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

Enhancing Deposit Protection under the Deposit Protection Scheme

Consultation Paper

April 2009

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Contents

The findings of a self-assessment on compliance with the core principles for effective deposit insurance systems recommended by the Basel Committee on Banking Supervision, and the specifications and assumptions of the funding model of the Deposit Protection Scheme can be found in the website version of this consultation paper at www.dps.org.hk

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Introduction

1. This consultation paper recommends enhancing the Deposit Protection Scheme to improve protection for depositors in Hong Kong, taking into account experience gained from operating the Scheme since its inception in 2006 and recent developments in international and local financial markets.

Deposit Protection Scheme

2. The Deposit Protection Scheme (DPS) in Hong Kong commenced operation in September 2006. It was established under the Deposit Protection Scheme Ordinance (DPSO) (Cap. 581) to protect depositors and help to maintain the stability of the banking system.

3. The DPS will compensate depositors for deposits at banks up to a specified limit when a bank failure occurs. Knowing that deposits are protected, depositors should be less likely to overreact to rumours and rush to withdraw their deposits. This will help reduce the likelihood of the occurrence of rumour-driven runs and bank failures, and the spreading of a bank run across the system in times of crisis, thereby helping to promote banking stability.

4. The Hong Kong Deposit Protection Board (the Board) is a statutory body established under the DPSO to establish and maintain the DPS.

5. Major features of the DPS include:

- unless exempted by the Board, all licensed banks are members of the DPS (Scheme members or banks). Restricted licence banks and deposit-taking companies are NOT members of the DPS.

- the DPS is funded by contributions collected from Scheme members. A Deposit Protection Scheme Fund (DPS Fund) has been established from the contributions collected. All costs and expenses incurred in the administration of the DPS are charged to the DPS Fund.

- the target size of the DPS Fund is 0.3% of the total amount of protected deposits maintained with all Scheme members (approximately HK$1.5 billion). The latest projection of the Board indicates the target fund size would be reached by 2012.

- the contribution payable by a Scheme member for a year is determined by the amount of protected deposits held with the Scheme member as of 20 October of the preceding year and the supervisory rating assigned by the Monetary Authority (MA) to the member.

- the compensation limit under the DPS is HK$100,000 per depositor per bank.

- compensation under the DPS is calculated on a net basis, that is, a depositor's liabilities to the failed Scheme member will be deducted from the depositor's protected deposits in determining entitlement to compensation.

- the calculation of compensation covers both the principal and interest of deposits and liabilities of depositors.

- the DPSO adopts the definition of deposit in the Banking Ordinance (BO) (Cap. 155) in defining whether a financial product is eligible for protection.

- certain types of deposit are not protected by the DPS, such as time deposits with a maturity longer than five years, structured deposits (such as foreign currency-linked and equity-linked deposits), secured deposits (such as deposits used as collateral to secure a banking facility), bearer instruments (such as bearer certificates of deposit) and offshore deposits.

- Scheme members are required to notify customers if a financial product has been described as a deposit but is not protected by the DPS.

- deposits held by certain types of depositor are not protected, including authorized institutions, banks and connected persons, for example, directors, controllers, or managers of the failed Scheme member.

- compensation from the DPS Fund should be paid to depositors of a Scheme member if a winding up order has been made against the Scheme member or the MA has decided that compensation should be paid by the DPS and has served notice on the Board accordingly.

- when compensation under the DPS becomes payable in respect of a Scheme member, the DPS will borrow from the Exchange Fund under a standby liquidity facility to pay compensation to depositors. The size of the facility offered by the Exchange Fund to the DPS is HK$40 billion.

- the DPS will seek reimbursement from the liquidation of the failed Scheme member for the compensation paid to depositors and repay the borrowings from the Exchange Fund. The cost of borrowing from the Exchange Fund, any compensation paid that cannot be recovered from the liquidation, and the administrative cost incurred by the DPS in making compensation payments, will be charged to the DPS Fund.

- the Board may make interim payments to depositors where there is uncertainty as to the exact amount of compensation payable to individual depositors, or where the time required to ascertain such amount would be so long as to unduly delay the payment.

- where compensation is paid to a depositor, the Board will be subrogated to the rights and remedies of the depositor against the failed Scheme member to the extent of the payment and thus will have the priority status afforded to his deposits under section 265(1)(db) of the Companies Ordinance (CO) (Cap. 32) in the liquidation of the failed Scheme member. Currently, the priority claim afforded to depositors under the CO is up to HK$100,000, the same as the DPS protection limit.

Enhancements to the DPS framework

6. Since the DPS commenced operation in 2006, the Board has endeavoured to improve the operation of the Scheme within the framework set by the DPSO. Specifically, the focus has been on monitoring the adequacy of the Scheme's coverage, enhancing its readiness to payout, and raising public awareness of its existence and understanding of its key features.

7. Despite the progress made in each operational area, the Board has noted that further enhancements can be made by making adjustments to the Scheme's framework to cater for circumstances that could not be fully anticipated when the DPS was developed, especially in terms of payout efficiency and transparency of product coverage.

8. Apart from potential enhancements identified from its own experience in operating the DPS, the Board has also paid close attention to the implications of developments in international and local financial markets to the operation of the DPS in Hong Kong.

9. Since the onset of the US sub-prime crisis in August 2007, a number of countries have proposed reforms to their financial regulatory and deposit insurance regimes. In March 2008, the US Treasury released a blueprint for modernising its financial regulatory structure. In the UK, following a run on the Northern Rock bank in September 2007, the authorities commenced consultation on measures to reform the UK financial regulatory and deposit insurance arrangements in January 2008. The Financial Stability Forum, a prominent international forum of national financial regulators, central banks and international financial institutions, issued recommendations in April 2008 to enhance financial market and institutional resilience. This led to the development and consultation of a set of recommended core principles for effective deposit insurance systems by the Basel Committee on Banking Supervision of the Bank for International Settlements (Basel Committee) in March 2009. The European Parliament adopted a series of amendments to its directive governing deposit insurance schemes in the European Union (EU) in December 2008. Extraordinary measures, such as capital injections to banks and blanket deposit guarantees, were introduced by many countries in the second half of 2008 to combat the deepening crisis in global financial markets.

10. The Hong Kong Monetary Authority (HKMA) released a consultancy report on its work on banking stability (HKMA consultancy report) in July 2008, which contains two recommendations in relation to Hong Kong's DPS:

(i) the DPS should review the level of deposit protection provided in Hong Kong and the potential for raising the protection limit without increasing the annual premium; and

(ii) the DPS should study the changes that are made to the UK scheme in the wake of Northern Rock and the new international principles for deposit insurance when they emerge to consider what application they may have to Hong Kong.

11. With reference to the reform experience in other countries and the emerging international principles for deposit insurance, the Board is of the opinion that the existing design features of the DPS in Hong Kong already comply substantially with international best practices. For example, a number of weaknesses in the UK system, revealed by the Northern Rock incident, were already addressed in the way in which the DPS in Hong Kong was set up. The DPS in Hong Kong is pre-funded; depositors are not required to share the loss under any co-insurance arrangement; it has in place a credible infrastructure to facilitate a fast payout; and extensive publicity activities have been undertaken to promote public awareness and understanding of it. The establishment of the DPS has also substantially met the core principles currently under consultation by the Basel Committee (the results of a self-assessment on compliance with the principles can be found in the website version of this consultation paper at www.dps.org.hk). Nevertheless, some of the overseas reform proposals have helped in identifying areas for enhancement.

