the banking industry were to be profound. There was a new class of corporate client. They were no longer arm's-length borrowers whose loans were self-liquidating and secured by solid collateral as manufacturers had been. Transactions were large, technically complex, competitive and generally public, and the new borrowers were increasingly sophisticated and demanding. Bankers had to become far more entrepreneurial and committed to the client's project because a bank would be making larger commitments to a single customer than had been acceptable previously. Foreign bankers were avid for this business, and all too many of them were naively convinced that Asian businessmen represented large family interests which would cooperate to rescue a relative from insolvency.[82]

The result was the emergence of a new banking style which was far more aggressive and less conformist than in the past. The contrast between HSBC and its merchant bank, Wardley, provides a striking illustration of the contrast between the old and the new banking cultures.

HSBC, as a corporation, remained cautious and conservative in its approach to banking during the excesses of the 1970s. For example:

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[80] Haddon-Cave, *Hong Kong Hansard*, 5 November 1975, p. 189, 8 January 1975, p. 342; 3 December 1975, p. 297; 16 November 1978, p. 209 and 28 February 1979, p. 554.

[81] Anthony Rowley, 'Banking/Hongkong: Not-so-super vision: The territory admits scrutiny of financial institutions is not all it should be and summons outside help', *FEER*, 1 March 1984.

[82] See, for example, the evidence given in the Carrian case by an HSBC Senior Manager Credit, *South China Morning Post*, 11 March 1986.

- HSBC's Deputy Chairman publicly denounced the speculative excesses of the share market 'bubble' in 1972.[83] The bank then withdrew from lending to individuals for investment in shares and did not resume this business until May 1974.[84]
- At the end of the decade, double-digit inflation was being generated by the Government's mismanagement of the currency and the banking system was fuelling excessive speculation in shares and property. HSBC's General Manager campaigned publicly for reforms to official policies.[85]
- HSBC did not exploit the opportunities created by the Government's flawed monetary policy to expand credit regardless of the inflationary consequences.[86]
- Nevertheless, HSBC did not escape direct involvement in the property excesses at the end of the decade and accounted for 15 per cent of the external liabilities of Carrian Holdings, the biggest of the corporate scandals.[87]

Wardley projected an entirely different image, with a willingness to court controversy in campaigning for its corporate clients. For example:

- Wardley caused astonishment when handling a rights issue for Wheelock Marden in 1976. Among other shortcomings, no balance sheet was supplied.[88]
- Wardley came under attack for limited disclosure of its relationship with Cheung Kong when managing major transactions. The Takeovers and Mergers Code was amended in 1977 to remove any ambiguity about merchant banks' duties in such circumstances.[89]
- Wardley assisted Sir Yue-kong Pao to defeat Jardine Matheson in a battle for control of the property-rich Hongkong & Kowloon Wharf in 1980. Wardley was willing to risk criticism from the Government's Takeovers and Mergers Committee for its activities on behalf of this client.[90]
- Wardley appears to have lost at least as much as its much-larger parent in the Carrian crash and was involved in other corporate disasters in this period.[91]
- Wardley's former Chief Executive fled from justice after been accused of accepting bribes in the early 1980s. When finally extradited to Hong Kong, an

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[83] 'Sandberg and the market', *FEER*, 23 September 1972; Stewart Dalby, 'Will the bubble burst?' *FEER*, 2 December 1972.

[84] 'Hongkong Bank spurs a rally', *FEER*, 13 May 1974.

[85] See Leo Goodstadt, 'Controls come to the rock of laissez-faire', *Euromoney*, April 1979, pp. 121-3; 'Whatever the Reasons, Hong Kong keeps Growing', *Euromoney*, July 1982, pp. 134-7; 'Why Hong Kong still trusts interests rates', *Asian Banking*, January 1982, p. 56.

[86] This restraint was a display of 'public-spiritedness' according to Kurt Schuler, 'Episodes from Asian Monetary History: A Brief History of Hong Kong Monetary Standards', *Asian Monetary Monitor*, September-October 1989, Vol. 12, No. 5, p. 23.

[87] *South China Morning Post*, 23 July 1985, 11 April 1986.

