

**SECRET***Please file  
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SECRET  
DEYOU  
ORIEL  
FM HONG KONG  
TO DESKBY 201200Z FCO  
TELNO 3465  
OF 200940Z OCTOBER 86

STRICTLY PERSONAL FOR HUM, HONG KONG DEPARTMENT FROM GOVERNOR

YOUR TELNOS 2295 AND 2296 : FUTURE OF HONG KONG'S MONETARY AND FINANCIAL SYSTEM

1. I WAS NOT AT ALL ENCOURAGED BY WHAT THE MIDLAND BANK'S REPRESENTATIVE SAID AT THE MEETING WITH THE PUS. FAR FROM DEMONSTRATING A REAL UNDERSTANDING OF THE COMPLEXITIES AND SENSITIVITIES OF THE SITUATION IT SEEMED TO ME TO DEMONSTRATE NO (REPEAT NO) INSIGHT INTO EITHER THE POLITICAL OR FINANCIAL REALITIES AT THIS END OR IN PEKING. IT IS NOW CLEAR THAT IT IS THE MIDLAND BANK WHO ARE PUSHING HARD FOR THE MERGER, WHICH, AS THEY DESCRIBE IT, WOULD BE VERY MUCH ON THEIR TERMS. I WAS AMAZED BY THEIR SUGGESTION THAT SANDBERG MIGHT ACT ON HIS OWN ACCORD AT ANY TIME. FROM MY CONVERSATION WITH HIM, IT IS CLEAR THAT HE HAS NO SUCH INTENTION AND FULLY RECOGNISES THE COMMITMENTS HE HAS MADE TO THE PRIME MINISTER AND MYSELF.

2. THE MIDLAND BANK HAVE ESSENTIALLY PRODUCED YET ANOTHER VARIATION UPON A THEME, AND ONE WHICH CONTAINS ALL THE FEATURES THAT WE HAVE ALREADY IDENTIFIED AS BEING UNACCEPTABLE TO THE CHINESE AND ALSO TO THE FINANCIAL COMMUNITY IN HONG KONG. IT WOULD BE SEEN BY BOTH AS A FLIGHT FROM HONG KONG OF A BANK CENTRAL TO THE HONG KONG ECONOMY. THE ONLY SIGNIFICANT VARIATIONS FROM WHAT WAS EARLIER PROPOSED ARE FIRST, THE HIGHLY UNUSUAL AND SEEMINGLY INVIDIOUS TREATMENT TO BE ACCORDED TO HKSB SHAREHOLDERS, WHICH WOULD BE IMMEDIATELY RECOGNISABLE AS SUCH HERE: AND SECONDLY, IF WE UNDERSTAND IT CORRECTLY, THE FACT THAT HKSB RATHER THAN THE HOLDING COMPANY WOULD CONTINUE TO OWN BBME AND THE 51 PERCENT OF MARINE MIDLAND. WE WOULD DOUBT IF THIS LATTER CONCEPT IS IN LINE WITH HKSB THINKING OR WHETHER, IN THE CASE OF MARINE MIDLAND, IT WOULD BE ACCEPTABLE IN THE LONGER TERM TO THE US AUTHORITIES.

3. IT MUST BE STRESSED, TOO, THAT THE PROPOSAL WOULD NOT (NOT) BE ACCEPTABLE TO THE HONG KONG GOVERNMENT EVEN BEFORE 1997. THE PRESENT CONFLICTS OF INTEREST WHICH ARISE BETWEEN THE HKSB'S COMMERCIAL INTERESTS AS A BANK FIRMLY ROOTED IN HONG KONG AND ITS QUASI-CENTRAL BANKING FUNCTIONS ARE BARELY TOLERABLE NOW. THESE CONFLICTS OF INTEREST WOULD BE INTENSIFIED TO THE POINT OF UNACCEPTABILITY ONCE STRATEGY FOR THE GROUP WAS DETERMINED FROM OUTSIDE THE TERRITORY.