12. The recommendations in this consultation paper to enhance the DPS are subject to the following assumptions and limitations:-

(i) the Board will not seek to review or make recommendations on how other safety net players should perform their functions, for example, the banking supervisor and the lender of last resort;

(ii) as a pre-emptive measure to reinforce confidence in the banking system in Hong Kong, the Hong Kong SAR Government announced in October 2008, the use of the Exchange Fund to guarantee repayment of all customer deposits held in all authorized institutions (AIs) in Hong Kong (Deposit Guarantee), following the principles of the DPS, until the end of 2010. Nothing in this consultation paper will bind the Government's decisions in relation to the Deposit Guarantee; and

(iii) the Board will not seek to cover areas that are not consistent with the role of the DPS as a "pay-box" type scheme as defined by the DPSO, such as the supervision of banks to minimise risk or loss, and problem bank resolution activities.

13. The potential enhancements to the DPS identified in the review carry different degrees of complexity and impacts on different stakeholders. Some enhancements envisaged may require adjustments not only to the DPSO, but also to the BO and CO, and can therefore be more complex to implement.

14. Because of the time required for consultation on the potential enhancements and effecting the relevant legislative changes, the Board finds it appropriate to divide the enhancements into two batches. Priority will be given to handling those that are more fundamental to the effectiveness or efficiency of the DPS. Peripheral enhancements and those that are more technical in nature will be reserved to the second batch, and are expected to be made available for consultation in the second half of 2009.

15. Potential enhancements to the DPS in the first batch are contained in this consultation paper and cover the following areas:

    - Protection limit (P.9-P.17)
    - Compensation calculation basis (P.18-P.22)
    - Product coverage (P.23-P.27)
    - Types of institutions covered (P.28-P.30)
    - Funding arrangements (P.31-P.33)

    Subject to the progress of the consultation, the Board intends to introduce the agreed enhancements under both batches as soon as possible, preferably before the end of 2010 so that the public will benefit from an enhanced deposit protection scheme when the Deposit Guarantee expires.

Consultation on the recommendations in this paper

16. Members of the public are welcome to submit their comments to the Board before 26 June 2009 through any of the following channels:

    By mail: Hong Kong Deposit Protection Board
78th floor
Two International Finance Centre
8 Finance Street
Central
Hong Kong
(Reference: DPS Review)

    By fax : 2290 5168

    By email: dps_review@dps.org.hk

    Website: www.dps.org.hk

17. In the interests of transparency, the Board may, as appropriate, reproduce, quote from, or summarise the submissions received during the consultation in the published report on the consultation. Where appropriate, the Board may attribute such reproductions of, quotations from, or summaries of, views received to the relevant organisations or individuals unless expressly requested in the submissions not to do so.

Protection limit

18. The appropriateness of the protection limit of a deposit insurance scheme cannot be discussed in isolation without considering the associated cost and moral hazard.

19. A key measurement of the effectiveness of a deposit insurance scheme is the percentage of depositors fully covered by the scheme, that is, those with deposits equal or below the protection limit. The likelihood of a bank failure caused by rumour-driven bank runs will decrease with an increase in the protection limit because more depositors will become fully covered and, hence, less likely to overreact to rumours. As such, a higher protection limit should be more effective in preventing the occurrence of failure and the spreading of a bank run across the system, thereby helping to promote banking stability.

20. The cost of deposit protection mainly comprises financing cost and shortfall loss to be incurred by the DPS in a payout. Financing cost refers to the interest cost of borrowing the funds required (from the Exchange Fund in the case of the DPS in Hong Kong) to finance payout to depositors from the date of payment to the date cash recoveries are received from a liquidation. Shortfall loss refers to the difference between the amount paid out by the DPS and the amount recovered from bank assets in a liquidation. Such costs will generally increase with the protection limit. Apart from financing cost and shortfall loss, a certain degree of administrative cost will be incurred in engaging professionals to handle the determination and payment of compensation to depositors in a payout.

21. Moral hazard refers to the risk of inducing excessive risk-taking behaviour by banks and depositors due to the provision of deposit protection. With deposit protection, depositors may adopt a lax attitude towards the choice of banks on the grounds of risk. Banks may be encouraged to take on more risk, in order to offer high interest rates to depositors, without the threat that depositors will withdraw their funds. This can distort competition between banks as well as increase the level of systemic risk. Such risks will generally increase with the level of protection limit. To contain these risks, the implementation of deposit insurance is prescribed to be accompanied by effective banking supervision.

22. In general, a higher protection limit will yield a higher percentage of fully covered depositors and, therefore, produce better effectiveness. However, it will result in a higher level of cost and moral hazard. While moral hazard is generally difficult to quantify, to assist in reviewing the protection limit, the Board has conducted analyses to project the impact on the percentage of depositors fully covered and the cost of the DPS if the limit is adjusted.

Percentage of depositors fully covered

23. The existing HK$100,000 protection limit under the DPS was set after thorough research and extensive consultation. According to the consultation paper on establishing the DPS released by the HKMA in October 2000, the limit, which was estimated to be able to fully cover 84% of depositors by number and 20% of deposits by value, was close to meeting the international benchmarks prevailing at the time. It was set in the light of general public support received from two rounds of public consultation, in 2000 and 2002.

24. To accurately assess the impact of adjusting the protection limit on the percentage of depositors fully covered and the value of deposits covered, the Board conducted a survey of 21 retail banks on the number of depositors with deposit balances below different thresholds as well as the value of deposits covered by each threshold as at 20 October 2008 (Survey) (These banks account for about three quarters of all customer deposits in the banking industry). The findings of the Survey are shown in the table below.

Protection limit	**Percentage of depositors fully covered (21 banks)**	**Percentage of value of deposits covered (21 banks)**	**Total value of deposits covered in 21 banks (in HK$ billions)**
HK$100,000	76.9	11.0	486
HK$200,000	83.9	16.8	724
HK$500,000	90.9	27.1	1,125
HK$800,000	93.8	33.2	1,348
HK$1,000,000	95.1	36.2	1,455

The table shows the marginal gain in the percentage of depositors fully covered by raising the protection limit diminishes at the higher levels of the limit.

Cost of providing deposit protection

25. To assess the impact of adjusting the protection limit on the total cost of the DPS, that is, the financing cost and shortfall loss, the Board has used the same statistical model employed by the HKMA in designing the DPS (DPS funding model). Generally, the model simulates the failure of one or more banks in a very wide range of possible combinations, based on ratings and default probabilities assigned by credit rating agencies. Using the same set of assumptions (including the choice of a cost estimate sufficient to cover 99.8% of the simulated outcomes), which have been assessed to remain robust and conservative, the Board has re-run the model by updating the amount of protected deposits and credit ratings of Scheme members (a description of the specifications and assumptions employed in the model can be found in the website version of this consultation paper at www.dps.org.hk). **It should be stressed that the model does not predict that any Scheme member will fail. Rather, it estimates the consequences of such a failure, were it to occur, for the DPS based on the assumptions applied.**

26. The total cost of providing deposit protection under different protection limits, as estimated by the DPS funding model, is shown in the table below.

