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Hong Kong: Private Emergency Loans, 1965

Benjamin Hoffner
Yale Program on Financial Stability

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Benjamin Hoffner[2]

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Abstract

In 1965, new prudential regulations and a real estate downturn triggered deposit runs in the British colony of Hong Kong that impacted local Chinese banks with large exposures to unfinished real estate projects and other illiquid assets. As a result of authorities' laissez-faire approach to the banking system, Hong Kong had no central bank or any other formal lender-of-last-resort (LOLR) policy when the crisis unfolded. Instead, two private British banks, Hong Kong and Shanghai Banking Corporation (HSBC) and Chartered Bank, provided emergency loans at market rates for commercial banks facing deposit withdrawals. Following each bank run, either HSBC or Chartered Bank intervened and publicly declared support, typically expressed as unlimited, for a distressed bank. HSBC, as the largest bank in Hong Kong, played the dominant role as private LOLR given its large, conservatively managed balance sheet that protected the bank from runs. However, the two banks did not disclose most of the terms of the emergency lending arrangements throughout the crisis. Although HSBC's initial pledge of liquidity assistance helped temporarily stave off deposit runs, inconsistent communication over the extent of its LOLR support undermined subsequent attempts to restore confidence in vulnerable banks. As bank runs continued, the government eventually intervened by introducing emergency liquidity policies: it set limits on deposit withdrawals, authorized British sterling as legal tender, and created a provision to return surplus banknotes to HSBC and Chartered Bank. The combined efforts by the government, HSBC, and Chartered Bank contained the effects of the crisis to local Chinese banks, and by the end of the year, only three of the 87 banks in Hong Kong had failed.

Keywords: broad-based, broad-based emergency liquidity, emergency liquidity, HSBC, private lender of last resort

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2 Research Associate, YPFS, Yale School of Management.

Overview

Hong Kong's 1965 banking crisis emerged in a unique banking system defined by the absence of a central bank to serve as lender of last resort (LOLR). Jao (1974, 3) characterizes Hong Kong's contemporary financial system as "one of the very few surviving instances of largely unfettered laissez-faire." The government licensed banks to operate in Hong Kong and maintained minimal financial regulations (Goodstadt 2006a). By 1965, there were 87 licensed banks in Hong Kong, composed of 38 local Chinese banks and 49 foreign banks (Goodstadt 2007, 159).[3] Included among foreign banks were two British banks, Hong Kong and Shanghai Banking Corporation (HSBC)[4] and Chartered Bank, which together had a near-monopoly on the issuance of banknotes. Their banknotes were ultimately backed by British pounds sterling (GBP) assets (Jao 1974, 141).

Toward the end of 1964, real estate and stock markets in Hong Kong began to decline following a speculative bubble in property developments (Schenk 2003). Meanwhile, in December, Hong Kong's government passed the new Banking Ordinance, introducing for

Key Terms

Purpose: To support illiquid local Chinese banks facing deposit runs	
Launch Dates	First loan: February 7, 1965
Expiration Dates	Final loan: Not given, at least until November 25, 1965 Final repayment: 1969
Legal Authority	Disputed, private lender of last resort
Peak Outstanding	HKD 354 million certificates of indebtedness issued; HKD 163 million peak government liquidity injections
Participants	Local Chinese banks facing deposit runs
Rate	Overnight market rates
Collateral	Mortgageable assets, securities, foreign balances, and secured advances
Loan Duration	Varied according to the needs of borrowers; at least one bank received support for more than four years
Notable Features	HSBC initially clarified that it would not provide unlimited support to vulnerable banks, which exacerbated deposit runs
Outcomes	3 of 87 banks failed

[3] Local Chinese banks were banks incorporated in Hong Kong and owned by local Chinese residents. Foreign banks included those owned by the Chinese state (Goodstadt 2005; 2007, 159).

[4] Hong Kong technically had three note-issuing banks, which included Mercantile Bank in addition to HSBC and Chartered Bank. As of 1965, HSBC owned Mercantile Bank, and for simplicity, we will not separate Mercantile Bank from HSBC's operations during the crisis (Jao 1974, 141).

the first time a statutory liquidity ratio[5] for licensed banks. Facing demands to meet the new prudential requirements of the law, which would become operational on June 1, 1965, banks liquidated riskier assets, intensifying the fall in property prices (Government of Hong Kong 1966; Schenk 2003). By the start of 1965, local Chinese banks were least compliant with new prudential requirements and remained heavily exposed to increasingly illiquid assets, especially unfinished property developments (Goodstadt 2006a). This feature of local Chinese banks made them most at risk of sudden losses in depositors' confidence. They were most affected by the waves of depositor runs that began just one month into the year (Schenk 2003). The runs coincided with the annual widespread cash withdrawals for the Chinese New Year holiday.

