For discussion
on 4 May 2015

Legislative Council Panel on Financial Affairs

**Proposed Enhancements to
the Deposit Protection Scheme**

PURPOSE

This paper briefs Members on the legislative proposals to enhance the Deposit Protection Scheme ("DPS"), with a view to accelerating the payout process for affected depositors in case there is a banking crisis.

BACKGROUND

2. The DPS was fully launched in 2006, under the Deposit Protection Scheme Ordinance ("DPSO") (Cap. 581), to provide protection for depositors and contribute to banking stability by reducing the risks of any bank runs and potential contagion during a banking crisis. The DPS is operated by the Hong Kong Deposit Protection Board ("HKDPB"), a statutory body established under the DPSO. All licensed banks, unless exempt by the HKDPB, are members of the Scheme ("Scheme members"). The current compensation limit of the DPS, at HK$500,000 per depositor per Scheme member, provides full coverage for around 90% of depositors in Hong Kong. In general, most types of deposits, including deposits denominated in Renminbi or foreign currencies, are covered by the DPS as "protected deposits". Structured deposits, offshore deposits, bearer form deposits, and time deposits with an original term to maturity longer than five years, are not covered. The DPS is funded by contributions from Scheme members. At present, the DPS Fund stands at about HK$2.4 billion. The DPS has not been triggered since its establishment.

3. The importance of having a sufficiently robust deposit protection regime, being part of the safety net in the banking system, was evident in the global financial crisis in 2007/08, as depositors' confidence in the banking system hinged on an effective deposit protection regime among other safeguards in the market regulatory framework. In the aftermath of the crisis, deposit insurers in major financial markets have focused on developing the

capacity to make prompter payouts during a bank failure. In light of this and the recent assessment result of the International Monetary Fund[1], the Government conducted, in September 2014, a public consultation on proposals to increase the speed of payout under the DPSO. These proposals include –

(a) adopting a "gross payout" approach to determine the DPS compensation, i.e. a depositor will be compensated an amount up to the DPS protection limit, without setting off the depositor's liabilities against his/her deposits owed to the same bank at the time of the payout determination and distribution;

(b) providing more certainty to determine the reference date used for calculating the deposit compensation amount; and

(c) enabling the use of electronic communication channels by the HKDPB, in addition to the conventional paper-form communication, to notify depositors of the compensation arrangements, in case the DPS is triggered.

PROPOSED LEGISLATIVE AMENDMENTS

I. Adopting the "gross payout" method

4. Under the DPSO as enacted in 2004, when the DPS is triggered in Hong Kong, the amount of compensation payable to a depositor is determined by calculating the aggregate amount of protected deposits after setting off liabilities owed by the depositor to the relevant bank (e.g. outstanding debts arising from overdrafts, personal loans, mortgages, credit cards, trade financing loans) and contingent liabilities (e.g. letters of guarantee and foreign-exchange options-related exposures), plus or minus any accrued interest on deposits or liabilities. After paying out the compensation to a depositor under the DPS, the HKDPB will be subrogated to all the rights and remedies of the depositor in relation to the deposits with the relevant Scheme member (to the extent of the net amount of compensation and the interest accrued thereon), and will be entitled to an

[1] In 2013, the Financial Sector Assessment Programme ("FSAP") led by the International Monetary Fund completed a review of the crisis management and bank resolution framework in Hong Kong, including the functioning of the DPS in contributing to financial stability. The FSAP concluded that the DPS is transparent and trusted, and recommended the Hong Kong authorities to consider changing the present full setting-off approach in the DPS compensation determination to a gross payout calculation, to achieve swifter payouts when the DPS is triggered.

reimbursement in full in relation to the paid compensation from the relevant Scheme member or its liquidator out of the assets of the Scheme member. In other words, the determination of the compensation payable to depositors and the reimbursement of the compensation paid by the HKDPB are both carried out on a net basis.