Protection limit	**Total cost (in HK$ millions)**	**Estimated total value of deposits covered in all banks (in HK$ billions)**	**Total cost as % of total protected deposit**
HK$100,000	724	495	0.15
HK$200,000	1,582	739	0.21
HK$500,000	2,551	1,149	0.22
HK$800,000	4,981	1,378	0.36
HK$1,000,000	5,455	1,488	0.37

The table shows that the cost of providing protection, in terms of total cost as a percentage of protected deposits, tends to increase with the level of protection limit.

27. A detailed analysis of the composition of the total cost revealed that, except at very high levels of protection (approaching HK$1 million), the shortfall loss expected to be incurred by the DPS is negligible. This is because the model employs an assumption that any increase in the protection limit will be matched by a corresponding increase in the level of priority claims afforded to depositors under the CO, to which the DPS will be subrogated in liquidations. This means the DPS will have priority over unsecured creditors in recovering all compensation paid to depositors

from the liquidated assets of the failed Scheme member. Without a full backing of the priority claims, the claims of the DPS not backed will rank equal to the claims of unsecured creditors, and the extent to which such claims can be recovered will depend on the asset recovery rate of the Scheme member in liquidation. For example, it is estimated that the shortfall loss could be as high as HK$5 billion, if the protection limit were raised to HK$200,000, while the level of priority claims continues to stay at the current level of HK$100,000. To raise the protection limit without making a corresponding change to the level of priority claims will therefore be prohibitively expensive.

28. When compared with the current target fund size of the DPS Fund of 0.3% of total protected deposits (about HK$1.5 billion), the target corresponding to a protection limit of HK$100,000 produced from re-running the DPS funding model (0.15% or HK$724 million), is about half the current target. The reduction observed is mainly due to the improvement in the credit rating of many banks since the model was run to set the target fund size at 0.3% about ten years ago. Such improvements have the effect of reducing the probabilities of default and hence the cost expected to be incurred by the DPS.

29. Based on the experience of the Board from payout rehearsals conducted so far, the administrative cost of handling a payout on an average small to medium-sized bank is estimated to be about HK$60-70 million. Like the financing cost and shortfall loss, such cost is also chargeable to the DPS Fund. A sum of about HK$150 million should, therefore, be added to the DPS Fund to meet the target of being prepared to handle the simultaneous failure of two Scheme members of average size within the small to medium-sized range. This is consistent with the international standard set by the International Monetary Fund (IMF) in relation to the objectives which deposit insurance schemes should seek to achieve.

Proposed Protection Limit

30. Generally, the choice of a protection limit involves striking a balance between maximising protection on the one hand and minimising cost and moral hazard on the other. The findings from the Survey and the cost estimates produced by re-running the DPS funding model confirm the need to review the coverage of the DPS from time to time. Nevertheless, the limit should not be changed too frequently as this may cause confusion on the part of the public. This would make public education efforts, which are essential to maintaining confidence, much more difficult. From public education’s perspective, the use of a rounded and easily recallable number is generally preferable.

31. Although the Basel Committee has not prescribed a percentage on the number of depositors to be fully covered, its core principles for effective deposit insurance systems, currently under consultation, stipulate the level of a scheme's coverage should adequately cover the large majority of depositors. Benchmarks for covering 80% to 90% of depositors by number and 20% of deposits by value were quoted in some discussion papers issued by the IMF in the past. Nevertheless, few overseas deposit insurers have recently released statistics on the percentage of depositors fully covered by their schemes.

32. Since the DPS commenced operation, the Board has been monitoring closely the percentage of depositors fully covered by collecting and analysing statistics from simulation tests conducted with Scheme members. Adequacy of the coverage of the DPS has been assessed with reference to a benchmark of 80%. As the statistics collected from simulation tests conducted in 2007 indicated the percentage was approaching the benchmark, the Board decided in early 2008 to prepare for reviewing the protection limit. The Board further decided in June 2008 to commence a review, and a project plan for the review was formulated in October 2008.

33. In the HKMA consultancy report, the consultant suggested that if an increase in the limit of the DPS, say, to HK$200,000, could result in a material increase in the percentage of depositors fully covered but did not require an increase in premium, it would be desirable to raise the limit. In response to the report, the Consumer Council said the existing HK$100,000 protection limit was quite low and suggested it should be reviewed, but the cost impact on depositors should be carefully considered. Some members of the public suggested the limit should be increased to HK$500,000 or HK$1 million, or that the protection should not be capped. The banking industry has no objection to reviewing the protection limit, as long as it would not cause an increase in premium.

34. Many countries have increased the protection limit of their deposit insurance schemes or have introduced blanket deposit guarantees to better protect depositors amid the deepening global financial crisis. For example, the US raised its limit temporarily from US$100,000 to US$250,000. The UK raised its limit from £35,000 to £50,000; and the floor applicable to countries in the EU was raised from €20,000 to €50,000.

35. In view of the findings of the review conducted by the Board and after carefully considering the comments of the public, the industry, the Consumer Council and other interested parties, the Board has considered the options of raising the protection limit of the DPS from HK$100,000 to either HK$200,000, as indicated by the consultant in the HKMA consultancy report, or HK$500,000.

Considerations for raising the limit to HK$200,000

36. Raising the protection limit to HK$200,000 has the following merits:

    (a) the effectiveness of the DPS, in terms of percentage of depositors fully covered, is restored to the level when it was designed;

    (b) there is no need to tinker with the premium since the total cost of providing protection is roughly the same as the present target fund size; and

    (c) the increase in moral hazard should be acceptable since the percentage of depositors fully covered and the value of deposits covered would be roughly the same as intended when the DPS was designed.

    However, this option has a number of shortcomings:

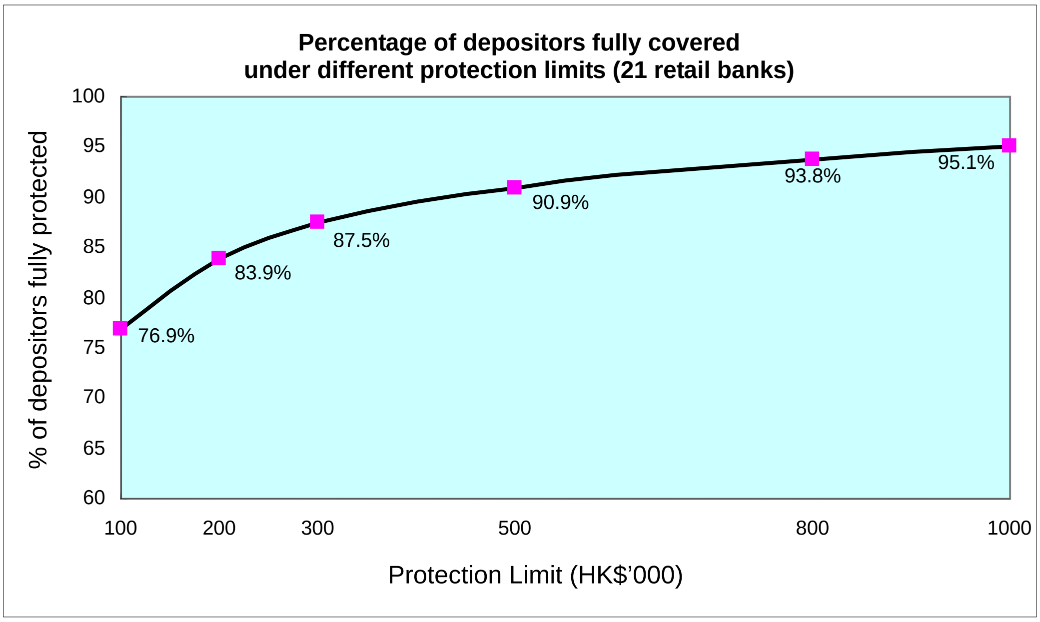
    (a) the percentage of depositors fully covered, at 84%, is not too far from the Board's benchmark for review of 80%. It is likely that the limit will need to be reviewed again in a few years' time. Too frequent changes in the protection limit are not conducive to building public awareness and understanding; and

    (b) the international standard as well as public expectation, having learnt from the current financial crisis, are now higher. Many countries including the US, UK and EU have raised their protection limits.