As the crisis emerged, HSBC was less exposed to real estate assets; HSBC targeted a 50% liquidity while the industry slipped below 30% (Schenk 2003; 2004). Consequently, while many local Chinese banks experienced deposit withdrawals in 1965, HSBC benefited from a "flight to quality," and its deposits increased 17% from 2.2 billion Hong Kong dollars (HKD) in December 1964 to HKD 2.6 billion (USD 450 million)[6] by the end of June 1965 (Goodstadt 2005). Similarly, Chartered Bank's deposits grew 18%, although from a much smaller base. These factors enabled the two note-issuing British banks to intervene as LOLRs in the local banking disturbances. In an April 1965 *Far East Economic Review* article, HSBC's deputy chief manager, Oliphant, summarized the general administration of private LOLR support in Hong Kong as follows:

> [HSBC and Chartered Bank] demand security in the form of mortgageable assets, securities, foreign balances or secured advances, any of which can be taken over as security for cash loans at commercial interest rates. Provided that a bank is being run on sound lines there should be no difficulty in obtaining help if it suffers a temporary shortage of liquidity; a contingency against which no bank can protect itself completely by the use of its own resources. (FEER 1965, vol. 48, 177)

Jao (1974, 244–46) divides the 1965 banking crisis into four phases, each marked by a unique wave of bank runs. Phase two of the crisis saw a contagion of bank runs in February and is the primary subject of this case study. Phases one in January, three in April, and four in November centered on bank-specific runs and did not necessitate the same broad-based support as needed to manage phase two.

Phase one began on January 27. Following news of Ming Tak Bank's default on large US dollar checks, depositors ran on the bank, forcing its closure, and the Banking Commissioner took it over (Jao 1974, 245). Although the government provided HKD 10 million to support illiquid real estate investments and mitigate further losses, the government ultimately allowed the Ming Tak Bank to fail (Schenk 2003).

[5] Article 18 of the 1964 Banking Ordinance required banks to hold liquid assets (cash, specie, call money, demand deposits, Treasury bills) equivalent to at least 25% of deposit liabilities (McCarthy 1985).

[6] The official exchange rate as of January 1965 was HKD 5.78 = 1 USD (Government of Hong Kong 1969).

Phase two began on February 6 with a run on Canton Trust and Commercial Bank. On February 7, HSBC agreed to extend Canton Trust an emergency loan of HKD 25 million to temporarily halt the run (Jao 1974, 246; Schenk 2003). Upon realizing that the public perceived HSBC's support to be unlimited, HSBC issued a controversial clarifying statement, informing the public that it would not provide unlimited support for Canton Trust. That announcement prompted mass withdrawals that forced Canton Trust to close; it was also taken over by the banking commissioner (Jao 1974, 246). The failure of Canton Trust on February 8 accelerated the spread of deposit runs at several local Chinese banks, which prompted HSBC and Chartered Bank to each intervene and pledge unlimited support through loans; over the next two days, HSBC supported three local banks and Chartered Bank, two. Aside from the identities of borrowers, our research has found few specific details of the loans; the loan amounts for Canton Trust (HKD 25 million) and Far East Bank (HKD 40 million-plus) constitute two exceptions (Jao 1974, 249; Schenk 2003).[7]

On February 9, the government introduced the following emergency liquidity policies through the Emergency (Bank Control) Regulations (Government of Hong Kong 1966):

1) Restricted cash withdrawals from local bank accounts to HKD 100 or less, although payments by check continued (Jao 1974, 247).

2) Authorized British sterling as temporary legal tender in Hong Kong; the Bank of England procured GBP 20 million[8] notes for export to Hong Kong (Schenk 2003).

3) Authorized the financial secretary to require local banks to report daily cash balances to the banking commissioner, who could in turn force banks to return surplus banknote holdings to HSBC and Chartered Bank (Jao 1974, 247).

The government also announced on February 9 that it endorsed the decision of the Exchange Banks' Association not to allow early withdrawal of time deposits (Jao 1974, 247). Along with the announcement, the governor of Hong Kong, David Trench, issued the following statement to reassure the public:

> Because so many people have gone to the banks to ask for their money in notes just after the Chinese New Year, when a lot of money is always withdrawn anyway, there is some danger we may run out of the actual notes needed. I emphasize again: The general position is that it is not *money* in its proper sense that may perhaps run short—we have ample financial resources here—but the paper notes which represent money. (Government of Hong Kong 1966)

The immediate relief provided by these emergency measures brought a quick end to the second phase of the crisis. Since the liquidity crisis did not spread outside vulnerable local

[7] See Key Design Decision No. 18, Disclosure, for further information on the limited disclosure of lending arrangements.

