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For information on
17 September 2003

Bills Committee on Deposit Protection Scheme Bill

Coverage Limit

Purpose

At the meeting of the Committee held on 18 July 2003, Members requested the Administration to advise the extent of coverage and the cost implications for banks if the protection level of the proposed deposit protection scheme (DPS) in Hong Kong is increased from HK$100,000 to HK$150,000 or HK$200,000. This paper provides the requested information[1].

Extent of coverage

2. As currently proposed, the coverage limit of the DPS would be set at HK$100,000. At this level, about 84% of depositors would be fully protected by the DPS, and the percentage of value of deposits covered would be 16%[2].

3. As shown in Table 1, raising the coverage limit from HK$100,000 to HK$150,000 would bring in an additional 4% of depositors who would be fully protected by the DPS. The percentage of value of deposits covered would increase by 5% to 21%.

Table 1

Coverage limit (HK$)	% of depositors fully protected	% of value of deposits covered
100,000	84%	16%
150,000	88% (+4%)	21% (+5%)
200,000	90% (+6%)	24% (+8%)

1 This paper should be read together with section IV of the paper on comparison with overseas schemes. The latter paper explains in fuller detail the reasons why the coverage limit is proposed to be set at HK$100,000.

2 These estimates are obtained from a survey of the profile of depositors in Hong Kong carried out in 2000.

4. If the coverage limit is increased from HK$100,000 to HK$200,000, 6% more depositors would be fully protected and the percentage of value of deposits covered would increase by 8% to 24%.

Cost implications

5. The consultant, who undertook the consultancy study in 2000, developed a model to estimate the cost of the DPS. Using this model, it is expected that, for a coverage limit of HK$100,000, a target fund size of around HK$1.6 billion, or 0.3% of total protected deposits, would be sufficient to cover most of the losses that would be sustained by the DPS. At this level, the DPS Fund would meet the International Monetary Fund's benchmark of being able to absorb the losses arising from the simultaneous failures of two medium sized banks. It is also largely consistent with the minimum capital adequacy ratio of 8% required of a bank under the Basel Capital Accord.

6. The HKMA proposes that the target fund size be built up within 5 years. This means that the central rate of contribution payable by banks would be set at 0.08% of protected deposits per annum during the fund build-up period. After that, the central rate of contribution would be reduced to 0.01% of protected deposits per annum. At these levels, the aggregate amount of annual contributions payable by banks would be HK$390 million during the fund build-up period and HK$54 million thereafter.

7. One important issue should be mentioned before we proceed to discuss the cost implications for banks if the coverage limit is increased to HK$150,000 or HK$200,000. An important reason for setting the coverage limit of the DPS at HK$100,000 is that this is consistent with the priority claim limit in the Companies Ordinance (Cap 32). Section 265 of that Ordinance provides that a depositor is entitled to receive priority in the repayment of his aggregate deposits, up to a limit of HK$100,000, in the winding up of a bank. Aligning the coverage limit of the DPS with the priority claim limit would ensure that the DPS could take over an equivalent amount of priority claim from each depositor to whom it has paid compensation. This is an essential feature aimed at reducing the cost of the scheme. For the purposes of the following discussion, it is assumed that any increase in the coverage limit would be matched by a corresponding adjustment to the priority claim limit. Otherwise, the DPS would be exposed to a substantially larger amount of shortfall risk[3], and the cost of the scheme would surge exponentially[4].

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3 Shortfall risk is the risk that the assets realised in a liquidation may be insufficient to meet the claims of depositors.

4 If there is no corresponding adjustment to the priority claim limit, assuming an asset recovery rate of 50% in the liquidation of the failed bank, the target fund size of the DPS would increase by approximately 300% if the coverage limit is increased from HK$100,000 to HK$150,000 and by 500% if the coverage limit is increased to HK$200,000, and the cost of the scheme would rise commensurately.

8. Assuming that the coverage limit and the priority claim limit are adjusted correspondingly, the consultant's model predicts that the cost of the DPS would increase in proportion to the total amount of deposits protected by the scheme[5]. If the coverage limit is increased to HK$150,000 or HK$200,000, the total amount of protected deposits would increase by 24% and 45% respectively. It follows that the target fund size required and the total annual contributions payable by banks would increase by the same proportion (see Table 2 below).

Table 2

Coverage limit (HK$)	**Target fund size required * (HK$ billion)**	**Total annual contributions payable by banks (HK$ million)**	
		During fund build-up period	**After fund build-up period**
100,000	1.65	390	54
150,000	2.05 (+24%)	484 (+24%)	66 (+24%)
200,000	2.39 (+45%)	564 (+45%)	77 (+45%)

* These estimates are derived based on the deposit figures as of May 2003. At these levels, the target fund size would be able to meet the International Monetary Fund's benchmark of being able to absorb the losses arising from the simultaneous failures of two medium sized banks. It is also largely consistent with the minimum capital adequacy ratio of 8% required of a bank under the Basel Capital Accord.

