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**Report of the Bills Committee on
Deposit Protection Scheme (Amendment) Bill 2010**

Purpose

This paper reports on the deliberations of the Bills Committee on Deposit Protection Scheme (Amendment) Bill 2010 (the Bill).

Background

2. The Deposit Protection Scheme Ordinance (Cap. 581) (DPSO) was enacted in May 2004, and the Hong Kong Deposit Protection Board (the Board) was formed in July 2004 to establish and administer the Deposit Protection Scheme (the Scheme). The Scheme commenced operation in September 2006 after enactment of the rules governing its operation.

3. The salient features of the Scheme are summarized below:

- (a) Unless exempted by the Board, all licensed banks are Scheme members from whom contributions are collected and paid into the Deposit Protection Scheme Fund (the Fund). The current target fund size of the Fund is 0.3% of the total amount of all relevant deposits;
- (b) 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 rating¹ assigned by the Hong Kong Monetary Authority (HKMA) to the member;

¹ Under section 2 of the DPSO, the supervisory rating assigned to a Scheme member reflects HKMA's assessment of the Scheme member's overall financial condition and of the quality of the Scheme member's management. "CAMEL Rating" is a supervisory rating currently adopted by HKMA to assess the financial condition and overall soundness of an authorized institution in the areas of Capital adequacy, Asset quality, Management, Earnings and Liquidity.

- (c) Compensation not exceeding \$100,000 may be paid to each depositor of a Scheme member (the failed Scheme member) in respect of which a winding up order has been made or the Monetary Authority has served a notice on the Board that compensation should be paid from the Fund;
- (d) Under section 1 of Schedule 1 to the DPSO, certain types of deposit, such as time deposits for a term exceeding five years, structured deposits and secured deposits, are not protected by the Scheme; and
- (e) The Scheme will borrow from the Exchange Fund to pay depositors any compensation payable in respect of a failed Scheme member. The Scheme will seek reimbursement from the liquidation of the failed Scheme member for the compensation paid to depositors. 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 Scheme will be charged to the Fund.

4. In the light of relevant developments in international and local financial markets since the outbreak of the global financial crisis, and experience gained from operating the Scheme since 2006, the Board completed a review of the Scheme and consulted the public on the findings thereof by two phases in 2009. Following the review, the Board proposed a number of enhancements to the Scheme for, among other objectives, meeting the public expectation for better deposit protection. Given the general support from the public and the relevant parties for the proposed enhancements to the Scheme, the Board proposes to amend the DPSO and the Companies Ordinance (Cap. 32) (CO) to effect the proposed enhancements.

The Bill

5. The Administration introduced the Bill into the Legislative Council on 9 April 2010. The main provisions of the Bill cover the following aspects:

Level and scope of protection

- (a) To amend the definition of "deposit" under the DPSO to expand the Scheme's coverage to include secured deposits, i.e. deposits subject to any security referable to the provision of any banking or financial services. *(Clause 3)*
- (b) To raise the limit on the total amount of compensation for each depositor under the Scheme from HK\$100,000 to HK\$500,000. *(Clause 4)*

Funding arrangements

- (c) To empower the Board to obtain information required for the assessment of contributions payable by Scheme members on a net deposit basis. *(Clause 9)*
- (d) To change the target size of the Fund from the current 0.3% of the total amount of relevant deposits to 0.25%; to reduce the percentages for charging annual build-up levies on Scheme members by 65%; and to allow Scheme members to report the amount of relevant deposits for contribution assessment purposes after deducting relevant liabilities owed by depositors. *(Clause 13)*

Processes for determining compensation

- (e) To empower the Board to determine under specified circumstances the amount of accrued interest and the value of annuities and future and contingent liabilities of depositors by making reasonable and appropriate estimates. *(Clause 4)*
- (f) To make necessary amendments to harmonize the maximum amount of compensation payable to depositors and the amount of excessive payment recoverable from depositors in light of the Board's expanded power mentioned in (e) above. *(Clauses 5 and 7)*
- (g) To empower the Board to make interim payments of different amounts to different depositors or different classes of depositors. *(Clause 6)*
- (h) To allow members of the Board to conduct meetings and approve written resolutions through electronic means. *(Clause 12)*

