Deposit Protection Scheme Bill

Background (1)

<u>First public consultation (10/2000 -1/2001)</u>

- There is broad public support for establishing a deposit protection scheme (DPS) in Hong Kong.
- The LegCo passed a motion on 13 December 2000 urging the Government to “expeditiously implement a DPS, which is cost effective and easy for depositors to understand, for effectively protecting small depositors, and to formulate appropriate complementary measures aiming at reducing the risk of moral hazard.”

Background (2)

<u>ExCo's decision (4/2001)</u>

- CE in Council approved in principle the establishment of a DPS in Hong Kong and requested the HKMA to work out the detailed design features of the scheme.

<u>Second public consultation (3/2002-5/2002)</u>

- Respondents are generally supportive of the HKMA's proposals on how the scheme should be structured. Having considered the comments received during the consultation, the HKMA refined its proposals and prepared a bill for implementing the DPS.

Main Provisions of DPS Bill

The main provisions of the DPS Bill cover the following areas:

- Establishment of Hong Kong Deposit Protection Board
- Membership of the DPS
- Coverage
- Calculation and payment of compensation
- Funding of the DPS
- Investment of DPS Fund
- Establishment of Deposit Protection Appeals Tribunal

Deposit Protection Board (1)

Establishment of the Board

- A separate legal entity would be established to oversee the operations of the scheme so as to offer greater accountability and transparency to the public.

Functions

- The Board would operate only as a "paybox" with functions confined to:
  - collection of contributions
  - management of the DPS Fund
  - making payouts to depositors in the event of a bank failure
  - recovering the payouts from the liquidator of the failed bank

Deposit Protection Board (2)

Composition

- The Board would consist of:
  - Secretary for Financial Services and the Treasury (or his representative)
  - Monetary Authority (or his representative)
  - chief executive officer of the Board
  - 4-7 unofficial members appointed by CE/SAR
- The Chairman of the Board would be appointed from the unofficial members.

Deposit Protection Board (3)

<u>Performance of functions</u>

- To keep the cost low, the Board would perform its functions through the MA.
  - Leverage on existing IT, staffing, office administration resources of the HKMA.
  - Avoid keeping a staff level required for bank crisis but otherwise not needed in normal times.
  - The cost incurred by the MA would be recoverable from the DPS Fund.

Deposit Protection Board (4)

<u>Governance and accountability arrangements</u>

- The accounts of the DPS Fund to be subject to regular audits. The Board's annual budget to be approved by the FS.
- Annual report and statement of accounts to be laid before LegCo every year.

[The above proposals relating to the Deposit Protection Board are set out in clauses 3-6 and 16-19 of the Bill]

Membership

- Mandatory participation by licensed banks
- RLBs and DTCs, which are not allowed to take small deposits under the current authorization system, would not be covered.
- Foreign bank's branches which are covered by a comparable scheme in their home jurisdiction may seek exemption from participation in the DPS, but will need to make proper disclosure to customers.

[The above proposals are contained in clauses 11-12]

Coverage

- Both Hong Kong dollar and foreign currency deposits would be covered.
- Coverage limit would be set at $100,000 per depositor per bank.
- Consistent with the existing priority payment system, certain deposits, e.g. interbank and connected deposits, would be excluded.
- The Bill contains provisions governing the treatment of multi-beneficiary accounts (e.g. joint, trust, agent and client accounts).

[These proposals are contained in Part 5 and Schedule 1]

Calculation and Payment of Compensation (1)

- Payout by the DPS would be triggered if: -

  (1) a winding-up order has been made, OR

  (2) a Manager under the Banking Ordinance or a provisional liquidator has been appointed, and

  the MA, after consultation with the FS, notifies the Board that payout should be triggered because the bank is insolvent or is likely to become unable to meet its obligations.

- MA's decision to trigger DPS payout is subject to review by ExCo.

Calculation and Payment of Compensation (2)

- A depositor’s liabilities to the failed bank would be fully netted off against his protected deposits in determining his entitlement to compensation.
- The Board may make an interim payment of compensation to a depositor where:
  - there is uncertainty as to the exact amount of compensation payable to the depositor; or
  - the time required to ascertain such amount would be so long as to unduly delay the compensation payment.
- This arrangement seeks to minimise the risk of domino effect on other banks due to prolonged uncertainty in payouts.