Summary

9. Any proposal to increase the coverage limit should be accompanied by a corresponding adjustment to the priority claim limit, otherwise the DPS would be exposed to an unacceptably high risk of loss. However, to increase the priority claim limit would affect the interests of other unsecured creditors. Since the real value of HK$100,000 has increased slightly since the priority claim system was introduced in 1995[6], it appears difficult to justify any significant upward adjustment of the priority claim limit.

10. Even on the assumption that the coverage limit of the DPS and the priority claim limit were to be adjusted correspondingly, we still need to weigh the costs and benefits of doing so. As shown in the above discussion, raising the coverage limit to HK$150,000 or HK$200,000 would increase the

5 This is because, assuming an asset recovery rate of 50%, the DPS would not suffer any shortfall loss under a coverage limit of HK$150,000 or HK$200,000. The cost of the DPS would mainly stem from the financing cost associated with the payments made to the depositors.

6 The composite consumer price index in July 2003 was 91.1, compared with 92.9 in 1995.

cost of the DPS markedly without bringing significant additional numbers of depositors within the scope of protection. Moreover, the higher the coverage limit is, the greater the risk of moral hazard becomes. Bearing in mind the desire to keep the cost low and the need to minimise moral hazard, the HKMA believes that it is more appropriate to set the coverage limit at HK$100,000.

Hong Kong Monetary Authority
Financial Services and the Treasury Bureau
4 September 2003

For information on
17 September 2003

Bills Committee on
Deposit Protection Scheme Bill

Comparison with Overseas Schemes

I. Introduction

This paper compares the proposed deposit protection scheme (DPS) in Hong Kong with its overseas counterparts in terms of the key features of the schemes. It is prepared in response to Members' request made in the meeting of the Committee held on 18 July 2003.

2. The overseas schemes selected for comparison include the Financial Services Compensation Scheme (FSCS) in the U.K., the Federal Deposit Insurance Corporation in the U.S., the Canada Deposit Insurance Corporation, and the proposed scheme in Singapore[1]. The first three schemes have a relatively long history of operation[2] and are commonly regarded as leading schemes in the world. The proposed scheme in Singapore is also included given the city state's proximity to Hong Kong, and the many similarities between the two economies.

3. This paper will focus only on the more important features of a DPS. It is divided into seven sections, each covering one of the following aspects:-

- Institutional structure and functions of the DPS;
- Membership and exemption arrangement;
- Coverage;
- Determination of compensation (including trigger conditions and netting approach);
- Funding and contributions;
- Investment of funds; and
- Appeal mechanism.

4. Each section will begin with tables comparing the relevant design features of the selected schemes. These will be followed by narrative descriptions of the practices of the overseas schemes, and the reasons why the relevant design features are proposed for the scheme in Hong Kong.

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1 A study conducted by the Monetary Authority of Singapore (MAS) in 2001 recommended the establishment of a DPS in Singapore. In August 2002, the MAS released a consultation paper setting out its recommendations on how the proposed DPS in Singapore should be structured.

2 The schemes in the U.K., the U.S. and Canada were established in 1979, 1934 and 1967 respectively.

II. Institutional Structure and Functions of the DPS

Table II-A

Scheme	**Institutional structure of DPS**	**Range of functions**	**Performance of functions**
HK	Separate public body	Narrow	The proposed DPS Board will perform functions through the Monetary Authority
UK	Separate public body	Narrow	The UK, US and Canadian schemes have their own staff force to assist the discharge of their functions
US	Separate public body	Broad	
Canada	Separate public body	Broad	
Singapore	Being considered	Being considered	Being considered

Institutional structure

5. The institutional structure of a DPS is an essential design feature affecting the governance of the whole system. As shown in Table II-A, the leading schemes in the U.K., the U.S. and Canada are all managed by a separate public body.

6. In line with the practice of the leading schemes, it is proposed that the overall management of the DPS in Hong Kong be vested in a new statutory body established under the DPS Bill (i.e. the DPS Board). This would promote greater accountability and transparency to the public and is widely supported in the first public consultation conducted in late 2000.

Range of functions

7. The deposit insurers in the U.S. and Canada are given a broad mandate and thus are entrusted with a wider range of functions. Not only are they responsible for operating the deposit protection system, they also carry out certain supervisory functions in collaboration with the bank regulator.

8. On the other hand, the U.K. scheme has a narrow mandate and operates as a "pay-box" system. Its functions are largely confined to collecting contributions from member institutions and paying the claims of depositors after a bank failure has occurred. The U.K. scheme does not have any regulatory responsibilities.