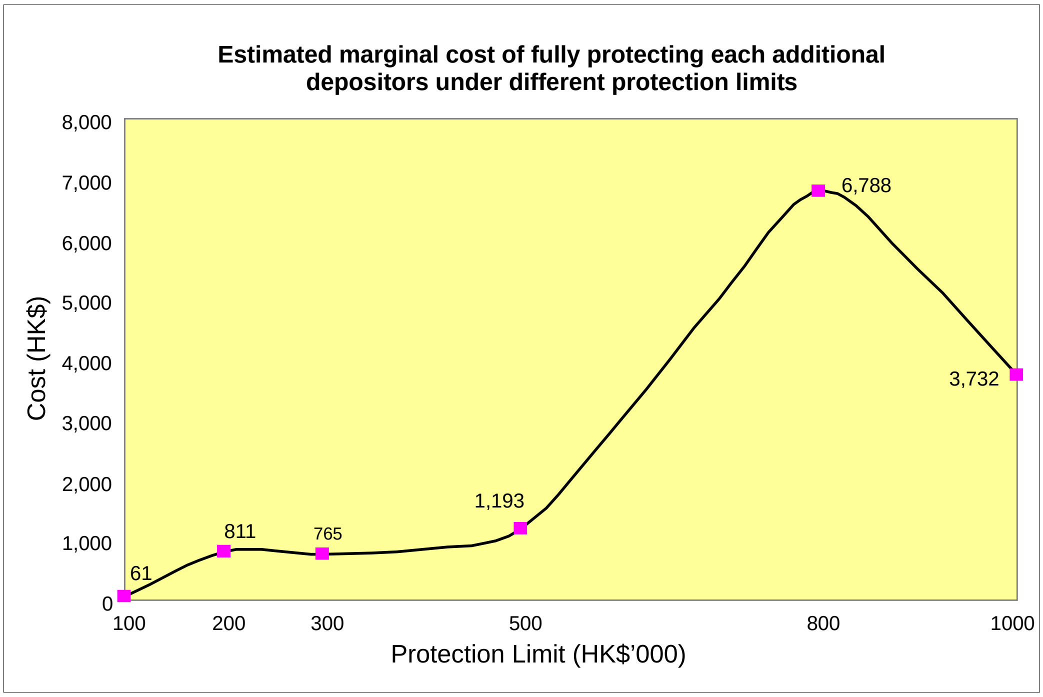
Considerations for raising the limit to HK$500,000

37. After careful consideration, the Board is of the view that a higher protection limit of HK$500,000 is more appropriate. At this level, the DPS can deliver a reasonably high level of protection that is cost effective to provide, accompanied by a manageable level of moral hazard and easily understandable by the public.

38. According to the Survey, about 90% of all depositors will become fully covered under a protection limit of HK$500,000, providing a buffer of about 10% over the 80%-benchmark observed by the Board. This will avoid the need to review the limit again in the near term, which will help to cultivate public confidence in the DPS. As the percentage of depositors fully covered tends to increase at a diminishing rate with the protection limit (see the following chart), pushing the limit beyond HK$500,000 will not add materially to the effectiveness of the DPS.



39. The cost estimates from the DPS funding model indicate that the cost of providing protection will increase with the protection limit (see the chart below). The estimated marginal cost of fully protecting each additional depositor spikes after passing the HK$500,000 threshold, indicating the cost of providing protection beyond this limit rises considerably. Higher costs will add burden to banks and will increase the likelihood that such costs are passed on to depositors.



40. The Board is mindful of the higher level of moral hazard associated with a higher level of deposit protection. As increasing the protection limit to HK$500,000 is able to deliver sufficient protection in a cost effective manner, the Board has reservation in recommending raising the limit beyond this amount. The Board believes the moral hazard associated with the proposed increase is manageable in the light of the sound corporate governance standards being practised by banks in Hong Kong as well as the robust prudential banking regulation and supervision in place.

41. Raising the limit to HK$500,000 will also bring the protection for depositors in Hong Kong in line with protection in major countries in absolute terms and as a ratio to per capita GDP (see the following table).

<table>
<tr><th></th><th>US</th><th>UK</th><th>EU minimum</th><th>Singapore</th><th>Hong Kong</th></tr>
<tr><td>Limit in home currency (‘000)</td><td>250[1]</td><td>50</td><td>50</td><td>20</td><td rowspan="2">500 (proposed)</td></tr>
<tr><td>Limit in HK$ equivalent (‘000)</td><td>2,000</td><td>550</td><td>500</td><td>104</td></tr>
<tr><td>Ratio of limit to per capita GDP</td><td>5.5[2]</td><td>2.2</td><td>2</td><td>0.4</td><td>2.1</td></tr>
</table>

<u>Note</u>
1. Effective from October 2008 to December 2009, US$100,000 before October 2008
2. If calculated at US$100,000, the ratio would be 2.2

42. As indicated by the DPS funding model, raising the protection limit without making a corresponding adjustment to the level of priority claims for depositors in the CO will be prohibitively expensive. Based on the protection limit of HK$500,000, it is estimated that the cost of the DPS will increase from HK$3.0 billion to HK$13.8 billion in terms of shortfall loss if the level of priority claims is HK$100,000 to HK$400,000 below the limit. This will be translated into a cost of HK$0.5 to HK$2.1 per additional HK$100 dollar of deposit protected. Therefore, it is necessary to match any adjustment in the protection limit by a corresponding change to the level of priority claims, preferably by linking it to the DPS protection limit so that the level will be adjusted automatically with the limit.

Considerations for raising the limit above HK$500,000

43. The Board has also considered the merits of raising the limit above HK$500,000. No doubt it will give rise to higher percentages of depositors fully covered. The improvements, however, are disproportionately costly to make and the depositors benefited are increasingly small in number. The moral hazard associated with higher protection limits is also more difficult to contain.

Recommendations on protection limit

It is recommended that the protection limit of the DPS be increased from the current HK$100,000 to HK$500,000, instead of HK$200,000 as indicated by the consultant in the HKMA consultancy report.

It is recommended that the level of priority claims for depositors under the CO be adjusted to link it to the DPS protection limit. Without this adjustment, an increase in the protection limit will be cost-prohibitive.

Compensation calculation basis

44. The HKMA consultancy report recommends the Board to study the changes to the UK deposit insurance regime after the collapse of Northern Rock, as well as new international principles for deposit insurance, and to consider what application they may have to Hong Kong's situation. In the report, the consultant specifically highlighted the UK proposal on switching the basis for calculating deposit compensation from net to gross for further study by the DPS.

