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**Panel on Financial Affairs
Meeting on 6 March 2006**

**Background Brief
on progress on the implementation of the Deposit Protection Scheme**

Purpose

This paper sets out the background of the implementation of the Deposit Protection Scheme (DPS), and summarizes the major views and concerns expressed by Members when the subject was deliberated at the meeting of the Panel on Financial Affairs (FA Panel) on 6 January 2003 and meetings of the Bills Committee on DPS Bill.

Background

2. The subject of deposit protection was publicly debated in 1992 when a full public consultation was carried out following the failure of the Bank of Credit and Commerce Hong Kong Limited and a number of bank runs in 1991. However, the proposal for establishing a DPS was subsequently rejected on cost, fairness and moral hazard concerns.

3. The Asian financial turmoil in 1997-98 highlighted the fact that external shocks and rumours might adversely affect confidence in individual banks and the banking system as a whole. In the Banking Sector Consultancy Study undertaken in 1998, the consultants considered that the existing protection arrangements did not appear to have sufficiently raised the confidence thresholds during crisis to avoid bank runs and that there was a strong case for enhancements to be made. In the international context, there was also a growing trend in international financial systems in favour of explicit forms of deposit protection. In the light of these developments, the Hong Kong Monetary Authority (HKMA) commissioned a consultancy study on enhancing deposit protection in Hong Kong in April 2000. A consultation paper was published in October 2000 to invite views on the establishment of a DPS to

strengthen the resilience of the banking system against external shocks. In December 2000, the Legislative Council (LegCo) passed a motion urging the Government to expeditiously implement a DPS for effectively protecting small depositors, and to formulate appropriate complementary measures to reduce the risk of moral hazard.

4. On 24 April 2001, the Chief Executive in Council approved in principle the establishment of a DPS and requested HKMA to work out the detailed design features of the Scheme. In March 2002, a second round of public consultation was conducted on HKMA's detailed recommendations focusing on the proposed structure for DPS. Responses received were generally supportive of HKMA's proposals, although there were some suggestions on reduction of cost of DPS through a smaller fund size, a longer built-up period and greater Government's commitment.

5. The FA Panel was briefed on 6 January 2003 on the proposed major features of DPS. While members had not raised any objection to the proposal, they raised questions on some aspects of the Scheme, such as the administration of the Scheme and the exemption from participation in the Scheme.

6. On 30 April 2003, the Administration introduced the DPS Bill into LegCo. A Bills Committee was formed to scrutinize the Bill. Following the passage of the Bill, the DPS Ordinance (Cap. 581) was enacted in May 2004 and the Hong Kong Deposit Protection Board (the Board) was formed in July 2004. Since then, the Board has developed a project plan for establishing DPS and commenced work on a number of key preparatory tasks.

Implementation of the Deposit Protection Scheme

Main features of the Deposit Protection Scheme

7. The DPS Ordinance provides for the establishment of a DPS by the Board for the purpose of providing compensation to depositors under certain circumstances in respect of deposits maintained with banks that are members of DPS; the establishment of a DPS Fund from which such compensation is to be paid; and contributions to the Fund, and entitlement to, and payment of compensation from the Fund.

8. The main features of DPS are as follows:

(a) Functions of the Board

The Board is required to establish and maintain DPS as well as to manage and administer the DPS Fund. The Board performs its functions through HKMA, but the cost incurred by HKMA will be recoverable from the Fund under the "users pay principle".

- (b) Membership of DPS
Unless exemption is granted by the Board, every licensed bank is a member of DPS.
- (c) DPS Fund
- (i) Every member of DPS is required to make an annual contribution to the Fund. The amount of contribution payable by a member will be assessed by the Board with reference to the amount of relevant deposits held with that member and its supervisory rating^{Note} assigned by the Monetary Authority;
 - (ii) It is expected that for a coverage limit of \$100,000 on a “per depositor per bank” basis, a target fund size of around \$1.6 billion or 0.3% of total protected deposits is expected to be built up within five years and sufficient to cover most of the losses that will be sustained by DPS. At this level, 84% of depositors will have their total deposits fully protected while 16% of deposits by value will be covered; and
 - (iii) Compensation from the Fund is payable if a winding up order has been made by the court or HKMA has made a decision that compensation should be paid. The HKMA’s decision is subject to review by the Chief Executive in Council.
- (d) Appeals tribunal
An independent Deposit Protection Appeals Tribunal is established to hear appeals from depositors and members of DPS against the decisions of the Board and HKMA relating to the entitlement of compensation under the Scheme; application for exemption from participation in the Scheme; and amount of contributions payable by a member of the Scheme.