9. As pointed out by the Financial Stability Forum (FSF)[3], there is no single mandate suitable for all deposit insurers. A deposit insurer's mandate

[3] The FSF was formed under the auspices of the Bank for International Settlements after the Asian financial crisis. Its main objectives are to promote international financial stability, to improve the functioning of markets, and to reduce systemic risk. In recognition of the increasing use of deposit insurance as an integral component of a financial safety net, the FSF issued in 2001 a set of guidance for developing effective deposit insurance systems.

should be set having regard to the circumstances of each country. Given the relatively small size of the Hong Kong banking sector and the comparative rarity of bank failures, the HKMA believes that the U.K. model (i.e. a pay-box system) is more suitable for Hong Kong. Confining the role of the DPS Board to that of a pay-box would also help to reduce the cost of deposit protection and avoid any duplications of functions with the bank regulator.

Performance of functions

10. All the leading schemes now have their own staff to assist the discharge of their functions. However, prior to the establishment of the FSCS in 2001, the deposit protection system in the U.K. was managed by the then Deposit Protection Board, which was supported by the staff of the Financial Services Authority (FSA) and before that the Bank of England[4].

11. Having regard to the practices of the leading schemes, the HKMA's original suggestion was that the DPS in Hong Kong should also have its own staff. This suggestion was however not supported by the banking industry, which was very concerned about the cost effectiveness of this arrangement. The industry counter-proposed that, as a means of cost savings, the DPS Board should outsource the day-to-day administration of the scheme to the HKMA. The Consumer Council has also made a similar comment.

12. The HKMA believes that the industry's proposal can help to reduce the administrative cost of the scheme. The proposed arrangement would allow the DPS Board to leverage on the existing IT, staffing and office administration resources of the HKMA. It would also relieve the Board of the need to maintain a staff level that is required to handle the workload in the event of a bank failure but otherwise not needed in normal times. Under this arrangement, the HKMA would essentially be acting as an agent of the Board in administering the scheme and would, in this respect, be subject to the oversight of the Board. In keeping with the user-pays principle, the costs incurred by the HKMA in administering the scheme would be recoverable from the DPS Fund at a rate to be determined by the Financial Secretary. A similar arrangement is found in the Protection of Wages on Insolvency Fund Scheme. As noted above, the proposed arrangement is also consistent with the former practice of the U.K. scheme. It has been approved by the Exchange Fund Advisory Committee.

[4] The Bank of England was previously responsible for banking supervision in the U.K. It transferred its banking supervisory functions to the Financial Services Authority (FSA) in June 1998. The FSA is now the single financial regulator in the U.K. It supervises all types of financial intermediaries including banks, securities brokers and insurance companies.

III. Membership and Exemption Arrangement

Table III-A

Scheme	Form of participation	Types of institutions covered	Exemption arrangement
HK	Compulsory	Licensed banks only	Yes
UK	Compulsory	Banks, building societies and credit unions (1)	Yes
US	Compulsory	Banks and savings associations (2)	No
Canada	Compulsory	Banks, trust companies and loan companies	No
Singapore	Compulsory	Full banks and licensed finance companies only (3)	Not mentioned in the consultation paper

Notes (1) The FSCS in the U.K. consists of three sub-schemes, namely Accepting Deposits Sub-scheme, Insurance Sub-scheme and Investment Business Sub-scheme. As the names suggest, these sub-schemes provide protection to depositors, insurance policy holders and investors respectively. In this paper, we will focus only on the Accepting Deposits Sub-scheme.

(2) The FDIC administers two deposit insurance funds, namely the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF). Commercial banks and savings banks are covered under the BIF, whereas savings associations are covered under the SAIF. Unless otherwise stated, references to the U.S. scheme in this paper refer only to the protection under the BIF.

(3) As of 17 July 2003, there were only 4 licensed finance companies in Singapore. The number of such companies has dropped significantly in the past years. As of 31 March 2001, there were 11 licensed finance companies.

Form of participation

13. Compulsory membership is commonly regarded as an important requirement for credibility by the FSF and the International Monetary Fund (IMF). On the contrary, a voluntary scheme may give rise to the problem of adverse selection whereby only riskier banks choose to join. During an impending crisis, a voluntary scheme may also exacerbate banking instability as depositors transfer their funds to protected banks. It is therefore not surprising that all the overseas schemes selected for comparison favour compulsory membership. The HKMA sees no good reasons why the Hong Kong scheme should deviate from this accepted practice.

Types of institutions covered

14. From the perspective of providing the best protection to depositors, it is desirable for the deposit protection system to cover as many types of deposit-taking institutions as possible. This line of thought underlies

why the leading schemes in the U.K., the U.S. and Canada have extended their coverage to both banks and non-bank financial institutions.

15. However, the benefits of expanding DPS membership beyond banks should be weighed against the costs involved. Where non-bank financial institutions are not allowed to take small deposits, the justification for covering these institutions would be weaker. In Singapore, for example, wholesale banks and offshore banks are not permitted to operate Singapore dollar savings accounts, nor to take Singapore dollar fixed deposits of less than S$250,000[5]. Therefore, it is recommended that these two types of institutions should not be covered by the proposed scheme in Singapore. On the other hand, licensed finance companies, which are allowed to take deposits below the proposed protection threshold (i.e. S$20,000), would be covered by the proposed scheme.

