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Panel on Financial Affairs
Meeting on 1 February 2010

Background brief
on review of the Deposit Protection Scheme

Purpose

This paper sets out background information on the review of the Deposit Protection Scheme (DPS) and provides a summary of the views and concerns expressed by members when relevant issues were deliberated at meetings of the Panel on Financial Affairs (FA Panel).

Background

Implementation of DPS

2. The Deposit Protection Scheme Ordinance (Cap. 581) (DPSO) was enacted in May 2004 and the Hong Kong Deposit Protection Board¹ (the Board) was formed in July 2004. Upon enactment of the rules governing the operation of the DPS, the DPS commenced operation in September 2006.

3. The major features of the DPS include -

- (a) Unless exempted by the Board, all licensed banks are DPS members. Restricted licence banks and deposit-taking companies are not members of DPS;
- (b) DPS is funded by contributions collected from Scheme members. A Deposit Protection Scheme Fund (DPS Fund) has been established from the contributions collected. The target size of the DPS Fund is 0.3% of

¹ The Hong Kong Deposit Protection Board is a statutory body established under the DPSO to establish and maintain DPS.

the total amount of protected deposits maintained with all Scheme members;²

- (c) 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 rating³ assigned by the Monetary Authority to the member;
- (d) 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;
- (e) The compensation limit under the DPS is HK\$100,000 per depositor per bank. 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 Monetary Authority has decided that compensation should be paid by the DPS and has served notice on the Board accordingly; and
- (f) When compensation under DPS becomes payable in respect of a Scheme member, 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. 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 DPS in making compensation payments, will be charged to the DPS Fund.

Temporary full deposit protection

4. Amid the global financial crisis in late 2008, the Financial Secretary announced on 14 October 2008 two pre-emptive measures to reinforce confidence in the banking

² As stated in the consultation paper issued by the Board in April 2009, 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 was estimated to be about HK\$1.5 billion. So far, the Board had collected about HK\$1 billion in contributions. Based on the existing contribution collection rate of about HK\$300-350 million a year, it was projected that the target size of the Fund would be reached by 2012.

³ "CAMEL Rating" is a supervisory rating currently adopted by HKMA to assess the financial strength and overall soundness of an authorized institution in the areas of Capital, Asset quality, Management, Earning and Liquidity.

system in Hong Kong, viz. the use of the Exchange Fund to guarantee repayment of all customer deposits held in all Authorized Institutions (AIs) in Hong Kong and the establishment of a Contingent Bank Capital Facility for the purpose of making available additional capital to local banks. The two measures would remain in force until the end of 2010 when a decision would be taken in the light of international financial conditions on whether they should be extended.

5. At the special meeting of the FA Panel on 17 October 2008, the Hong Kong Monetary Authority (HKMA) briefed the Panel on the two new measures. With regard to the provision of full deposit protection, members noted that implementation of the measure would follow the principles of the DPS, but would cover Restricted-Licence Banks and Deposit-Taking Companies as well as Licensed Banks and would apply to all Hong Kong-dollar and foreign-currency deposits held with AIs in Hong Kong, including those held with Hong Kong branches of overseas institutions. While members in general supported the introduction of the two measures to safeguard banking stability, some members expressed concern about the moral hazards involved as the measures might dampen banks' incentives for prudent risk management. Some members were also concerned that the cessation of the new measures after 2010 might have significant impact on Hong Kong's credit ratings in the international financial market and might lead to an outflow of capital from Hong Kong.

6. While acknowledging that the two precautionary measures to strengthen confidence in Hong Kong's banking system might have their downside risks, HKMA advised that the best way to manage such risks was to make stakeholders fully aware of them. HKMA assured members that they would closely monitor the situation and take appropriate supervisory actions. HKMA also advised that they would liaise with the relevant authorities in other jurisdictions which had adopted similar measures to devise a feasible approach broadly in line with international practice for lifting the full deposit protection after 2010.