[8] As of 1965, HKD notes were pegged to the British pound sterling (GBP) at a fixed rate of HKD 16 = GBP 1. To issue HKD notes, note-issuing banks had to deposit sterling assets with Hong Kong's Exchange Fund to receive certificates of indebtedness (CIs) at a small spread (Nugée 1995).

Chinese banks, the government had no need to circulate the imported sterling notes; rather, the GBP 20 million notes served as an additional liquidity precaution. Once the sterling notes arrived in Hong Kong, the government quickly removed the restriction on cash withdrawals on February 16 (Jao 1974, 247).

Following the emergency measures, the government "provided considerable financial support, through the media of [HSBC and Chartered Bank] which acted as its bankers, to those adversely affected by the run" (Government of Hong Kong 1966). The mechanics of the government's support are unclear. However, Goodstadt (2005) notes that, during the crisis, the government injected liquidity, which peaked at HKD 163 million; the government deployed HKD 104 million, the majority of the injection, through HSBC. According to Goodstadt (2007, 148), if not for the government's liquidity injections, another four local Chinese banks would have failed.

Summary Evaluation

Jao (1974, 244) says that, relative to other financial crises in Hong Kong's history, the 1965 crisis saw few bank failures, all limited to local banks. Similarly, Schenk (2006) notes that the 1965 crisis was characterized by a shift of deposits from riskier, local Chinese banks to reputable, large foreign banks—deposits did not decline in aggregate.

HSBC's clarifying statement about Canton Trust remains controversial. It was only after the government declared emergency measures on February 9 that the panic subsided. Nevertheless, two additional waves of bank runs emerged in April and November 1965, in the third and fourth phases of the crisis (Jao 1974, 247).

Phase three of the crisis consisted of a run on the largest local Chinese bank, Hang Seng Bank. After losing almost one-third of its deposits since February, Hang Seng Bank succumbed to a wave of withdrawals on April 9, 1965. Unlike previous runs, the scale of withdrawals at Hang Seng Bank prevented HSBC and Chartered Bank from safely supporting the runs through emergency loans. HSBC ultimately agreed to acquire a controlling interest (51% equity) in Hang Seng Bank for HKD 51 million, the announcement of which subdued the deposit run and put an end to the third phase of the crisis (Jao 1974, 248; Schenk 2003).

The fourth and smallest phase began toward the end of November 1965 and lasted through late 1966. Phase four saw minor runs on Far East Bank and Yau Yue Bank. At the request of the government, HSBC promised unlimited lending support as Far East Bank experienced withdrawals in November 1965; HSBC's outstanding emergency loans to the bank exceeded HKD 40 million, secured by Far East Bank's entire portfolio of assets. In 1966, as Yau Yue succumbed to deposit withdrawals, HSBC took over the bank and the government announced a guarantee of HKD 24 million of its deposits (Jao 1974, 250).

Aside from the minor disturbances during the fourth phase, confidence in Hong Kong's banking system quickly returned from May 1965 onward. Despite the crisis, the Hong Kong economy still grew at 14.5% during 1965 (Goodstadt 2006b). Jao (1974, 260) attributes the successful resolution of the 1965 crisis to two main factors: (1) HSBC and Chartered Bank's ability to quickly supply liquid domestic currency to distressed banks and (2) the avoidance of a general credit contraction. As for the latter, healthy banks (e.g., HSBC and Chartered) continued lending throughout the crisis, and as a result, the total level of loans outstanding increased from the end of December 1964 to the end of March 1965 (Jao 1974, 260–61). Nevertheless, many local banks complained of a credit squeeze and were unable to obtain interbank financing. Jao (1974, 261) notes that "liquidity conditions were so difficult for some banks that the government had to extend help *quietly* to them from Hong Kong's sterling reserves in London." Later in 1966, Financial Secretary John Cowperthwaite released a statement crediting the government's liquidity injections with resolving the lasting credit squeeze (Goodstadt 2006b).

Context: Hong Kong 1965–1966	
GDP (SAAR, nominal GDP in LCU converted to USD)	$2.7 billion in 1965 $2.8 billion in 1966
GDP per capita (SAAR, nominal GDP in LCU converted to USD)	$758.0 in 1965 $768.8 in 1966
Sovereign credit rating (five-year senior debt)	Moody's Ca in 1965 Moody's Ca in 1966
Size of banking system (bank assets)	$2.2 billion in 1965 $2.7 billion in 1966
Size of banking system as a percentage of GDP	81.0% of 1965 GDP 97.1% of 1966 GDP
Size of banking system as a percentage of financial system	100% of financial system assets in 1965 100% of financial system assets in 1966
Five-bank concentration of banking system	Data not available
Foreign involvement in banking system	Data not available
Government ownership of banking system	Data not available
Existence of deposit insurance	None in 1965 None in 1966
Source: Jao 1974, Schenk 2001	