5. In the wake of the global financial crisis, deposit insurers in major markets have undertaken reforms to strengthen their respective deposit insurance regime to mitigate any possible repercussions of the crisis or future crises. In particular, a number of member jurisdictions of the Financial Stability Board[2] have adopted directly, or changed from a net payout to, a gross payout approach to speed up the payout process. At present, more than half of the FSB member jurisdictions have adopted the gross payout approach for their deposit insurance regime[3]. As a result, and consequent to other enhancements pursued, the average target timeframe for payouts by the deposit insurers in these economies has been materially shortened from an average of two to three months to less than one month, or even a week or so.

6. In view of these developments, and notwithstanding that Hong Kong has a very resilient banking system and regulatory framework, the HKDPB has over the years implemented various enhancement measures, such as establishing an early warning system with the Hong Kong Monetary Authority, requiring speedier and enhanced information submission by banks, and building up a stronger system processing capacity, to streamline a payout process of the HKDPB in the event that the DPS is triggered. That said, the existing setting-off requirement is still an impediment to shortening the payout timeframe to seven days, which is a target shared by other deposit insurance schemes in comparable markets (e.g. the UK and Singapore).

7. Therefore, we propose switching the compensation determination approach under the DPSO from the net to the gross basis. With the adoption of the gross approach (i.e. without any setting-off of the depositors'

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[2] The Financial Stability Board ("FSB"), established by the Group of Twenty ("G-20"), is a leading international forum for the promotion of financial stability and financial regulatory reforms. Hong Kong is a member jurisdiction of the FSB, and is actively pursuing reforms proposed by the FSB.

[3] These include Argentina, Australia, Brazil, Canada, France, Japan, Mexico, the Netherlands, Singapore, Spain, Switzerland, Turkey and the United Kingdom ("UK"). Following the issuance of a revised directive on deposit guarantee schemes by the European Union ("EU") in April 2014, it is expected that more countries in the EU, including Germany and Italy, will move to the gross payout approach. The deposit insurance scheme in the Mainland of China, which will be launched in May 2015, will also adopt the gross payout approach for compensation determination.

liabilities against their protected deposits for the purposes of determining the amount of compensation), it is expected that the HKDPB will be able to make full compensation payments to depositors within seven days under most circumstances, as compared to the prevailing target of making an interim payment within two weeks and settling the remaining payment for a depositor in six weeks, depending on the complexity of the bank's operation. Consequently, we propose that the HKDPB be allowed to be reimbursed from the relevant Scheme member's assets for the gross amount of compensation paid out to the depositors and to collect contributions from Scheme members to the DPS Fund in accordance with the relevant deposits placed on them on a gross basis.

8. Upon the implementation of the gross approach, a depositor will be entitled to the aggregate sum of his protected deposits placed with the relevant Scheme member up to the DPS protection limit (i.e. $500,000 per person per Scheme member at present) in case the DPS is triggered. Any deposit in excess of the DPS compensation limit will continue to be set off against the depositor's liabilities owed to the Scheme member under the relevant law.

9. The adoption of the proposed gross payout approach will not extinguish a depositor's liabilities to the relevant Scheme member. The depositor is still obliged to settle any outstanding debt owed to the bank in question or its liquidator after receiving a deposit compensation from the HKDPB. The current creditor hierarchy in the insolvency of a bank under the Companies (Winding Up and Miscellaneous Provisions) Ordinance ("CWUMPO") will remain unchanged. It is theoretically possible that, if a compensated depositor subsequently defaults on his or her liabilities owed to a failed bank, there could be a potential reduction in liquidated assets to be recovered by a liquidator of the bank for distribution to creditors. But statistics collected from major retail banks in Hong Kong show that most deposits are unencumbered and therefore not subject to setting-off. Together with the chronically low charge off rates of liabilities, it is envisaged that such potential reduction in liquidated assets under a gross approach in the DPS would be marginal. It is also not expected that there would be a surge in the cost of the liquidator in any bank recovery action.