7. When issues relating to the stability of the banking system were discussed at subsequent FA Panel meetings, members expressed concern about the scope of coverage of the temporary full deposit protection, noting that some deposits (such as saving accounts with overdraft facilities or for settling securities transactions) were not covered, and the adequacy of publicity and disclosure by AIs to their customers about the protection status of different financial products. Members also raised questions about the measures that would be taken by the Administration to maintain the liquidity and stability of those AIs excluded from the DPS upon the lifting of the temporary full deposit protection measure.

Review of the Deposit Protection Scheme

8. In the light of the experience gained from the operation of the DPS, and developments in international and local financial markets since the outbreak of the

global financial crisis, the Board commenced a review of the DPS in the fourth quarter of 2008 with a view to enhancing the effectiveness and efficiency of the Scheme. The review was conducted in two phases. The first phase of the review focused on potential enhancements to the DPS in the areas of protection limit, compensation calculation basis, product coverage, types of institutions covered, and funding arrangements. The second phase focused on technical enhancements that could contribute to the effectiveness of the DPS by improving its payout efficiency and the transparency of its coverage.

First phase of the review

9. The Board published a consultation paper on “Enhancing Deposit Protection under the DPS” on 27 April 2009. The key recommendations in the consultation paper include -

- (a) raising the protection limit of the DPS from the current HK\$100,000 to HK\$500,000;
- (b) expanding the coverage of the DPS to include secured deposits referable to the provision of banking and financial services;
- (c) halving the rates for charging contributions on banks to neutralize the cost impact of raising the protection limit; and
- (d) keeping certain features of the DPS unchanged, including calculating deposit compensation on a net deposit basis; not covering deposits held with institutions other than licensed banks; and the exclusion of structured deposits from protection.

10. The FA Panel was briefed on the recommendations at the meeting on 1 June 2009. Individual members expressed the following views and concerns:

- (a) In pursuing the enhancement proposals, consideration should be given to striking a balance between maximizing protection on the one hand and minimizing cost on the other;
- (b) With the protection limit raised to \$500,000, depositors might incline to split their deposits to get more protection, and this might affect the effectiveness of the DPS;
- (c) While 90% of depositors would be fully protected if the protection limit was raised to \$500,000, the remaining 10% of depositors might seek to withdraw their deposits in excess of \$500,000 from a bank in the event of rumours of bank failure, and the withdrawal of deposits by these depositors might affect banking stability and undermine the effectiveness of the DPS;

- (d) On depositors' awareness of the protection status of their deposits, there was room to enhance the representation requirements on Scheme members to notify their customers of their non-protected deposits. The Board should also step up its publicity efforts, in particular, in explaining to the public the definition of more complicated concepts such as structured deposits; and
- (e) Regarding the investment strategy and return of the DPS Fund, the Administration / the Board might consider whether the sums in the DPS Fund should be placed with the Exchange Fund for investment, and adopt the "fixed rate" sharing arrangement for investment income like the fiscal reserve.

11. Subsequent to the meeting on 1 June 2009, the Board provided supplementary information (**Appendix I**) on the investment strategy of the DPS Fund, percentage of depositors holding a non-protected deposit, percentage of depositors covered under the respective scenarios of raising the protection limit to \$200,000 and \$500,000, and the number of deposit accounts in restricted licence banks and deposit-taking companies.

12. In publishing the consultation report on 18 August 2009, the Board informed the FA Panel, in its letter of the same day, that during the two-month consultation period, the Board received more than 800 responses from the general public. Comments were also received from major stakeholder groups. Towards the end of the consultation, the Board conducted a territory-wide opinion survey to obtain a comprehensive view of the public sentiment towards the recommendations. In general, the consultation concluded that there was broad public support for the Board's recommendations.

Second phase of the review

13. On 18 August 2009, the Board published the consultation paper on "Strengthening the operation of DPS" for the second phase of the review. The main recommendations made in the consultation paper include (i) streamlining proceedings of the Board and processes for determining compensation for depositors to speed up payouts; and (ii) strengthening the representation regime of the DPS to enhance the transparency of its coverage. A summary of the recommendations is in **Appendix II**. The Board published a report on the public consultation on 30 November 2009. The relevant press release is at **Appendix III**.

