



香港存款保障委員會
HONG KONG DEPOSIT
PROTECTION BOARD

Briefing to Legislative Council Panel on Financial Affairs

6 March 2006



香港存款保護局
HONG KONG DEPOSIT
PROTECTION BOARD

(I) Purpose

- To update LegCo on the latest progress in relation to the establishment of the Deposit Protection Scheme (DPS) in Hong Kong

(II) Background

- Enactment of DPS Ordinance in May 2004
- Formation of Hong Kong Deposit Protection Board in July 2004
- The Board currently consists of 5 appointed members and 2 ex officio members who are responsible for the establishment of the DPS

3

- The DPS Ordinance, providing for the establishment of a DPS in Hong Kong, was passed by the Legislative Council in May 2004. Under the DPS Ordinance, a deposit protection scheme with a coverage limit of HK\$100,000 per depositor per bank will be established to provide a measure of protection to depositors and to contribute to the stability of the banking system.
- An independent board called the Hong Kong Deposit Protection Board was established in July 2004 to establish and administer the DPS.
- Currently, the Board consists of 5 members appointed by the Chief Executive of the HKSAR and 2 ex officio members representing the Monetary Authority and the Secretary for Financial Services and the Treasury.



香港存款保護委員會
HONG KONG DEPOSIT PROTECTION BOARD

Composition of the Board

Professor Andrew Chan Chi-fai	Chairman & Member
Mr Ian Chapman	Member
Dr David Cheung Wai-lok	Member
Mr Nicholas Peter Etches	Member
Mr Nam Lee-yick	Member
Monetary Authority (represented by DCE(B) / HKMA)	Ex officio member
Secretary for Financial Services and the Treasury (represented by PSFS)	Ex officio member

4

- Members of the Board come from different professions such as accounting, banking, consumer protection, insolvency law, information technology and public administration. The Monetary Authority is represented by Deputy Chief Executive (Banking) of the HKMA and the Secretary for Financial Services and the Treasury is represented by Permanent Secretary for Financial Services and the Treasury (Financial Services).



Performance of Functions

- According to section 6 of the DPS Ordinance, the Board shall perform its functions through the Monetary Authority unless otherwise directed by the Financial Secretary
- The HKMA has assigned an Executive Director and a team of staff to assist the Board. The Executive Director is authorised to discharge his duties for the Board as its CEO
- The Board has also employed its own legal counsel and a payout consultant
- More details in the first annual report of the Board submitted to LegCo in Oct 2005

5

- Pursuant to Section 6 of the DPS Ordinance, the Board shall perform its functions through the Monetary Authority unless otherwise approved by the Financial Secretary. This means that the HKMA will act as the executive arm of the Board in carrying out the day-to-day administration of the scheme and will, in this respect, be subject to the oversight of the Board. Such arrangement can allow the Board to minimise its operating costs during normal times.
- The HKMA has assigned an Executive Director and a team of staff to assist the Board in establishing the DPS. The Executive Director is authorised to discharge his duties for the Board as its CEO. Other major types of support services provided by the HKMA include accounting, administration, human resources and information technology.
- The Board has also employed an in-house legal counsel to advise on legal matters and a payout consultant to help establish the payout system and procedures.
- The first annual report of the Board containing the detailed resource arrangement of the Board was submitted to LegCo in Oct 2005.



Recent Developments

- The Board is making the necessary preparations for the launch of the DPS
- As will be shown in the next section, good progress has been made by the Board in the past 20 months

6

- There is a large volume of preparatory work to be completed before deposit protection can commence. Since its inception in July 2004, the Board has developed a two-year project plan for establishing the DPS. For the past 20 months, the Board has made good progress in the establishment of the DPS.



香港存款保護委員會
HONG KONG DEPOSIT
PROTECTION BOARD

(III) Major Preparatory Tasks

1. System for assessment of contributions
2. Development of rules and guidelines governing the operation of the DPS
3. Payout infrastructure
4. Publicity campaign
5. Others



1. System for Assessment of Contributions

- Scheme members submitted the first deposit returns and the HKMA provided the supervisory ratings in Dec 2005
- Ready to assess the amount of contributions payable by Scheme members in 2006

8

- The Board has already developed a system for assessing the amount of annual contributions payable by a Scheme member with reference to the amount of relevant deposits held by the Scheme member and its supervisory rating assigned by the HKMA.
- Scheme members have submitted the first return of relevant deposits to the Board, and the HKMA has provided the Board with the relevant supervisory ratings of Scheme members in Dec 2005. With the required information, the Board is ready to assess the amount of contributions payable by Scheme members in 2006.