16. Hong Kong's situation is comparable to that of Singapore. Given that restricted licence banks (RLBs) and deposit-taking companies (DTCs) are not allowed to take deposits of less than $100,000, it is considered that there is not a strong case for including these two tiers of institutions in a scheme designed to protect only small depositors. In any case, the entry criteria for a banking licence were substantially relaxed in 2002. A RLB or DTC which wishes to take deposits protected under the DPS may seek to upgrade to licensed bank status.

17. It is also important to note that not all RLBs and DTCs are interested in joining the proposed DPS in Hong Kong. That is why the DTC Association has previously suggested that RLBs and DTCs should not be excluded from the scheme but should have the <u>option</u> whether to join. As noted above, DPS membership must be compulsory to avoid the problem of adverse selection. It would clearly be undesirable and unfair to have a scheme in which participation is mandatory for banks but voluntary for RLBs and DTCs.

Exemption arrangement

18. In the European Union (EU), exemption arrangements for banks from other member states are commonly found. Therefore, a Belgian bank operating a branch in Spain can opt out of the Spanish scheme, in consideration of the fact that deposits taken by the branch are already insured by the Belgian scheme and that the schemes in the two countries are comparable to each other.

19. Some EU countries, such as the U.K., have extended this arrangement to non-EU banks. If a non-EU foreign bank is protected by a comparable scheme in its home jurisdiction, the bank can seek exemption from joining the U.K. scheme. In the Asian region, the scheme in Taiwan also offers similar flexibility.

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[5] It is relevant to note that the proposed scheme in Singapore would only cover Singapore dollar deposits. See Section IV below.

20. In the U.S. and Canada, the situation is different. In these two countries, foreign banks which wish to take insured deposits have to operate as a local subsidiary[6] and become a member of FDIC or CDIC respectively. There is therefore no need for any exemption arrangement for foreign bank "branches".

21. The HKMA believes that it is desirable as a matter of general principle to allow an overseas incorporated bank to apply for exemption if the deposits taken by the bank's Hong Kong offices are protected by a scheme in the bank's home jurisdiction and the scope and level of protection afforded by that scheme are not less than those afforded by the DPS in Hong Kong. This arrangement would avoid double charging of premiums and help to maintain Hong Kong's attractiveness as an international financial centre. However, an exempted bank should be required to inform its depositors or prospective depositors that it is not a member of the DPS in Hong Kong and therefore any deposits taken by it are not protected by the scheme. The bank should also provide details of the protection offered by its home jurisdiction scheme including the level of protection and the types of deposits protected.

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[6] This means that the foreign bank's business should be carried out through a company incorporated in the U.S. or Canada (as the case may be), rather than through a branch of the foreign bank.

IV. Coverage

Table IV-A

Scheme	Coverage limit	Times per capita GDP covered (2)	% of depositors fully covered	% of value of deposits covered
HK	HK$100,000	0.5x	84%	16%
UK	£31,700 (1)	1.8x	Information not available	Information not available
US	US$100,000	2.8x	99%	65%
Canada	C$60,000	1.6x	85-90%	36%
Singapore	S$20,000	0.5x	86%	Information not available

Table IV-B

Scheme	Basis of coverage	Foreign currency deposits protected	Co-insurance
HK	Per depositor per bank	Yes	No
UK	Per depositor per bank	Yes	Yes (1)
US	Per depositor per bank	Yes	No
Canada	Per depositor per bank	No	No
Singapore	Per depositor per bank	No	No

Notes (1) The coverage limit of the U.K. scheme was adjusted in 2001. At present, 100% cover is available for the first £2,000 and 90% for the next £33,000, with an aggregate protection of £31,700 (100% x £2,000 plus 90% x £33,000). Before the adjustment, the maximum protection was £18,000 (90% of £20,000). This was equivalent to approximately one time per capita GDP. The percentage of depositors fully covered was about 70%.

(2) Per capita GDP figures are those of 2002.

Coverage limit

22. Coverage limit refers to the point at which a depositor's claims against the DPS will be capped. According to the guidance provided by the IMF, a well structured DPS should aim to protect small depositors who are likely to have low incomes, be unsophisticated in the ways banks operate, and lack the time, information and means to study the condition of their bank. Excluding larger depositors from coverage, thereby exposing them to loss, will cause these depositors to monitor the condition of their banks carefully and to impose market pressure on the banks to remain sound. This discipline will support the supervisors' efforts to encourage institutions to remain strong.

23. Accordingly, the international body recommends that the aggregate amount of coverage offered to each depositor in any bank should be relatively low. As a starting point, coverage could be considered in the region

of one or two times per capita GDP, but the limit may be set with more precision by examining the distribution of deposits by size. Within this distribution, the limit should be set to cover the majority of the total number of deposits (say, 80 to 90 percent of the number of deposits), but only a smaller percentage of the total value of deposits (say, 20 percent of the value of all deposits).