45. Netting for deposit insurance purposes refers to the process whereby the deposit claims of a depositor on a failed bank are set-off against the depositor's liabilities to the bank in determining entitlement to compensation. The decision whether or not to net and, if so, to what extent, will affect the compensation payable to depositors and the cost of providing deposit protection.

46. In theory, there is a range of options for netting a depositor's liabilities in determining compensation, each differs in the extent of netting or set-off. At one end of the spectrum, all liabilities of a depositor can be netted against the deposits (full netting). At the other end, no netting will be applied and compensation will simply be paid on a gross deposit basis. In between these two extremes, some forms of partial netting can be applied, where only part of a depositor's liabilities will be set-off against his deposits.

47. While the actual practices on netting vary from country to country, a certain degree of netting is usually applied in the schemes in other countries. For example, partial netting is applied in the US, Canada and Japan. Other countries, like the UK, Singapore and South Korea practise full netting. Pure gross payout (no netting), on the other hand, is not a common practice. As far as international bodies are concerned, there does not appear to be a consensus on the preferred netting approach. The report issued by a working group of the Financial Stability Forum on deposit insurance points out that some countries emphasise the importance of set-off while others believe that it can contribute to unequal treatment. If it is allowed, a number of issues should be considered, including whether a set-off should apply to all loans or only when the loan is due or in default. Set-off can be influenced by the priority of claims in a bank failure. These issues generally involve trade-offs among public policy objectives, requiring country-specific solutions.

48. In Hong Kong, full netting has been adopted for the DPS after thorough consultation, with all liabilities of a depositor being netted against his deposits in the determination of entitlement to compensation. The major reason for adopting this approach was to bring it in line with Hong Kong's insolvency regime, so the DPS would not experience a shortfall loss on its claims in bank liquidations.

49. In its latest recommendations for reforming the UK deposit insurance regime, issued in January 2009, the UK authorities propose making a number of changes to speed up payouts and implement measures to raise public awareness about deposit protection. Consultation on the recommendations just ended in early April 2009.

50. The UK recommendations for speeding up payout mainly involve simplifying the procedures for determining compensation entitlements and expediting the compensation delivery process. By making the proposed changes, the UK authorities aim to achieve a seven-day payout for the majority of eligible depositors after the default of a deposit-taking firm. It is estimated that six months are required at present. The changes should provide depositors with fast access to liquid funds and thus minimise their hardship due to a bank default, thereby helping to contribute to confidence in the deposit insurance regime.

51. The Board is well aware of the importance of the ability to make fast payments in cultivating confidence in the DPS. Since the formation of the Board in 2004, it has been heavily involved in improving the DPS's capability to make fast payments. Indeed, many recommendations in the UK proposal have already been implemented by the Board in a way suitable to Hong Kong's context. For instance, the UK proposal recommends making changes to the IT infrastructure of deposit takers and the deposit insurer to speed up the calculation of compensation. In Hong Kong, the Board has developed an in-house IT system (Payout System) for compensation determinations and has required banks to ensure their data conform with the standards acceptable to the Payout System and are available on a timely basis. These requirements should be as effective as those proposed by the UK. Regular simulations and rehearsals are being conducted by the DPS to ensure the readiness of its processes and systems, and the banks' processes, to payout. The Board expects the DPS to be in a position to make payment in respect of an average small to medium-sized bank within two weeks after it is triggered.

52. Efficient IT infrastructure has been implemented in Hong Kong to support the DPS to make payment in a reasonably expeditious manner. Nevertheless, because of the importance attached to improving payout speed in the UK proposal, it is worth considering whether the netting approach adopted for compensation determinations in Hong Kong should be adjusted to further speed up the process.

53. Currently, banks in Hong Kong are required, under a statutory guideline issued by the Board, to have their customer data and the processes necessary to make that data available, ready for payouts. Banks with a large number of depositors must be ready to submit all deposit and customer liabilities' records to the Board in conformity with the specifications in the guideline. The specifications were drawn up to ensure the records received could be readily processed by the Board's Payout System in the event of a payout.

54. The Board believes payouts under the DPS can be speeded up if netting is eliminated. Based on the Board's experience from payout rehearsals and simulation tests, the number of customer liabilities' records to be processed in a payout will usually exceed the number of deposit records. The processing of such a large number of records for determining compensation entitlements is very time-consuming even with the help of the Payout System, not to mention the time required for verifying the terms and conditions of customer liabilities to ascertain the amount to be set-off. If the volume of data to be processed can be trimmed by switching to no netting, the Board believes the target of making payment within two weeks can be achieved even for large banks, and less time will be required for payout on smaller ones.

55. In theory, simplifying the netting regime will also contribute to the effectiveness of the DPS by enhancing the liquidity position of depositors. Arguably, under a full netting approach, depositors with liabilities to banks will still be entitled to the full value of their deposits, only that their deposits will first be applied to extinguish their liabilities. However, as some of the liabilities may not yet be due for payment, the effect of the acceleration of such liabilities will put the liquidity of depositors in a disadvantaged position. This may be sufficient to trigger withdrawals of deposits on rumours, thereby undermining the objective of the DPS in maintaining banking stability.

56. On the other hand, payout on a gross deposit basis is arguably tilting the balance too much in favour of depositors. In the extreme, a depositor may be compensated even if he has defaulted on repaying his credit card debt, leaving the DPS and other stakeholders in a worse position in a bank liquidation. This may be the reason why pure gross payout is seldom practised by deposit insurance schemes elsewhere. Relatively speaking,

partial netting of liabilities due for payment tends to be a fairer approach but this may not offer the same advantage of speeding up payout as under a gross approach. This is because it is still necessary to process customer liabilities' records under partial netting and, depending on the readiness of the records, additional effort may indeed be required to identify and extract those liabilities due for payment to apply netting.

57. Based on the statistics observed by the Board at simulation tests with a number of retail banks, on average less than 30% of depositors also had liabilities to banks. Another observation is that the average gross deposit balance of such depositors is small in comparison with their liabilities. This may suggest that these depositors mainly keep their deposit balances with the banks concerned for servicing their liabilities rather than for savings purposes. Therefore, changing the netting approach may not have a very significant effect on improving the liquidity position of depositors in general.

58. In terms of cost, reducing the scope of netting means the DPS will need to pay a greater amount of compensation, which will lead to higher financing costs. In addition, if the change in the netting approach for the DPS is not matched by the approach for determining priority claims for depositors under the CO, the DPS may risk incurring a significant amount of shortfall loss. In the case if compensation under the DPS is calculated on a gross deposit basis (no netting), but full netting continues to apply for priority claims, the DPS will not be able to fully subrogate into the priority claims of depositors for payments made in excess of those calculated on a fully netted basis. Based on the statistics from the Survey, the excess can be as high as HK$3 billion in payouts on small to mediums-sized retail banks. This will cause a significant depletion in the DPS Fund (the Fund will accumulate up to HK$2.8 billion under a protection limit of HK$500,000), leading to the need to levy surcharges on banks.

59. The Board understands that under Hong Kong's insolvency law, mutual credits and debts between the insolvent entity and its creditors and debtors will be set-off against each other in liquidations. Changing the netting approach for priority claims will amount to modifying the insolvency regime in Hong Kong and providing for better depositor preference. To confine the impact of the change, the UK proposal is to dis-apply set-off in liquidation of banks up to the deposit insurance limit. The Board understands that this has met with substantial controversy in the UK and the way forward is unclear. The responses to the previous round of consultation in the UK indicate little support for changing the insolvency regime to provide for depositor preference. Careful consideration has been called for on any proposals to change the regime.