4. WE HAVE THE FOLLOWING MORE SPECIFIC POINTS:

(A) PARAGRAPH 5:

WE DO NOT UNDERSTAND WHY IT IS THOUGHT THAT THE HKSB WOULD BE VULNERABLE TO TAKEOVER BY AN UNWELCOME PREDATOR. APART FROM THE POWERS VESTED IN THE BOARD OF THE BANK TO PREVENT ANY PERSON FROM HOLDING MORE THAN ONE PERCENT OF HKSB SHARES, IT MUST BE CLEAR TO THE HKSB THAT THE HONG KONG GOVERNMENT COULD, AND WOULD, OPPOSE ANY SUCH MOVE AND THAT THEIR OPPOSITION WOULD BE DECISIVE.

(B) PARAGRAPH 10:

THE 40-40-20 CONCEPT WAS, OF COURSE, REPORTED TO HAVE BEEN PUT FORWARD WHEN SIR KIT MCMAHON FIRST SAW THE GOVERNOR OF THE BANK OF ENGLAND IN SEPTEMBER.

(C) PARAGRAPHS 12 AND 14:

IT CANNOT BE ACCEPTED THAT THE MIDLAND BANK ENJOYS ANY SPECIAL RELATIONSHIP WITH THE CHINESE AUTHORITIES. CLAIMS OF THIS SORT ARE CONSTANTLY BEING MADE BY EVERY BANK SEEKING TO DO BUSINESS WITH THE CHINESE. NOR IS THE HKSB'S RELATIONSHIP PARTICULARLY CLOSE. TO PUT THE REFERENCE TO THE HKSB'S LICENCE TO OPERATE IN THE SPECIAL ZONE IN CONTEXT, IT IS NOTEWORTHY THAT THIS PRIVILEGE IS SHARED BY THE UBIQUITOUS BANK FOR CREDIT AND COMMERCIAL INTERNATIONAL (BCCI) WHOSE CHEQUERED HISTORY IS WELL KNOWN TO THE TREASURY AND BANK OF ENGLAND.

5. SEE MIFT FOR AN ACCOUNT OF MY MEETING WITH THE SECRETARY OF STATE YESTERDAY.

YOUDE  
HMLNAN 3544.

LIMITED  
HD.HKD.  
PS.  
PS/MR. RENTON  
PS/PUS  
MR. GILLMORE  
MR. WILSON.

**SECRET**

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SECRET  
DEYOU  
ORIEL  
FM HONG KONG  
TO DESKBY 201200Z FCO  
TELNO 3466  
OF 200940Z OCTOBER 86