Key Design Decisions

1. Purpose: The private banks extended emergency loans to stop deposit runs on local Chinese banks.

HSBC and Chartered Bank acted as private lenders of last resort by deploying emergency loans in response to local deposit runs. The bank runs in 1965 coincided with a collapsing stock market and real estate bubble. Local Chinese banks faced widespread exposures to increasingly illiquid assets, in particular, unfinished property developments (Schenk 2003). Beginning with the run on, and subsequent failure of, Ming Tak Bank in January 1965, waves of deposit withdrawals affected several local Chinese banks. The 1965 banking crisis illustrated a flight to quality in which depositors demanded currency from local Chinese banks while increasing their deposits in more reputable foreign banks (Goodstadt 2005). The British note-issuing banks, HSBC and Chartered Bank, benefited from the flight to quality and, therefore, were in a strong position to support distressed banks. The support was purely reactive in stopping runs once they had materialized and used to prevent widespread bank failures among local Chinese banks (Jao 1974, 246–48).

2. Legal Authority: In the absence of a central bank, the financial system in Hong Kong relied on HSBC and Chartered Bank to act as LOLRs.

Hong Kong's quasi currency board system operated with HSBC and Chartered Bank as the sole private issuers of domestic currency backed by British sterling assets, although the government also issued a negligible quantity of currency (Jao 1974, 141). Article 10 of the Hongkong and Shanghai Banking Corporation Ordinance (Cap. 70) provided HSBC with the authority to "issue, re-issue and circulate notes of the bank (HSBC) payable to bearer on demand," exclusively within the Hong Kong region. Unlike HSBC, Chartered Bank received the authority to issue notes through its charter of incorporation rather than by ordinance (McCarthy 1985).

The passage of the 1964 Banking Ordinance authorized the newly established banking commissioner to impose prudential controls (e.g., regulating financial reporting and liquidity requirements), but the banking system continued to operate without a central bank (Jao 1979). The role of LOLR fell to HSBC and Chartered Bank during the 1965 crisis; these two banks previously acted as LOLR during a much smaller panic in 1961. As the licensed note-issuing banks, HSBC and Chartered Bank could supply banks experiencing runs with currency backed by British sterling assets (Jao 1974, 141).

3. Part of a Package: The government took over failed banks, implemented emergency regulations to stop depositor runs, and used the sterling reserves of the Exchange Fund to back HSBC's and Chartered Bank's support to vulnerable banks.

Following the failure of Ming Tak Bank in January 1965, HSBC extended emergency loans to Canton Trust amidst the second wave of deposit runs in early February. The forced closure of Canton Trust shortly thereafter spurred additional runs on other local Chinese banks. Although HSBC and Chartered Bank publicly offered unlimited support for these affected banks, deposit withdrawals persisted; see Key Design Decision No. 17, Communication, for a discussion of the wavering promises of unlimited support (Jao 1974, 247). As a result, the government introduced the Emergency (Bank Control) Regulations on February 9, effective February 10 (Government of Hong Kong 1966; Jao 1974, 247).

First, the government imposed a daily limit of HKD 100 (roughly USD 17.3) on cash withdrawals from accounts at local banks, although payments by check continued. It declared British sterling notes a temporary legal tender in Hong Kong. Next, under the regulations, the financial secretary could require banks to report daily cash balances to the banking commissioner, who could then force banks to hand over surplus banknotes to the licensed note-issuing banks, HSBC and Chartered Bank (Jao 1974, 247).

The February 1965 emergency liquidity provisions alleviated depositors' fears, and within one week the government was able to lift restrictions on cash withdrawals without resurgent bank runs (Jao 1974, 247). Moreover, Schenk (2003) notes that the government removed the withdrawal restrictions after receiving a shipment of sterling notes from London, which were ultimately never circulated.

A third phase of bank runs erupted on April 9 when news circulated of investigations into Hang Seng Bank, the largest local Chinese bank. HSBC quickly responded by acquiring Hang Seng Bank at the request of the government. Schenk (2003) notes that the announcement of HSBC's acquisition—complemented by emergency loans for other vulnerable banks, provided by HSBC and Chartered Bank—quickly restored confidence amongst depositors.

The government also provided liquidity injections to struggling banks using its sterling reserves in London (Jao 1974, 261). To augment domestic liquidity, the government could transfer some of its sterling reserves, held in London, for deposit with Hong Kong banks.[9] Since Hong Kong's quasi currency board arrangement required all HKD to be backed by sterling, sterling inflows provided for additional note issues and domestic lending (Goodstadt 2007, 185; McCarthy 1985).

