# *立法會*
# *Legislative Council*

LC Paper No. CB(1) 2226/02-03(01)

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**Background brief on**
**Deposit Protection Scheme Bill**

**Purpose**

This paper sets out the background to the introduction of the Deposit Protection Scheme, and provides a summary of the major concerns expressed by members of the Panel on Financial Affairs (FA Panel) on the subject.

**Background**

2. In April 2000, in the light of the growing trend in international financial systems in favour of explicit forms of deposit protection, the Hong Kong Monetary Authority commissioned a consultancy study on enhancing deposit protection in Hong Kong. A consultation paper was published in October 2000 to invite views on the establishment of a Deposit Protection Scheme (DPS) to strengthen the resilience of the banking system against external shocks. According to the Administration, the results of the consultation exercise indicated that there is broad public support for a DPS. In December 2000, the Legislative Council also passed a motion urging the Government to expeditiously implement a DPS for effectively protecting small depositors, and to formulate appropriate complementary measures to reduce the risk of moral hazard.

3. On 24 April 2001, the Chief Executive in Council approved in principle the establishment of a DPS and requested the HKMA to work out the detailed designed features of the scheme. In March 2002, a second round of public consultation was conducted on HKMA's detailed recommendations focusing on HKMA's proposed structure for DPS. A total of 20 written submissions were received from the banking industry, insolvency practitioners, the Consumer Council and other interested parties. Responses received were generally supportive of HKMA's proposals, although there were some suggestions on reduction of cost of DPS through a smaller fund size, a longer fund build-up period and greater Government's commitment.

4. On 6 January 2003, HKMA presented its recommendations to the FA Panel on how the proposed DPS should be structured. In the meantime, HKMA produced a draft Bill for implementing the proposed DPS and consulted the industry. On 17 April 2003, the Deposit Protection Scheme Bill (the Bill) was introduced to the Council.

**Major proposals in the Bill**

5. The principal object of the Bill is to provide for –

(a) the establishment of a Hong Kong Deposit Protection Board (HKDPB);

(b) the establishment by the Board of a DPS for the purpose of providing compensation to depositors under certain circumstances in respect of deposits maintained with banks that are members of the Scheme;

(c) the establishment of a Deposit Protection Scheme Fund from which such compensation is to be paid; and

(d) contributions to the Fund, and the entitlement to, and payment of, compensation from the Fund.

**Major issues raised at the FA Panel meeting on 6 January 2003**

6. On the ***administration of HKDPB***, Panel members are concerned that the proposed appointment of HKMA as the agent of HKDPB to undertake the day-to-day administration of DPS may undermine the credibility and independence of the Scheme. There will be conflicting role for HKMA as the regulator of banks. Besides, HKMA may not be able to deploy adequate staff to take up the necessary duties in the event of a large bank failure.

7. On the ***exemption from DPS***, members cast doubt on whether the proposal to exempt an overseas bank that has a comparable scheme in the bank's home jurisdiction which extends its deposit protection to its Hong Kong office would encourage depositors to move their deposits to the overseas home bank.

8. On ***contributions from banks according to the CAMEL rating***[1] ***system***, there is concern that lower rated banks may be forced to undertake businesses with higher risks in order to recover the higher cost incurred under the proposed system. The

[1] The "CAMEL Rating" is a supervisory rating currently adopted by the HKMA to assess the financial strength and overall soundness of an authorized institution in the areas of **C**apital, **A**sset quality, **M**anagement, **E**arning, and **L**iquidity.

question of moral hazard may arise if banking institutions try to recoup cost for the Scheme from customers through fee increases.

9. On ***interim payments to depositors***, there is a suggestion that interim payments should be made to depositors pending the determination of compensation.

10. The relevant extract of the minutes of the FA Panel meeting on 6 January 2003 is at **Appendix I**.

**Reference materials**

11. The following papers are relevant to the Bill -

(a) Legislative Council Brief (Ref: B9/2/2C VII (2000) dated 24 October 2000);

(b) Consultation paper on Enhancing Deposit Protection in Hong Kong (LC Paper No. CB(1) 111/00-01 issued on 30 October 2000);

(c) Information paper on establishment of a Deposit Protection Scheme in Hong Kong (LC Paper No. CB(1) 588/02-03(03) issued on 30 December 2002); and

(d) A summary of views pertaining to the 20 submissions received during the second round consultation in March 2002 and the Administration's response (LC Paper No. CB(1) 2226/02-03(02)).