STRICTLY PERSONAL FOR HUM, HONG KONG DEPARTMENT FROM GOVERNOR

MIPT : FUTURE OF HONG KONG'S MONETARY AND FINANCIAL SYSTEM

1. WE DISCUSSED THE ISSUES ARISING FROM THE MERGER PROPOSED WITH THE SECRETARY OF STATE ON 19 OCTOBER IN THE LIGHT OF OUR CORRESPONDENCE SO FAR AND THE PUS DISCUSSIONS WITH THE MIDLAND REPRESENTATIVES.
2. THE BURDEN OF OUR ARGUMENT WAS THAT THE FIRST PROBLEM WAS TO RESOLVE THE QUESTION OF HONG KONG'S FUTURE MONETARY SYSTEM, AND IN PARTICULAR TO DECIDE WHAT FUNCTIONS NOW CARRIED OUT BY THE HKSB SHOULD BE TAKEN OVER BY THE HKG BEFORE 1997. THIS WOULD REQUIRE EXTREMELY DELICATE DISCUSSION WITH THE CHINESE AND WITH THE HKSB. AT THE PRESENT TIME, WE CANNOT FORESEE HOW THESE ISSUES WILL BE RESOLVED.
3. THE OUTCOME OF THESE DISCUSSIONS IS BOUND TO HAVE A DETERMINING EFFECT ON THE ACCEPTABILITY OF ANY MERGER AND, IF ACCEPTABLE, ITS EVENTUAL FORM. TO SEEK TO DEAL WITH THE MERGER-FIRST WOULD COMPLICATE THE DISCUSSION ENORMOUSLY AND INCREASE THE ALREADY CONSIDERABLE DIFFICULTIES RELATED TO THE MAINTENANCE OF CONFIDENCE IN HONG KONG. IT IS, THEREFORE, IMPORTANT TO DISENTANGLE THE QUESTION OF THE MONETARY SYSTEM FROM THE MERGER PROPOSALS: AND IN PARTICULAR NOT TO ALLOW THIS EXERCISE TO BECOME 'MERGER-LED'.
4. WE WERE CONCERNED THAT THERE WAS NOT SUFFICIENT APPRECIATION IN LONDON OF THE SERIOUS IMPLICATIONS OF FURTHER PREMATURE DISCUSSIONS WITH THE BANKS ON THE MERGER PROPOSALS, NOR OF THE DIFFICULTIES THAT WOULD BE POSED BY A CONSUMMATION OF THE MERGER BEFORE WE HAD COME TO SOME UNDERSTANDING WITH THE CHINESE WHAT CHANGES NEEDED TO BE MADE TO HONG KONG'S MONETARY SYSTEM BEFORE 1997.

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5. WE CAN SEE THAT THE VULNERABLE POSITION OF THE MIDLAND BANK IS A CONTINUING SOURCE OF WORRY FOR HMG: AND THAT WE THEREFORE NEED TO SET OUT IN THE PAPER FOR THE MINISTERIAL MEETING A VERY STRONG CASE FOR INSSRUCTING THE BANKS NOT TO PROCEED WITH THE DISCUSSIONS. TO SEEK TO SOLVE THAT PROBLEM AT THE EXPENSE OF HMG'S RELATIONS WITH CHINA, AND AT THE RISK OF DESTABILISING THE HONG KONG FINANCIAL SYSTEM, IS IN NO-ONE'S INTEREST, NOT EVEN THOSE OF THE BANKS' THEMSELVES.

6. APART FROM BEING UNACCEPTABLE TO THE HONG KONG GOVERNMENT, THE MERGER PROPOSALS NOW BEING PUT FORWARD BY THE MIDLAND MIGHT WELL NOT BE CONSISTENT WITH THE HKSB'S OWN IDEAS. HMG SHOULD NOT THEREFORE ALLOW ITSELF TO BE PUT IN A POSITION WHERE IT APPEARED TO GIVE APPROVAL TO THE DETAILS OF A COMMERCIAL ARRANGEMENT. INDEED, IT WOULD BE INAPPROPRIATE TO DISCUSS THE MERGER ARRANGEMENTS ANY FURTHER WITH THE BANKS AT THIS STAGE. THE FIRST AND ESSENTIAL STEP IS NOW TO OPEN A CHANNEL TO THE CHINESE SEMICOLON HENCE OUR PROPOSALS THAT THE FS SHOULD TAKE UP THE INVITATION FROM THE DEPUTY GOVERNOR OF THE PEOPLE'S BANK OF CHINA. IT MIGHT BE APPROPRIATE FOR JACOBS TO TAKE WITH HIM A LETTER FROM THE SECRETARY OF STATE TO WU XUEQIAN TO SHOW THAT THE INITIATIVE HAD THE FULL SUPPORT OF HMG. WE COULD OBVIOUSLY NOT DISCUSS WITH THE HKSB OUR IDEAS ON WHAT NEEDED TO BE DONE BEFORE 1997 UNTIL WE HAD A CLEAR PICTURE OF CHINESE THINKING ON THIS.