Representation, disclosure and acknowledgement requirements

- (i) To empower the Board to make additional rules to prescribe the representation, disclosure and acknowledgement requirements relating to protected and non-protected deposit products. *(Clause 10)*

Consequential amendments to the Companies Ordinance

- (j) To amend section 265 of the CO to link the limit on priority claims of depositors in a bank liquidation to the limit on the amount of compensation under section 27 of the DPSO and to adopt the definitions of "deposit" and "depositor" in the DPSO. *(Section 2 of the Schedule)*

The Bills Committee

6. At the House Committee meeting on 23 April 2010, Members agreed to form a Bills Committee to study the Bill. Under the chairmanship of Hon CHAN Kam-lam, the Bills Committee has held three meetings with the Administration to scrutinize the Bill. The membership list of the Bills Committee is at the **Appendix**.

Deliberations of the Bills Committee

7. The Bills Committee supports the Bill which seeks to enhance the protection to depositors under the Scheme and to improve the Scheme's operating efficiency. The Bills Committee has examined the Bill in detail and its deliberations are summarized in the ensuing paragraphs.

Consultation on the proposals under the Bill

8. The Bills Committee has sought details on how the consultation on the proposals under the Bill had been conducted by the Board. The Administration has advised that the Board conducted a public consultation in two phases in 2009. It launched a publicity campaign through the mass media to encourage public participation in the consultation, and set up a hotline for receiving public enquiries. During the consultation, the Board invited relevant industry organizations and professional bodies including The Hong Kong Association of Banks, the Hong Kong Institute of Certified Public Accountants and the Law Society of Hong Kong, the Consumer Council and other related organizations to give views on the proposals. More than 800 responses were received during the consultation period. The Board had also commissioned the Chinese University of Hong Kong to conduct an opinion survey to gauge public views about the proposals.² The public consultation documents and the reports on the two phases of consultation have been published online. In view of the extensive public consultation that had been conducted by the Board in 2009 on the proposals under the Bill, the Bills Committee agreed at its first meeting that there was no need for the Bills Committee to further solicit public views on the Bill.

Commencement (Clause 2)

9. The Bills Committee has noted that upon enactment, most of the provisions under the Bill will come into operation on 1 January 2011 while other provisions will commence on 20 October 2010 or on the day the Bill is published in the Gazette as an Ordinance. Given that the temporary full deposit guarantee³ is due to expire at the

² The Administration has provided a copy of the opinion survey report and a summary of the survey findings for members' reference, vide LC Paper No. CB(1)1906/09-10(01).

³ Amid the global financial crisis, the Financial Secretary announced on 14 October 2008 the use of the Exchange Fund to guarantee full repayment of all customer deposits held with authorized institutions in Hong Kong. The guarantee is due to expire at the end of 2010.

end of 2010, the Bills Committee considers it important for the proposed enhancements under the Bill to take effect on time to dovetail with the lifting of the temporary full deposit guarantee. The Bills Committee supports the proposed commencement dates provided in the Bill.

10. On the concern about possible huge capital outflow from Hong Kong to other countries where full or enhanced deposit guarantee continues to be in force beyond 1 January 2011, the Administration has advised that the temporary full deposit guarantee in Hong Kong is a time-limited arrangement, and a decision would be taken at the end of 2010 in the light of international financial conditions on whether the arrangement should be extended. Singapore, Malaysia, Brunei and Taiwan are the jurisdictions in Southeast Asia with full deposit guarantee in place and they have indicated their intention to withdraw the full deposit guarantee at the end of 2010. HKMA and the central banks in Singapore and Malaysia have set up a tripartite liaison group to co-ordinate the timing for lifting their full deposit guarantee. At this stage, the parties in the tripartite liaison group hold a common view that there is no need to extend the temporary full deposit guarantee. At the Bills Committee's request, the Administration has provided information on the deposit protection arrangement in other jurisdictions.⁴

Definition of "deposit" (Clause 3)