[88] Philip Bowring, 'Freebooters must abide by ethical standards', *FEER*, 17 September 1976.

[89] *FEER*: 'Extending Code', 16 September 1977; Philip Bowring, 'There is still much investigation needed', 23 September 1977.

[90] Leo Goodstadt, 'The weekend Wardley won Wharf for Pao', *Asian Banking*, August 1980.

[91] See Christopher Wood, 'Company Profile: The Hongkong Bank must diversify while avoiding headlong retreat. Strategy for Survival', *FEER*, 20 September 1984.

initial guilty verdict was overturned, but the court held that he had drawn suspicion on himself.[92]

Back to the Past

This cultural shift away from discreet conservatism was not confined to merchant bankers and DTCs. The regulators reverted to the past, paralleling remarkably the bureaucrats' indifference to misconduct and mismanagement before the 1964 Banking Ordinance.

- Regulators contented themselves with purely mechanical application of auditing and other technical requirements and refrained from serious investigation of individual banks.
- Criminal offences were not prosecuted on the grounds that information obtained from banks and DTCs was confidential.[93]

The message to bankers was plain, according to the official entrusted with cleaning up the industry in 1984: as long as the accounting and other technicalities prescribed by law seemed in order, the regulators would take no further interest in a bank's behaviour.[94]

The message was reinforced by a lack of prudence and restraint among the official overlords of the regulatory system that paralleled the propensity for self-destruction among bankers.

- The Secretary for Monetary Affairs oversaw the regulation of the entire financial system. After he retired in 1986, he was invited to run a nightclub by the chairman of the Hong Kong Stock Exchange (subsequently gaoled on corruption-related charges). He was prevented from embarking on this career by a public warning that his government pension would be stopped.
- The life style of a former Commissioner of Securities led to his arrest and a six-month investigation by the Independent Commission Against Corruption (ICAC) in 1982. A Commissioner of Banking and DTCs also aroused the attention of the ICAC, who investigated his financial affairs after his retirement. (Neither man was charged.)
- The Deputy Public Prosecutor who handled criminal cases relating to three major bank failures in this decade was gaoled on corruption charges relating to their affairs.

Contagion Compounded

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[92] *South China Morning Post*, 22 March 2002.

[93] Anthony Rowley and Philip Bowring, 'Finance: With cynical abandon: Hongkong's authorities continue to look on as the scale of DTC failure grows – and depositors lose their money', *FEER*, 3 March 1983.

[94] Fell, *Crisis and Change. The Maturing of Hong Kong's Financial Markets*, p. 159.

On the basis of Hong Kong past experiences, the consequences were predictable. After 1978, property values surged, with prices rising almost 50 per cent for residential and retail units by 1981 and even faster in office and industrial buildings. Interest rates then rose to record heights, and property prices slumped sharply during 1982, undermining the stock market and business confidence generally. By now, both banks and DTCs had recklessly expanded their property exposure. In 1982, property and related activities accounted for 35 per cent of local lending by banks and 42 per cent by DTCs.[95] The weaker DTCs and their associated banks made desperate efforts first to shore up their balance sheets and then to conceal their losses and disguise their liquidity problems. The mounting financial crisis was aggravated by the acrimonious 1982-84 Sino-British diplomatic negotiations about Hong Kong's future and the collapse of the currency in 1983.[96]

Regulation introduced for DTCs from 1978 had come too late. They had already contaminated several licensed banks, not surprisingly since 28 of the 124 licensed banks had set up DTC subsidiaries, while a further 187 DTCs were associated with overseas banks either locally licensed or with representative offices.[97] Between 1982 and 1986, seven licensed banks failed, brought down not just by the insolvency of corporate clients but by fraud and corruption in their DTCs.[98] To prevent a general collapse in public and business confidence, the Government was forced to spend HKD3.8 billion on rescuing and restructuring them.[99] The contribution to GDP of 'Financing, insurance, real estate and business services' fell from 23 percent in 1980 to 17 per cent in 1986.[100]