10. With a simpler and easy-to-understand compensation determination process under the gross approach, all depositors will have quicker access to the compensation in relation to the protected deposits and obtain better reassurance they need in case the DPS is triggered. This in turn can reinforce the effectiveness of the DPS as part of the safety net to maintain banking stability and reduce any contagion effect resulting from a

banking crisis. While no adjustment to the level of premium rates currently applicable to Scheme members is proposed[4], contributions to be paid by some Scheme members could increase as the amount of relevant deposits is to be calculated on a gross basis, although the magnitude should not be significant. Individual banks are expected to benefit from lower IT maintenance and compliance costs because of streamlined data maintenance requirements under the gross approach.

II. Enhancing certainty for determination of the Quantification Date

11. The DPS compensation covers both the principal balance and interest accrued on the protected deposits. Where deposits are denominated in currencies other than the Hong Kong dollar, the compensation payable to depositors will be converted into Hong Kong dollars. Currently the amount of interest accrued on protected deposits and the conversion of non-Hong Kong dollar deposits are determined with reference to a quantification date ("QD"). In other words, the interest will be accrued up to the QD, and the exchange rate used to convert a non-Hong Kong dollar deposit is the market exchange rate on the QD. The QD is currently defined in section 25 of the DPSO as the date of the appointment of a provisional liquidator in respect of the bank concerned, unless the HKDPB specifies the QD as the DPS trigger date if the HKDPB –

(a) has knowledge that a provisional liquidator will not be appointed;

(b) is of the opinion that it is uncertain whether a provisional liquidator will be appointed; or

(c) is of the opinion that an appointment of a provisional liquidator will take so long as to unduly delay the payment of compensation to the depositors of the Scheme member by the HKDPB.

The reasons for the above arrangement is to align the QD with the date used in determining the compensation recovery by the DPS under the insolvency regime as far as possible, to minimise any shortfall loss arising from differences in the date of determination of compensation paid by the HKDPB and the corresponding reimbursement for the DPS Fund from the proceeds of the winding up of the bank.

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4 In accordance with Schedule 4 to the DPSO, the build-up premium and expected loss premium payable by a Scheme member range from 0.0175% to 0.049% and from 0.0075% to 0.02% of the relevant deposits respectively, and are divided into four tiers corresponding to the supervisory rating assigned to the Scheme member.

12. Owing to the administrative and legal procedures required in appointing a provisional liquidator, the appointment may take a week or two after the DPS is triggered. This will be an impediment to a fast payout even after the gross payout approach is adopted. Although the DPSO provides for a power for the HKDPB to specify the QD as the DPS trigger date under the specified conditions as mentioned in paragraph 11 above, the existing arrangement may still present some uncertainties for the HKDPB to make use of such a power to determine the compensation payable. This is because we envisage that in practice it will be difficult for the HKDPB, during a banking crisis, to have knowledge or form an opinion to speculate over the possibility of the appointment of a provisional liquidator and the date for the appointment if materialised. The decisions of the HKDPB, with reference to the knowledge or opinion formed in accordance with any of the conditions (a) to (c) referred to in paragraph 11 above, may be subject to dispute.

13. To remove the existing uncertainties in the reference to a QD to determine the DPS compensation payment, we propose amending the DPSO by defining the QD as the date of the "specified event" referred to in section 22 of the DPSO that will trigger the DPS. Under that section, the "specified event" will occur if (a) a winding-up order has been made by the Court in respect of a Scheme member; or (b) the Monetary Authority has served on the HKDPB a notice of his decision that the DPS should be triggered[5]. The automatic alignment of the QD with the date of the "specified event" that triggers the DPS will remove unnecessary uncertainties in connection with the determination of the amount of the compensation during a payout process.

