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Paper for the House Committee meeting on 30 June 2006

**Report of the Subcommittee to Study Four Items of Subsidiary Legislation
under the Deposit Protection Scheme Ordinance**

Purpose

This paper reports on the deliberations of the Subcommittee to Study Four Items of Subsidiary Legislation under the Deposit Protection Scheme Ordinance.

Background

2. The subject of deposit protection was publicly debated in 1992 when a full public consultation was carried out following the failure of the Bank of Credit and Commerce Hong Kong Limited and a number of bank runs in 1991. However, the proposal for establishing a Deposit Protection Scheme (DPS) was subsequently rejected on cost, fairness and moral hazard concerns.

3. The Asian financial turmoil in 1997-98 highlighted the fact that external shocks and rumours might adversely affect confidence in individual banks and the banking system as a whole. In the Banking Sector Consultancy Study undertaken in 1998, the consultants considered that the existing protection arrangements did not appear to have sufficiently raised the confidence thresholds during crisis to avoid bank runs and that there was a strong case for enhancements to be made. In the international context, there was also a growing trend in international financial systems in favour of explicit forms of deposit protection. In the light of these developments, the Hong Kong Monetary Authority (HKMA) commissioned in April 2000 a consultancy study on enhancing deposit protection in Hong Kong. A consultation paper was published in October 2000 to invite views on the establishment of a DPS to strengthen the resilience of the banking system against external shocks. In December 2000, the Legislative Council (LegCo) passed a motion urging the Government to expeditiously implement a DPS for effective protection of small depositors, and to formulate appropriate complementary measures to reduce the risk of moral hazard.

4. On 24 April 2001, the Chief Executive in Council approved in principle the establishment of a DPS and requested HKMA to work out the detailed design features

of the Scheme. Following consultation with the public and the Panel on Financial Affairs (FA Panel), the Administration introduced the DPS Bill into LegCo on 30 April 2003. A Bills Committee was formed to scrutinize the Bill.

5. The DPS Ordinance (Cap. 581) was enacted in May 2004 and the Hong Kong Deposit Protection Board (HKDPB) was formed in July 2004. Since then, HKDPB has developed a project plan for establishing DPS and commenced work on a number of key preparatory tasks. On 6 March 2006, the FA Panel was briefed on the progress made, including the proposed amendments to Schedules 1 and 4 to the DPS Ordinance, and the two sets of rules (rules on payment of contribution and rules on representation) to be issued by HKDPB as subsidiary legislation. The FA Panel supported in principle the proposed amendments to Schedules 1 and 4 to the DPS Ordinance, and the main contents of the two sets of rules.

6. On 19 May 2006, the following four items of subsidiary legislation were published in the Gazette:

- (a) DPS Ordinance (Amendment of Schedules 1 to 4) Notice 2006 (“Amendment Notice”);
 - (b) DPS (Representation on Scheme Membership and Protection of Financial Products under Scheme) Rules (“Representation Rules”);
 - (c) DPS (Payment of Contributions, Late Payment Fees and Rebates) Rules (“Contribution Rules”); and
 - (d) DPS Ordinance (Commencement) Notice 2006 (“Commencement Notice”)
- (collectively “the four items of subsidiary legislation”).

7. The four items of subsidiary legislation were tabled before LegCo on 24 May 2006 for negative vetting.

The four items of subsidiary legislation

8. The Amendment Notice is made by the Chief Executive in Council in accordance with section 54 of the DPS Ordinance. It serves to clarify that structured products are not protected by the DPS and provides for miscellaneous amendments to improve the operation of Schedules 1 and 4 to the Ordinance.

9. The Representation Rules and the Contribution Rules are made by HKDPB under section 51 of the DPS Ordinance. The former rules govern the representations that should be made by members of the DPS (Scheme members) regarding their membership and the protection status of their financial products. The latter rules prescribe the manner in which Scheme members should pay contributions and any late payment fees to HKDPB, as well as the manner in which HKDPB should pay rebates of contributions to Scheme members.