11. The Bills Committee has examined the types of deposit that are not currently but will be brought under the protection of the Scheme under the Bill. According to the Administration, the proposed new definition of "deposit" seeks to expand the protection coverage of the Scheme to include secured deposits, so long as the security (including any form of encumbrance, charge, mortgage, pledge, lien and right of set off) to which a deposit is subject is referable to the provision of any banking or financial services. The following types of secured deposits are examples of deposits that will be brought under the protection of the Scheme -

- (a) a deposit secured for a guarantee issued by a bank in favour of a third party to undertake a rental payment, provided that the third party was not the bank itself;
- (b) a deposit secured in a bank for obtaining the services of securities trading provided by the bank; and
- (c) a deposit secured for a letter of credit issued by a bank.

On the other hand, the following types of payments to a bank, among others, are not and will not be covered by the Scheme even with the proposed new definition of "deposit" -

⁴ Annex A to LC Paper CB(1)1906/09-10(01)

- (a) a deposit collected by a bank for the purpose of securing tenancy of a property owned by the bank itself;
- (b) a sum of money deposited in a bank for settlement of securities transactions;
- (c) a sum of money deposited in a margin account if the sum of money was used to pay for the service charges for trading on margin; and
- (d) a sum of money deposited in a bank for the specified purpose of payment to a third party even if the sum of money was not eventually paid to the third party because the specified purpose had failed.

Entitlement to compensation (Clause 4)

12. The Bills Committee has sought clarification on the policy intent of introducing the proposed section 27(4)(c) and (d), which empowers the Board to determine under specified circumstances the amount of accrued interest and the value of annuities and future and contingent liabilities of depositors by making reasonable and appropriate estimates. The Administration has advised that according to the existing DPSO, the Board is required to apply the rules currently in force under the law of bankruptcy in the process of determining the amount of liabilities of a person to the failed Scheme member, the value of annuities and future and contingent liabilities and the amount of interest accrued on deposits or liabilities. The process can take a considerable amount of time and may delay the payment of compensation to the person entitled to it. The proposed provisions seek to inject flexibility into the compensation determination process by empowering the Board to make estimates of the compensation and shorten the time required for making compensation to depositors.

13. Members have expressed concern whether there is any mechanism for depositors to appeal against the amount of compensation as decided by the Board by applying the proposed section 27(4)(c) or (d). The Administration has advised that according to section 41(1) of the DPSO, a person who is aggrieved by a decision of the Board under section 32(5)(b) of the DPSO may apply to the Deposit Protection Appeals Tribunal (the Tribunal) for a review of the decision. Section 32(5)(b) of the DPSO refers to the amount of compensation to which a depositor is entitled as determined by the Board under Division 2 of Part 5 of the DPSO, and Division 2 of Part 5 of the DPSO comprises sections 27, 28, 29, 30 and 31. Therefore, the amount of compensation to which a depositor is entitled as determined by the Board by applying the proposed section 27(4)(c) or (d) may be subject to the review of the Tribunal. The Administration has confirmed that this is consistent with its policy intent.

Interim payment (Clause 6)

14. Under the existing section 36 of the DPSO, in the event of insolvency of a Scheme member, the Board may make an interim payment to a depositor of an amount that the Board considers appropriate, if the Board considers that -

- (a) there is uncertainty as to the entire amount of compensation payable to the depositor in accordance with the DPSO; or
- (b) the time required to ascertain the entire amount of compensation payable to the depositor in accordance with the DPSO would be so long as to unduly delay the payment of compensation to the depositor by the Board.

15. The Bill seeks to amend section 36 by adding the proposed section 36(2) to empower the Board to make interim payments of different amounts to different depositors, or different classes of depositors, as the Board considers appropriate.

16. Members including Hon Miriam LAU and Hon Audrey EU have expressed concern that while the existing section 36 sets out two factors that the Board will consider in determining whether it should make an interim payment, the Bill does not specify any criteria, such as the financial position of individual depositors as mentioned by the Administration at the Bills Committee meetings, for the Board's exercise of the discretion under the proposed section 36(2). Members consider that if the policy intent is for the Board to take into account the financial position of the depositor and/or other factors in exercising its discretion under section 36, the Administration should further amend section 36 to spell out such criteria.