24. Set against these standards, the coverage limits of the U.K. and the Canadian schemes seem to be about right, whereas the protection level in the U.S. appears to be a bit on the high side. On the other hand, the coverage limits of the proposed schemes in Hong Kong and Singapore are relatively low in terms of times per capita GDP covered. However, they fare well in terms of the percentage of depositors fully protected.

25. In determining an appropriate coverage limit for the Hong Kong scheme, the HKMA has taken into account the views of the public and the banking sector. During the first public consultation conducted in late 2000, most of the respondents, while supporting the introduction of a DPS in Hong Kong, stressed the importance of keeping the cost down and the need to minimise moral hazard. In fact, the same concerns were expressed by members of the Legislative Council when this subject was discussed in a motion debate held on 13 December 2000[7].

26. Bearing these views in mind, the HKMA believes that it is more appropriate to set the coverage limit at HK$100,000 (which also coincides with the existing limit for priority claims of depositors in a liquidation laid down in the Companies Ordinance). To raise the coverage limit to, say, HK$200,000 would significantly increase the costs to the banks and the possible demands on the Exchange Fund for liquidity, without bringing significant additional numbers of depositors within the scope of protection[8]. Moreover, as the coverage cap increases, so will the risk of moral hazard. It is relevant to note that the Consumer Council is amenable to an initial coverage limit of HK$100,000, although it also suggests that the proposed limit should be subject to review at a later stage.

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7 On 13 December 2000, the Legislative Council passed a motion by a wide margin urging the Government "expeditiously to implement a DPS which is <u>cost effective</u> and easy for depositors to understand, for effectively protecting small depositors, and to <u>formulate appropriate complementary measures aiming at reducing the risk of moral hazard</u>".

8 The percentage of depositors covered under a coverage limit of HK$150,000 and HK$200,000 and the associated cost implications are discussed in a separate paper.

Basis of coverage

27. Applying the coverage limit on a “per depositor per bank” basis is commonly regarded as a better practice than applying the limit on a “per account” basis. The latter approach would encourage depositors to split their accounts within the same bank, which would increase the administrative costs of the DPS and erode the benefits of having a coverage limit. For this reason, it is recommended that the coverage limit of the Hong Kong scheme should be applied on a per depositor per bank basis, as in the case of all the overseas schemes selected for comparison.

Foreign currency deposits

28. The practices of the selected schemes vary in this respect. Whereas the U.K. and the U.S. schemes cover foreign currency deposits, the Canadian scheme and the proposed scheme in Singapore confine their protection to local currency deposits.

29. As noted by the IMF, the decision whether to cover foreign currency deposits depends on the circumstances of each country. Where most transactions are conducted in the domestic currency and the total value of retail foreign currency deposits is small, the authorities may choose not to extend coverage to foreign currency deposits, without affecting the effectiveness of the scheme. On the other hand, where foreign currency deposits are widely used, the deposit insurance system may insure foreign currency deposits to promote financial stability.

30. Given that over 40% of total customer deposits are held in foreign currencies in Hong Kong, it is recommended that the DPS in Hong Kong should cover both local and foreign currency deposits. Excluding foreign currency deposits may render the DPS in Hong Kong ineffective.

Co-insurance

31. Co-insurance refers to the arrangement whereby the depositor is required to share part of the loss (e.g. where the DPS payout is only a proportion of the depositor's covered deposit). Of the four overseas schemes selected for comparison, only the U.K. scheme has adopted this practice.

32. While co-insurance has the merit of maintaining market discipline in the system, it is contrary to the primary objective of protecting small depositors. Given the relatively low coverage limit that is proposed, there seems little point in paying small depositors less than 100% of the protected amount. There should in any case be sufficient depositors with deposits above the coverage limit to exert market discipline on the banks.

V. Determination of Compensation

Table V-A

Scheme	**Trigger Conditions**
HK	- a winding-up order has been made; or - 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 the bank concerned is insolvent or likely to become unable to meet its obligations.
UK	- the FSA is of the opinion that the participant firm is unable to satisfy protected claims against it; or - a judicial authority has made a ruling that has the effect of suspending the ability of eligible claimants to bring claims against the participant firm.
US	- the regulator determines that the institution is no longer viable (e.g. the bank is seriously undercapitalised or has insufficient liquidity); and - the FDIC is of the view that payment to depositors is the least cost method to resolve the failed institution.
Canada	- a winding-up order has been made; or - the CDIC decides to make payment where: (i) the member institution that holds the deposit is unable, by reason of an order of a court or any action taken by a supervisory or regulatory body, to make any payment in respect of the deposit; or (ii) the policy of deposit insurance of the member institution that holds the deposit is terminated or cancelled (e.g. by the CDIC itself).
Singapore	Being considered.