10. In view of the progress of the preparatory tasks for the implementation of DPS, the Secretary for Financial Services and the Treasury issued the Commencement Notice for the purpose of bringing the entire DPS Ordinance into operation, appointing 25 September 2006 as the day on which those provisions of the DPS Ordinance that have not yet been commenced shall come into operation.

The Subcommittee

11. The House Committee agreed at its meeting on 26 May 2006 to form a Subcommittee to study the four items of subsidiary legislation. The Subcommittee met on 12 June 2006 and Hon SIN Chung-kai was elected Chairman. The membership list of the Subcommittee is in **Appendix I**.

12. To allow more time for the Subcommittee to examine the four items of subsidiary legislation, the scrutiny period was extended to 12 July 2006, by resolution of LegCo on 21 June 2006.

Deliberations of the Subcommittee

13. The Subcommittee supports the four items of subsidiary legislation. Its major deliberations are summarized in the following paragraphs.

Amendment Notice

14. The Subcommittee notes that the proposed amendments to the DPS Ordinance under the Amendment Notice provide for the exclusion of structured deposits from DPS protection and miscellaneous amendments to improve the operation of the DPS. The Amendment Notice shall come into operation on the day appointed for the commencement of Schedule 4 to the Ordinance (i.e. 25 September 2006).

Proposal to exclude structured deposits from DPS protection

15. The Subcommittee is advised by HKDPB that in the course of making the necessary preparations for the launch of the DPS in the latter half of 2006, the Board has observed that a significant number of Scheme members are unclear about the protection status of the structured products¹ they are offering to their customers. According to the legal advice obtained by HKDPB, whether a structured product is a “deposit” within the meaning of section 2(1) of the Banking Ordinance (Cap. 155)²

¹ Structured products are complex financial products the returns of which depend on the performance of a financial asset, an index or the occurrence or non-occurrence of a specified event (e.g. whether a company has defaulted payment). Typical examples include equity-linked deposits, currency-linked deposits, credit-linked deposits, index-linked deposits, inverse floaters and range accruals.

² For a financial product to be protected by the DPS, it must be a “deposit” within the meaning of section 2(1) of the Banking Ordinance.

and thus is protected by the DPS needs to be determined on a case by case basis having regard to the terms and conditions of the product. HKDPB points out that given such uncertainty, Scheme members will need to incur additional costs in determining the nature of their structured products on a case by case basis. Despite the additional costs and efforts involved, some Scheme members may not be able to correctly advise their customers whether a structured product is protected by the DPS. As a result, consumers may make wrong decisions as to whether a structured product is suitable for them. In order to eliminate this uncertainty, HKDPB proposes to exclude structured products from DPS protection, irrespective of whether they fall within the definition of a “deposit” under the Banking Ordinance.

16. Regarding members’ concern whether the proposal is in line with the practices of other jurisdictions, the Subcommittee is advised by HKDPB that in general, structured deposits are excluded from deposit protection schemes in other jurisdictions. However, the definition of “deposit” and the scope of coverage of the schemes in other jurisdictions are different from those in Hong Kong.

17. Regarding the impact of the proposal on the general public, the Subcommittee is assured by HKDPB that the general public would not be materially affected. First, many common structured products offered in the market are not deposits. They will not be protected by the DPS anyway. Secondly, the DPS in Hong Kong is aimed at protecting small, unsophisticated depositors. On the contrary, most depositors who invest in structured products are large and sophisticated depositors. Excluding structured products from deposit protection is therefore not inconsistent with the original policy objective of establishing a DPS in Hong Kong to protect small depositors.

18. Regarding the impact of the proposal on the DPS, the Subcommittee is advised by HKDPB that the aggregate amount of structured products which are likely to be deposits and are protected under the DPS Ordinance is very small. Therefore, the proposed exclusion of structured products from DPS protection is unlikely to undermine the effectiveness of the DPS in terms of its ability to contribute to banking stability. However, HKDPB will keep this issue under constant review. It has established a set of quantitative benchmarks for triggering a review of this matter³. In the unlikely event that the exclusion of structured products would materially affect the effectiveness of the DPS, the Board will consider reversing the exclusion by introducing appropriate amendments to the DPS Ordinance.