Recent developments

14. In the light of the general support for the Board's recommendations in the public consultation exercises, the Board has commenced drafting the legislative

amendments for effecting the enhancements concluded in both phases of the review. The Administration will brief the FA Panel at the meeting on 1 February 2010 on the relevant legislative proposal.

Relevant papers

15. The relevant papers are available at the following links:

Consultation Paper on enhancing deposit protection under DPS (April 2009)

<http://www.legco.gov.hk/yr08-09/english/panels/fa/papers/facb1-1428-e.pdf>

Background brief on enhancing deposit protection under DPS

<http://www.legco.gov.hk/yr08-09/english/panels/fa/papers/fa0601cb1-1708-e.pdf>

Minutes of the FA Panel meeting on 1 June 2009 (Paragraphs 9 to 25)

<http://www.legco.gov.hk/yr08-09/english/panels/fa/minutes/fa20090601.pdf>

Report on the public consultation on enhancing deposit protection under DPS (August 2009)

<http://www.legco.gov.hk/yr08-09/english/panels/fa/papers/facb1-2491-2-e.pdf>

Consultation paper on strengthening the operation of the DPS (August 2009)

<http://www.legco.gov.hk/yr08-09/english/panels/fa/papers/facb1-2491-3-e.pdf>

Report on the public consultation on strengthening the operation of DPS (November 2009)

<http://www.legco.gov.hk/yr09-10/english/panels/fa/papers/facb1-532-2-e.pdf>

Council Business Division 1
Legislative Council Secretariat
28 January 2010

**Responses to the follow-up questions of the
Legislative Council Panel on Financial Affairs**

Enhancing deposit protection under the Deposit Protection Scheme

- (1) *In relation to Hon Paul CHAN's concern about the investment strategy and return of the Deposit Protection Scheme (DPS) Fund, the Administration/Hong Kong Deposit Protection Board (HKDPB) were requested to consider and advise whether the sums in the DPS Fund should be placed with the Exchange Fund for investment, and receive a "fixed rate" fee payment like that for the fiscal reserves.*

The main investment objectives of the DPS Fund are to preserve capital and maintain a high level of liquidity for meeting the cost of payouts. Consistent with these objectives, the DPS Ordinance specifies that the DPS Fund can be invested only in:

- (a) deposits with the Exchange Fund;
- (b) Exchange Fund Bills;
- (c) US Treasury Bills;
- (d) exchange rate or interest rate contracts for hedging purpose; and
- (e) any other investments approved by the Financial Secretary (FS).
Up-to-date, the FS has approved, subject to specified limits, investments in Exchange Fund Notes and US Treasury Notes of a tenor up to 2 years, and the maintenance of bank balances to facilitate the investment in the government papers.

The DPS Ordinance also specifies that the HKDPB has a function to manage and administer the DPS Fund. For the performance of this function, the HKDPB has established an investment committee. The committee comprises members with expertise in investment, banking and accounting. Given the relatively limited investment mandate and scope of the DPS Fund, the investment operation of the DPS Fund has been conducted very smoothly under the guidance of the committee.

The Exchange Fund does not have a mandate to provide fund management or investment service to other entities. Currently, it pays a market-based interest rate on deposits it takes from the DPS Fund. Unlike fiscal transfers from the Hong Kong SAR Government, which are public monies, the DPS Fund mainly comprises contributions paid by banks. Requiring the Exchange Fund to offer a fixed rate of interest to the placements by the DPS Fund similar to that applicable to fiscal transfers may result in the Exchange Fund's subsidisation of the privately-funded DPS.

- (2) *In relation to Hon James TO's concern about the implementation of the full deposit guarantee arrangement, the HKDPB was requested to provide the latest information on the number of account holders with non-protected deposits, following the deadline for notifications by Authorized Institutions (AIs) to account holders with non-protected deposits by the end of May 2009.*

According to the statutory guideline issued by the Hong Kong Monetary Authority (HKMA) in December 2008, all AIs are required to notify their customers of the non-protected deposits held by them before the end of May 2009. Based on the statistics reported by major retail banks after the completion of the notification exercise, it is estimated that less than 5% of their depositors are holding a non-protected deposit.