Table V-B

Scheme	**Netting approach**	**Flexibility to make interim payment**
HK	Full netting	Available
UK	Full netting	Available
US	Partial netting	Unavailable
Canada	Partial netting	Available. CDIC may make early payment on a case by case basis if substantial hardship is involved.
Singapore	Being considered	Not mentioned in the consultation paper

Trigger conditions

33. The trigger of a DPS is the point in time at which the scheme is required to make payout to depositors after a bank failure has occurred. As shown in Table V-A, the proposed trigger conditions of the DPS in Hong Kong are generally consistent with the practices in the U.K., the U.S. and Canada. Nonetheless, it is relevant to note that, in the U.S. and Canada, the decision to trigger insurance payout rests with the deposit insurer, whereas, in the U.K. and Hong Kong, the decision is, or would be, vested in the regulator. This

difference is attributable to the fact that the latter two schemes are "pay-box" systems.

Netting approach

34. Netting for deposit protection purposes refers to the process whereby the DPS deducts the liabilities of a depositor to the failed bank from his protected deposits in determining his entitlement to compensation. The decision whether to net or not, and if so to what extent, is an important consideration affecting the payout to depositors and ultimately the cost of the DPS.

35. To various extent, all the leading schemes apply netting in determining a depositor's entitlement to compensation. In the U.S. and Canada, a partial netting approach is adopted, i.e. only those liabilities of the depositor which are due or in default will be deducted from his deposits. In the U.K., on the other hand, a full netting approach is followed.

36. The HKMA has explored the possibility of adopting a partial netting approach for the scheme in Hong Kong and has consulted widely for this purpose. In principle, partial netting would serve the objectives of a DPS better since it would involve less disruption to the cash flow of the depositor (i.e. there would be greater scope for them to receive payment from the DPS without deductions from their deposits of liabilities that are not yet due). However, this approach is not consistent with the existing insolvency regime, which follows the full netting concept[9]. For this approach to be feasible, it would be necessary to introduce certain changes to the present insolvency regime, otherwise the DPS would face greater shortfall risk and the costs of the DPS would increase. These changes are however controversial. They are not supported by the insolvency practitioners with whom the HKMA has discussed this issue or by the Standing Committee on Company Law Reform. In view of this, it is proposed that the DPS in Hong Kong should apply full netting in determining payout to depositors, in accordance with the current insolvency law and practice.

Interim payment

37. As shown in Table V-B, both the U.K. and the Canadian schemes are empowered to make interim payment to depositors.

38. The HKMA considers it desirable for the DPS Board to have the power to make interim payment to depositors, as in the case of the U.K. and the Canadian schemes. The payment would be made within a short period after the DPS is triggered. It would help to relieve the cash flow problems of depositors caused by a bank failure.

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[9] Section 35 of the Bankruptcy Ordinance provides that mutual credits, mutual debts or other mutual dealings between a bankrupt and its creditors or debtors shall be set off against each other in a liquidation.

VI. Funding and Contributions

Table VI-A

Scheme	Funding approach	Target fund size (1)	Rebate and surcharge system	Government support
HK	Ex-ante	0.3%	Yes	Liquidity support only
UK	Ex-post	Not applicable	Not applicable	Nil
US	Ex-ante	1.25%	Yes (3)	Liquidity support only (4)
Canada	Ex-ante	No target set (2)	No	Liquidity support only
Singapore	Ex-ante	0.3%	Yes	Liquidity support only

Table VI-B

Scheme	System for assessment of contributions	Range of contribution (% of protected deposits)
HK	Differential rate system based on supervisory ratings	Build-up levy: 0.05 – 0.14 Expected loss levy: 0.0075 – 0.02
UK	Flat rate system	Dependent on the amount of compensation paid out
US	Differential rate system based on supervisory ratings and capital ratios	0 – 0.27 (5)
Canada	Differential rate system based on supervisory ratings and other objective factors such as capital adequacy, return on assets and volume of non-performing loans	0.02 – 0.16
Singapore	Differential rate system based on supervisory ratings and, in the case of foreign bank branches, asset maintenance ratios as well	0.025 – 0.3

Notes

(1) As percentage of total protected deposits.

(2) As of 31 March 2003, the actual fund size of the Canadian scheme was C$1.09 billion, which represented about 0.3% of total protected deposits.

(3) The FDIC conducted a review of the deposit insurance system in the U.S. in 2001. One of the proposals is to enhance the current rebate and surcharge mechanism.

(4) The U.S. Government provided initial capital to the FDIC when it was first established in 1934. It also bore some of the losses caused by the savings and loans crisis in 1980s. At present, however, the FDIC no longer receives any appropriation from the Government.

(5) The current law restricts the FDIC from charging premiums on banks with good ratings as long as the insurance fund is above the Designated Reserve Ratio of 1.25% of insured deposits. As a result, only 8% of banks and savings institutions are paying premiums at present.