4. Management: The Hong Kong banking commissioner supervised banks while the financial secretary controlled the Exchange Fund, ultimately backing all note issues; HSBC and Chartered Bank, in the absence of a central bank, managed the extension of liquidity support, including issuing banknotes.

The banking commissioner acted as the prudential supervisor in Hong Kong. The 1964 Banking Ordinance required licensed banks to produce monthly financial materials (selected balance sheet and income statement figures) for the banking commissioner. The banking

[9] These injections were largely secretive, and our research has not found explicit disclosure of the mechanics of these injections during 1965. However, the government provided similar injections in 1967 through HSBC to support the distressed Bank of China (Schenk 2009). In this arrangement, the government placed a GBP 10 million seven-day deposit with HSBC; HSBC could then increase note issues or lend to the Bank of China with its additional sterling funds (Schenk 2009).

commissioner also had the authority to inspect and take over licensed banks (McCarthy 1985).

The financial secretary managed Hong Kong's Exchange Fund, a large portfolio of international reserves used to ensure the full backing of the HKD's exchange rate. As of 1965, the HKD was informally linked to British sterling, which composed almost all of the Exchange Fund's assets (McCarthy 1985).

Despite being private banks, HSBC and Chartered performed special roles in Hong Kong. They served as the sole issuers of private banknotes (HKD) (Jao 1974, 141). HSBC, the largest bank in Hong Kong, also managed Hong Kong's clearinghouse, helped the government maintain the official exchange rate, and served as lender of last resort. The role of HSBC as the manager of Hong Kong's clearinghouse enabled it to use the banking system's surplus reserves to assist banks in settling balances. According to Goodstadt (2005), HSBC could use the surpluses of the banking system "free of charge" to lend to illiquid banks "at commercial rates" to cover deficit balances.

5. Administration: Following a request from the government, HSBC and Chartered bank administered emergency loans to distressed banks.

After the failure of Canton Trust created public outrage and panic, the government became determined to combat subsequent bank runs (Goodstadt 2007, 150). Once a run ensued on a local bank, the government requested either HSBC or Chartered Bank to intervene, typically through pledging emergency loans. Whenever HSBC or Chartered announced their willingness to support a bank experiencing deposit runs, they emphasized that support would be unlimited (Jao 1974, 246–48). With little disclosure of these lending arrangements, it is difficult to determine most of the mechanics of these interbank loans and the extent of the government's involvement.

To issue notes, HSBC or Chartered transferred sterling assets to the Exchange Fund and received certificates of indebtedness (CIs) valued at par in HKD (McCarthy 1985; Nugée 1995). All banknotes had to be backed by either CIs or the note-issuing banks' own sterling assets; in practice, almost all notes were backed by CIs, and the amount of notes backed by banks' sterling was limited to HKD 30 million (Jao 1974, 141; McCarthy 1985). The Exchange Fund provided these HKD certificates in a ratio of HKD 16 per GBP (Nugée 1995). HSBC and Chartered could also redeem the certificates of indebtedness for sterling under par (0.84% spread) at the Exchange Fund.[10] The government, however, agreed to abolish this spread during the 1965 crisis (Nugée 1995).

[10] Source states that the CI redemption rate was 1 shilling and 2.75 pence per HKD, implying a 1.67% spread. By 1965, the spread had halved (Nugée 1995).

6. Eligible Participants: HSBC and Chartered Bank provided emergency liquidity to local banks facing deposit runs; some form of solvency test was likely used when deciding to extend loans.

At the start of 1965, there were 87 licensed banks in Hong Kong, 38 of which were local Chinese banks and 49 foreign-owned, including those owned by the Chinese state (Goodstadt 2007, 159). Local Chinese banks experiencing runs were the only recipients of emergency loans (Goodstadt 2005).

Although foreign banks in Hong Kong inherited the prudential norms of their native financial systems, local Chinese banks operated with minimal supervision. The first statutory liquidity requirement established in 1964 forced many local Chinese banks to liquidate assets to become compliant (Schenk 2003).

7. Funding Source: HSBC and Chartered Bank extended loans using their balance sheets and issued additional notes by depositing their sterling assets with the Exchange Fund; the government also used its sterling reserves to bolster domestic liquidity.