[The above proposals are set out in Part 5 of the Bill]

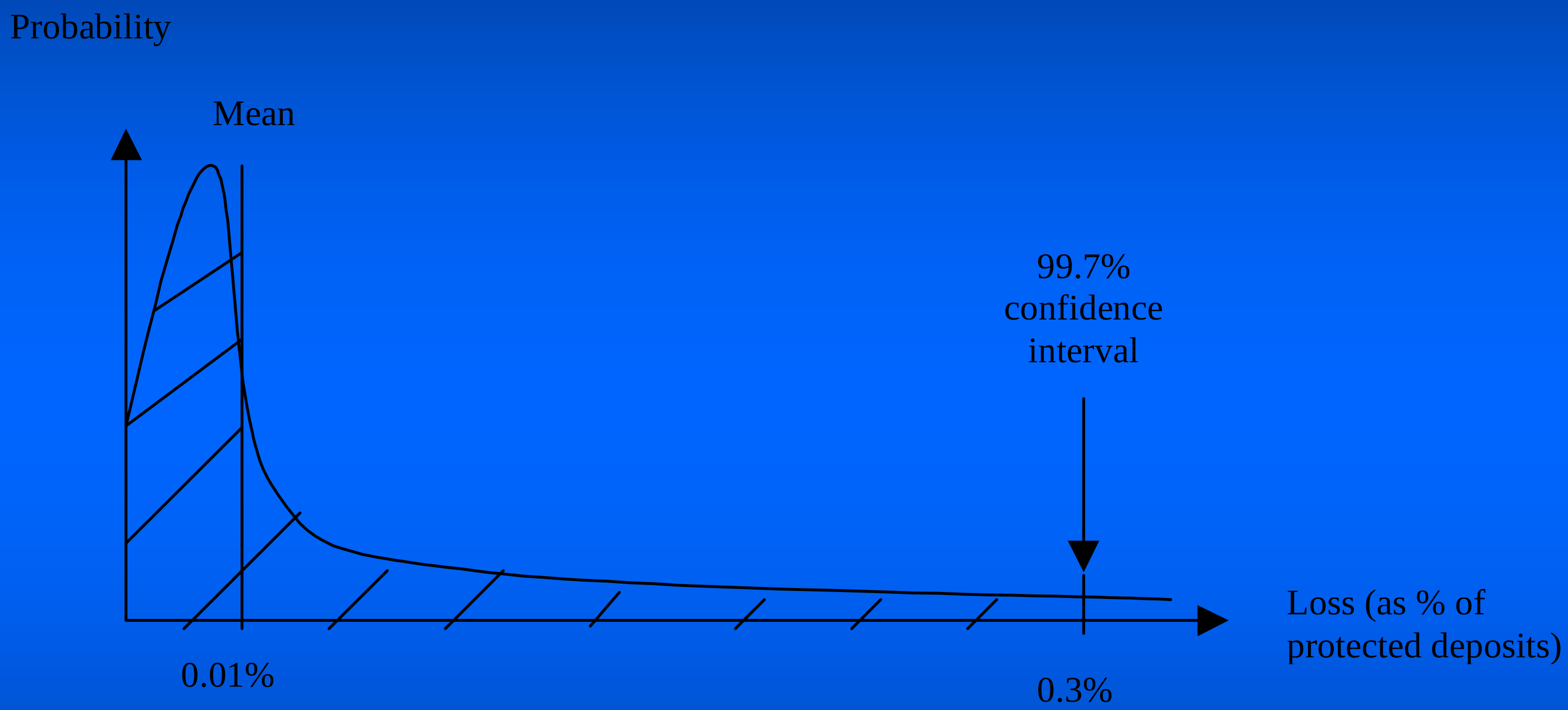
Funding of the DPS (1)

- A DPS Fund funded by contributions collected from Scheme members would be established for this purpose.
- In considering the appropriate fund size, the aim is to cover potential losses that might be suffered by the scheme, not the liquidity required for making payouts.
- In the event of a bank failure, the Exchange Fund would provide back-up funding at market rate to enable the Board to make prompt payment to depositors.

Funding of the DPS (2)

- The target level of the DPS Fund would be set at 0.3% of the total amount of protected deposits of the banking sector (about $1.6 billion based on the current level of protected deposits).
- The main considerations for the proposed fund size are:
  - The proposed fund size corresponds to a solvency standard that matches an investment grade rating of BBB-; and
  - The proposed fund size meets the IMF's benchmark of being able to cope with the failure of 2 medium-sized banks.

