

LEGISLATIVE COUNCIL BRIEF

Bills of Exchange Ordinance (Chapter 19)

BILLS OF EXCHANGE (AMENDMENT) BILL 2003

INTRODUCTION

At the meeting of the Executive Council on 21 January 2003, the Council ADVISED and the Chief Executive ORDERED that the Bills of Exchange (Amendment) Bill 2003 (at Annex A) should be introduced into the Legislative Council.

JUSTIFICATIONS

2. Implementation of cheque imaging and truncation would improve cheque clearing efficiency and security, and lower the cost of cheque clearing and settlement. The clearing would in future be on the basis of electronic presentation of the cheque images and relevant data of the cheque. The cheque images and data, instead of physical cheques, would be presented to the paying bank for clearing. The data and images taken from the cheque are much less expensive to handle and store than physical cheques (on average about 500,000 cheques processed a day) and can be retrieved more conveniently and almost instantaneously from the image database through PC workstations.

3. Furthermore, the adoption of cheque imaging and truncation system in Hong Kong could provide a technology that facilitates Hong Kong's efforts to broaden its current work on promoting cross-border joint cheque clearing, which relies on the transport of physical cheques back to Hong Kong for clearing. Cheque imaging and truncation could allow joint cheque clearing to be done over longer distance and not be confined to neighbouring regions of Hong Kong.

OTHER OPTIONS

4. A possible alternative to the amendment of the Bills of Exchange Ordinance is to put in place contractual obligations between drawing banks and drawee banks and their respective customers to waive the need for physical presentment. However, there are circumstances under which the contract between a bank and its customer might be deemed not to have come into existence or might be deemed to have been frustrated, discharged or amended. Given the need for waivers of physical presentment to be effective across the board, the legal advice is that the legislative route is a more desirable option as it gives certainty to all parties concerned.

THE BILL

5. The purpose of the Bill is to add a new section 73A to the Ordinance to enable a cheque to be presented by a banker for payment by notification of certain information relating to the cheque by electronic means, rather than by physical presentment (clause 2). Consequent upon the introduction of electronic presentment of cheques for payment, the Bill also-

- (a) adds a new section 73B to the Ordinance to modify the application of section 52(4) of the Ordinance, which concerns the duties of holders of bills, to such presentment (clause 2) ; and
- (b) amends section 85 of the Ordinance to facilitate proof of payment of unindorsed cheques that have been presented electronically (clause 4).

The existing provisions being amended are at Annex B.

LEGISLATIVE TIMETABLE

6. Subject to Members' approval of the introduction of the Bill into the Legislative Council, the legislative timetable will be –

Publication in the Gazette	14 February 2003
First Reading and commencement of Second Reading debate	19 February 2003
Resumption of Second Reading debate, committee stage and Third Reading	to be notified

IMPLICATIONS OF THE PROPOSAL

7. Economic and financial implications of the proposal are as set out at Annex C. The proposal is in conformity with the Basic Law, including the provisions concerning human rights. It has no productivity, environmental, civil service or sustainability implications.

PUBLIC CONSULTATION

8. We briefed the Financial Affairs Panel of the Legislative Council on this subject on 2 December 2002. Members were generally supportive of the legislative proposal to enable cheque imaging and truncation to take place in Hong Kong. Three questions were raised by Members in the discussion-

- (a) whether banks would pass on to customers the benefits of lower cost of cheque clearing as a result of the implementation of the proposal;
- (b) whether the proposed six-month retention period is compatible with the new Securities and Futures Ordinance (SFO); and
- (c) with the improved efficiency of the new system, whether banks can advance the cheque clearing and settlement time a little bit, say, in the morning of T+1 rather than at 3 pm on T+1.

9. In response to the first point, we have conveyed Members' concerns to the Hong Kong Association of Banks (HKAB) who advised that in Hong Kong's very competitive environment, banks have a strong incentive to contain their operating costs and to provide better customer service at more competitive pricing. Generally, banks do not charge customers for collecting/clearing Hong Kong dollar cheques.

10. On the second point, the SFO does not prescribe any cheque retention period which contravenes the proposed period of cheque retention of six months. Accordingly, there is no compatibility problem with the SFO. We have in fact consulted a number of relevant parties on the six-month retention period, including the Securities and Futures Commission (SFC). The SFC made no comment on the cheque retention period.

11. On the third point, HKAB explained that the further advancement of the timeframe for cheque settlement might present practical problems as there might not be sufficient time for banks to check customers deposit balance, verify signatures and to contact their customers if necessary.

PUBLICITY

12. A spokesman will be available to answer media and public enquiries.

BACKGROUND

Current cheque processing arrangement in Hong Kong

13. Cheques are widely used as a means of payment in Hong Kong. Currently cheques are submitted in physical form for clearing through a cheque clearing system operated by HKICL for all licensed banks. Collecting banks, which receive cheques paid in by their customers, are required to deliver the physical cheques to HKICL for processing in the evening of the day they are paid in ("Day D"). A total of about 500,000 cheques are physically transported to HKICL each day. HKICL processes the cheques and the paying banks then collect the cheques from HKICL around midnight of Day D or in the morning of Day D+1. The paying banks check the availability of funds in the cheque drawers' accounts and verify the signatures on the cheques. The paying banks return any unpaid cheques (for example cheques for which there are insufficient funds or which bear incorrect signatures or have other technical errors) by physical delivery to HKICL at around noon on Day D+1 for return to the relevant collecting banks. Around 1% or 5,000 cheques are returned each day. The collecting banks collect returned cheques from HKICL in the afternoon of Day D+1. After arranging to exclude such returned cheques from processing, HKICL runs the cheque settlement at 3 p.m. on Day D+1 to post the clearing results to the banks' settlement accounts with the HKMA.