Funding approach

39. Funding for a deposit protection system can take the form of either building a reserve or a fund on an ex ante basis or having the power to raise funds when needed on an ex post basis. The drawback of ex post funding is that the whole cost would have to be met by member banks after a failure, at a time when banks may be least able to bear the cost. Moreover, the bank that failed would not have paid for the cost of protection. Having an upfront fund would allow contributions to be collected in good times at rates that are within a pre-defined range. It would also enable banks to better estimate future funding requirements. Given the many benefits of ex-ante funding, it is not surprising that most of the overseas schemes selected for comparison have adopted this approach. The HKMA proposes that the scheme in Hong Kong should follow this good practice.

Target fund size

40. Although there is a general consensus that ex-ante funding is the preferred approach, schemes which follow this approach have different assessment of what the optimal size of the ex-ante fund should be. In the U.S., the target fund size is set at 1.25% of total insured deposits. This figure is enshrined in the Federal Deposit Insurance Corporation Act. In Canada, however, no target fund size has been set. Coincidentally, both the Hong Kong scheme and the Singaporean scheme are proposing to set the target fund size at 0.3% of total protected deposits.

41. The wide disparity between the target fund size of the U.S. scheme and that of the Hong Kong and the Singaporean schemes may in part be attributed to the different designs of the schemes. The fact that the protection level in the U.S. is much higher than those proposed for the Hong Kong and the Singaporean schemes is a case in point. Another probable reason is that, based on historical data, the incidence of bank failures in the U.S. is relatively higher than that in the two Asian economies.

42. The HKMA believes that setting the target fund size at 0.3% of total protected deposits is generally appropriate. This is equivalent to approximately HK$1.6 billion based on the current level of protected deposits. At this level, the DPS Fund would meet the IMF's benchmark of being able to absorb the losses arising from the simultaneous failures of two medium sized banks[10]. The proposed target fund size is also largely consistent with the minimum capital adequacy ratio of 8% required of a bank under the Basel

[10] It is important to note that the purpose of the DPS Fund is to cover the potential losses that might be suffered by the scheme, not the liquidity required for making payouts to depositors. The latter would be met by borrowings from the Exchange Fund or the inter-bank market.

Capital Accord[11]. To raise the target fund size further would unnecessarily increase the financial burden on the banks. On the other hand, any significant reduction of the target fund size, as previously suggested by the Hong Kong Association of Banks (HKAB), could undermine the credibility of the scheme.

43. It is proposed that the target fund size be built up within 5 years. This would mean that the central rate of contribution payable by banks would be set at 0.08% per annum during the fund build-up period. After that, the central rate of contribution could be reduced to around 0.01% per annum.

Rebate and surcharge mechanism

44. A rebate and surcharge mechanism aims to keep the DPS Fund within a pre-defined range. Without a rebate mechanism, the DPS Fund may continue to grow without bounds if there are no payouts for a long period of time. On the other hand, a surcharge system is necessary so that the DPS Fund can be replenished after a payout.

45. As noted above, the FDIC conducted a comprehensive review of the deposit insurance system in the U.S. in 2001. One of the recommendations arising from the review is to enhance the current rebate and surcharge mechanism. While the FDIC is still in the process of implementing this recommendation, both Hong Kong and Singapore have benefited by incorporating this proposed new feature into their respective schemes.

46. As currently proposed, the DPS in Hong Kong will levy a surcharge on member institutions when the balance of the DPS Fund drops below 70% of the target fund size. On the other hand, a rebate will be paid when the balance of the DPS Fund exceeds 115% of the target fund size[12]. Setting a target fund range (i.e. –30% and +15% of the target fund size) will reduce the incidence of rebate and surcharge and thus the volatility of the annual contribution.

Government support

47. As in the case of the U.S., Canada and Singapore, government support provided to the deposit insurance system is generally confined to the provision of back-up liquidity. This is consistent with the HKMA's proposal that the Exchange Fund should provide funding support to the DPS to enable it to make prompt payment to depositors in the event of a bank failure. The

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[11] The Basel Capital Accord is an internationally accepted framework for measuring the capital adequacy of banks. Under the existing accord, a bank is required to maintain its ratio of capital to risk-weighted assets at a minimum of 8%.

[12] The HKMA's original proposal was to set the target fund range at +/- 30%. During the second public consultation, HKAB considered that the proposed target fund range was too wide, particularly the upper limit. In response to this, the HKMA has proposed to adopt an asymmetric target range by reducing the upper limit to +15% while maintaining the lower limit of –30%. This adjustment would increase the likelihood and frequency of rebates, thereby helping to reduce the financial burden of the scheme on the banks.

practices of the overseas schemes also lend support to the Government's decision not to provide any form of direct subsidies to the DPS as previously suggested by HKAB (e.g. provide initial capital contribution to the DPS Fund or absorb the administrative costs of the scheme).