Overseas associations compounded the contagion in a way which had not been true in the 1961-65 bank failures. The Wing On Bank was brought down by the Chief Manager's personal fraudulent loans, but it hardly deserved to survive once it became associated with the notorious Australian Nugan Hand Bank.[101] Connections with Malaysia, Singapore and Thailand were aggravating factors in the downfall of Hang Lung and Overseas Trust Banks and the near collapse of Ka Wah Bank.[102] The colonial administration could no longer assume that the major threat came from the local Chinese banks. Foreign banks were also at risk. Head offices of foreign banks had ample resources to underwrite their Hong Kong branches, but their management

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[95] Andrew F. Freris, *The Financial Markets of Hong Kong* (London: Routledge, 1991), Tables 2.14, 2.15, p. 48

[96] See Chesterton and Ghose, *Merchant Banking in Hong Kong*, pp. 24-6.

[97] *FEER*: 'The banking system: Protect depositors – or let jungle law prevail', 17 March 1983.; Anthony Rowley, 'Banking: A time for change: More professionalism is being introduced into Hongkong's financial administration', 9 May 1985.

[98] A useful though incomplete summary of the bank failures is provided by Freris, *The Financial Markets of Hong Kong*, Table 2.9, pp. 40-1. On p. 39, he misleadingly argues that criminal activities were not a major factor.

[99] Ghose, *The Banking System*, p. 96. The actual exposure of the Exchange Fund in supporting these banks was probably significantly higher at the height of the crisis.

[100] *2003 Gross Domestic Product*, p. 81.

[101] *FEER*: Brian Robins, 'Companies: No helping hand: The affairs of Nugan Hand will continue to be probed despite the lack of cooperation from the CIA and FBI', 21 April 1983; Philip Bowring, 'Companies: Milchcow to turn sour?: Wing On minority may block bank cash injection', 12 June 1986.

[102] Anthony Rowley, 'Hongkong regulation: Fresh powers to tackle a "deadly mixture"', *FEER*, 8 May 1986.

standards could not be taken for granted, and executives from Lloyds, Barclays and WestLB Banks were convicted on criminal and corruption charges.

Conclusions

In terms of the behaviour of both bureaucrats and bankers, the Hong Kong landscape seemed to change very little between the 1950s and 1970s. In that earlier period, the bureaucrats' replacement of regulations by rules created a banking environment conducive to misconduct. Mismanagement took time to reach self-destructive proportions, and the crisis was postponed until the runs on five banks between 1961-65. Their woes followed over-expansion of credit as the banks financed rampant property speculation. Similarly, the bureaucrats' policies in the 1970s imposed no penalties on mismanaged DTCs, which allowed them to embark on self-destructive behaviour. Financial ruin, however overtook the worst of them only in the following decade.[103] Virtually unrestricted creation of credit in the 1970s fuelled an unsustainable rise in property prices before the crash began in 1982.

This paper has shown how the process of economic development generates pressures for changes in existing business models. In the 1950s, the existence of a liquidity loophole enabled foreign banks to make a major contribution to industrial take-off. But local Chinese banks did not take full advantage of the profitable and very secure lending opportunities in manufacturing. In the 1970s, the liquidity gap refusal facilitated the arrival of foreign bankers and accelerated Hong Kong's emergence as a regional financial centre. At the same time, the refusal to licence newcomers to the Hong Kong banking industry facilitated mismanagement and misconduct throughout the industry . A general collapse of public confidence in the financial system was averted in the 1980s only at considerable cost to the official reserves.

The parallels between the period 1948-65 and 1970-86 are not surprising. Although Hong Kong's economy was undergoing radical and very different transformations in the two periods, the regulatory outlook of the colonial administration remained largely unchanged. The bureaucrats and their rules encouraged self-destructive behaviour among bankers, the paper has demonstrated, very much as Baumol's theory would predict.

[103] On the latter period, see the comments of Richard Farrant, Adviser to the Banking Commissioner, in Philip Bowring, *et al.*, 'Symposium on Prudential Supervision of Financial Institutions in Hong Kong', *Hong Kong Economic Papers*, Vol. 1985 No. 16 (1985 Dec), pp. 104-5.