Progress of the Board’s preparatory work

9. In May 2005, the Board provided the FA Panel with an information paper on the progress of its preparatory work for the implementation of DPS (**Appendix I**). The progress made is summarized as follows:

- (a) Development of a system for the assessment of contributions payable by DPS members has been completed;

^{Note} “CAMEL Rating” is a supervisory rating currently adopted by HKMA to assess the financial strength and overall soundness of an authorized institution in the areas of Capital, Asset quality, Management, Earning and Liquidity.

- (b) Development of a set of procedures and the associated information systems for assessing and paying compensation to depositors is in good progress with the appointment of a consultant and an information technology company to help out on this task;
- (c) Preparation of five sets of rules governing the operation of DPS is in good progress. These rules will be issued in the form of subsidiary legislation and will be tabled before LegCo for negative vetting; and
- (d) The Deposit Protection Appeals Tribunal was established in January 2005. Sittings of the Tribunal will be convened on a need basis.

10. The FA Panel was further updated on the progress of the preparatory work during the briefing on the work of HKMA at the Panel meetings on 7 November 2005 and 6 February 2006. At the latter meeting, the Panel noted that the drafting of the rules governing the operation of DPS had been substantially completed; the payout system was being tested; and a publicity strategy for the launch of DPS had been formulated. It was expected that DPS would start collecting contributions and providing deposit protection in the second half of 2006.

Major views and concerns expressed by Members

11. Members' major views and concerns expressed on the DPS at the FA Panel meeting on 6 January 2003 and meetings of the Bills Committee on DPS Bill are summarized as follows:

- (a) The appointment of HKMA as the agent for day-to-day administration of DPS may have the possible negative impact of undermining the credibility and independence of the Scheme, and may result in a conflict of roles for HKMA, which is the regulator of banks;
- (b) The exemption from the participation in DPS of an overseas incorporated bank that has a comparable scheme in the bank's home jurisdiction which protects deposits taken by its Hong Kong office may encourage depositors in Hong Kong to move their deposits to overseas banks. An exempted bank should be required to inform its depositors or prospective depositors that it is not a DPS member;
- (c) As contributions to the DPS Fund will be based on the supervisory ratings of banks and banks with higher ratings would pay lower

rates to the Fund, lower rated banks may be forced to undertake businesses with higher risks in order to recover the higher cost involved. The question of moral hazard may arise if banks try to recoup cost for DPS from customers through fee increases;

- (d) The coverage limit of \$100,000 is relatively low. However, it is noted that the higher the coverage limit is, the greater the risk of moral hazard becomes; and
- (e) Compensation should be paid out as soon as possible, and it is necessary to put in place contingency arrangements, such as retrieval of necessary information and provision of enquiry services to the public, to avoid possible confusion in the event of a bank failure.

12. The extract of the minutes of the FA Panel meeting on 6 January 2003 is in **Appendix II**.

Latest developments

13. The Board will report to the FA Panel on 6 March 2006 on the progress of its preparatory work for the implementation of DPS.

Reference

14. A list of relevant papers is in **Appendix III**.

Council Business Division
Legislative Council Secretariat
2 March 2006

For information**Legislative Council Panel on Financial Affairs****Establishment of the Deposit Protection Scheme****Introduction**

The Deposit Protection Scheme Ordinance (Cap. 581) was enacted in May 2004. The Hong Kong Deposit Protection Board (the Board), assisted by the Hong Kong Monetary Authority (HKMA), is making the necessary preparations for launching the Deposit Protection Scheme (DPS). This paper reports on the progress made by the Board so far.

