REVIEW OF CODE OF BANKING PRACTICE
CHAPTER 2 – ACCOUNTS AND LOANS

1. Purpose

1.1 This paper sets out the changes proposed by Informal Working Group (IWG) to strengthen the provisions contained in the Code of Banking Practice (the Code) in relation to account and loan services provided by authorised institutions.

2. Background

2.1 In 1999, the HKMA undertook to deregulate the remaining interest rate rules (IRRs) of the Hong Kong Association of Banks (HKAB) by two phases. The first phase of deregulation covering time deposits with a maturity of under 7 days was implemented in July 2000. The second and final phase covering current and savings account deposits is scheduled to take place in July 2001.

2.2 After the second phase of deregulation, all HK$ deposits will no longer be subject to interest rate caps. It is likely that the IRRs issued by HKAB will be dispensed with substantially or entirely. Given that the IRRs contain a number of requirements on member banks to observe certain best practices, it is desirable that these rules are incorporated into the Code and therefore retained.

2.3 From a self-assessment exercise conducted by 44 major retail banks last year, it is envisaged that banks may react to deregulation by increasing fees and charges (Indeed, some banks have already announced changes to their fees and charges). This is partly in anticipation of the forthcoming deregulation, but also a response to increasing pressure on interest margins as result of intensified competition in the banking industry. To prepare for these changes, there is a need to enhance the relevant provisions contained in the Code to provide more detailed guidance to banks in relation to the setting and revision of fees and charges.

2.4 The opportunity is also taken to amend certain provisions pertaining to the operation of deposit and loan accounts.

3. Recommended practices

3.1 Institutions should advise customers of the interest rate, if any, that will apply on time deposits which have matured but have not been renewed or withdrawn.

3.2 **If the date of maturity of a time deposit falls on a day which is not a business day, the deposit shall be deemed to mature on the succeeding business day.**

3.3 **Institutions should provide customers with a contemporaneous receipt or advice for deposits at call or notice or fixed deposits which should show the date of deposit, the rate of interest, and, in the case of fixed deposits, a single date of maturity.**

The IWG considers that the above best practices set out in the IRRs of HKAB should be incorporated into the Code in anticipation of the second phase of deregulation. The retention of these rules can help to minimise any potential dispute between AIs and their customers in the taking of time deposits. AIs are expected to follow these practices insofar as they are applicable to them (e.g. since DTCs are only allowed to take deposits with a maturity of 3 months or above, the third recommendation is only partially applicable to them).

3.4 **Institutions should give at least 30 days' notice to affected customers before any change in the level of fees and charges (including any change in the basis on which fees and charges are determined) takes effect, unless such changes are not within their control. Institutions should adopt effective means of notification which would provide reasonable assurance that their customers will be informed of the change and which do not rely unduly on the customers' own initiative. Individual notification of customers (whether by written notice, statement insert or email message) is likely to be effective in achieving these objectives. But where this is not appropriate on grounds of disproportionate costs or likely ineffectiveness (e.g. in the case of passbook savings accounts where the latest address of the customers may not be known to the institution), institutions may adopt other means of notification, such as one or more of the following:**

(i) **press advertisement;**
(ii) **prominent display of notice in banking halls;**
(iii) **display of notice on ATM sites/screens;**
(iv) **phone-banking message; and**
(v) **notice posted on the website of the institution.**

In accordance with section 6.3 of the Code, AIs should give 30 days' notice to affected customers before any change in fees and charges takes effect. The Code, however, does not specify how such notice should be given to affected customers.

To meet this requirement, it is noted that institutions usually display an updated list of all fees and charges at their branches 30 days before adjustments to their fees and charges take effect. However, not all customers may visit branches.

Simply displaying an updated list of fees and charges at the branches is therefore not a sufficient way to draw customers' attention to the fee adjustment.

To enhance the transparency of fee adjustment, it is important that institutions should first of all give affected customers a notice of fee adjustment showing clearly the variation, rather than just an updated list of fees and charges. In addition, the notice should indicate how affected customers can seek assistance from institutions if they do not agree to the change (e.g. how they can terminate the relevant service if they so decide).

Regarding the way through which the notice of fee adjustment should be disseminated, the IWG believes that institutions should make their best endeavours to inform affected customers of the impending revisions in fees and charges. It is considered that sending an individual notice to each affected customer is an effective means of notification. Many account holders already receive regular monthly statements from institutions, and the notice can simply be provided by means of a letter or a statement insert mailed to the affected customers.

However, this means of notification may not be appropriate in the case of passbook savings accounts. Since a large number of these accounts were opened years ago, institutions may not have the current address of the account holders. The lack of the latest address of the account holders will affect the effectiveness of this means of notification. Moreover, the requirement of individual notification may increase the cost of providing passbook savings accounts, which might eventually be passed onto the account holders. The IWG therefore considers that other means of notification such as a newspaper advertisement is more likely to be read by an affected customer than a letter with an incorrect address.

