CB(1) 2533/02-03(03)

For discussion on
3 October 2003

Bills Committee on
Deposit Protection Scheme Bill

Coverage

To facilitate Members' discussion, this paper sets out the main proposals of the Administration in relation to coverage of the proposed deposit protection scheme (DPS) in Hong Kong.

Coverage limit

2. 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. The same concerns were also expressed by members of the Legislative Council when this subject was discussed in a motion debate held on 13 December 2000[1]. Bearing these views in mind, the Administration proposes that the coverage limit of the DPS in Hong Kong be set at $100,000. At this protection level, 84% of depositors would be fully protected while 16% of deposits by value would be covered. The following table illustrates the effect if the coverage limit were to be increased:-

Coverage limit (HK$)	% of depositors fully protected	Marginal increase[2] of depositors fully protected	% of value of deposits covered	Marginal increase[2] of value of deposits covered
100,000	84%	N.A.	16.9%	N.A.
150,000	88%	4.76%	20.9%	24%
200,000	90%	7.14%	24.3%	45%

1 On 13 December 2000, the Legislative Council passed a motion by a wide margin urging the Government "expeditiously to 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".

2 Marginal increase is the proportional increase using the base case scenario of a coverage limit of $100,000 as a basis. For example, if the coverage limit is increased from $100,000 to $150,000, the marginal increase of depositors fully protected will be 4.76% [(88%-84%)/84%].

3. In other words, if the coverage limit were to be increased to $150,000, the number of depositors fully protected would increase by 4.76% but the value of deposits protected, to which costs directly relate, would increase disproportionately by 24%. (For further information about this issue, please refer to paragraphs 22 – 26 of the paper on “Comparison with Overseas Scheme” and the paper on “Coverage Limit”. The reference number of both papers is CB(1) 2440/02-03 (07)).

Basis of coverage

4. In line with overseas best practice, it is proposed that the coverage limit be applied on a “per depositor per bank” basis. This means that the balances in all the deposit accounts of a depositor with the failed bank will be aggregated in considering whether the coverage limit is reached. (For further information, please refer to paragraph 27 of the paper on “Comparison with Overseas Scheme”).

Treatment of accrued interest

5. It is further proposed that both the principal amount of a protected deposit and the interest accrued thereon[3] be covered by the DPS. Thus, if the principal is $95,000 and the accrued interest is $7,000, the depositor will be entitled to a compensation of $100,000 (rather than $102,000 because this will exceed the coverage limit).

Foreign currency deposits

6. 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. (For further information, please refer to paragraphs 28 - 30 of the paper on “Comparison with Overseas Schemes”).

Co-insurance

7. 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). Given the relatively low coverage limit that is proposed, there would seem to be little point in paying

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[3] Normally, the interest accruing and payable in relation to a protected deposit will be calculated up to the date of appointment of a provisional liquidator.

depositors less than 100% of the protected amount. For this reason, it is proposed that no co-insurance arrangement be introduced for the DPS in Hong Kong. (For further information, please refer to paragraphs 31 – 32 of the paper on “Comparison with Overseas Schemes”).

Treatment of special types of accounts

8. It is proposed that special types of accounts such as trust, agent, client, joint and partnership accounts be protected by the DPS in accordance with the following principles:-

(i) Trust accounts – For active trusts, the trustee will be treated as a separate depositor and thus is entitled to compensation in his own right. For bare trusts (i.e. where a trustee holds property for a beneficiary who is absolutely and solely entitled to that property), each beneficiary will be entitled to compensation according to his share in the account, but such entitlement should be aggregated with the balances in the beneficiary’s other accounts with the failed bank in determining whether the coverage limit has been reached;

(ii) Agent accounts – The underlying principals, rather than the agent in whose name the account is held, will be regarded as being entitled to compensation in respect of the balance in the agent account. The entitlement of each principal in the account will then be aggregated with the balances in the principal’s other accounts with the failed bank in determining whether the coverage limit has been reached;

(iii) Client accounts – In general, the clients, rather than the account-holder in whose name the account is held, will be regarded as being entitled to compensation in respect of the balance in the client account. The entitlement of each client in the account will then be aggregated with the balances in the client’s other accounts with the failed bank in determining whether the coverage limit has been reached. However, in the case of stakeholders’ accounts[4], the funds held by the agent as stakeholder have yet to be vested in the client. Given that the agent holds those funds on active trust on terms agreed among the agent as stakeholder, the client and the counterparty, it is proposed that such accounts should be treated in the same way as

[4] A typical example is the proceeds from a pre-sale of real property. The proceeds are held by a law firm acting for the developer, who acts as the stakeholder. The developer is not entitled to the funds until certain conditions are met (e.g. construction has reached a certain stage and the relevant surveyor’s certificate has been obtained, etc.).

funds held on active trust under the DPS;

(iv) Joint accounts – The balance in a joint account will be deemed to be equally held by all the account-holders unless there is satisfactory evidence as to their otherwise respective shares. The deemed share of each of the account-holders will then be aggregated with their respective other entitlements in determining whether the coverage limit has been reached; and

(v) Partnership accounts – These accounts will be treated as a joint beneficial entitlement separate from the entitlements of the individual partners.

Deposits excluded from protection

9. Consistent with the arrangement under the priority claim systems in the Companies Ordinance, certain deposits such as inter-bank deposits and connected deposits (e.g. those taken from the directors and managers of the failed bank) will be excluded from the protection of the scheme (please refer to the **Annex** for more details).

Hong Kong Monetary Authority
Financial Services and the Treasury Bureau
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Annex

Deposits Excluded From Protection

The following types of deposits will not be covered by the Deposit Protection Scheme:-

(i) a term deposit where the current term agreed to by the depositor at the most recent time it was negotiated exceeds 5 years;

(ii) a deposit the repayment of which is secured either in whole or in part on the assets of the bank;

(iii) a bearer instrument;

(iv) a deposit taken by an office of the bank outside Hong Kong;

(v) a deposit held for the account of the Exchange Fund;

(vi) a deposit held by an excluded person in his own right (in the case where the deposit is held by an excluded person and a non-excluded person in their own right (except where those persons carry on business in partnership), the portion of the deposit attributable to the excluded person's share in the deposit would be excluded);

(vii) a deposit held by a person as trustee on an active trust for the benefit of an excluded person only; and

(viii) a deposit held by a person as a bare trustee on a bare trust or as an agent on an agency, or in a client account, for an excluded person (in the case where the deposit is so held for an excluded person and a non-excluded person (except where those persons carry on business in partnership), the portion of the deposit attributable to the excluded person's share in the deposit would be excluded).

2. For the purposes of paragraph (vi) – (viii) above, "excluded person" means:-

(i) a holding company of the bank, a subsidiary of the bank or a subsidiary of the holding company;

(ii) a director, controller, chief executive or manager of the bank, a subsidiary of the bank, a holding company of the bank or a subsidiary of the holding company;

(iii) a multilateral development bank as defined in paragraph 1 of the Third Schedule to the Banking Ordinance (e.g. the International Bank for Reconstruction and Development, the Asian Development Bank, etc);

(iv) an authorized institution; and

(v) an overseas bank which is not an authorized institution in Hong Kong.

3. The above exclusions are largely based on the exclusions under the priority claim provisions in the Companies Ordinance. Items (ii) and (iii) in paragraph 1 – deposits secured on the assets of the failed bank and bearer instruments – are also excluded in line with overseas practices. Item (iv) is excluded because the DPS will not protect deposits taken by overseas branches of Scheme members.