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Subcommittee on Deposit Protection Scheme (Representation on Scheme Membership and Protection of Financial Products under Scheme) (Amendment) Rules 2010

Background brief

Purpose

This paper provides background information on the Deposit Protection Scheme (Representation on Scheme Membership and Protection of Financial Products under Scheme) (Amendment) Rules 2010 (Amendment Rules), and outlines the proposals under the Amendment Rules. It also provides a summary of views and concerns expressed by members of the Panel on Financial Affairs (the Panel) and the Bills Committee on Deposit Protection Scheme (Amendment) Bill 2010.

Background

Deposit Protection Scheme Ordinance and Hong Kong Deposit Protection Board

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 to oversee the operation of the Deposit Protection Scheme (the Scheme) in Hong Kong. Upon enactment of the rules governing the operation of the Board, the Scheme commenced operation in September 2006. The current main features of the Scheme are set out in **Appendix I**.

Temporary full deposit protection

3. 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 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

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

available additional capital to local banks. The two measures are due to expire at the end of 2010.

The Deposit Protection Scheme (Amendment) Ordinance 2010

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 in two phases in 2009.

5. Given the general support from the public and the relevant parties for the proposed enhancements to the Scheme, the Administration introduced the Deposit Protection Scheme (Amendment) Bill 2010 into the Legislative Council on 9 April 2010 to implement the proposed enhancements. The Bill was passed on 30 June 2010. The enhancements covered by the Deposit Protection Scheme (Amendment) Ordinance 2010 include the following:

Level and scope of protection

- (a) expanding 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;
- (b) raising the limit on the total amount of compensation for each depositor under the Scheme from HK\$100,000 to HK\$500,000;

Funding arrangements

- (a) empowering the Board to obtain information required for the assessment of contributions payable by Scheme members on a net deposit basis;
- (b) changing the target size of the Deposit Protection Scheme Fund from 0.3% of the total amount of relevant deposits to 0.25%; reducing the percentages for charging annual build-up levies on Scheme members by 65%; and allowing Scheme members to report the amount of relevant deposits for contribution assessment purposes after deducting relevant liabilities owed by depositors;

Processes for determining compensation

- (a) empowering 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;
- (b) empowering the Board to make interim payments of different amounts to different depositors or different classes of depositors;

- (c) allowing members of the Board to conduct meetings and approve written resolutions through electronic means; and

Representation, disclosure and acknowledgement requirements

- (a) empowering the Board to make additional rules to prescribe the representation, disclosure and acknowledgement requirements relating to protected and non-protected deposit products.

6. The provisions of the Amendment Ordinance regarding the Board's powers to obtain information required for the assessment of contributions payable by Scheme members and to make additional rules have taken effect. The other provisions will take effect on 1 January 2011.

Deposit Protection Scheme (Representation on Scheme Membership and Protection of Financial Products under Scheme) (Amendment) Rules 2010

7. The Deposit Protection Scheme (Representation on Scheme Membership and Protection of Financial Products under Scheme) Rules (Cap. 581 sub. leg. A) (Representation Rules) provides for the disclosure requirements in relation to the protection status of financial products offered by Scheme members and the offences for non-compliance of the requirements under the Representation Rules.

8. These Amendment Rules are made by the Board under section 51 of the DPSO. The Amendment Rules seek to amend the Representation Rules to -

- (a) amend all references to the protection limit of the Scheme from HK\$100,000 to HK\$500,000 per depositor to reflect the new protection limit introduced by the Deposit Protection Scheme (Amendment) Ordinance 2010;
- (b) require disclosures by Scheme members as to financial products not protected by the Scheme on a transaction basis except for automatic re-investment of financial products, transactions with institutional customers and money invested into financial products for payment purpose (new sections 6A to 6D);
- (c) restrict the use of the term "structured deposit" by Scheme members (new section 6E);
- (d) require disclosures by Scheme members as to the deposits maintained or to be taken by them that are qualified for protection under the Scheme (new sections 6F to 6K);
- (e) require Scheme members to reply to depositors' enquiries on the protection status of their deposits in specified manner and within a specified timeframe (new section 7A); and

- (f) impose standards on the representations given under the Representation Rules to ensure that they are prominent and legible. (new section 7B).

9. The Amendment Rules will come into operation on 1 January 2011 except for new section 6E which will come into operation on 1 July 2011 to allow sufficient time for Scheme members to make relevant changes to their product nomenclatures.

10. According to the relevant LegCo Brief (Ref: B9/2/2C) issued by the Administration, the Board has conducted extensive public consultation on the proposals for enhancing the representation arrangements. It has proactively approached interested parties for comments on the scope of the enhancement proposals, including industry associations, statutory advisory committees, the Consumer Council and professional bodies. In addition, in accordance with section 51 of the DPSO, the Board has consulted the Hong Kong Association of Banks and the Financial Secretary on the Amendment Rules. The relevant comments received together with the Board's responses have been published on the Board's website, and are reproduced in **Appendix II**.