60. In summary, the Board does not recommend changing the netting approach (full netting) applicable to the DPS because:

(a) gross payment will accelerate payouts by only a few days in the Hong Kong context. The benefit is not as substantial as that envisaged in the UK;

(b) gross payout is arguably unfair in certain circumstances. Partial netting may be fairer but may not facilitate quick payouts;

(c) many Hong Kong depositors seem to be borrowing from banks other than those in which they put their deposits as savings. If this is the case, gross payout will not have material benefits on the effectiveness of the DPS; and

(d) to make gross payout cost viable for the DPS, the insolvency regime for banks needs to be changed. This is the UK's proposal which is giving rise to substantial controversy. It may be useful to monitor the developments in the UK. In the meantime, such a fundamental change does not seem to be warranted.

Recommendation on compensation calculation basis

The Board does not recommend changing the netting approach (full netting) applicable to the DPS for the time being. However, international developments should be monitored and the subject should be kept under review.

Product Coverage

Secured deposits

61. According to the DPSO, except a few types of deposit, all deposits meeting the definition of deposit in the BO are eligible for protection under the DPS. Indeed, the product coverage of the DPS is very comprehensive.

62. The Board has noted that since the introduction of the Deposit Guarantee in October 2008, public attention to the coverage of the DPS has risen markedly. This is understandable as the unlimited protection under the Guarantee is provided in accordance with DPS principles. However, there has been some recent public concern about deposits held in integrated accounts being secured for services bundled with the accounts and becoming unprotected without the knowledge of customers. The issue also triggered unfounded speculation that customers' deposits could become unprotected due to other business relationships with banks. The observations were also reported by the Consumer Council in its response to the HKMA consultancy report. The Hong Kong Association of Banks submitted that protected deposit under the DPS had been defined in a complex way which made it difficult to understand, and suggested its definition be refined.

63. Based on the public comments and the Board's experience in examining the protection status of financial products, including during payout rehearsals and simulation tests, and in handling enquiries from banks and depositors received on the Board's enquiry hotline, the Board believes that the source of the confusion observed was a lack of understanding by some depositors about whether their deposits had been pledged. In addition, the way in which banking and financial services are now offered makes it less straightforward for depositors to tell whether a deposit has been taken as security.

64. Deposits secured for a credit facility, or other services provided by banks, whether or not in an integrated account, are not protected by the DPS as they no longer meet the definition of deposit in the BO. Under the BO, a loan of money upon terms referable to the provision of property or services does not constitute a deposit. When a depositor pledges a deposit with a bank for a credit facility, the deposit is considered to be a loan of money referable to the provision of the credit facility, and will fall outside the definition of deposit. This renders the deposit no longer eligible for protection under the DPS. The practice of excluding secured deposits from protection can also be found in other countries, for example, in the UK and Singapore.

65. Nowadays, some banks are able to offer a wide range of banking and financial services collectively to customers in a package, possibly as a result of technological advancements and financial innovations. The services bundled together may be governed by a single agreement or multiple interrelated agreements. Some of these arrangements may, in effect, charge the deposits of customers and hence render the deposits unprotected. Others may give rise to a right of set-off or lien on a deposit, which typically do not affect the protection status of the deposit. Based on the public comments, some depositors have found it difficult to tell whether their deposits are subject to any encumbrances. The fact that a range of services is provided simultaneously by banks also raised suspicions that deposits could be linked to the provision of these services, potentially rendering them unprotected.

66. However, in accordance with the representation requirements under the DPSO, banks are required to notify customers of deposits not protected by the DPS. Before varying the terms of a deposit, which will render the deposit unprotected, such as effecting a charge on a deposit, banks must notify and obtain an acknowledgement from their customers.

67. Despite the fact that a deposit can become unprotected only under very limited circumstances and banks are required to notify customers of non-protected deposits, the Board is mindful of the risk that the misunderstandings and suspicions may cause an erosion of public confidence in the DPS and impair its effectiveness, especially during a crisis. The Board considers it necessary to take appropriate measures to reinforce the clarity and certainty of the product coverage of the DPS.

68. Apart from the potential negative impacts on public confidence, the Board has noted that the exclusion of secured deposits from the coverage of the DPS may have an undesirable impact on the effectiveness of the DPS.

69. A depositor who has pledged a deposit for a credit facility may not be fully utilising the facility at all times. In this situation, the depositor is normally entitled to withdraw at least the portion not required to secure the utilised limit. If such portion is not covered by the DPS, the depositor will have an incentive to withdraw at least that portion on hearing rumours concerning the bank, thereby adding to the likelihood of the occurrence and the impact of rumour-driven runs. As the practice of offering such services becomes increasingly popular, which seems to be the current market trend, the "leakage" of funds from the DPS coverage and, hence, the negative impact on its effectiveness will be more significant.

70. It is beyond the Board's authority to require banks to refrain from offering services in a way that may trigger customers' suspicions about the protection status of their deposits, for example, not offering integrated accounts. In fact, the Board does not consider it desirable to do so as this may inhibit financial innovations that are otherwise beneficial to customers. To eliminate the potential for misunderstanding and concern about the coverage of the DPS and remove the undesirable impact on its effectiveness due to the exclusion of secured deposits, the Board recommends redefining the coverage of the DPS to bring secured deposits under protection.

71. After considering various options, the Board believes it is inappropriate to initiate a change to the definition of deposit in the BO, to which the DPSO refers in defining deposits eligible for protection. Changing the definition of deposit in the BO may interfere with its wider functions of governing banking and deposit-taking activities in general. It is therefore recommendable to change the definition of deposit in the DPSO to bring secured deposits under protection.

72. Improving the robustness of the definition of deposit in the DPSO is also expected to contribute to the quality, and promote acceptance, of the representations made by banks on the protection status of their financial products.

73. Expanding the coverage of the DPS to include secured deposits will increase the amount of compensation payable to depositors and, therefore, the financing cost of payouts. However, the additional cost should be justifiable in the context of upholding the effectiveness of the DPS. On the basis of data available to the Board, it is estimated that the amount of secured deposits in banks should be less than 10% of total deposits. As some of these deposits may exceed the protection limit, or are held by depositors also holding protected deposits, not all of them will be payable as compensation. Netting these deposits against liabilities that they are pledged for will further reduce the amount of compensation payable on them. The cost of financing the additional payout amount on secured deposits should therefore not be significant.

74. As with the adjustment to the DPS protection limit, any adjustment made to product coverage should be matched by a corresponding change in the priority claims for depositors under the CO. As the CO also adopts the definition of deposit in the BO in defining eligibility to priority claims, secured deposits are also not covered by the priority claims. Indeed, the exclusions in the DPSO referring to the types of deposit and depositor not protected, were intentionally brought in line with the exclusions in the priority claims for depositors in bank liquidations. This arrangement is intended to ensure the DPS can fully subrogate into the priority claims of

depositors and recover the compensation paid to depositors from bank liquidations. Although the cost of financing the additional payout amount on secured deposits may not be significant, as the size of the DPS Fund is small relative to the amount of protected deposits (0.25% under the proposed limit of HK$500,000, please refer to paragraph 97), the DPS will risk suffering a significant amount of shortfall loss from the additional amount paid on secured deposits if it is not given a priority to recover them in bank liquidations. The loss incurred will eventually be passed on to banks as surcharges and, if substantial, increase the likelihood of being eventually passed on to depositors.