- (3) *To address Hon James TO's concern about the scope of protection under the DPS, the HKDPB was requested to provide the following information:*

- (a) *if the protection limit under the DPS was increased to HK\$200,000, the percentage of depositors and the percentage of value of deposits covered (taking into account the effect of account splitting behaviour of depositors in response to the increase); and*
- (b) *if the protection limit under the DPS was increased to HK\$500,000, the percentage of depositors and the percentage of value of deposits covered and not covered (taking into account the effect of account splitting behaviour of depositors in response to the increase)*

Based on the statistics reported by major retail banks to a survey of the HKDPB (with reference to their end-October 2008 positions), it is projected that about 84% and 91% of their depositors would be fully protected by the DPS if the protection limit is raised to HK\$200,000 and HK\$500,000 respectively. In terms of value of deposits covered, the corresponding percentages are estimated to be 17% and 27%. The estimations, however, were made without considering possible deposit splitting behaviour of depositors.

The findings of the past opinions surveys conducted by the HKDPB suggest that splitting of deposits into different banks has not been common among depositors under the current protection limit of HK\$100,000. Whether depositors will opt to split their deposits at higher protection limits will depend on a host of factors, for example, the stability and the competitive environment of the banking sector, the benefits and costs relevant to individual depositors. It is therefore potentially difficult, if not impossible, to model the deposit splitting behaviour of depositors. The HKDPB,

however, will continue to monitor the relevant trends and patterns through regular opinion surveys.

The current design of the DPS can to some extent accommodate an increase in deposit splitting behaviour. As the contributions payable by banks are calculated as a percentage of the amount of relevant deposits held with them, the amount of contributions collected will increase with the growth in the amount of relevant deposits due to deposit splitting behaviour. Hence, the effectiveness of the DPS will not be unduly affected unless deposit splitting becomes very common place. As mentioned above, the Board will keep this under close monitor.

- (4) To address the Chairman's concern about the types of institution covered by the DPS, the HKDPB was requested to provide Information regarding the number of deposit accounts in the restricted licence banks (RLBs) and deposit-taking companies (DTCs), with breakdown by the number of accounts with a deposit of HK\$500,000 or below and those with a deposit of over HK\$500,000***

Compensations under the DPS are calculated on a per depositor basis, that is, the deposits of a depositor in different accounts will be aggregated for compensation assessment purpose. It is therefore more relevant to assess the effectiveness of the DPS in terms of the number of depositors, instead of the number of accounts, of an institution covered by it. For the DPS to be effective in preventing rumour-driven run on an institution, it must be able to provide full protection to a majority of its depositors. Under a protection limit of HK\$500,000, over 90% of depositors at banks would become fully protected by the DPS.

As RLBs are permitted by law to take only deposits of HK\$500,000 or above, they have no depositors with a deposit balance of less than HK\$500,000. In other words, none of their depositors would become fully protected under a protection limit of HK\$500,000.

DTCs are permitted by law to take only deposits of HK\$100,000 or above. Based on the statistics available to the HKDPB, only 8 out of the all 27 DTCs have more than 10 depositors. On average, about 60% of the depositors of DTCs have a deposit balance of over HK\$500,000. Only around 40% of their depositors have a balance of HK\$500,000 or below. This confirms that the DPS will not be able to fully protect a majority of their depositors even if its protection limit is raised to HK\$500,000.

Summary of recommendations

1. Processes for determining compensation

- *It is recommended that members of the Board outside Hong Kong be allowed to participate in Board meetings through electronic means.*
- *It is recommended that the Board be given the power to determine the amount of accrued interest on a deposit or customer liability if the Board considers there is uncertainty over the amount of accrued interest, or that the time required to ascertain the amount in accordance with the DPSO would be so long as to unduly delay the payment of compensation.*
- *It is recommended that the Board be given the power to determine the value of an annuity, or future or contingent liability of a depositor, if the Board considers there is uncertainty over the value, or that the time required to ascertain the value according to the DPSO would be so long as to unduly delay the payment of compensation.*
- *It is recommended that the power of the Board to make interim payments to depositors by class and determine the amount of payment for each class be articulated more clearly in the DPSO.*