New processing approach

14. Whilst this paper-based system is cumbersome and relatively expensive, requiring over ten million cheques to be delivered to, and collected from, HKICL each month, physical cheque processing has until recently been the only viable option. However, banking technology has now advanced to a level which can support paperless cheque clearing, obviating the need for the bulk shipment of physical cheques around Hong Kong. Cheques can now be cleared through the transfer of “electronic information” by means of cheque imaging and cheque truncation. Cheque imaging involves the scanning of a cheque to create a digital image which can be transferred through a data link, CD-ROM or cartridge. Cheque truncation is the electronic presentation of the essential details of a cheque without the cheque itself having to be physically presented. With cheque imaging and truncation, the physical cheques remain with the collecting bank, or with HKICL if the collecting bank commissioned HKICL to do the imaging on its behalf.

15. In designing the new system, we had full regard to the question of reliability of the cheque images as evidence in court. Electronic Transactions Ordinance, Cap. 553 provides that without prejudice to any rules of evidence, an electronic record shall not be denied admissibility in evidence in any proceedings on the sole ground that it is an electronic record. Besides, Evidence Ordinance, Cap. 8 provides that statements contained in a document produced by a computer shall be admissible as prima facie evidence in civil and criminal proceedings provided that certain conditions (e.g. conditions as to the supply and retrieval of the information to and from the computer) as set out in the Evidence Ordinance are satisfied. To maintain integrity of the system, the banking industry has agreed on a common set of control policies and procedures for the imaging process and operations. To ensure compliance by the banks and the HKICL, it has been agreed that they have to go through a Compliance Assessment Programme performed by qualified external auditors or internal auditors. On successful assessment, the chief executives of the banks and HKICL are required to issue a letter stating their full compliance with the requirements of the Programme.

16. As regards the retention period for low-value physical cheques, it is noted that the current practice varies considerably among banks. For example, a major bank keeps cheques under HKD500,000 for 15 days, whereas another major bank keeps all cheques for an indefinite holding period. In all, the bulk of the cheques processed today are kept for less than, say, three months. Under the new cheque imaging and truncation system, the settled low-value cheques will be retained for six months by all banks. This proposed period was arrived at after consultation with the HKAB, the Commissioner of Police,

the Commissioner of ICAC, the SFC and the Director of Public Prosecutions. As noted above, this is already longer than the retention period for the low value cheques of most of the banks under the existing system.

17. As regards the choice of HK\$20,000 as the threshold value, this is a value set by the HKAB and may be reviewed periodically. For instance, after some experience with the operation of the new system, if the fraud rate does not increase, there may be scope to increase the threshold in order to capture more benefits of the imaging and truncation project. The HKMA and the HKAB consider HK\$20,000 to be an appropriate level to begin with. The HKMA will be consulted on any change to the threshold value in future. To maintain flexibility, the above retention period and threshold value will not be specified in the Bill at Annex A.

18. With regard to the international experience in implementing cheque-imaging systems, the HKMA found that in some countries such as the UK, Belgium, Denmark and Germany, they have adopted a system of cheque truncation but without cheque imaging. In other words, in these countries certain cheques are cleared by the transmission of “electronic data” from the collecting bank to the paying bank without the processing and presentment of physical cheques and without the paying bank receiving either the cheque in its physical form or in its image form for record purposes. This wholesale cheque truncation approach, i.e. without any imaging at all, is not favoured in Hong Kong. The HKMA and HKAB are both of the view that a system of imaging and truncation is more secure than a system of truncation alone.

Security measures

19. The industry will adopt a set of control policies and procedures relating to the cheque imaging and truncation system. Full compliance with these will ensure that cheque images are generated from a reliable and secure imaging process. Images produced will be transmitted by encrypted leased line or delivered by sealed security bags if the images are stored in CD-ROM or tapes.

**Financial Services and the Treasury Bureau
12 February 2003**

Economic and financial Implications

The establishment of a paperless cheque clearing system will yield a variety of advantages. First, the electronic processing and storage of cheque images is expected to result in improved efficiency of cheque clearing and in cost savings. Secondly, imaged cheques are easier to process, transfer and retrieve. Remote access to the image database through PC workstations allows instantaneous information retrieval to facilitate checking and investigation of cheque images. Thirdly, the adoption of cheque imaging and truncation system in Hong Kong could provide a technology that facilitates Hong Kong's efforts to promote cross-border joint cheque clearing, which relies on the transport of physical cheques back to Hong Kong for clearing, whereas imaging could conceivably allow joint cheque clearing to be done over longer distance and not be confined to neighbouring regions of Hong Kong.

In general, moves to adopt viable technology to expedite regular bank operations, as with this one, will help raise overall operational efficiency of the banking sector, in line with Hong Kong's position as an international financial centre. Initial investment by the banking sector for this new system is required, and new compliance requirements will have to be met. Yet these should be worth incurring in view of the desired efficiency gain.

The implementation of the proposal requires HKICL to develop a new computer system at an estimated one-off cost of about \$50m to process the imaged cheques and truncated information. Such cost will be absorbed by HKICL which would recover it through the transaction fees income from cheque clearing and settlement services. There is no financial implication for the Government.