Council Business Division 1
Legislative Council Secretariat
17 July 2003

**Appendix I**

**Extracts from the minutes of the meeting of the Panel on Financial Affairs held on 6 January 2003**

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**IV Progress on the establishment of the Deposit Protection Scheme**
(LC Paper No. CB(1) 588/02-03(03))

8. Upon the Chairman's invitation, the Executive Director (Banking Development), Hong Kong Monetary Authority (ED(BD)/HKMA) briefed the Panel on HKMA's latest recommendations on how the proposed Deposit Protection Scheme (DPS) in Hong Kong should be structured.

Proposed Major Design Features and Implementation of the DPS

9. ED(BD)/HKMA advised that the majority of the opinions received from the HKMA consultation exercise supported the DPS to confine its role to a "pay box". There was also support for the establishment of a separate legal entity to oversee the operations of the scheme in order to offer greater accountability. It was therefore proposed to establish a new statutory body -- the Hong Kong Deposit Protection Board (HKDPB) to administer the DPS and to appoint HKMA as the agent to carry out the day to day administration of the scheme. The decisions of the HKDPB would be subject to the review of the independent Deposit Protection Appeals Tribunal. ED(BD)/HKMA added that participation by licensed banks in the scheme would be mandatory. The coverage limit would be set at $100,000 per depositor per bank. As regards funding for the DPS, ED(BD)/HKMA said that the DPS fund would be established by means of contributions from banks based on their respective "CAMEL rating". On average, the rate of contribution payable by banks until the first year in which the target fund size was reached was 0.08%, and there after at 0.01%. It was expected that the proposed target fund size of 0.3% of the banking sector's total amount of protected deposits (approximately $1.6 billion based on the level of protected deposits as at August 2002) would be reached in approximately five years. ED(BD)/HKMA further advised that the HKMA was currently consulting the banking industry on the draft Bill. It was expected that the Bill would be introduced into the Legislative Council in the first half of 2003. Depending on the progress of the necessary preparatory work, the scheme could commence operation in 2005.

Discussion with Members

*Exemption from the DPS*

10. Mr Bernard CHAN noticed that under the proposal, an overseas incorporated bank could apply for exemption from participating in the DPS if the deposits taken by the bank's Hong Kong offices were protected by a scheme in the bank's home

jurisdiction and the scope and level of protection afforded by that scheme were not less than under the DPS in Hong Kong. He enquired about the number of overseas incorporated banks in Hong Kong which would be eligible for the exemption.

11. In reply, ED(BD)/HKMA remarked that few overseas incorporated banks with DPSs established in their home jurisdictions would offer protection for deposits taken by their overseas offices. The DPS set up by Germany was one of the few systems which provided for such protection. Hence, it was envisaged that few overseas banks operating in Hong Kong would be eligible for exemption from the DPS.

12. On Mr Henry WU's concern that the proposed exemption for overseas banks and possible higher level of compensation in overseas DPSs would encourage depositors to move their deposits to overseas banks, ED(BD)/HKMA remarked that as the DPS in Hong Kong was basically a protection scheme for small depositors, it was unlikely that small depositors would be lured to move their deposits to overseas banks.

*Deposit Protection Appeals Tribunal*

13. In response to Mr NG Leung-sing's enquiry about the composition and purview of the proposed Deposit Protection Appeals Tribunal, ED(BD)/HKMA replied that the Tribunal would consist of independent members appointed by the Chief Executive from relevant fields. The Tribunal would be empowered to review the decisions of the HKDPB, including those relating to the determination of compensation payments, exemption from the DPS, and the assessment of contributions payable by banks. As to Mr Henry WU's concern about possible role conflict for the Tribunal to determine the amount of compensation and receive appeals at the same time, ED(BD)/HKMA stressed that the HKDPB and the Tribunal were two separate entities. The HKDPB would determine the amount of compensation whereas the Tribunal would receive appeals against the determination of the Board. There would be no role conflict between the two bodies.

*Contributions from banks and the CAMEL rating system*

14. As contributions towards the DPS fund would be based on the "CAMEL rating" of banks and banks with higher ratings would pay lower rates to the fund, Mr Albert HO expressed concern that lower rated banks would be forced to undertake businesses with higher risks in order to recover the higher cost involved.

15. In response, ED(BD)/HKMA remarked that there was support from the public consultation to adopt a differential system for assessment of contributions. As banks would try to improve their risk-management and asset quality with a view to obtaining a higher CAMEL rating in order to lower payments to the fund, the proposed contribution mechanism would help reduce the potential moral hazard risks associated with the DPS.