As indicated in Key Design Decision No. 5, Administration, HSBC and Chartered Bank were able to fund HKD liquidity support using the CIs they received after depositing sterling assets with the Exchange Fund (McCarthy 1985; Nugée 1995). Aside from their note-issuing powers, the two banks also benefited from their relatively insulated financial positions during the deposit runs. When the crisis emerged, HSBC and Chartered Bank were conservatively managed and less exposed to real estate assets (Goodstadt 2005; 2007, 154); HSBC maintained this conservative reputation by aiming for a 50% liquidity ratio while the industry slipped below 30% (Schenk 2003; 2004). Consequently, while many local Chinese banks experienced deposit withdrawals in 1965, the two banks benefited from a "flight to quality;" in the first half of 1965, HSBC and Chartered Bank's deposits increased 17% and 18%, respectively (Goodstadt 2005). Figure 1 depicts the deposit growth experienced by the two British colonial banks, HSBC and Chartered, which helped fund emergency loans to banks facing runs (Goodstadt 2005).

Figure 1: Deposits for Banks in Hong Kong during the First Half of 1965 (HKD Millions)

Deposits of:	December 31, 1964	February 24, 1965	April 30, 1965	June 30, 1965
HSBC	2,188	2,364	2,379	2,558
Chartered Bank	485	485	556	573
All other banks	3,409	3,219	3,259	3,383

Source: Goodstadt 2005.

The government accumulated large fiscal surpluses, which were deposited in sterling accounts in London. The government could transfer these funds into the colony, increasing the supply of the reserve currency used to back HKD liquidity (Goodstadt 2007, 186, 189). During April and May in 1965, the government transferred reserves from London into the the Hong Kong banking system to provide additional liquidity support for various distressed local banks (FEER 1966, vol. 52, 67–69; Jao 1974, 261).

8. Program Size: HSBC and Chartered issued HKD 354 million worth of notes to meet the demand for currency; aggregate government liquidity injections into Chinese-owned banks peaked at HKD 163 million.

Measured in terms of certificates of indebtedness—which HSBC and Chartered received when transferring sterling to the Exchange Fund for the right to issue currency—note issues totaled HKD 354 million during the crisis period (Nugée 1995).

At its peak, emergency liquidity provided by the government to local banks amounted to HKD 163 million, HKD 104 million of which was channeled through HSBC (Goodstadt 2005, footnote).

9. Individual Participation Limits: There was no indication of participation limits, with most emergency loans providing "unlimited" support.

At first, HSBC extended limited support in the amount of HKD 25 million to Canton Trust amidst its deposit run (Schenk 2003). While the public perceived HSBC's support for Canton Trust as being unlimited, HSBC subsequently corrected the record and noted that unlimited support would be impossible. Thereafter, deposit runs intensified, resulting in the closure of Canton Trust and the spread of contagion to other local Chinese banks (Jao 1974, 246). Following Canton Trust's failure, HSBC and Chartered Bank declared "unlimited support" as they each extended emergency loans to these distressed banks (Jao 1974, 246).

10. Rate Charged: Typically, HSBC and Chartered Bank charged overnight market rates.

The exact rates charged on emergency loans to vulnerable banks were not publicized. However, Goodstadt (2005) notes that HSBC—in its role as LOLR—charged "whatever overnight rates the market would bear" during panics. During 1965, interbank interest rates ranged from 5.0% to 7.4% annually, peaking during the months of January and February (Government of Hong Kong 1969; Jao 1974, 76). In 1965, HSBC's deputy chief manager, Oliphant, stated that HSBC and Chartered Bank provided LOLR cash loans at commercial rates (FEER 1965, vol. 48, 177).

Additionally, the 0.84% spread that the Exchange Fund charged HSBC and Chartered for the redemption of CIs (which were noninterest bearing) for sterling represented a cost for these banks to provide HKD liquidity (McCarthy 1985; Nugée 1995). With the high demand for currency at the beginning of 1965, HSBC and Chartered petitioned the government to remove the spread for the stability of the banking system. The government agreed to the demands and abolished the spread, allowing HSBC and Chartered to more freely issue banknotes during the crisis (Nugée 1995).

11. Eligible Collateral: Banks facing runs secured emergency loans with a broad range of unspecified assets.

The limited publication of financial data makes it challenging to identify the collateral used to secure emergency interbank loans from HSBC and Chartered Bank during the 1965 crisis. However, Oliphant described the various types of collateral accepted for LOLR support as “mortgageable assets, securities, foreign balances or secured advances” (FEER 1965, vol. 48, 177). At the time, banks in Hong Kong did not have access to a functioning bond market, and the government managed its budget without issuing any Treasury bills, limiting the available collateral options (Jao 1974, 74).

During crises, emergency loans were most likely secured by a range of illiquid bank assets, as evidenced in the bank runs of 1961—a smaller crisis to that of 1965 also caused by the bursting of a real estate and stock market bubble (Schenk 2003). HSBC and Chartered Bank provided emergency loans to Liu Chong Hing Bank during a deposit run in 1961. Jao (1974, 239) notes that the terms of the loans were not publicized; however, leaked information suggested that real estate assets collateralized the transactions.