Formation of the Board

2. Following the enactment of the DPS Ordinance, the Chief Executive appointed Professor Andrew Chan as the Chairman of the Board on 1 July 2004. He also appointed four persons, with expertise in the fields of accounting, banking, information technology and insolvency laws, as members of the Board. Including the two ex-officio members, namely the Monetary Authority (MA)¹ and the Secretary for Financial Services and the Treasury², the Board currently consists of seven persons.

3. Since its formation in July 2004, the Board has held seven meetings. It has developed a detailed project plan for establishing the DPS and has commenced work on a number of key preparatory tasks as described below.

System for assessment of contributions

4. The DPS will be funded by the banking industry. Every Scheme member is required to make an annual contribution to the DPS Fund. The amount of contribution payable by a Scheme member will be assessed by the Board with reference to the amount of relevant deposits held with that Scheme member and its supervisory rating assigned by the MA. In relation to the former, the Board has developed an annual return for Scheme members to

¹ Pursuant to section 4(1)(b) of the DPS Ordinance, the MA has appointed Deputy Chief Executive (Banking) of the Hong Kong Monetary Authority as his representative to be an ex-officio member of the Board.

² Pursuant to section 4(1)(a) of the DPS Ordinance, the Secretary for Financial Services and the Treasury has appointed the Permanent Secretary for Financial Services and the Treasury (Financial Services) as his representative to be an ex-officio member of the Board.

report their amount of relevant deposits. Scheme members will submit the first return in December 2005 regarding the amount of relevant deposits as of 20 October 2005. As regards the latter, the Board and the HKMA have jointly worked out a mechanism through which the HKMA will provide the Board with the supervisory ratings of individual Scheme members. These two elements together constitute the system for the assessment of contributions payable by Scheme members.

Development of payout procedures and systems

5. Among the preparatory tasks to be completed by the Board before the DPS can start providing deposit protection, the development of a set of procedures and the associated information systems for assessing and paying compensation to depositors is the most complicated one. To ensure the smooth completion of this task, the Board has appointed a consultant with practical experience in deposit insurance operation to help out on this task. In addition, the Board has engaged an information technology company to develop the requisite information systems.

6. The progress of this task has so far been on schedule. The payout consultant has already developed a broad framework for the payout procedures. In the months ahead, he will, with the assistance of the other staff of the Board and the HKMA, work out the detailed procedures. Meanwhile, the user requirements of the payout systems have been specified, and the information technology company is now developing the functional specifications of the systems. It is expected that the payout procedures and systems will be ready for testing in the first half of 2006.

Preparation of rules

7. The Board and the MA are empowered under the DPS Ordinance to make rules governing the operation of the DPS. These rules should be issued in the form of subsidiary legislation and therefore should be tabled before the Legislative Council for negative vetting. They should be in place before the DPS starts providing deposit protection.

8. There are altogether five sets of rules to be made by the Board and the MA. They are namely –

Rules to be made by the Board

- (i) rules governing the representations that should be made by Scheme members regarding their membership as well as the coverage of the DPS;

- (ii) rules concerning the manner in which Scheme members should pay contributions to the DPS Fund;
- (iii) rules on the information systems and records to be maintained by Scheme members for the purpose of facilitating the Board to pay compensation to depositors expediently;
- (iv) rules concerning the forms in which compensation will be paid to eligible depositors; and

Rules to be made by the MA

- (v) rules governing the maintenance of assets in Hong Kong by Scheme members.

9. The preparation of the above rules is in good progress. The banking industry has been consulted on the main principles to be incorporated into these rules. It is expected that the above rules will be ready for tabling before the Legislative Council for negative vetting by stages starting from late 2005 or early 2006.

Establishment of Deposit Protection Appeals Tribunal

10. Under the DPS Ordinance, certain decisions of the Board and the MA³ are appealable to a tribunal known as the “Deposit Protection Appeals Tribunal”. The Tribunal was established in January 2005. Mr Simon Herbert Mayo, a former Vice-President of the Court of Appeal of the High Court, was appointed by the Chief Executive as the Chairman of the Tribunal. A panel of six persons, from which the Financial Secretary may appoint as members of the Tribunal, have also been appointed. Sittings of the Tribunal will be convened on a need basis. If there is an application to the Tribunal for a review of the Board’s or the MA’s decision, the Chairman together with at least two members appointed by the Financial Secretary will hear the case.