2. Development of Rules and Guidelines Governing the Operation of the DPS

- 3 sets of rules to be tabled before LegCo for negative vetting:
 - i) Rules on Payment of Contributions
 - ii) Rules on Representations
 - iii) Asset Maintenance Rules
- Information system guideline

9

- The Board and the MA are empowered under the DPS Ordinance to make rules governing the operation of the DPS. These rules will be promulgated in the form of subsidiary legislation and therefore will be subject to negative vetting by the LegCo.
- The two sets of rules to be issued by the Board are:
 - i) Rules on Payment of Contributions
 - ii) Rules on Representations
- The Asset Maintenance Rules will be issued by the MA.
- The above rules are now being finalised and will be tabled before LegCo soon.
- Apart from the rules, the Board has also recently issued an information system guideline.
- Details of the rules and the guideline are explained below.



i) Rules on Payment of Contributions

- Specify the manners in which Scheme members should pay the contributions and late payment fees (if any) to the Board
- Industry consulted and only has minor technical comments

10

- The purpose of the Rules on Payment of Contributions is to specify the manners in which Scheme members should pay the contributions and any late payment fees to the Board.
- In principle, a Scheme member is required to pay contribution not later than 21 days from the date of the demand notice issued by the Board. The Board will impose a late payment fee on a Scheme member if there is any delay in payment of contribution.
- As this set of rules is relatively straight forward, the industry has only some minor technical comments in response to our consultation on the draft rules, and the draft rules are close to finalization.

ii) Rules on Representations

- Display the DPS Membership Sign in local branches
- Restrictions on advertisement of membership status and protected deposits
- Negative disclosure to customers and obtain their acknowledgement before purchase of non-protected deposits

11

- The Rules on Representations are to govern the representations that should be made by Scheme members regarding their membership as well as the coverage of the DPS. The requirements to be included in the rules are developed with reference to the practice of leading deposit insurers in the US, UK and Canada.
- The major requirements are as follows:
 - A Scheme member is required to make known to the public that it is a member of the DPS by displaying the DPS membership sign in its local branches
 - If an advertisement contains any information to the effect that a Scheme member is a member of the DPS or a financial product offered by the Scheme member is a protected deposit, the information relating to the membership or the protected deposit must take a specified format:

“[Name of the Scheme member] is a member of the Deposit Protection Scheme. Eligible deposits taken by this Bank are protected by the Scheme up to a limit of HK\$100,000 per depositor.”
 - In addition, if an advertisement covers both protected and non-protected deposits, the Scheme member shall clearly specify which product is not protected by the DPS.
 - Before a customer purchases a non-protected deposit product, a Scheme member is required to make a negative disclosure to the customer and obtain his acknowledgment of the fact that the product is not a protected deposit and is not protected by the DPS.



香港存款保護委員會
HONG KONG DEPOSIT PROTECTION BOARD

ii) Rules on Representations

- Notify customers when protected deposits become unprotected by the DPS (e.g. extension of maturity date to over 5 years or the depositor pledges the deposit as security for credit facilities) and obtain their acknowledgement
- Industry and Consumer Council agree with the principles

12

- It is possible that a protected deposit may become unprotected due to a subsequent change in terms and conditions or provision of banking services (e.g. extension of the maturity date to over 5 years or the depositor pledges his deposit with the Scheme member as security for credit facilities). If this happens, the Scheme member is required to make a negative disclosure to the customer and seek the customer's acknowledgement.
- The Board has consulted the industry and the Consumer Council on the major principles to be incorporated in the rules and they generally agree with the proposed principles.



iii) Asset Maintenance Rules

- Purpose is to require troubled Scheme members to maintain sufficient assets in Hong Kong to meet the priority claims of depositors such that the potential shortfall loss of the Board can be minimised
- Circumstances under which the MA may impose the asset maintenance requirements are specified

13

- The Asset Maintenance Rules aim to empower the MA to require troubled Scheme members to maintain sufficient assets in Hong Kong to meet the priority claims of depositors up to HK\$100,000 per depositor. If the assets available in the liquidation is insufficient to meet all the priority claims, it is possible that the Board will suffer a larger shortfall loss (i.e. money recoverable from the liquidator not sufficient to cover compensation paid to depositors).
- In general, the MA may impose an asset maintenance requirement on a Scheme member if he is of the opinion that the Scheme member is likely to become unable to meet its obligations, to suspend payment to its depositors or to become insolvent, or is carrying on its business in a manner detrimental to the interests of its depositors.