In view of the above, it is considered that, where individual notification is not appropriate on grounds of disproportionate costs or is unlikely to be effective, institutions should be given some flexibility in determining which means of notification is most appropriate in informing customers of the fee adjustments. They should adopt other means of notification that provide reasonable assurance that customers will be informed of the change and that do not rely unduly on the affected customers' own initiative to know of the change. Effective notification may require a combination of the measures set out in paragraph 3.4.

3.5 Institutions should inform customers of the basis on which fees and charges on deposit accounts will be determined.

After the final phase of deregulation, AIs may introduce different types of charges on deposit accounts. The level of these charges may vary depending on the profitability of individual customers to the banks and the nature of banking services offered. For example, savings and current account holders may be required to pay a charge if the average monthly balance of their accounts falls below a predetermined minimum amount, or the number of cheques issued by them exceeds a specified level. While there is a provision in the Code which requires AIs to inform customers of the basis on which interest will be determined (see section 17.2(b) of the Code), there is currently no similar provision in respect of fees and charges. The IWG considers that the above provision should be incorporated into the Code after section 17.2(b).

3.6 The number of days used as the basis of interest calculation for loans and deposits should be consistent.[1]

At present, there is no standard practice in respect of the bases on which interest for loans and deposits is calculated. Some institutions calculate interest on a monthly basis and some on a daily basis, some using 365 days for ordinary years and 366 for leap years as the basis of interest computation, and others simply using 365 days for any year (see formula below).

Interest for the relevant month
= Outstanding balance at the end of preceding month X interest rate
X number of days in the relevant month / 365 or 366 days (depending on whether it is a leap year and the method of calculation adopted)

The Consumer Council has pointed out that institutions which use 365 days as the basis for calculating <u>mortgage</u> interest could have charged their customers one extra day of interest during leap years (because the total number of days in the numerator is 366 whereas that in the denominator is 365 only).[2] Some mortgagors complained that this calculation method is unfair to them and therefore should not be used.

In this connection, it should be noted that it is a market convention to assume 365 days in all years in calculating interest for HKD interbank borrowing or

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1 This provision will not apply to mortgage loans retrospectively. It is noted that the basis of interest calculation is usually stated in mortgage deeds and a change in the basis for interest calculation would entail amendments to these legal documents which would incur extra costs to either the customer or the institution. To avoid these unnecessary costs, institutions should be allowed to continue to use the calculation method stipulated in the mortgage deeds of existing customers.

2 This provision does not affect loans where interest is calculated on a monthly basis. The problem of charging customers an extra day of interest during leap years does not arise as the formula for interest computation is unaffected by the leap year problem:-

Interest for the relevant month = Outstanding balance X interest rate X 1/12 lending. A significant number of institutions, particularly those which rely on interbank borrowing for funding, also follow this basis to calculate interest for deposits and loans in order to avoid interest mismatch on their asset and liability sides. Therefore, it may be unreasonable to require AIs not to use 365 days as the basis of interest calculation in leap years.

Nevertheless, it is agreed that AIs should not take advantage of this technicality of interest calculation (i.e. by using a different number of days in relation to deposits and loans). In accordance with sections 17.2 and 18.2 of the Code, they should inform customers of the basis on which interest will be determined, including the numbers of days in both ordinary and leap years that are used as the basis of calculation. Moreover, those institutions which use the 365-day year method to calculate interest on deposits should use the same basis to calculate interest on loans.

3.7 Institutions should give 14 days' prior notice to customers when a charge accrues on dormant accounts for the first time.

Section 6.5 of the Code states that institutions should inform customers of the nature and amount of any charges debited to their accounts promptly after such charges are debited. Many institutions, however, notify customers of dormant accounts (i.e. accounts which have not been operated for at least 6 months) before charges are debited from these accounts. This is considered to be a good practice which can avoid potential disputes between institutions and customers of dormant accounts and should be followed by all AIs.

The IWG has considered whether AIs should be required to give a prior notice to customers whenever a charge is debited from dormant accounts. In this connection, it is noted that some institutions may charge dormant accounts on a more regular basis (e.g. monthly). If they are required to give a prior notice to customers whenever a charge is debited from dormant accounts, this may incur significant costs to them. These costs would likely be passed onto the holders of the dormant accounts. Moreover, such a requirement would also defeat the purpose of imposing a service charge on dormant accounts to encourage customers to use account services in a more efficient manner (e.g. closing unused accounts) so as to promote the efficiency of account operations.

3.8 Institutions should set out in their terms and conditions the circumstances under which they would exercise their right of set-off.

Section 16.3 of the Code provides that institutions should inform customers promptly after exercising any right of set-off. To provide greater transparency of the operation of the right of set-off, AIs should set out in their terms and conditions the circumstances under which they would normally exercise their right of set-off.

4. Implementation

4.1 Recommended practices 3.4 and 3.5 are effective from 15 June 2001 in view of the impending deregulation of the remaining IRRs in early July 2001. Authorised institutions should adopt these recommended practices as quickly as possible but in any event not later than the effective date. Other recommended practices in this paper will become effective on a date to be specified later upon completion of review of the Code.

Hong Kong Monetary Authority
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