17. The Administration has clarified that under the existing section 36 of the DPSO, it is intended that the Board can make different amounts of interim payment to different depositors. In order to reflect the policy intent more clearly, the proposed section 36(2) further provides that the Board may make interim payments of different amounts to different depositors, or different classes of depositors, as the Board considers appropriate when either of the conditions specified in the proposed section 36(1) (which are the existing conditions in section 36) is met. The Administration does not seek to change the conditions as currently specified in section 36 under which the Board may make an interim payment or exercise its discretion in determining the amount of such interim payment. However, without limiting the scope of factors that the Board may consider in determining the amount of interim payment to be made to a depositor under section 36, the Administration has agreed to move a Committee Stage amendment (CSA) to highlight that the financial position of the depositor is one of the possible factors to be taken into consideration by the Board in determining the amount of interim payment to be made to a depositor.

18. Members including Hon Miriam LAU and Hon Audrey EU have queried whether the Board's decisions on interim payments made under section 36 of the DPSO are subject to review by the Tribunal. In this connection, members have

pointed out that estimates made under the proposed section 27(4)(c) or (d), which according to the Administration are subject to review by the Tribunal, can affect the amount of interim payments determined by the Board under section 36. The Administration has advised that decisions made by the Board under section 36 are not decisions that may be subject to review by the Tribunal under section 41(1) of the DPSO. Section 36 does not require the Board to make an interim payment; nor does it specify how the Board should arrive at the amount of interim payment to be made to a depositor. This is to allow the Board to apply a method that it considers most suitable to the circumstances of the depositor, which may involve producing a reasonable estimate of the compensation to which the depositor is entitled. The Administration affirms that it does not have any intention to make the Board's decisions made under section 36 of the DPSO reviewable by the Tribunal, including decisions on the method used for producing the reasonable estimate of a depositor's compensation entitlement at the time of the interim payment, which may or not may not be the same as the methods applied in the proposed section 27(4)(c) or (d).

Recovery of payment by the Board (Clause 7)

19. Clause 7 seeks to amend section 37 of the DPSO to harmonize the amount of excessive payment that can be recovered from depositors in light of the expanded power of the Board to determine the amount of accrued interest and the value of annuities and future and contingent liabilities by making estimates under the proposed section 27(4)(c) or (d) of the DPSO. The Bills Committee has noted that the proposed section 37(5) describes the amount of compensation paid as a result of an estimate made under section 27(4)(c) or (d) as "the paid amount", whereas the amount of compensation that would have been paid to the depositor if the estimate had not been made is described as "the entitled amount". Members have expressed concern whether these descriptions may give rise to an argument that since an amount of compensation paid by the Board as a result of an estimate made under the proposed section 27(4)(c) or (d) is not an "entitled amount" under the proposed section 37(5), it is also not an "amount of compensation to which he is entitled" within the meaning of section 32(5)(b), and consequently such estimate does not fall within the Tribunal's jurisdiction under section 41(1).

20. The Administration has explained that the proposed section 37(5) seeks to clarify that, for the purposes of section 37(1), the amount of compensation overpaid to a depositor as a result of an estimate made under the proposed section 27(4)(c) or (d) may be recovered by the Board. Hence, the proposed section 37(5) does not affect other provisions of the DPSO and will not exclude from the Tribunal's jurisdiction a decision of the Board based on an estimate it makes under the proposed section 27(4)(c) or (d). However, to address members' concern, the Administration agrees to move a CSA to change the term "the entitled amount" in the proposed section 37(5) to "the reference amount" to eliminate any possible confusion.

Disclosure on protection status of deposit products (Clause 10)

21. The Bills Committee has expressed concern whether and how the public would be informed of the changes to the protection status of their deposits after the lifting of the temporary full deposit guarantee and the implementation of the enhanced Scheme on 1 January 2011. As deposits at restricted licence banks (RLBs) and deposit-taking companies (DTCs)⁵, which are covered under the temporary full deposit guarantee, will revert to the non-protection status starting from the beginning of 2011, members are particularly concerned whether and how RLBs and DTCs will be required to duly inform their clients of the change in the protection status of their deposits.

