

For information on  
4 November 2003

**Bills Committee on  
Deposit Protection Scheme Bill**

**Administration Cost**

**Background**

At the meeting of the Committee held on 21 October 2003, Members requested the Administration to provide:-

- (i) the basis, including the underlying assumptions, upon which the estimated annual administration cost of the DPS Board in normal times is arrived at; and
- (ii) the estimated cost to be incurred by the Board in the event of a failure of a medium-sized bank.

**Administration costs**

2. As reported to the Committee previously, it is difficult to provide an accurate estimate of the administration cost of the Board at this stage. The actual figure will depend on the percentage of time that officers from the HKMA will need to spend on the affairs of the DPS and the level of professional fees payable for retaining the service providers.

3. Nonetheless, based on the proposed structure of the Board shown in **Annex A**, it is estimated that the annual administration cost of the Board would probably be in the range of \$7 million to \$8 million in normal times (i.e. when there are no bank failures). A breakdown of this estimate and the underlying assumptions are set out in detail at **Annex B**. As shown in the

analysis, it is possible that the HKMA staff assigned to assist the Board could spend a lesser amount of their time on DPS related matters after the Board is operational for some years. If that is the case, the administration cost of the Board can be reduced to a lower level.

4. The Administration has also been requested to estimate the administration cost to be incurred by the Board in the case of a failure of a medium-sized bank. Again, it should be stressed that it is extremely difficult to make any accurate forecast at this stage. The actual figure will depend on a host of factors including the number of depositors of the failed bank, the complexity of its operations, the reliability of the bank's IT systems and records, the level of professional fees payable to various service providers such as the payout agent and external legal advisers etc.

5. On the key assumptions that the number of depositors of the failed medium-sized bank is about 200,000 and that the IT systems and records of the bank are in reasonably good shape, it is expected that a team of about 60 to 80 accountants would be adequate to handle the payout process. The annual administration cost of the Board would thus increase to approximately \$40 million to \$50 million. **Annex C** shows the detailed calculation as well as the underlying assumptions.

6. However, if any of our assumptions made in the analysis are incorrect (e.g. the IT systems and records of the bank were not in shape and thus could not be relied upon by the Board in determining individual depositors' entitlement to compensation), a larger team of staff would be required by the Board to handle the payout process and the administration cost of the Board would then be higher<sup>1</sup>.

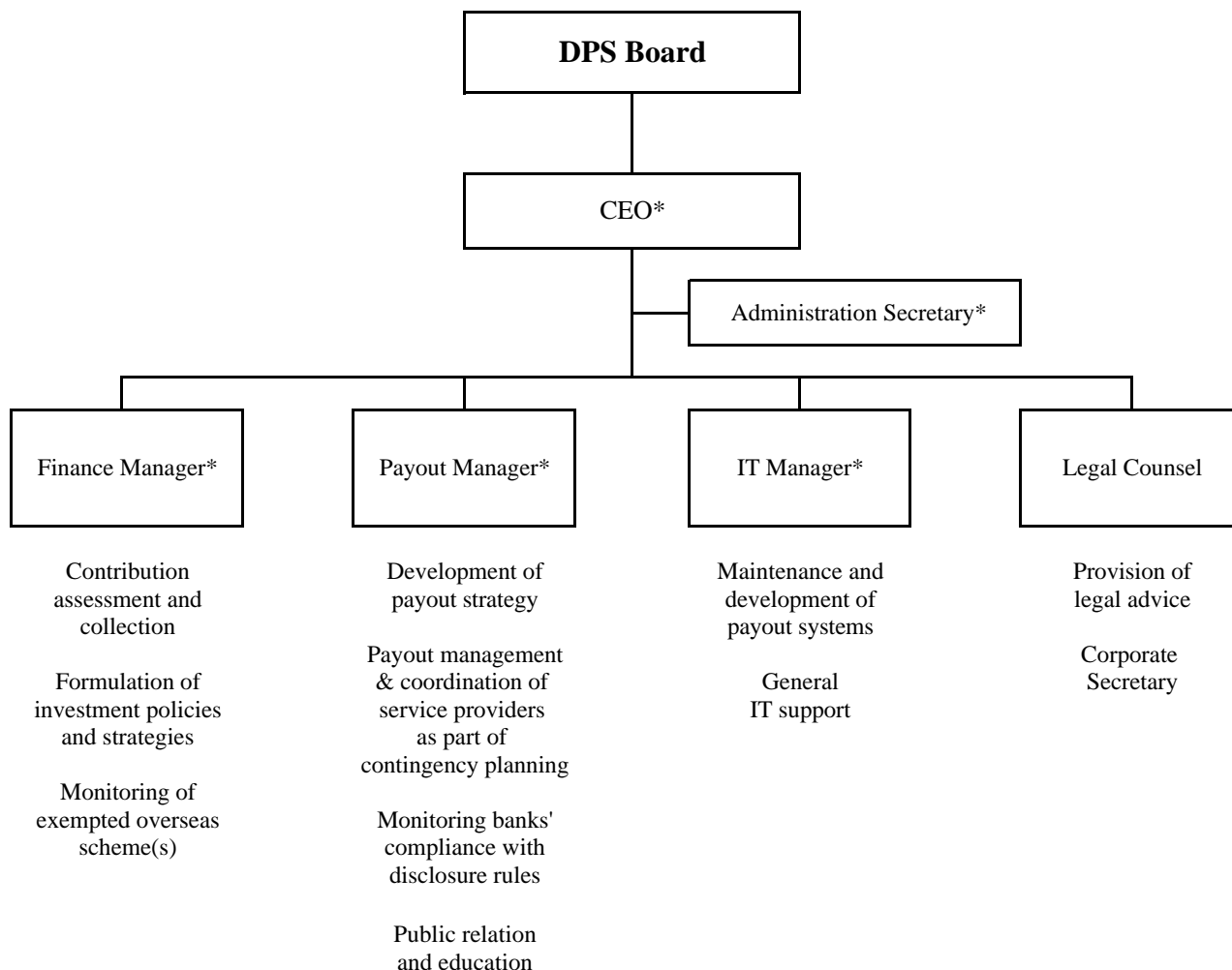
Hong Kong Monetary Authority  
Financial Services and the Treasury Bureau  
November 2003