To collateralize HKD banknote issues, HSBC and Chartered Bank deposited sterling cash with the Exchange Fund. Under this arrangement, HSCB and Chartered Bank credited the Exchange Fund’s account with sterling and received HKD CIs at the official rate (Schenk 2009).

12. Loan Duration: Emergency lending did not stipulate a precise term, as evidenced by certain loans that extended for years after the crisis.

Despite the limited disclosure of lending arrangements, the details of phase four of the 1965 crisis suggest considerable accommodation for maturities and duration of lending activity. After HSBC’s acquisition of Hang Seng Bank, the banking disturbances stabilized, and the period of mass bank runs ended. However, in November 1965, a minor run ensued on Far East Bank, which, at the time, was the only licensed bank operating in violation of the liquidity requirement. Although the imminent failure of the bank did not necessarily threaten the system as a whole, HSBC, at the government’s request, extended emergency loans to Far East Bank. HSBC’s financial support continued into 1969 when Far East Bank was eventually taken over by another bank (Jao 1974, 249).

13. Other Conditions: Research could not determine other conditions on emergency loans.

Due to the lack of transparency surrounding the terms of emergency loans, we find no additional conditions aside from those previously identified.

14. Impact on Monetary Policy Transmission: To accommodate the large liquidity injections into distressed banks, the government declared British sterling a temporary legal tender and imported GBP 20 million.

As mentioned in Key Design Decision No. 3, Part of a Package, the government deployed a series of emergency liquidity measures on February 9 and 10 as bank runs continued to spread amongst local Chinese banks. Among the measures, the government declared British sterling notes as temporary legal tender in Hong Kong to accommodate the large demands on Hong Kong currency. This was followed by the importation of GBP 20 million sterling notes that were ultimately never circulated (Schenk 2003). Both Jao (1974, 247) and Schenk (2003) note that the provision for additional currency options in the form of sterling notes relieved the present currency shortage and prevented a cash crisis.

15. Other Options: Although the government initially permitted distressed banks to fail, public disapproval pushed the government to intervene and prevent future bank runs using the assistance of HSBC and Chartered Bank.

In the initial deposit runs on Ming Tak Bank and Canton Trust, the government allowed the banks to fail and took them over, which was consistent with the colonial government's laissez-faire banking policy. While Ming Tak Bank was amongst several unlicensed banks in Hong Kong, Canton Trust was officially licensed by the government, and its failure drew considerable public backlash from the bank's 100,000-plus depositors. Goodstadt (2007, 150) notes that the failure of Canton Trust marked a turning point for the government's approach to bank runs: from then on, the government aggressively combatted runs and tacitly ensured depositors' protection. Still, the repayment of depositors took time. For the remainder of the crisis, the government quickly intervened in bank runs, typically by requesting that HSBC and Chartered Bank provide unlimited emergency loans to distressed banks (Jao 1974, 246–49).

16. Similar Programs in Other Countries: There were no analogous lending programs in 1965 outside of Hong Kong.

Because the 1965 banking crisis was confined to Hong Kong's unique financial system, similar liquidity interventions did not take place in other countries.

17. Communication: HSBC, Chartered Bank, and the government all announced liquidity relief measures in the press and over the radio; however, inconsistent communication surrounding emergency liquidity assistance damaged confidence during the early stages of the crisis.

HSBC and Chartered Bank typically announced emergency loans for distressed banks over the radio and in newspaper advertisements (Jao 1974, 247). During the run on Ming Tak, the first bank run of the year, the banking commissioner published a statement that emphasized the isolated character of the panic, which did not threaten the otherwise sound banking system. Similarly, during the second phase of the crisis, the financial secretary made an announcement that there was sufficient liquidity in the banking system. However, the government's messaging did little to restore confidence in vulnerable banks (Jao 1974, 245–46).

HSBC first intervened in the 1965 crisis during the run on Canton Trust; the run subsided once HSBC communicated its intention to extend HKD 25 million in emergency funding to Canton Trust (Schenk 2003). Within one day of this announcement, however, HSBC issued a clarifying statement after realizing that the initial LOLR pledge had "unfortunately been misinterpreted to mean that [HSBC] was giving the Canton Trust unlimited support, which was impossible" (Jao 1974, 246). Following the clarification, runs on Canton Trust resumed and the bank was forced to close; thereafter, HSBC and Chartered Bank announced unlimited support when extending loans to banks facing runs.

18. Disclosure: Typically, HSBC and Chartered announced borrowers of emergency loans without disclosing the terms of such loans.