7. MIFT CONTAINS SUGGESTED AMENDMENTS TO THE PAPER IN YOUR TELNOS 2278-2280 IN THE LIGHT OF THIS DISCUSSION.

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HMLNAN 3545

LIMITED

HO. HKD.

PS.

PS/MR. RENTON

PS/PUS

MR. GILLMORE

MR. WILSON.

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**SECRET**

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SECRET  
DEYOU  
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FM HONG KONG  
TO DESKBY 201200Z FCO  
TELNO 3467  
OF 200940Z OCTOBER 86

STRICTLY PERSONAL FOR HUM, HONG KONG DEPARTMENT FROM GOVERNOR

MIPT : FUTURE OF HONG KONG'S FINANCIAL AND MONETARY SYSTEM

1. IN THE LIGHT OF THE FURTHER INFORMATION NOW AVAILABLE AND OUR DISCUSSION WITH THE SECRETARY OF STATE (MIPT), I OFFER THE FOLLOWING ADDITIONAL COMMENTS ON THE REVISED DRAFT OF THE PAPER TO MINISTERS (YOUR TELNOS 2278/80).
2. THE KEY POINT IS THAT NO PROGRESS CAN BE MADE ON THE QUESTION OF ANY MERGER INVOLVING HKSB (WHETHER WITH MIDLAND OR WITH ANYONE ELSE), UNTIL WE HAVE A CLEARER PICTURE OF THE IDEAS OF THE CHINESE AUTHORITIES ON THE FUTURE MONETARY AND FINANCIAL STRUCTURE OF THE TERRITORY AND UNTIL WE HAVE DEVELOPED OUR OWN THINKING ON WHAT CHANGES NEED TO BE MADE BEFORE 1997. THIS IS NOW SO SELF-EVIDENT AS FAR AS WE ARE CONCERNED THAT WE SUGGEST YOU CONSIDER REVERSING THE ORDER OF OPTIONS (I) AND (II).
3. IN ANY EVENT, IN DISCUSSION OF THE PRESENT OPTION (II) YOU SHOULD MAKE IT CLEAR THAT THE WIDER DIALOGUE IS SOMETHING WHICH, REGARDLESS OF THE PROPOSED MERGER, NEEDS TO BE INITIATED AS A MATTER OF SOME URGENCY, PARTICULARLY AS THE DEBATE ON FUTURE MONETARY AND FINANCIAL ARRANGEMENTS, AND IN PARTICULAR WHETHER HONG KONG NEEDS A CENTRAL BANK, IS HOTTING UP HERE IN HONG KONG (WE HAVE SENT YOU RECENT CONTRIBUTIONS FROM DAVID LI AND SIR MICHAEL SANDBERG) AND THE BASIC LAW DRAFTING COMMITTEE ARE LIKELY SHORTLY TO TURN THEIR ATTENTION TO THIS SUBJECT.
4. IT WILL ALSO BE NECESSARY TO ADD A PARAGRAPH UNDER THE EXAMINATION OF THE PRESENT OPTION (I), POINTING TO THE IMPOSSIBILITY OF LETTING THE BANKS GO AHEAD ON WHAT WOULD IN EFFECT BE A FALSE PROSPECTUS. THE VALUE OF HKSB'S CONTRIBUTION TO THE MERGED INSTITUTION CAN ONLY PROPERLY BE DETERMINED WHEN IT BECOMES KNOWN IN THE COURSE OF DISCUSSIONS WITH THE CHINESE AUTHORITIES TO WHAT EXTENT HKSB WILL BE ABLE TO RETAIN ANY OF ITS PRESENT CENTRAL BANKING FUNCTIONS. ADDITIONALLY WE HAVE ONLY THE MIDLAND'S ACCOUNT OF WHAT THEY WOULD LIKE TO SEE: THE HKSB HAVE NOT YET SHOWN THEIR HAND.