Consultation with banking industry

11. The Board has kept the industry informed of the development of the DPS project. It has established a Consultative Committee comprising 13 representatives of the banking industry. The committee serves as a useful

³ These decisions include the Board’s decisions regarding whether a foreign bank branch can be exempted from participation in the DPS, the amount of contribution payable by a Scheme member and the amount of compensation payable to a depositor; and the MA’s decision to impose an asset maintenance requirement on a Scheme member.

forum for the Board and the banking industry to exchange views on issues of common interest. For instance, members of the Consultative Committee have provided many useful comments to the Board in preparing the rules governing the operation of the DPS.

Commencement of deposit protection

12. So far, the Board has made good progress in the establishment of the DPS. In the year ahead, the Board will continue to develop the payout procedures and systems as well as the rules governing the operation of the DPS. It will also formulate a strategy to educate the public about the protection available under the DPS before the Scheme is launched. It is expected that the DPS will be ready to start providing deposit protection in the second half of 2006.

Hong Kong Deposit Protection Board
May 2005

**Extract from the minutes of meeting
of the Panel on Financial Affairs on 6 January 2003**



Action

IV Progress on the establishment of the Deposit Protection Scheme
(LC Paper No. CB(1) 588/02-03(03))

8. Upon the Chairman's invitation, the Executive Director (Banking Development), Hong Kong Monetary Authority (ED(BD)/HKMA) briefed the Panel on HKMA's latest recommendations on how the proposed Deposit Protection Scheme (DPS) in Hong Kong should be structured.

Proposed Major Design Features and Implementation of the DPS

9. ED(BD)/HKMA advised that the majority of the opinions received from the HKMA consultation exercise supported the DPS to confine its role to a "pay box". There was also support for the establishment of a separate legal entity to oversee the operations of the scheme in order to offer greater accountability. It was therefore proposed to establish a new statutory body -- the Hong Kong Deposit Protection Board (HKDPB) to administer the DPS and to appoint HKMA as the agent to carry out the day to day administration of the scheme. The decisions of the HKDPB would be subject to the review of the independent Deposit Protection Appeals Tribunal. ED(BD)/HKMA added that participation by licensed banks in the scheme would be mandatory. The coverage limit would be set at \$100,000 per depositor per bank. As regards funding for the DPS, ED(BD)/HKMA said that the DPS fund would be established by means of contributions from banks based on their respective "CAMEL rating". On average, the rate of contribution payable by banks until the first year in which the target fund size was reached was 0.08%, and there after at 0.01%. It was expected that the proposed target fund size of 0.3% of the banking sector's total amount of protected deposits (approximately \$1.6 billion based on the level of protected deposits as at August 2002) would be reached in approximately five years. ED(BD)/HKMA further advised that the HKMA was currently consulting the banking industry on the draft Bill. It was expected that the Bill would be introduced into the Legislative Council in the first half of 2003. Depending on the progress of the necessary preparatory work, the scheme could commence operation in 2005.

Discussion with Members

Exemption from the DPS

10. Mr Bernard CHAN noticed that under the proposal, an overseas incorporated bank could apply for exemption from participating in the DPS if the deposits taken by the bank's Hong Kong offices were protected by a scheme in the bank's home jurisdiction and the scope and level of protection afforded by that scheme were not less than under the DPS in Hong Kong. He enquired about the number of overseas incorporated banks in Hong Kong which would be eligible for the exemption.

11. In reply, ED(BD)/HKMA remarked that few overseas incorporated banks with DPSs established in their home jurisdictions would offer protection for deposits taken by their overseas offices. The DPS set up by Germany was one of the few systems which provided for such protection. Hence, it was envisaged that few overseas banks operating in Hong Kong would be eligible for exemption from the DPS.