Our research could not determine the specific lending terms including rates, collateral, and loan maturities. In his coverage of HSBC and Chartered Bank's emergency loans during the 1961 bank runs, Jao (1974, 239) notes that lending terms were not disclosed; the same situation might have applied to the 1965 intervention. However, throughout the crisis, HSBC and Chartered Bank publicized each recipient of emergency loans. When a local Chinese bank experienced a run, either HSBC or Chartered Bank responded by announcing financial support. As a key feature of the emergency loans, these announcements utilized the reputations of the two large British banks in an attempt to assure creditors of distressed local banks (Jao 1974, 246–47).

Additionally, we have identified the amount lent to individual banks on two occasions in 1965: the runs on Canton Trust in February and on Far East Bank in November. Before its failure, Canton Trust received a loan of HKD 25 million from HSBC (Schenk 2003). Similarly, Far East Bank borrowed more than HKD 40 million in emergency loans from HSBC. Notably, another bank acquired Far East Bank years later with some portion of these obligations still outstanding (Jao 1974, 249). In these instances, the loan amounts may have been disclosed only after the failure of Canton Trust and the acquisition of Far East Bank.

The government also did not disclose specifics of its liquidity support to distressed banks. A letter from the banking commissioner to the financial secretary on September 2, 1965, revealed peak outstanding liquidity injections from the government, which totaled HKD 163 million (9.7% of local Chinese banks' combined liquidity) (Goodstadt 2007, 155, 271). It is difficult to determine the mechanics of this support, which Goodstadt (2007, 155) describes as "secret injections."

19. Stigma Strategy: Banks receiving emergency loans had already lost their depositors' trust, and participation in the loans did not produce stigma.

Throughout the crisis, HSBC and Chartered Bank extended emergency loans in order to stop deposit runs on local Chinese banks. At the beginning of the crisis, the initial announcement of HSBC's loan to Canton Trust helped assure depositors and temporarily stopped the run (Jao 1974, 246). As discussed in Key Design Decision No. 17, Communication, following

HSBC's clarification on the limits of its lending, future announcements of emergency lending proved less effective in averting runs. Nevertheless, HSBC and Chartered made sure to publicize subsequent lending in bank runs, demonstrating the absence of a stigma strategy in the emergency loans (Jao 1974, 247).

20. Exit Strategy: There is no indication that liquidity assistance offered throughout the crisis stipulated an exit plan; rather, the lending persisted so long as banks faced runs.

The exit from emergency liquidity support provided by the government, HSBC, and Chartered Bank did not follow a predefined strategy and was rather dictated by incidences of withdrawals from local Chinese banks. As private LOLRs, HSBC and Chartered responded to runs on various local banks by pledging emergency loans for individual banks facing runs; since such support constituted interbank loans, it did not follow a uniform policy with specific exit dates (Jao 1974, 246–47). As for the government's emergency liquidity policies introduced in February, research could not determine whether such announcements included exit strategies. While the emergency provisions imported GBP 20 million in British sterling notes authorized as temporary legal tender, the government found no need to ever circulate these notes as liquidity shortages affected local Chinese banks rather than the system as a whole (Schenk 2003). However, the assurance of emergency liquidity in the form of sterling notes enabled the government to promptly eliminate the temporary restriction on cash withdrawals within one week of its introduction (Jao 1974, 247). As such, the exit from the withdrawal restriction coincided with the physical delivery of sterling notes in Hong Kong (Schenk 2003).

The continued support HSBC and the government offered through 1965 and well into 1966 provides further evidence for the absence of an exit strategy. Although the waves of widespread bank runs ended by the third phase of the 1965 crisis in April, HSBC and the government supported two small banks in November 1965 and September 1966 (Jao 1974, 249–50).

Hong Kong's government also established permanent structural changes in 1965 following the episodes of bank runs in order to prevent similar panics in the future. These 1965 changes can be thought of as anticompetitive regulations protecting local banks, including a moratorium on new bank licenses that lasted through 1981 and the formal adoption of a cartel amongst licensed banks to fix interest rates on deposits[11] (Goodstadt 2006a). Scholarship has routinely criticized the government's pursuit of anticompetitive banking policies following the 1965 crisis. Schenk (2006) argues that such anticompetitive legislation addressed a misguided belief that Hong Kong was "overbanked" while failing to remedy the source of the 1965 crisis, namely, the failure of local banks to adhere to prudential norms. Similarly, Goodstadt (2007, 171) criticizes the 1965 structural changes for providing little

[11] Prior to the government's formal adoption of the cartel in 1965, HSBC organized an unofficial interest rate cartel to protect Hong Kong banks from competing for deposits by hiking interest rates (Goodstadt 2006a).

benefit to local banks through protectionist policies rather than developing a better system for prudential supervision.

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