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5. I FEEL YOU SHOULD ALSO MAKE IT CLEAR THAT THE STRUCTURE REFERRED TO IN PARA 17 OF THE PAPER IS INTENDED ONLY TO BE ILLUSTRATIVE OF THE POSSIBLE MINIMUM ACCEPTABLE TO THE CHINESE. IT IS INCOMPLETE AND INDEED COULD NOT BE COMPLETED WITHOUT SUBSTANTIALLY MORE INFORMATION THAN WE HAVE ABOUT CHINESE PERCEPTIONS AND HKSB INTENTIONS ON THE FUTURE OF THE FINANCIAL SYSTEM. IT IS CERTAINLY NOT SOMETHING WHICH CAN BE FLOATED OVER EITHER HKSB OR MIDLAND. INDEED ANY FURTHER DISCUSSION WITH THESE BANKS ON THE SUBJECT OF STRUCTURE SEEMS TO US DANGEROUS AS IT WOULD BRING EVEN NEARER THE POINT OF TIME AT WHICH A "NOTIFIABLE TRANSACTION" REQUIRING PUBLIC DISCLOSURE OCCURS.

6. FINALLY, I THINK THAT THE PAPER AS A WHOLE NEEDS TO BRING OUT MORE CLEARLY THE POINT THAT WE NEED URGENTLY TO ADDRESS OURSELVES TO THE ISSUES SET OUT IN THE BANK OF ENGLAND PAPER WHICH I WAS SHOWN IN LONDON IN SEPTEMBER. THIS IS A PREREQUISITE FOR ANY SUBSTANTIVE DIALOGUE WITH THE CHINESE ON THE FUTURE OF THE HKSB, AND THUS FOR ANY FURTHER CONSIDERATION OF THE MERGER PROPOSALS.

7. IT FOLLOWS THAT I SEE NO POINT IN DISCUSSING IN DETAIL ON 24 OCTOBER THE IMPLICATIONS OF THE MIDLAND'S PROPOSED STRUCTURE NOR, IN THE LIGHT OF IT, OUR ILLUSTRATIVE IDEAS (LAST PARAGRAPH, YOUR TELNO 2294). IF, HOWEVER, YOU FEEL IT WOULD BE HELPFUL FOR DAVID NENDICK TO BE PRESENT AT THAT MEETING TO EMPHASISE THE REALITIES OF THE SITUATION IN HONG KONG AND THE POLITICAL ARGUMENTS AS SEEN FROM HONG KONG, I WOULD BE HAPPY FOR HIM TO ATTEND. HE COULD ALSO DISCUSS WITH THE BANK OF ENGLAND THE PAPER WHICH I WAS SHOWN IN LONDON IN SEPTEMBER, WHICH AS STATED ABOVE IS ONE OF THE KEY DOCUMENTS IN THIS WHOLE EXERCISE AND WHICH WE NEED TO DEVELOP AS A PREPARATION FOR THE EVENTUAL DISCUSSIONS WITH THE CHINESE.

YOUDE  
4NLNAN 3546

LIMITED

HO. HKD.

PS.

PS/MR. RENTON

PS/PUS

MR. GILLMORE

MR. WILSON.

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SECRET

DEYOU

FM HONG KONG

TO DESKBY 201200Z FCO

TELNO 3468

OF 200940Z OCTOBER 86

STRICTLY PERSONAL FOR HUN, HONG KONG DEPRMENT FROM GOVERNOR

MY SECOND IPT : FUTURE OF HONG KONG'S MONETARY AND FINANCIAL  
SYSTEM

1. I THINK THE SECRETARY OF STATE APPRECIATED THE ARGUMENTS  
WHICH WE PUT TO HIM AND SHARED OUR CONCERN ON MANY OF THE POINTS.  
YOU WILL WISH TO CHECK WITH GALSWORTHY ON THEIR RETURN.

YOUDE

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HMLNAN 3547

LIMITED

HO. HKD.

PS.

PS/MR. RENTON

PS/PUS

MR. GILLMORE

MR. WILSON.

SECRET DEYOU