香港存款保障局
HONG KONG DEPOSIT PROTECTION BOARD

iii) Asset Maintenance Rules

- Types of eligible assets and the relevant discount ratios are defined
- To consult industry on rule drafting shortly

14

- Major types of eligible assets include cash, gold, securities, claims on authorized institutions, shares, real property, loans and residential mortgages. The discount ratios vary from 0% to 50%, depending on the marketability and quality of the assets.
- The draft rules will be available for industry consultation shortly.



iv) Guideline on Information Systems

- Require Scheme members to keep and provide information in specified formats
- Facilitate expeditious determination and payment of compensation to depositors
- Tests will be conducted to ensure compliance with the guideline

15

- The guideline requires Scheme members to keep and provide information to the Board in specified formats. This is to ensure that the Board can determine entitlement to compensation and pay compensation to depositors in a speedy manner. After consulting the industry, the Board issued the requirements in the form of a guideline in Feb 2006.
- In order to ensure compliance with the guideline, the Board will conduct simulation tests to check whether the relevant data from Scheme members can be properly processed by the Board's payout system.

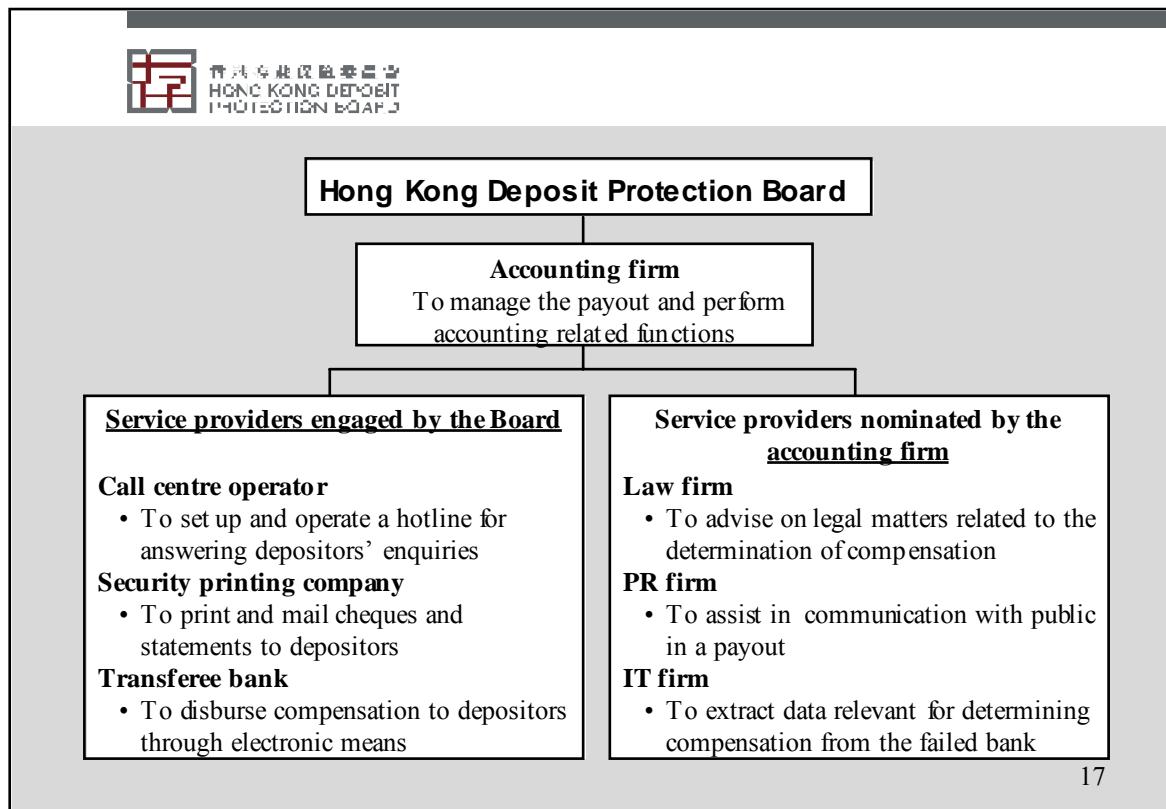


3. Payout Infrastructure

- Payout system development is progressing well
- Payout procedures are being finalised
- Secured a standby facility from Exchange Fund to ensure prompt payments of compensation to depositors when there is a bank failure
- Selected service providers to assist in payouts

16

- In order to maintain public confidence in the DPS, it is important for the Board to make compensation to depositors expeditiously. The Board therefore is developing a payout system to ensure quick determination and disbursement of compensation to depositors. The development of the payout system is progressing well and the user-acceptance tests are now underway.
- The payout procedures are being written in the form of a comprehensive manual, which will set out the key payout processes and various payout activities. This can allow the Board together with the selected service providers to perform the payout functions in a co-ordinated and efficient way.
- The Board has secured a standby facility from the Exchange Fund to provide for the necessary liquidity requirement for payment of compensation to depositors in a payout.
- Under a payout situation, the Board requires external support to carry out different payout functions. Therefore, the Board needs to identify the suitable service providers in advance to ensure that the payout operation, if triggered, can be carried out in an efficient manner.



- After a careful study of different payout models, the Board considers that it is more appropriate to pre-engage an accounting firm to provide the necessary services required in a payout either by its in-house resources or its network of sub-contractors (subject to the Board's final approval).
- The accounting firm will play the role as a lead payout agent responsible for managing the payout project and recommending appropriate law firm, public relations firm and IT firm.
- On the other hand, the Board will also designate a call centre operator, a security printing company and a transferee bank to support the payout processes.