2. Representation arrangements

- *It is recommended that Scheme members be required to make negative disclosures and obtain customer acknowledgements on a transaction basis, except for automatic rollovers.*
- *It is recommended that Scheme members be required to make positive disclosures on the protection status of their deposits. Disclosures for deposits covered by an account can be made on an account basis. For deposits not covered by an account, the disclosures have to be made on a transaction basis. For existing accounts or deposits, a one-off disclosure should be made.*
- *It is recommended that Scheme members be obliged to respond to depositors' requests for positive disclosure within a specified time frame and in a specified manner.*

- *It is recommended that the positive and negative disclosures made by Scheme members be required to meet certain standards in terms of size and location to ensure they are sufficiently prominent and easily identifiable by depositors.*
- *It is recommended that Scheme members be prohibited to call financial products not meeting the definition of structured deposit in the DPSO a structured deposit.*

(Source: Appendix to the Consultation Paper on "Strengthening the Operation of DPS" published by the Board on 18 August 2009.)

PRESS RELEASE**HKDPB publishes the report on the second phase of the review of the Deposit Protection Scheme**

The Hong Kong Deposit Protection Board (the Board) today (Monday) published a report on the public consultation on the second phase of the review of the Deposit Protection Scheme (DPS). The report also contains the Board's decision on the adjustments to the funding arrangements for the DPS, which have not yet been concluded in the consultation on the first phase of the review.

Following the completion of the public consultation on the recommendations for enhancing deposit protection identified in the first phase of the review, the Board commenced consulting the public in mid-August 2009 on the recommendations identified in the second phase of the review, which focused on improving payout efficiency of the DPS and the transparency of its coverage. The two-month consultation period ended on 17 October 2009.

The recommendations on streamlining payout processes received a general support in the consultation. Comments received mainly requested that the flexibilities to be added to the payout processes be executed in a prudent, fair and transparent manner, and be accompanied by proper checks and balances. The spirit of keeping depositors well informed of the protection status of their deposits enshrined in the package of recommendations for enhancing the DPS representation regime also received wide recognition, including that of the industry. The Board noted the industry's comments that banks might encounter genuine difficulties in implementing some of the recommendations. The Board is prepared to provide flexibilities that can address the reasonable concerns of the industry, but, at the same time, will not compromise the achievement of the intended policy objectives.

In parallel with the consultation on the second phase of the review, the Board continued to discuss with the banking industry on the adjustments to the funding arrangements for the DPS to offset the cost impact of raising the DPS protection limit. After having discussed with the industry, the Board did not find it appropriate to cut the contribution rates¹ by as much as 75% as proposed by the industry as it will risk significantly under-charging banks holding the bulk of protected deposits and causing a significant delay for the DPS Fund to reach its target. However, to better eliminate the potential for cost transfer to depositors, the Board agreed to cut the rates by 65%, after taking into consideration the Board's own estimation and the notable growth in the deposit market since late last year when the Board's estimation was made.

Professor Andrew Chan Chi-fai, Chairman of the Board, said, "The completion

of the consultation on the second phase of the review marked the end of the two-phase review of the DPS commenced by the Board in the fourth quarter of 2008. We are truly thankful to the public, the industry and other parties in providing their valuable comments to us, especially under the relatively compact consultation schedule.”

Mr Raymond Li, Chief Executive Officer of the Board, added, “Following the completion of the review and consultation work, the next milestone to achieve is the commencement of the legislative process to effect the changes concluded in the review. The Board has already commenced drafting the relevant legislative amendments. The Board will continue to seek support and comments from the relevant parties to ensure that the detailed requirements developed can meet their intended objectives and, at the same time, not too costly or burdensome to implement.”

The Board intends to introduce the enhancements to the DPS concluded in both phases of the DPS review as soon as possible, preferably before the end of 2010 so that the public can benefit from an enhanced DPS when the full deposit guarantee provided by the Government expires.

The full report on the consultation on the second phase of the review can be found at the Board’s website (www.dps.org.hk).

¹contribution rates mean the rates for charging build-up levies on Scheme members during the initial, build-up phase of the DPS Fund.

Annex: Report on public consultation on strengthening the operation of the DPS

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Hong Kong Deposit Protection Board
30 November 2009