Structured deposits

75. While the recent public discussion on the coverage of the DPS focused on secured deposits, there were comments on the treatment of structured deposits under the DPS. In its response to the HKMA consultancy report, the Consumer Council noted that the use of the term “deposit” in structured deposit may be potentially problematic, and suggested the treatment of structured deposits under the DPS should be kept under review.

76. Structured deposits are not covered by the DPS because many of them do not fit in with the definition of deposit and it is generally difficult to ascertain whether they do. To provide maximum certainty to depositors, such deposits have been carved out from the coverage of the DPS. The DPS aims to protect small, unsophisticated depositors. The exclusion of structured deposits, which are mainly held by large and sophisticated depositors, is therefore consistent with the objective of the DPS. Based on the Board’s experience in payout rehearsals, it is generally difficult to determine the value of a structured deposit before its maturity, and to determine the compensation payable on such deposits would take a lot of time and a disproportionate amount of effort. Therefore, the inclusion of structured deposits is not consistent with the aim of achieving a fast payout.

77. The Board has been monitoring closely the popularity of structured deposits among small depositors since the inception of the DPS. When structured deposits were carved out from the protection of the DPS, the Board also set triggers for reviewing their protection status in terms of number of small depositors holding these deposits as a percentage of all depositors (3% for all structured deposits; 2% for individual types of structured deposit). The Board is prepared to conduct a review of the protection status of the deposits if it is established that they have become popular with small depositors and that the exclusion of them will materially affect the effectiveness of the DPS.

78. However, a survey conducted by the Board in 2007 showed the number of small depositors holding structured deposits as a percentage of all depositors (at 0.5%) remained significantly lower than the triggers for review set by the Board. The Board therefore does not see any urgent need to bring structured deposits under the coverage of the DPS.

79. Given that structured deposits are more akin to investment, they are not popular with small depositors, and it is difficult to make fast payments on them, the Board does not recommend bringing these products under the protection of the DPS at this stage. However, the Board will continue to monitor the popularity of these products among small depositors to assess the need to review their protection status.

Recommendations on product coverage

It is recommended that secured deposits which fall outside the present definition of "deposit" under the BO because they are referable to the provision of banking and financial services be brought under the protection of the DPS by revising the definition of "deposit" in the DPSO.

It is recommended that the definition of "deposit" for the priority claims for depositors under the CO be brought in line with the revised definition of deposit in the DPSO.

The Board does not recommend bringing structured deposits under the protection of the DPS.

Types of institution covered

80. According to the DPSO, it is mandatory for licensed banks to participate as members of the DPS. A licensed bank (LB) is one of the three types of financial institution authorized by the MA under the BO to carry on a banking business or a business of taking deposits in Hong Kong (commonly known as the three-tier authorization system). The two other types of authorized institution (AI) are the restricted licence bank (RLB) and deposit-taking company (DTC). RLBs and DTCs are not members of the DPS.

81. Under the three-tier authorization system, only LBs can carry on the full range of banking business - operating current and savings accounts, accepting deposits of any size and maturity from the public and paying or collecting cheques drawn or paid in by customers. In short, they may therefore engage in the full range of retail and wholesale banking business.

82. RLBs and DTCs may not carry on banking business and the deposits that they can take from the public are subject to restrictions. RLBs may take call, notice or time deposits from the public in the amounts of HK$500,000 or above without restriction on maturity. DTCs are restricted to taking deposits of HK$100,000 or above with a term to maturity, or call or notice period, of at least three months. RLBs and DTCs are generally involved in specialised activities, such as merchant banking, capital market operations, consumer finance, trade finance or securities business. Except for a couple of DTCs engaged in consumer finance, accessibility of ordinary retail depositors to RLBs and DTCs is generally very limited.

83. At the end of 2008, there were 145 LBs, 27 RLBs and 28 DTCs in Hong Kong. Customer deposits held in RLBs and DTCs accounted for about 0.5% of all customer deposits in AIs.

84. In connection with the consultation exercise on the DPS in 2000, the DTC Association had suggested that RLBs and DTCs should be allowed to join the DPS. However, protection was not extended to cover RLBs and DTCs at the time because it was doubtful whether that was consistent with the objective of the DPS in relation to protecting small depositors (these institutions cannot take small deposits). This arrangement was consistent with the international best practice of aligning the membership of a deposit insurance scheme with the focus of protecting small depositors. As well, RLBs and DTCs can seek to be upgraded to an LB should they wish to become protected under the DPS.

85. Small localised deposit takers with a narrow business focus are covered by deposit insurers in many other countries, such as credit unions, savings associations, building societies and labour banks. Unlike the RLBs and DTCs in Hong Kong, such institutions are usually allowed to take deposits from small depositors, either in the form of direct deposits or through subscription of shares.

86. The issue of whether RLBs and DTCs should be brought under the protection of the DPS has arisen again as a result of the introduction of the Deposit Guarantee, which covers all three types of AIs, that is, LBs, RLBs and DTCs. As the Guarantee is scheduled to expire by the end of 2010, there is concern over the impact of the removal of the protection status from the RLBs and DTCs after the Guarantee expires. In response to the HKMA consultancy report, the Consumer Council pointed out that the public may be attracted to deposit with RLBs and DTCs offering high interest rates on the assumption that the deposits at such institutions will still be protected beyond 2010. Therefore, this issue needs to be clarified as soon as possible. The Council also suggested the DPS should explore the feasibility of extending protection to RLBs and DTCs to offer better protection to depositors in Hong Kong. The Council recommended the types of AI covered by the DPS should be kept under review, taking into account developments in market strategies and changes in consumer behaviour that may result from the proposal in the HKMA consultancy report to simplify the three-tier authorization system.

87. Unlike the Deposit Guarantee, the DPS is not designed to handle a short-term systemic crisis. It is meant to be a long term and self-sustaining arrangement for maintaining banking stability, at a reasonable cost and a manageable level of moral hazard, by fully protecting a large majority of depositors so they are less likely to overreact to rumours.

88. Under the three-tier authorization system, RLBs and DTCs are not allowed to take deposits from small depositors (deposits of an amount below HK$100,000). Even if the protection limit were increased to HK$500,000, only very few of their depositors would become fully protected, and this would not be helpful in preventing rumour-driven runs on these institutions. In fact, RLBs and DTCs have been relying heavily on funding from banks and other professional players (customer deposits account for less than 20% of their fundings, compared with about 60% for LBs). The total amount of customer deposits held with these institutions is some 0.5% of the entire banking industry. Extending protection to RLBs and DTCs is expected to add little to the overall effectiveness of the DPS.

89. After critically reviewing the merits of bringing RLBs and DTCs under the protection of the DPS, the Board is of the opinion that there has been no material change in the nature and scope of their operation to warrant the membership composition of the DPS to be re-defined since the current regime was determined ten years ago.

90. As the merits of extending protection to RLBs and DTCs are not apparent, the Board does not recommend bringing these institutions under the protection of the DPS at this stage.