12. On Mr Henry WU's concern that the proposed exemption for overseas banks and possible higher level of compensation in overseas DPSs would encourage depositors to move their deposits to overseas banks, ED(BD)/HKMA remarked that as the DPS in Hong Kong was basically a protection scheme for small depositors, it was unlikely that small depositors would be lured to move their deposits to overseas banks.

Deposit Protection Appeals Tribunal

13. In response to Mr NG Leung-sing's enquiry about the composition and purview of the proposed Deposit Protection Appeals Tribunal, ED(BD)/HKMA replied that the Tribunal would consist of independent members appointed by the Chief Executive from relevant fields. The Tribunal would be empowered to review the decisions of the HKDPB, including those relating to the determination of compensation payments, exemption from the DPS, and the assessment of contributions payable by banks. As to Mr Henry WU's concern about possible role conflict for the Tribunal to determine the amount of compensation and receive appeals at the same time, ED(BD)/HKMA stressed that the HKDPB and the Tribunal were two separate entities. The HKDPB would determine the amount of compensation whereas the Tribunal would receive appeals against the determination of the Board. There would be no role conflict between the two bodies.

Contributions from banks and the CAMEL rating system

14. As contributions towards the DPS fund would be based on the "CAMEL rating" of banks and banks with higher ratings would pay lower rates to the fund, Mr Albert HO expressed concern that lower rated banks would be forced to undertake businesses with higher risks in order to recover the higher cost involved.

15. In response, ED(BD)/HKMA remarked that there was support from the public consultation to adopt a differential system for assessment of contributions. As banks would try to improve their risk-management and asset quality with a view to obtaining a higher CAMEL rating in order to lower payments to the fund, the proposed contribution mechanism would help reduce the potential moral hazard risks associated with the DPS.

16. As regards Mr Henry WU's enquiry about the breakdown of the number of banks by their ratings under the CAMEL rating system, ED(BD)/HKMA advised that majority of the banks had achieved a second rating. On whether banks could appeal to the Deposit Protection Appeals Tribunal if they were not satisfied with their CAMEL ratings, ED(BD)/HKMA explained that CAMEL ratings were determined by the Monetary Authority (MA) and the Tribunal would not be empowered to review MA's decisions on the ratings.

17. Noting that the target size of the DPS fund was set at \$1.6 billion to be achieved in about five years, Ms Emily LAU asked about the implications on banks' contribution rate if such target was not attained. ED(BD)/HKMA replied that the contribution rate (on average) would remain at 0.08% if the target fund size was not achieved. The rate would be reduced to 0.01% after the target was reached.

The problem of moral hazard

18. Noting that only 16% of the total deposits in Hong Kong vis-à-vis 84% of the depositors would have their total deposits fully protected under the DPS with the proposed coverage limit of \$100,000 per depositor per bank, Mr CHAN Kam-lam expressed concern over the problem of moral hazard associated with the scheme. Given that medium and large depositors, which comprised the bulk of the total deposits in Hong Kong, would not be protected, and banks would increase charges from customers to recover the cost for the scheme, Mr CHAN was concerned that the interest of medium and large depositors would be adversely affected as they would be subsidizing the small depositors in the scheme. In this connection, Mr LEE Cheuk-yan expressed concern that banks would pass on the cost of the DPS to small depositors and ask whether there would be measures to protect their interests.

19. In reply, ED(BD)/HKMA said that it had been argued that as large depositors would have more resources to protect their interests and would exercise prudence in choosing their bankers, the DPS in Hong Kong was mainly designed for protecting the small depositors. However, it should be noted that even medium and large depositors would be protected under the DPS because the first \$100,000 of their deposits would be fully protected by the scheme.

20. On the concern about cost to be borne by customers, ED(BD)/HKMA stressed that how banks charged their clients would be a commercial decision which was inappropriate for HKMA to interfere. However, it had been revealed in HKMA's study and overseas experience that smaller banks tended to be more active in competing for small deposits. Hence, it was envisaged that depositors would have a wider choice in banking service after implementation of the DPS.