Members' views and concerns

Panel discussion in February 2010

11. On 1 February 2010, the Administration and the Board briefed the Panel on the progress of the review of the Scheme, including the proposals for enhancing the representation arrangements under the Scheme. Panel members in general supported the enhancement proposals, and considered that Scheme members should be required to notify their customers on both protected and non-protected deposits. Members also urged the Board to step up publicity efforts in explaining to the public the new deposit protection arrangements and the more complicated concepts such as "structured deposits".

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

12. During the scrutiny of the Deposit Protection Scheme (Amendment) Bill 2010, the Bills Committee expressed concern on 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)², which are covered under the temporary full deposit guarantee, will revert to the non-protection status starting from the beginning of 2011, members were particularly concerned whether and how RLBs and DTCs would be required to duly inform their clients of the change in the protection status of their deposits.

² RLBs and DTCs are not Scheme members under the DPSO. No change to this arrangement was proposed under the Bill.

13. The Administration assured the Bills Committee that the Hong Kong Monetary Authority (HKMA) and the Board would 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, would be made aware of the impending changes to the deposit protection arrangements in Hong Kong. The Board would launch a publicity campaign, while HKMA would, after consulting the industry concerned, decide on the manner in which AIs would inform their clients of the changes to the deposit protection arrangements.

14. The Administration also advised the Bills Committee that additional disclosure rules would be made under section 51 of the DPSO after enactment of the Bill. The additional rules would 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.

Relevant papers

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

Papers relevant to the Deposit Protection Scheme (Representation on Scheme Membership and Protection of Financial Products under Scheme) (Amendment) Rules 2010

http://www.legco.gov.hk/yr10-11/english/hc/sub_leg/sc04/general/sc04.htm

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

<http://www.legco.gov.hk/yr09-10/english/bc/bc05/reports/bc050630cb1-2344-e.pdf>

Minutes of the FA Panel meeting on 1 February 2010 (Paragraphs 39 to 52) (February 2010)

<http://www.legco.gov.hk/yr09-10/english/panels/fa/minutes/fa20100201.pdf>

Background brief on review of the Deposit Protection Scheme (January 2010)

<http://www.legco.gov.hk/yr09-10/english/panels/fa/papers/fa0201cb1-977-e.pdf>

Administration's paper on Review of the Deposit Protection Scheme (January 2010)
<http://www.legco.gov.hk/yr09-10/english/panels/fa/papers/fa0201cb1-978-4-e.pdf>

Report on the second phase 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>

Report on the first phase 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>

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Current main features of the Deposit Protection Scheme

- (a) Unless exempted by the Board, all licensed banks are Scheme members. Restricted licence banks and deposit-taking companies are not members of the Scheme;
- (b) A Deposit Protection Scheme Fund (DPS Fund) has been established from the contributions collected from Scheme members. The target size of the DPS Fund is 0.3% of the total amount of protected deposits maintained with all Scheme members;³
- (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 rating⁴ assigned by the Hong Kong Monetary Authority to the member;
- (d) Certain types of deposit are not protected by the Scheme, including secured deposits (such as deposits used as collateral to secure a banking facility), time deposits with a maturity longer than five years, structured deposits (such as foreign currency-linked and equity-linked deposits), 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 Scheme is HK\$100,000 per depositor per bank. Compensation should be paid to depositors of a Scheme member if a winding up order has been made against the Scheme member or the Hong Kong Monetary Authority has decided that compensation should be paid by the Scheme and has served notice on the Board accordingly; and
- (f) When compensation under the Scheme becomes payable in respect of a Scheme member, the Scheme 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 Scheme is HK\$40 billion. The Scheme will seek reimbursement from the liquidation of the failed Scheme member for the compensation paid to depositors and repay the borrowings from the

³ 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.

⁴ “CAMEL Rating” is a supervisory rating currently adopted by Hong Kong Monetary Authority to assess the financial strength and overall soundness of an authorized institution in the areas of Capital, Asset quality, Management, Earning and Liquidity.

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 Scheme in making compensation payments, will be charged to the DPS Fund.

**Extract from
"Report on public consultation on strengthening the operation of the
Deposit Protection Scheme" issued by the Hong Kong Deposit Protection
Board**

2. Representation Arrangements

The Board's recommendations

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.

Views from the public consultation

25. The package of recommendations to strengthen the representation regime of the DPS was well received by the public and consumer interest groups. There were also proposals to further enhance the regime. The importance of keeping depositors properly informed of the protection status of their deposits was shared by the industry. Nevertheless, the industry also pointed out the practical difficulties and the cost expected for implementing some of the new requirements, and suggested alternatives for the Board's consideration.
26. On the abolishment of the flexibility of making negative disclosure on an account basis, the industry pointed out that the disclosure and acknowledgement process could be potentially difficult to administer on a transaction basis for customers engaged in highly frequent and time-critical transactions, for example, investment related transactions of institutional investors. It was suggested the

option of making negative disclosure on an account basis be retained, but to be supplemented by regular reminders to customers, say on an annual or semi-annual basis.