4. Publicity Campaign

- A must to ensure effectiveness of the DPS
- Intensive publicity activities shortly before and after the official launch of the DPS
- TV and radio commercials for 4 to 6 weeks
- Information leaflets to be distributed through the branch networks of Scheme members
- Exhibitions at major shopping malls in the two-month period after the launch of DPS
- On-going publicity activities to maintain awareness of the DPS

18

- The effectiveness of the DPS to contribute to banking stability hinges on the level of public confidence in the DPS. For the DPS to be effective, it is essential that the public are well informed of its benefits and limitations.
- The objective of the publicity campaign is to notify the public of the launch of the DPS and to increase their awareness of the Scheme's key features. The promotional activities will start shortly before the official launch of the DPS.
- TV and radio commercials will be broadcast for 4 to 6 weeks to reinforce the message that the DPS has started offering deposit protection.
- Information leaflets will be distributed through the branch networks of Scheme members. The leaflet will provide the public with more detailed information about the DPS.
- Exhibitions will be conducted at major shopping malls and MTR stations in the two-month period following the launch of the DPS.
- The Board will develop an on-going strategy for maintaining a high level of public awareness of the DPS.

5. Others

Proposing amendments of Schedules 1 and 4 to the DPS Ordinance:

- Schedule 1: to clarify the treatment of structured products under the DPS
- Whether a structured product constitutes a deposit needs to be determined on a case-by-case basis, therefore, high operational costs and uncertainty to bank customers
- Many structured products are not deposits. Even if they are deposits, the holders are likely to be large depositors

19

- The Board is proposing to amend Schedules 1 and 4 of the DPS Ordinance in the light of the experience in the establishment of the DPS.
- The amendment of Schedule 1 is mainly to clarify the treatment of structured products under the DPS.
- Structured products are complex financial products of which the returns depend on the performance of a financial asset, financial index or the occurrence of a specified event (e.g. whether a company has defaulted payment). Typical examples are equity-linked notes, credit-linked notes, inverse floaters and ranger accruals.
- The Board has sought legal opinions as to whether structured products are “deposits” and thus are protected by the DPS. The legal opinions received point out that whether a structured product constitutes a deposit and hence be protected by the DPS should be determined on a case-by-case basis having regard to the terms and conditions of a particular product. Scheme members will incur high operational costs to identify whether a structured product is protected by the DPS and correctly advise their customers of the same. The uncertainty regarding the protection of structured products under the DPS Ordinance is undesirable to the Board and the public.
- According to a survey conducted by the Board, many structured products existing in the market are not deposits. Even if they are deposits, the majority of the holders of structured products are large depositors.