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<sup>1</sup> This explains why it is proposed that the Board should be empowered to make rules specifying the requirements of the information systems to be maintained by Scheme members so as to facilitate payment of compensation to depositors (see clause 49 of the DPS Bill).

**Proposed organisation structure of the DPS Board**



*(\* HKMA staff who are not expected to work full time on the DPS)*

Note:

The HKMA will provide internal audit services, administrative and clerical support, human resources management and accounting services to the Board.

## Annex B

### Estimated annual administration cost of the DPS Board (During normal times)

(Figures in \$'000)	<u>Estimated cost</u>	<u>Assumptions</u>
Staff cost	3,600 - 4,200	Note B1
Office rental	120	Note B2
Systems maintenance	500	Note B3
Retainer fees for service providers	1,200	Note B4
Public education	100 - 200	Note B5
Miscellaneous	<u>1,000</u>	Note B6
<b>Total</b>	<b><u>6,520 - 7,220</u></b>	

#### Note B1:

- \* Please refer to the proposed organisation structure of the Board at Annex A.
- \* The DPS Board only has limited functions. After it is operational for some years, it is expected that the HKMA staff assigned to assist the Board would only need to spend, say 40%, of their time on DPS related matters. However, in the initial years of operation, it is probable that they may need to spend more of their time, say 50%, on DPS matters.
- \* Since the CEO of the Board will be responsible for overseeing the Board's entire operation, in particular managing the whole payout operation in the event of a bank failure, it is expected that the post would need to be filled by an individual with experience and seniority comparable to that of an assistant head of department in the Government.
- \* Each of the Finance, Payout and IT Managers will be responsible for a key function of the Board. As advised by Canada Deposit Insurance Corporation, these posts should be filled by individuals with strong technical knowledge and professional background, preferably with over 10 years' experience in the relevant field. In view of this, it is assumed that these posts would be filled by individuals with experience and seniority comparable to that of a senior professional in the Government.
- \* It is further assumed that the Board would employ a legal counsel of its own.

Based on the above assumptions, the staff cost of the Board is expected to be:-

	<u>Lower estimate</u>	<u>Upper estimate</u>
Legal Counsel	1,400	1,400
HKMA Staff		
40% of time spent on DPS matters	2,240	
50% of time spent on DPS matters		2,800
Total of staff costs	<u>3,640</u>	<u>4,200</u>

**Note B2:**

- \* It is assumed that the Board would require an office space of around 1,000 square feet.
- \* The Board would be charged rental based on the prevailing market rate. For this exercise, it is assumed that the rate of rental payable by the Board would be \$20 per square foot per month, which reflects the current state of the market.
- \* The amount of rental payable by the Board would also need to be adjusted to reflect the percentage of time spent by HKMA staff on DPS matters. For simplicity, it is assumed that the percentage of time spent by HKMA staff on DPS matters would be 50%. Accordingly, the rental payable by the Board would be:-

$$\$20 \times 1,000 \times 12 \times 50\% = \$120,000$$

**Note B3:**

It is difficult to provide an accurate estimate for systems maintenance cost at this stage. The actual expenditure would depend on the sophistication of the Board's systems, the nature and quality of service required by the Board etc.