Administration of the Hong Kong Deposit Protection Board

21. On the proposal of appointing the HKMA as the agent of the HKDPB to undertake the day to day administration of the DPS, Ms Emily LAU expressed concern about possible negative impact of undermining the credibility and independence of the scheme, and conflict for the HKMA as the regulator of banks to take up the role. She doubted if the proposal would lower the administrative cost for the scheme since the HKMA would fully recover the cost it incurred from the DPS fund. There was also concern that in the event of a large bank failure, the HKMA might not be able to deploy adequate staff to take up the necessary duties. Ms LAU further enquired about overseas experience in administering the DPS.

22. In reply, ED(BD)/HKMA advised that depending on the scope of the DPSs, institutions responsible for administering the schemes in overseas jurisdictions had different structure. For instance, the DPS in the United States did not only operate as a pay box hence the institution had a bigger establishment. In devising the present proposal, the HKMA had made reference to the experience in the United Kingdom whose DPS was also a paybox where the Bank of England was appointed as the agent for administering the scheme. ED(BD)/HKMA said that for a pay box scheme, it would probably not be cost-effective for the HKDPB to maintain a staff level that was required to handle the workload in the event of a bank failure but otherwise not needed in normal time. He advised that the proposal was supported by the Hong Kong Association of Banks and the Consumer Council. On the subject of role conflict, ED(BD)/HKMA explained that in line with overseas practice, this could be addressed by functional separation between bank regulation and administration of the DPS in the HKMA. As regards the concern about staff deployment in the event of a large bank failure, ED(BD)/HKMA remarked that the HKMA could consider outsourcing some of the work and engaging external professionals as necessary in such circumstances.

23. Upon request of Ms Emily LAU, the HKMA agreed to provide the Consumer Council's views on the proposal for members' reference.

(Post-meeting note: The Consumer Council's letter issued to the HKMA in October 2002 was circulated to members vide LC Paper CB(1) 655/02-03 on 8 January 2003.)

Interim Payments to Depositors

24. Responding to Mr Jasper TSANG's enquiry about the proposal of making interim payments to depositors, ED(BD)/HKMA explained that the proposal was to provide payment of up to 25% of the depositor's entitlement (but without adjustments for interest accrual) within 10 days after the collapse of a bank. Such proposal would help restore depositor's confidence in the banking system and avoid undue delay of payment to the depositors where the time required to ascertain the amount of compensations would be long. He added that there would be legal provision to recover payment from a depositor if the amount of interim payment had exceeded the entitled amount of compensation.

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Implementation of the Deposit Protection Scheme

List of relevant papers (Position as at 2 March 2006)

Paper	LC Paper No.
LegCo Brief on “Enhancing deposit protection in Hong Kong”	— <i>(discussed at the FA Panel meeting on 6 November 2000)</i>
Consultation Paper on Enhancing Deposit Protection in Hong Kong	CB(1)111/00-01 <i>(discussed at the FA Panel meeting on 6 November 2000)</i>
Minutes of the FA Panel meeting on 6 November 2000	CB(1)295/00-01
Information paper on “Progress on the Deposit Insurance Scheme” provided by HKMA	CB(1)1114/01-02(02) <i>(issued for FA Panel members’ information in February 2002)</i>
Information paper on “Establishment of a Deposit Protection Scheme in Hong Kong” provided by HKMA	CB(1)588/02-03(03) <i>(discussed at the FA Panel meeting on 6 January 2003)</i>
Minutes of the FA Panel meeting on 6 January 2003	CB(1)919/02-03
Letter dated 30 October 2002 from the Consumer Council to HKMA on the Deposit Insurance Scheme	CB(1)655/02-03 <i>(circulated to FA Panel members on 8 January 2003)</i>
LegCo Brief on “Deposit Protection Scheme Bill”	—

Paper	LC Paper No.
“Report of the Bills Committee on Deposit Protection Scheme Bill” prepared by the LegCo Secretariat	CB(1)1303/03-04 <i>(paper for the House Committee meeting on 19 March 2004)</i>
Information paper on “Establishment of the Deposit Protection Scheme” provided by the Hong Kong Deposit Protection Board	CB(1)1666/04-05(01) <i>(issued for FA Panel members’ information in May 2005)</i>