27. Though the industry was of the opinion that it would be impractical to set a single timeframe for Scheme members to respond to customers' enquiries on the protection status of their deposits, which can be of different levels of complexity, the industry found it agreeable to follow the principles set out in the Code of Banking Practice in handling such enquiries.
28. The industry also agreed that written disclosures on protection status should be clearly legible and sufficiently prominent in print, but it was concerned the specified standards could be costly to implement. The industry therefore requested to be consulted on the formulation of the detailed requirements to ensure effectiveness and workability. On the other hand, the Consumer Council recommended that the disclosures should be written in simple and easily understandable terms and preferably be put on the front page of product documentation.
29. The industry did not object to imposing restrictions on the use of the term "structured deposit" but requested the restrictions be imposed only on new products as substantial cost and effort may be involved in making adjustments to the infrastructure supporting the existing products to effect a name change.
30. On the introduction of positive disclosures, the industry opined that such disclosures should continue to be made voluntarily by banks as the publicity activities undertaken by the Board since the inception of the DPS had already fostered a good level of public awareness of deposit protection. The industry commented that the objective of bringing to the attention of depositors the protection status of their deposits could be achieved by continued publicity, especially when explaining the impending changes to the DPS. The industry committed to assist the Board in implementing the relevant publicity initiatives. In addition, the industry's commitment to respond in a timely manner to customers' requests would also help enhance the clarity of deposit protection coverage.
31. In addition to comments directly related to the recommendations, the Board also received other suggestions, mainly from the public, on further improving the regime. For example, the Board was reminded to put in place an effective surveillance mechanism to monitor Scheme members' compliance with the relevant requirements. The Consumer Council further reminded that Scheme members should be advised to use the term "deposit" cautiously to avoid causing confusion. There were also suggestions on promulgating unified product nomenclature to signify protection status, and setting selling practices for non-protected deposits.

The Board's responses and conclusions

32. The Board is glad to note that the importance of keeping depositors well informed of the protection status of their deposits is recognised by the public and stakeholder groups consulted. It is understandable that the implementation of the recommendations may have a different impact on the various parties involved, and it is natural for them to have different views and concerns.
33. On the abolishment of the flexibility of making negative disclosures on an account basis, the Board notes that individual banks may encounter genuine practical difficulties in making such disclosures on a transaction basis in certain areas of their operations and to certain types of customers. However, leaving the option of making such disclosures on an account basis open generally may create greater confusion rather than clarity, as depositors may end up receiving different treatment from different banks. To address the industry's concern and, at the same time, preserve the effectiveness of the recommendation, the Board suggests confining the option of making negative disclosure on an account basis to disclosures made to institutional clients who are generally in a better position than ordinary retail depositors to understand the risks of their investments, including bank deposits. As suggested by the industry, annual reminders can be sent to institutional clients to better alert them on the non-protected deposits they hold.
34. Similar to the rationale for imposing unified negative disclosure standards, different positive disclosures that may be practised by different banks in the absence of a set of unified standards may not be helpful in improving the clarity of the coverage of the DPS and promoting confidence, especially in times of crisis. The Board notes the industry's concerns about the cost and effort required to implement the enhanced disclosures. Due consideration has already been given to containing implementation costs in formulating the recommendations in the consultation paper, which mainly require the disclosures to be delivered through existing channels, rather than new ones, for example, printing the disclosures in deposit documentation for new transactions, and in regular account statements for existing transactions.
35. The Board appreciates the industry's proposal of following the standards in the Code of Banking Practice in handling enquiries on deposit protection. However, unlike the standards in the Code, which cover enquiries on a wide range of issues, the standards intended to be promulgated by the Board are narrowly focused on confirming the protection status of a financial product. Given that banks should be well aware of which types of their products are eligible for protection, especially after secured deposits are brought under the protection of the DPS as proposed in the first phase of the review, and it is not the intention of the Board to require banks to find out whether a depositor is an excluded person, it is doubtful whether banks would require as much as 30 days, as specified in

the Code, to be able to confirm whether a deposit product is eligible for protection. The Board believes that banks would be able to meet better standards in replying to customers on the protection status of the deposit products offered by them.

36. The Board will consult the relevant parties, including the industry and the Consumer Council, when ironing out the detailed standards on the size and location of DPS disclosures and the restrictions on the use of the term “structured deposit” to ensure the requirements are effective, practical and cost-amicable to implement. In fact, the amended or new representation requirements proposed in the review will be promulgated in the form of statutory rules which, according to the DPS legislation, have to be made in consultation with the Hong Kong Association of Banks.
37. The Board welcomes the comments made by the public and other stakeholder groups on further enhancing the representation regime of the DPS. Some of the recommendations have already been implemented by the Board, for example, the Board has already implemented a review mechanism for monitoring Scheme members’ compliance with the representation requirements. The Board will continue to monitor the operation of the DPS and relevant developments in the local and international markets, to assess the need for introducing other new measures.