16. As regards Mr Henry WU's enquiry about the breakdown of the number of banks by their ratings under the CAMEL rating system, ED(BD)/HKMA advised that majority of the banks had achieved a second rating. On whether banks could appeal to the Deposit Protection Appeals Tribunal if they were not satisfied with their CAMEL ratings, ED(BD)/HKMA explained that CAMEL ratings were determined by the Monetary Authority (MA) and the Tribunal would not be empowered to review MA's decisions on the ratings.

17. Noting that the target size of the DPS fund was set at $1.6 billion to be achieved in about five years, Ms Emily LAU asked about the implications on banks' contribution rate if such target was not attained. ED(BD)/HKMA replied that the contribution rate (on average) would remain at 0.08% if the target fund size was not achieved. The rate would be reduced to 0.01% after the target was reached.

*The problem of moral hazard*

18. Noting that only 16% of the total deposits in Hong Kong vis-á-vis 84% of the depositors would have their total deposits fully protected under the DPS with the proposed coverage limit of $100,000 per depositor per bank, Mr CHAN Kam-lam expressed concern over the problem of moral hazard associated with the scheme. Given that medium and large depositors, which comprised the bulk of the total deposits in Hong Kong, would not be protected, and banks would increase charges from customers to recover the cost for the scheme, Mr CHAN was concerned that the interest of medium and large depositors would be adversely affected as they would be subsidizing the small depositors in the scheme. In this connection, Mr LEE Cheuk-yan expressed concern that banks would pass on the cost of the DPS to small depositors and ask whether there would be measures to protect their interests.

19. In reply, ED(BD)/HKMA said that it had been argued that as large depositors would have more resources to protect their interests and would exercise prudence in choosing their bankers, the DPS in Hong Kong was mainly designed for protecting the small depositors. However, it should be noted that even medium and large depositors would be protected under the DPS because the first $100,000 of their deposits would be fully protected by the scheme.

20. On the concern about cost to be borne by customers, ED(BD)/HKMA stressed that how banks charged their clients would be a commercial decision which was inappropriate for HKMA to interfere. However, it had been revealed in HKMA's study and overseas experience that smaller banks tended to be more active in competing for small deposits. Hence, it was envisaged that depositors would have a wider choice in banking service after implementation of the DPS.

*Administration of the Hong Kong Deposit Protection Board*

21. On the proposal of appointing the HKMA as the agent of the HKDPB to undertake the day to day administration of the DPS, Ms Emily LAU expressed concern about possible negative impact of undermining the credibility and independence of the

scheme, and conflict for the HKMA as the regulator of banks to take up the role. She doubted if the proposal would lower the administrative cost for the scheme since the HKMA would fully recover the cost it incurred from the DPS fund. There was also concern that in the event of a large bank failure, the HKMA might not be able to deploy adequate staff to take up the necessary duties. Ms LAU further enquired about overseas experience in administering the DPS.

22. In reply, ED(BD)/HKMA advised that depending on the scope of the DPSs, institutions responsible for administering the schemes in overseas jurisdictions had different structure. For instance, the DPS in the United States did not only operate as a pay box hence the institution had a bigger establishment. In devising the present proposal, the HKMA had made reference to the experience in the United Kingdom whose DPS was also a paybox where the Bank of England was appointed as the agent for administering the scheme. ED(BD)/HKMA said that for a pay box scheme, it would probably not be cost-effective for the HKDPB to maintain a staff level that was required to handle the workload in the event of a bank failure but otherwise not needed in normal time. He advised that the proposal was supported by the Hong Kong Association of Banks and the Consumer Council. On the subject of role conflict, ED(BD)/HKMA explained that in line with overseas practice, this could be addressed by functional separation between bank regulation and administration of the DPS in the HKMA. As regards the concern about staff deployment in the event of a large bank failure, ED(BD)/HKMA remarked that the HKMA could consider outsourcing some of the work and engaging external professionals as necessary in such circumstances.

23. Upon request of Ms Emily LAU, the HKMA agreed to provide the Consumer Council's views on the proposal for members' reference.

> *(Post-meeting note:* The Consumer Council's letter issued to the HKMA in October 2002 was circulated to members vide LC Paper CB(1) 655/02-03 on 8 January 2003.*)*

*Interim Payments to Depositors*

24. Responding to Mr Jasper TSANG's enquiry about the proposal of making interim payments to depositors, ED(BD)/HKMA explained that the proposal was to provide payment of up to 25% of the depositor's entitlement (but without adjustments for interest accrual) within 10 days after the collapse of a bank. Such proposal would help restore depositor's confidence in the banking system and avoid undue delay of payment to the depositors where the time required to ascertain the amount of compensations would be long. He added that there would be legal provision to recover payment from a depositor if the amount of interim payment had exceeded the entitled amount of compensation.

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