**Note B4:**

The retainer fees are professional fees to be charged by service providers (e.g. audit firms) for committing to make available sufficient resources when required by the Board to assist in making compensation payment. They should maintain a state of readiness by keeping abreast of the payout rules and procedures developed by the Board and participate in regular rehearsals from time to time. As advised by Canada Deposit Insurance Corporation, at least 3 accounting firms should be retained to assist in making compensation payment. This is to avoid possible conflict of interest (e.g. where one of the accounting firms retained is the auditor of the failed bank). It is difficult to predict the level of retainer fees payable at this stage. When the Board is set up, it will invite bids from interested parties. In determining which firms should be selected, factors such as the level of professional fee required, technical expertise, resources committed to be made available would be taken into account.

**Note B5:**

The actual expenditure would depend on the media selected by the Board. For the initial years, it is likely that the Board would incur more expenses on public education in order to promote the public's awareness of the scheme.

**Note B6**

These include expenditures relating to audits, accounting, administrative support, office supplies, and utilities received from the HKMA and membership of international bodies (e.g. International Association of Deposit Insurers) etc.

## Annex C

### Estimated administration cost of the DPS Board (In the event of a failure of a medium-sized bank)

(Figures in \$'000)	<u>Estimated cost</u>	<u>Assumptions</u>
<b><i>General costs</i></b>		
Staff costs	7,000	Note C1
Office rental	240	Note C2
Systems maintenance	500	Note C3
Retainer fees for service providers	1,200	Note C4
Public education	100 - 200	Note C5
Miscellaneous	2,000	Note C6
<b><i>Expenses in relation to compensation payout</i></b>		
Professional fees - payout agent	26,000 - 34,000	Note C7
Professional fees - legal adviser	1,200 - 1,600	Note C8
Printing and mailing of cheques and statements	1,200 - 1,600	Note C9
Miscellaneous out of pocket expenses (including the cost of running a communication centre, issuing press notices etc)	<u>1,000 - 2,000</u>	
<b>Total</b>	40, 440 - 50, 340	Note C10
	<i>Approximately:-</i>	<b><u><u>40,000 - 50,000</u></u></b>

#### Note C1:

It is assumed that in the event of a bank failure, the HKMA staff would need to spend 100% of their time on DPS related matters. The staff costs of the Board would therefore become:-

	<u>\$'000</u>
Legal Counsel	1,400
HKMA Staff (100% of time spent on DPS matters)	<u>5,600</u>
Total of staff costs	<b><u><u>7,000</u></u></b>

**Note C2:**

Since the HKMA would need to spend 100% of their time on DPS related matters, the rental expenditure payable by the Board would become:-

$$\$20 \times 1,000 \times 12 \times 100\% = \$240,000$$

**Note C3:**

Same as during normal times.

**Note C4:**

Same as during normal times. Please note that the retainer fees paid to service providers would unlikely be recoverable even though one or more than one of them are called upon to provide the contracted services.

**Note C5:**

Same as during normal times.

**Note C6:**

It is assumed that, in the event of a bank failure, expenses such as audit fees, charges for accounting, administration and clerical support received from the HKMA would be doubled.

**Note C7:**

It is assumed that the medium-sized bank has around 200,000 depositors. It is further assumed that the bank's systems and records are in reasonably good shape. Based on these assumptions and having consulted a leading insolvency practitioner, it is estimated that a team of about 60 to 80 accountants would be sufficient to handle the payout process. The professional fees payable to the payout agent would thus be (hourly charges shown below are provided by insolvency practitioners):-

(Figures in \$)	<u>Hourly rate</u>	<u>Lower estimate</u>	<u>Upper estimate</u>
1 Partner (200 hours, i.e. 1 mth)	4,500	900,000	900,000
5 to 6 Senior Manager (200 hours each, i.e. 1 mth)	3,500	3,500,000	4,200,000
10 to 14 Manager (300 hours each, i.e. 1.5 mths)	2,800	8,400,000	11,760,000
40 to 52 Junior Accountant (400 hours each, i.e. 2 mths)	800	12,800,000	16,640,000
4 to 7 Admin Assistant (200 hours each, i.e. to 1 mth)	400	320,000	560,000
		<u>25,920,000</u>	<u>34,060,000</u>
	<i>Approximately:-</i>	<u><u>26,000,000</u></u>	<u><u>34,000,000</u></u>

**Note C8:**

It is expected that the Board would have increased demand for legal advisory services in the event of a bank failure. Assuming a requirement of 300 to 400 hours and a hourly rate of \$4,000, the professional fees payable to external legal advisers would be \$1.2 million to \$1.6 million.

**Note C9:**

For a medium-sized bank, it is likely that the Board would need to make an interim payment and a final payment to depositors. This means that the Board has to print and mail around 400,000 statements (including cheques) to depositors. Assuming an overall charge of \$3 to \$4 per statement, the total printing and mailing costs would be \$1.2 million to \$1.6 million.

**Note C10:**

It is important to note that the administration costs do not include any shortfall loss and financing cost incurred by the Board in the payment.