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Journal of Banking & Finance 27 (2003) 2231–2248

Journal of BANKING & FINANCE

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Impact of deposit rate deregulation in Hong Kong on the market value of commercial banks

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Received 16 August 2001; accepted 18 April 2002

Abstract

This paper examines the effects of a series of events leading up to the deregulation of deposit interest rates in Hong Kong on the market value of banks. All the evidence suggests that banks earned rents from deposit interest rate rules (IRRs) and deregulation would lower these rents and hence bank market values. On average, the total abnormal return due to interest rates deregulation was around negative 4%. There is some evidence that large banks and banks with high deposit-to-asset ratio suffered a bigger drop in value, suggesting that these banks enjoyed a bigger subsidy under the IRRs.

JEL classification: G21; G28
Keywords: Deposit rate deregulation; Interest rate rules; Hong Kong banks

1. Introduction

The regulation of interest rates paid to bank depositors represents one form of government intervention in the financial market that may lead to misallocation of funds. In the last two decades, policy makers in countries with deposit rate regulations have started to relax those restrictions in order to limit or eliminate such

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[1] This research was conducted while I was visiting the Hong Kong Institute for Monetary Research.

0378-4266/$ - see front matter
doi:10.1016/S0378-4266(02)00322-9

distortions, from big countries like the US to small city-states like Hong Kong. The deregulation of deposit interest rates in the US has been studied extensively in the banking literature. For example, Dann and James (1982) found that stockholder-owned savings and loan associations (S&Ls) experienced statistically significant declines in equity market values at the announcement of the removal of rate ceilings on certain consumer certificate accounts and the introduction of short-term variable rate money market certificates, suggesting that S&Ls had earned economic rents from interest rate restrictions. Millon-Cornett and Tehranian (1989) studied the effects of the passage of the Depository Institutions Deregulation and Monetary Control Act of 1980 on bank shareholders' wealth; they found that small bank stocks experienced negative abnormal returns (AR), while large bank stocks incurred significantly positive AR, suggesting that the act resulted in an intra-industry wealth transfer. However, studies of interest rate deregulation in other countries are relatively few, and to my knowledge none exists for the case of Hong Kong which is considered an important international financial center.

This paper examines the effects of deposit interest rate deregulation in Hong Kong on bank equity values. Hong Kong has been well known for its laissez-faire economy. It has a highly competitive banking environment, with over 150 licensed banks in a city with only 1100 km^2 of land area. Furthermore, Hong Kong banks in general have a much higher deposit-to-asset ratio, averaging about 80% in 1999, than commercial banks in the US, which averaged only about 65%. Hence, given the somewhat different industrial organizational structure and balance sheet compositions among Hong Kong banks, it would be of interest to find out whether the effects of interest rate deregulation on Hong Kong banks were similar to those experienced in the US.

Since 1964, interest rates on bank deposits in Hong Kong have been regulated by a set of interest rate rules (IRRs) issued by the Hong Kong Association of Banks (HKAB) under the HKAB ordinance. The IRRs originally applied to interest rates paid by licensed banks to customers on Hong Kong dollar (HK$) deposits of less than $500,000 and with a maturity of less than 15 months. [2] Under the IRRs, no interest is paid on current accounts. Interest rates on other accounts covered by the IRRs are determined from time to time by the HKAB Committee after consultation with the Hong Kong Monetary Authority (HKMA) under delegated authority from the Financial Secretary of Hong Kong. The IRRs were in full operation until 1994, when the rules were first relaxed by removing the interest rate cap on certain types of time deposits. In May 2000, after the sovereignty of Hong Kong had been returned to China in 1997, and after the local economy had recovered from the Asian financial crisis, the HKMA announced steps to abolish the IRRs entirely.

This paper tests three hypotheses about the effects of deregulating deposit interest rates on bank equity values. The first hypothesis is the Subsidy Reduction Hypo-

[2] Specifically, the IRRs set rates on the following accounts: (a) current accounts (same as demand deposits); (b) savings accounts; (c) 24-hour call deposits; (d) 7-day call deposits; and (e) time deposits up to 15 months in maturity.