5. Others

- Proposes to exclude all structured products from DPS protection initially to provide absolute clarity to banks and depositors
- Very clear representation will be required
- Industry and Consumer Council agree to exclude structured products from protection, subject to review

20

- The Board also notes that the aggregate amount of structured products which can benefit from protection under the DPS, i.e. they are legally deposits and do not exceed the protection limit of HK\$100,000 on aggregation, is small.
- Taking into account all the above factors, it is considered that exclusion of all structured products from DPS protection can provide absolute clarity to banks and depositors without undermining the effectiveness of the DPS in terms of its ability to contribute to banking stability.
- The Board will require Scheme members to make very clear representation to customers buying structured products that will be excluded from protection by the DPS. Customer acknowledgement will be required.
- The industry and the Consumer Council agree to the Board's proposal to exclude structured products from protection subject to a regular review of the market development of structured products.



5. Others

Benchmarks for triggering a review:

- No. of depositors holding principal-linked or interest-linked products and having an aggregate deposit balance $\leq \$100,000$ with banks constitutes 3% or more of the total no. of depositors in Hong Kong
- No. of depositors holding either type of structured products and having an aggregate deposit balance $\leq \$100,000$ with banks constitutes 2% or more of the total no. of depositors in Hong Kong
- 24 months have lapsed after the launch of the DPS

21

- The Board has established a set of quantitative benchmarks for triggering a review of this matter:
 - No. of depositors holding principal-linked or interest-linked products and having an aggregate deposit balance $\leq \$100,000$ with banks constitutes 3% or more of the total no. of depositors in Hong Kong
 - No. of depositors holding either type of structured products and having an aggregate deposit balance $\leq \$100,000$ with banks constitutes 2% or more of the total no. of depositors in Hong Kong
 - 24 months have lapsed after the launch of the DPS
- The Board will reverse the exclusion if the review shows that the exclusion of structured products would materially affect the effectiveness of the DPS.



5. Others

- Schedule 1 & 4: miscellaneous amendments to improve the operation of the DPS
 - To allow Scheme members not to exclude deposits held by certain excluded persons in the assessment of contributions
 - To clarify that contributions for the first year will be assessed on a time pro-rata basis
 - To specify that Scheme members should report their deposit positions on the preceding day if 20 Oct of the year is a general holiday

22

- The Board also proposes other miscellaneous amendments with a view to improving the operation of the DPS.
- For assessment of contribution payment, each Scheme member is required to report the amount of relevant deposits for its position of 20 Oct on an annual basis which does not include deposits held by excluded persons (e.g. a related company of the Scheme member). Some Scheme members indicate that the cost in identifying the amount of deposits held by certain excluded persons (e.g. officers of the Scheme members' subsidiaries) may outweigh the saving in their contribution payment to the Board. To alleviate the reporting burden, the Board proposes to give some flexibility to Scheme members not to exclude deposits held by the officers of the Scheme members and their related companies in reporting the amount of relevant deposits.
- Currently, it is unclear that the DPS Ordinance allows the payment of contributions for the first year on a time pro-rata basis even if the DPS commences operation in the middle of the year. Accordingly, it is proposed to amend the law to clarify this.
- For assessment of contributions, the DPS Ordinance has specified 20 Oct as the date on which the amount of contribution payable by each scheme member, the target fund size and the balance of the DPS Fund should be determined. However, Scheme members expressed difficulty in reporting the amount of relevant deposits as of 20 Oct if it falls on a general holiday. To address this issue, the Board suggests using the positions of the immediately preceding business day for reporting if 20 Oct falls on a general holiday.



(IV) Way Forward

- Expect to complete the remaining tasks in the next 6 months
- If everything goes smoothly, deposit protection will commence in the second half of 2006

23

- It is expected that the outstanding tasks can be completed in the next 6 months and, if everything goes smoothly, deposit protection will commence in the second half of 2006.