Assessment of contributions

48. Three of the four overseas schemes selected for comparison have adopted, or intend to adopt, a differential rate system for assessment of contributions. As noted by the FSF, it is preferable to adopt a differential contribution system to guard against moral hazard and to reduce cross-subsidisation amongst banks.

49. The HKMA also favours a differential rate system to assess contributions. This is in fact the majority opinion received from the first public consultation exercise. The HKMA believes that it is feasible to introduce, from the outset, a relatively simple differential system based on the CAMEL ratings of individual banks. The objective is to differentiate between the riskiness of banks in a manner that is fairly broad-brush, but which would nevertheless award the better performers with lower contributions and give an incentive to the others to improve.

50. Use of CAMEL ratings for assessment of contributions is consistent with the current approach adopted by the FDIC, except that it also takes into account capital adequacy as a separate element. The CDIC differentiates banks by a number of objective factors (e.g. return on assets and asset quality) in combination with supervisory ratings. The HKMA considers that CAMEL rating is a good starting point as the system has been well established and understood by the banks. In the light of experience, it may be possible to adopt a more sophisticated approach in the future.

Range of contributions

51. The current risk-based premium charged by the FDIC varies between 0% and 0.27%. The Canadian scheme charges a premium ranging from 0.02% to 0.16%. The premium to be charged by the proposed scheme in Singapore will range from 0.025% to 0.3%.

52. In the case of Hong Kong, it is proposed that the following contribution structure be adopted:-

Banks with CAMEL Rating	**Rate of contribution payable (as % of protected deposits)**	
	During the build-up period	**After the build-up period**
1	0.05%	0.0075%
2	0.08%	0.01%
3	0.11%	0.015%
4 & 5	0.14%	0.02%

53. During the second public consultation conducted in 2002, some respondents, who favour a flat rate system, expressed preference for a narrower range of contributions. On the other hand, the CDIC noted that the proposed range of contributions might not be wide enough. The HKMA believes that it would be more prudent to adopt a less steep structure at the beginning. Under the proposed structure of contributions, moving to a better category would still enable a bank to achieve reasonable cost savings.

VII. Investment of Funds

Table VII-A

Scheme	**Investment policy**
HK	Investments confined to safe financial instruments such as deposits with Exchange Fund, Exchange Fund bills; and U.S. Treasury bills.
UK	As noted in Section VI above, the U.K. scheme has adopted an ex-post funding approach. It therefore only maintains a small fund for meeting everyday expenses. The fund is mainly placed as term deposits with banks.
US	Investments confined to U.S. government securities.
Canada	The CDIC is allowed to invest in a wide range of financial instruments. However, it must have regard to the liquidity, risk and return of the financial instruments.
Singapore	Not mentioned in the consultation paper.

54. As noted by the FSF, deposit insurers should ensure that their funds are well managed and readily available to cover losses as they arise. This emphasises the need for capital preservation and liquidity in the investment of deposit protection funds. Another cardinal principle is that, save for the portion required for meeting everyday expenses, the funds should not be put in banks which the scheme seeks to protect.

55. All the leading schemes have followed this best practice. They have adopted prudent investment strategies in managing their funds. The HKMA believes that the Hong Kong scheme, being a pay-box system, should also have a limited investment mandate. In keeping with the principles mentioned above, it is proposed that the DPS Fund should be allowed to invest only in deposits with the Exchange Fund; Exchange Fund bills; U.S. Treasury bills; and foreign exchange and interest rate contracts (including derivative products) which are necessary for hedging purposes.

VIII. Appeal Mechanism

Table VIII-A

Scheme	**Appeal mechanism**
HK	The decisions and assessments of the DPS Board, particularly those relating to the determination of compensation payments, would be appealable to the Deposit Protection Appeals Tribunal to be established under the DPS legislation.
UK	There is no independent appeals tribunal. A depositor who is unhappy with the decision of the FSCS will have to take legal action against the FSCS if he wishes to pursue the matter further.
US	Similar to the situation in the U.K.
Canada	Similar to the situation in the U.K.
Singapore	Not mentioned in the consultation paper.

56. As shown in Table VIII-A, there are no independent appeal mechanisms in respect of the schemes in the U.K., the U.S. and Canada. In spite of this, the HKMA still believes that it is desirable to establish an independent tribunal to review the decisions of the DPS Board and the MA made under the DPS legislation. Compared with the court system, a tribunal will be able to hear cases more speedily and in a more cost effective manner. This would be in the interests of all the parties concerned. The proposed set-up of the Deposit Protection Appeals Tribunal is generally consistent with that of the Securities and Futures Appeals Tribunal established under the Securities and Futures Ordinance.

IX. Summary

57. As shown in the above discussion, the proposed structure of the DPS in Hong Kong is generally in line with the practices of the leading schemes in the U.K., the U.S. and Canada. Where international practices differ, the HKMA has selected the design feature most appropriate for the circumstances of Hong Kong, bearing in mind the desire to keep the cost low and the need to minimise the potential moral hazard.

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