22. The Administration has assured the Bills Committee that HKMA and the Board will take appropriate measures to ensure that the public and clients of all authorized institutions (AIs), which included all Scheme members as well as DTCs and RLBs, are made aware of the impending changes to the deposit protection arrangement in Hong Kong, including the fact that deposits at RLBs and DTCs will no longer be covered by any form of deposit protection starting from 1 January 2011 (i.e. reverting to the situation before the introduction of the full deposit guarantee). This is to enable the relevant clients to make timely preparations for the transition if they deem it necessary.

23. The Administration has also advised that upon enactment of the proposed amendments to section 51 of the DPSO under clause 10 of the Bill, the Board will make additional rules on disclosure of deposit protection status in the form of subsidiary legislation, which will be subject to the negative vetting procedure. With the additional disclosure rules, Scheme members will be required to make disclosure to their clients in relation to both protected and non-protected deposits. The Board will also launch a publicity campaign about the impending changes to the deposit protection arrangement in Hong Kong.

24. On the measures for AIs to inform their clients of the changes to the deposit protection arrangement due to the lifting of the temporary full deposit guarantee and the implementation of the enhanced Scheme, the Administration has advised that it has yet to determine whether the disclosure should be made by means of a letter to each client or by other means. HKMA would, after consulting the industry concerned, decide whether statutory guidelines will be issued to AIs in this regard. Hon Audrey EU has opined that the measures to be adopted for informing the public and depositors about the changes to the deposit protection arrangement should at least be as comprehensive and informative as those adopted when the temporary full deposit guarantee was implemented in late 2008. The Administration has taken note of this view.

25. With regard to the additional disclosure rules to be made under section 51 of the DPSO after enactment of the Bill, the Administration has advised that the

⁵ RLBs and DTCs are not Scheme members under the DPSO. No change to this arrangement is proposed under the Bill.

additional rules will provide for the following disclosure requirements on Scheme members -

- (a) negative disclosures (i.e. that the relevant deposit is not protected under the Scheme) are to be made on a transaction basis except for disclosures to institutions and on automatically rolled over transactions;
- (b) positive disclosures (i.e. that the relevant deposit is protected under the Scheme) have to comply with specified requirements and within a specified timeframe;
- (c) disclosure statements are to be displayed prominently, according to specified standards on size and location; and
- (d) a deposit should not be named a "structured deposit" unless it falls within the definition of the term in the DPSO.⁶

Committee Stage amendments

26. The Bills Committee agrees to the CSAs to be moved by the Administration. It has not proposed any CSA to the Bill.

Recommendation

27. The Bills Committee supports the resumption of the Second Reading debate on the Bill on 30 June 2010.

Consultation with the House Committee

28. The House Committee was consulted on 18 June 2010 and supported the recommendation of the Bills Committee in paragraph 27.

Council Business Division 1
Legislative Council Secretariat
23 June 2010

⁶ At present, there is no restriction on how banks should name their deposit products. Some have named their protected deposits as a structured deposit, which is a category of non-protected deposits as specified in sections 1(aa) and 2A of Schedule 1 to the DPSO. By virtue of the proposed section 56(3), the new rule will be applicable to new deposits only; existing deposits already described as "structured deposits" will not be affected by the new rule and will be allowed to mature gradually over time.

Bills Committee on Deposit Protection Scheme (Amendment) Bill 2010

Membership list

Chairman Hon CHAN Kam-lam, SBS, JP

Members Hon Albert HO Chun-yan
Dr Hon David LI Kwok-po, GBM, GBS, JP
Hon Fred LI Wah-ming, SBS, JP
Hon Miriam LAU Kin-yee, GBS, JP
Hon Tommy CHEUNG Yu-yan, SBS, JP
Hon Audrey EU Yuet-mee, SC, JP
Hon WONG Ting-kwong, BBS, JP
Hon Ronny TONG Ka-wah, SC
Hong CHIM Pui-chung

(Total: 10 Members)

Clerk Ms Anita SIT

Legal Adviser Mr Bonny LOO