Funding of the DPS (3)



- The target fund size is set so as to enable the DPS to cover up to 99.7% of the losses it might face (i.e. a 99.7% confidence interval). This is consistent with an investment grade credit rating.

Funding of the DPS (4)

- The target fund size would be built up over 5 years.
- During the Fund build-up period, the central rate of contribution would be 0.08% p.a.
- Once the Fund reaches the target level, the central rate of contribution would be reduced to 0.01% p.a.
- There would be a rebate and surcharge mechanism to keep the DPS Fund within the target range of +15% and -30%.

Funding of the DPS (5)

- A differential rate system based on CAMEL ratings would be used to assess contribution.

CAMEL Rating	Build-up Levy	Expected loss levy
1	0.05%	0.0075%
2	0.08%	0.01%
3	0.11%	0.015%
4 & 5	0.14%	0.02%

[The above proposals are contained in clauses 13-15 and Schedule 4 of the Bill]

Investment of DPS Fund

- In keeping with the need for capital preservation and liquidity, the Fund would be allowed to invest only in: -
  - deposits with Exchange Fund
  - Exchange Fund Bills
  - US Treasury Bills
  - exchange rate and interest rate contracts, including derivative products, which are necessary for hedging purposes
  - other investments approved by the FS

[The above proposal is set out in clause 20 of the Bill]

Deposit Protection Appeals Tribunal

- A Deposit Protection Appeals Tribunal would be established. It would be chaired by a judge or a retired judge. All members of the Tribunal would be appointed by CE/SAR.
- The following decisions made by the Board and the MA would be appealable to the Tribunal:
  - The Board's decisions relating to exemption of branches of foreign banks, assessment of contributions and entitlement to, and determination of, compensation payments.
  - The MA's decision to require a Scheme member to maintain sufficient assets in HK to cover its protected deposits.
- The Bill contains detailed provisions governing the operation of the Tribunal.

Rules to be made under the DPS Legislation (1)

- The rules mainly cover procedural matters and may need to be updated from time to time. To provide flexibility, it is proposed that they are effected in the form of subsidiary legislation.

Rules to be made by the Board

- Under clause 49 of the Bill, the Board would be empowered to make rules governing the detailed operation of the Board, e.g.
  - the manner in which contributions are paid by Scheme members
  - the manner in which compensation is paid to depositors
  - the requirements of the information systems to be maintained by Scheme members so as to facilitate payment of compensation
  - the information and documents that the Board may require for determining a depositor's entitlement to compensation
  - the manner in which membership status and other relevant matters are to be disclosed

Rules to be made under the DPS Legislation (2)

Rules to be made by the MA

- Under clause 51 of the Bill, the MA would be empowered to make rules for the purpose of requiring a Scheme member to maintain sufficient assets in HK to cover its protected deposits.
- This would help to minimise the risk of loss to the DPS.

Moral Hazard

- The proposed scheme has incorporated features to minimise moral hazard:-
  - a relatively low level of protection; and
  - a differential system for assessment of contributions.
- These features, coupled with effective banking supervision and a high level of financial disclosure by banks, would help to keep the risk of moral hazard under control.

Industry's Concerns (1)

- The major concerns of the industry are the cost of the DPS and the timing of implementing the Scheme.

HKAB's suggestions	**HKMA's responses**
(a) Cost of the DPS	
• A smaller fund size	• Proposed target fund size is in line with international standards. Further reduction would undermine the credibility of the DPS.
• A longer build-up period	• If the DPS commences operation in 2005, the fund size would only be reached in 2009/10. There seems to be a sufficiently lengthy period for the fund to build up.

Industry's Concerns (2)

HKAB's suggestions

- Government to make initial capital contribution and absorb administration cost of the DPS

HKMA's responses

- In keeping with the user-pays principle, it is not appropriate for the Government to provide subsidies to the DPS.
- Nonetheless, we have taken on board the industry's suggestion that the Board should perform its functions through the MA as a means of cost saving.

(b) Implementation Timetable

HKAB's suggestions:

- The DPS should be launched only when the economic environment has improved

HKMA's responses:

- Given the amount of preparatory work that needs to be completed, the DPS would not be ready to commence operation until 2005.
- We believe that the Government would take into account all relevant factors in determining the appropriate time to commence the operation of the scheme.

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