III. Issuing electronic notices in addition to paper-form notices

14. When the DPS is triggered, the HKDPB is required under the DPSO to inform relevant depositors of their compensation entitlement and the relevant detail as soon as practicable. This notification to depositors has

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[5] Under section 22(2) of the DPSO, the Monetary Authority may, after consultation with the Financial Secretary, decide that compensation should be paid from the DPS Fund to the depositors of the Scheme member and shall serve on the HKDPB a written notice of his decision, if –
- (a) in respect of the Scheme member –
  - (i) a Manager has been appointed under section 52 of the Banking Ordinance (Cap. 155); or
  - (ii) a provisional liquidator has been appointed; and
- (b) the Monetary Authority is of the opinion that the Scheme member –
  - (i) is likely to become unable to meet its obligations;
  - (ii) is about to suspend payment to its depositors; or
  - (iii) is insolvent, has ceased to pay its debts in the ordinary course of business, or cannot pay its debts as they become due.

to be made individually in writing under section 32(7) of the DPSO. The established mechanism for this is that the HKDPB will send a written payment notice to each depositor by post, together with a paper cheque bearing the amount of the depositor's entitled payment. With the advancement of technology and frequent use of electronic communications, it is envisaged that electronic communications can enable the HKDPB to give notification to depositors more swiftly. We therefore propose fine-tuning the DPSO to empower the HKDPB to send notice to depositors on the compensation decision by any appropriate electronic means. This may improve the payout operation efficiency and shorten the timeframe for depositors who are to receive their compensation under the DPS.

15. In determining whether to issue electronic notices to the affected depositors, the HKDPB will consider the information obtained from the bank concerned and have regard to the circumstances of the relevant depositors (particularly, the validity and level of usage of electronic communication between a depositor and the bank, and the security standard of a specific electronic channel) to satisfy itself that any electronic notices so sent will reasonably come to the attention of the relevant depositors. The electronic notices will contain the essential payment detail and, subject to the readiness or reliability of the relevant payment technologies, an e-cheque[6] or any other forms of payment facilities to effect the compensation.

16. To better ensure that all affected depositors will be properly notified when the DPS is triggered, the proposed electronic notice will be issued to those depositors who are used to receiving electronic communications from the bank concerned, in addition to the conventional paper notice that they and other affected depositors will receive. For depositors who are not identified by the HKDPB for notification by electronic means (including those affected depositors who do not use electronic banking services), the HKDPB will maintain the existing established practice to send them paper-form notices. Also, the HKDPB will provide a paper notice to depositors who have received an electronic notice after the disbursement of compensation for record purposes.

CONSULTATION

17. We conducted a 3-month public consultation on the proposals contained in paragraphs 4-16 above from September to December 2014 and received 17 submissions. The respondents include the Hong Kong Association of Banks, the Hong Kong Institute of Certified Public

[6] The Electronic Transactions Ordinance (Amendment of Schedule 1) Order 2014 has granted e-cheque the same legal status as paper cheque.

Accountants, the Consumer Council, as well as some banks, financial institutions, accountancy firms and individuals. The submissions reveal broad support for the proposals.

18. In particular, the banking industry notes that the proposed adoption of the gross payout approach will increase the payout efficiency and accelerate any compensation process. It will also streamline banks' work on information management regarding depositors' liabilities. Some respondents also acknowledge that the impact of the gross payout approach on the liquidation regime for banks would be minimal.

19. In addition, respondents agree that the proposal to enhance the certainty of determining the QD will facilitate the compensation determination process. They also support the proposal to empower the HKDPB to issue electronic notices to depositors during the payout process, and some have offered operational suggestions in ensuring the reliability, safety and effectiveness of electronic communications. We will issue a consultation conclusion to address these comments and suggestions shortly.

WAY FORWARD

20. The Government is drafting a Bill to amend the DPSO in relation to the above proposals, with a view to introducing the Bill into the Legislative Council later this year. Members are invited to note the legislative proposals outlined in this paper.

Financial Services and the Treasury Bureau
Hong Kong Monetary Authority
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