91. The Board is aware that the HKMA consultancy report carries a recommendation to the HKMA to review the three-tier authorization system. The Board will keep in view the developments in this area. If any changes to the system are anticipated to have significant impacts on the effectiveness of the DPS, and the associated cost and moral hazard, the Board will initiate a review of the membership of the DPS with a view to restore the balance.

Recommendation on types of institution covered

The Board does not recommend extending the coverage of the DPS to deposits held in restricted licence banks and deposit-taking companies.

Funding arrangements

92. Currently, the funds required to meet the cost of the DPS in a payout, that is, the target size of the DPS Fund, is accumulated through the collection of annual contributions from Scheme members. The contributions payable by individual Scheme members for accumulating the Fund (the build-up levies), are determined based on the amount of protected deposits held with them and the supervisory ratings assigned to them by the MA.

93. Based on the current target fund size of 0.3% of total protected deposits under the protection limit of HK$100,000, the target size of the DPS Fund is estimated to be about HK$1.5 billion. So far, the Board has collected about HK$1 billion in contributions. Based on the existing contribution collection rate of about HK$300-350 million a year, it is projected that the target size of the Fund will be reached by 2012.

94. The proposals on protecting secured deposits and raising the protection limit are expected to result in an increase in the amount of deposits protected by the DPS. As the annual contributions paid by Scheme members are determined by the amount of protected deposits held with them, additional contributions will become payable if the two proposals are implemented.

95. The Board is mindful of the cost impacts on Scheme members because of the proposals, which, if substantial, can increase the likelihood of being passed on to depositors. The concern has also been raised in the HKMA consultancy report and in various public responses to the report. In view of these concerns, the Board considers it appropriate to supplement the implementation of the two proposals by cost mitigating measures to alleviate burden on Scheme members, thus reducing the potential for cost transfer to depositors.

96. To contain the cost impact due to protecting secured deposits, the Board recommends bringing the basis for assessing contribution in line with compensation determination. Currently, Scheme members are required to report the amount of protected deposits held with them for contribution assessment on a gross deposit basis, that is, without netting depositors' liabilities. Compensation under the DPS, on the other hand, will be determined on a net deposit basis. The Board sees that it is more equitable to allow Scheme members to report protected deposits for contribution assessment on a net basis, at least to the extent they find it cost effective to do so. In these cases, Scheme members will only be required to pay a contribution on the amount of protected deposits payable as compensation. At the current HK$100,000 protection limit, some Scheme members may find the savings in contributions not worth the

administrative or system enhancement cost of performing netting. The savings can be more significant under the proposed limit of HK$500,000. According to information available to the Board, the reduction in the amount of protected deposits reported for contribution assessment should largely offset the increase in the amount due to the inclusion of secured deposits (estimated to be much less than 10%) and hence neutralising the impact on contributions.

97. On the financing cost and shortfall loss in a payout, the DPS funding model estimates that the size of the DPS Fund should be increased to HK$2.6 billion to be able to absorb the costs under a limit of HK$500,000, on the assumption there is a matching level of priority claims for depositors under the CO. After adding an expected administrative cost of HK$0.2 billion, the target size of the DPS will amount to HK$2.8 billion, equivalent to about 0.25% of the total amount of deposits protected.

98. As the amount of protected deposits will more than double, from the current HK$495 billion to HK$1,149 billion, if the protection limit is raised from HK$100,000 to HK$500,000, the total amount of build-up levies[1] payable by Scheme members will also increase by the same magnitude if contributions are charged at the current rates.

99. To contain the cost impact due to raising the protection limit, the Board proposes cutting the rates for charging build-up levies by half to keep the absolute amount of annual contributions payable by Scheme members largely unchanged (see table below).

Supervisory rating	**Current build-up levies (as % of protected deposits)**	**Proposed build-up levies (as % of protected deposits)**
1	0.05	0.025
2	0.08	0.04
3	0.11	0.055
4 and 5	0.14	0.07

The Board believes that by halving the rates, the increase in the protection limit will not add materially to the financial burden of Scheme members. As the annual cost of protecting each dollar of deposit will actually be lower, it should not add any pressure on Scheme members to pass the cost on to depositors. Indeed, since the inception of the DPS in 2006, the Board has not noticed any reports of Scheme members passing on the cost of deposit protection to depositors.

1 Build-up levies refer to the contributions payable by Scheme members for accumulating the DPS Fund to reach its target fund size during the initial “build-up” phase of the Fund.

100. The tradeoff for cutting contribution rates is an extension in the time required for the DPS Fund to reach its target. Under a slightly higher contribution collection rate of about HK$350-400 million a year, it is expected to take about four years to complete the accumulation of the required funds of HK$1.3 billion for providing the additional protection (on top of the target of HK$1.5 billion under the current protection limit of HK$100,000). According to the Board's projection, the target fund size for the HK$500,000 protection limit will be reached by 2016, compared to 2012 under the current limit.

101. As the surcharges payable by Scheme members after a significant depletion in the DPS Fund, for example after a payout, are also capped by the amounts of the build-up levy, cutting the contribution rates for collecting the levies will also have the effect of prolonging the time for replenishing the Fund after a payout.

102. The Board has also reviewed other charges payable by Scheme members under the DPS and is of the opinion that there is no need to adjust these charges.

Recommendations on funding arrangements

It is recommended that Scheme members be offered an option to report protected deposits for contribution assessment purposes on a net deposit basis to the extent that they see appropriate.

It is recommended that the target fund size of the DPS Fund be adjusted from the current 0.3% to 0.25% of total protected deposits

It is recommended that the annual contribution by Scheme members be maintained largely at the current level in absolute terms. This will mean the contribution rates for collecting build-up levies from Scheme members are to be reduced by half.

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Appendix

Summary of recommendations

1. Protection limit

- *It is recommended that the protection limit of the Deposit Protection Scheme (DPS) be increased from the current HK$100,000 to HK$500,000, instead of HK$200,000 as indicated by the consultant in the HKMA consultancy report.*

- *It is recommended that the level of priority claims for depositors under the Companies Ordinance be adjusted to link it to the DPS protection limit. Without this adjustment, an increase in the protection limit will be cost-prohibitive.*

2. Compensation calculation basis

- *The Board does not recommend changing the netting approach (full netting) applicable to the DPS for the time being. However, international developments should be monitored and the subject should be kept under review.*

3. Product coverage

- *It is recommended that secured deposits which fall outside the present definition of "deposit" under the Banking Ordinance because they are referable to the provision of banking and financial services be brought under the protection of the DPS by revising the definition of "deposit" in the DPS Ordinance.*

- *It is recommended that the definition of deposit for the priority claims for depositors under the Companies Ordinance be brought in line with the revised definition of deposit in the DPS Ordinance.*

- *The Board does not recommend bringing structured deposits under the protection of the DPS.*

4. Types of institution covered

- *The Board does not recommend extending the coverage of the DPS to deposits held in restricted licence banks and deposit-taking companies.*

5. Funding arrangements

- *It is recommended that Scheme members be offered an option to report protected deposits for contribution assessment purposes on a net deposit basis to the extent that they see appropriate.*

- *It is recommended that the target fund size of the DPS Fund be adjusted from the current 0.3% to 0.25% of total protected deposits*

- *It is recommended that the annual contribution by Scheme members be maintained largely at the current level in absolute terms. This will mean the contribution rates for collecting build-up levies from Scheme members are to be reduced by half.*