19. Regarding the definition of “structured deposit”, the Subcommittee notes that it is provided in the proposed new section 2A of Schedule 1 to the DPS Ordinance

³ The quantitative benchmarks are:

- (a) Number of depositors holding principal-linked or interest-linked products and having an aggregate deposit balance \leq \$100,000 with banks constitutes 3% or more of the total number of depositors in Hong Kong;
- (b) Number of depositors holding either type of structured products and having an aggregate deposit balance \leq \$100,000 with banks constitutes 2% or more of the total number of depositors in Hong Kong; or
- (c) 24 months have lapsed after the launch of the DPS.

(section 2(3) of the Amendment Notice). Under the proposed new section 2A(a)(i), a deposit is a structured deposit if the loan of money, or any part of the loan, may be repaid in a currency that is different from that in which the loan of money was made. Noting the practice adopted by some banks to reserve their rights to repay in Hong Kong dollar deposits made in foreign currencies, the Subcommittee is concerned whether the proposed new section 2A(a)(i) would have the effect of including some deposits in foreign currencies as “structured deposits” thereby excluding them from the DPS, which is inconsistent with the original policy objective of the Administration. In order to ensure that foreign currency deposits would not inadvertently be captured under the definition of “structured deposit” and thereby excluded from deposit protection, the Administration proposes to amend the proposed new section 2A(a)(i) to the effect that a deposit is a structured deposit if the loan of money, or any part of the loan, may be repaid in another currency to be converted, at an exchange rate specified in terms of a ratio at the time when the loan of money was made, from the currency in which that loan was made. The Administration also proposes to amend the proposed new section 2A(b) accordingly. The Subcommittee supports the proposed amendments.

Other proposed amendments to the DPS Ordinance

20. In the light of the experience gained by HKDPB in the establishment of the DPS, the Board proposes the following miscellaneous amendments to Schedules 1 and 4 of the DPS Ordinance:

- (a) amending the definition of “excluded person” in section 3 of Schedule 1 to the DPS Ordinance so that Scheme members need not exclude the deposits held by officers of Scheme members and their related companies for the purpose of calculating the amount of contribution to be paid into the DPS Fund. This amendment aims at alleviating the reporting burden of Scheme members which consider that the resources required to identify the amount of such deposits outweigh any savings in their contribution to be paid to the Board;
- (b) amending Schedule 4 to provide that if 20 October (the date for Scheme members to report the amount of relevant deposits each year) of any year is a general holiday, Scheme members should report the amount of relevant deposits based on the position of the immediate preceding day which is not a general holiday; and
- (c) amending section 3 of Schedule 4 to allow the calculation of the build-up levy for the first year of operation of the DPS to be made on a pro rata basis as the DPS is expected to come into operation on a date other than 1 January.

21. Regarding the Subcommittee’s concern about the inconsistency of the term used to refer to “holiday” in the proposed amendments to Schedule 4 to the DPS Ordinance (“general holiday”) and in the Contribution Rules (“public holiday”), the

Administration agrees to replace the term “general holiday” by “public holiday” in the English version of the Amendment Notice.

Representation Rules

22. The Subcommittee notes that the Representation Rules govern the representations that should be made by Scheme members regarding their membership and the protection status of their financial products. The objective of the Representation Rules is to assist members of the public to distinguish between DPS protected and non-DPS protected financial products, so that they can make an informed decision in selecting financial products suitable for them. The Representation Rules shall come into operation on the day appointed for the commencement of Part 5 of the Ordinance (i.e. 25 September 2006).

23. Under the Representation Rules, a Scheme member is required:

- (a) to make known to the public that it is a member of the DPS:
 - (i) by displaying a Membership Sign at its relevant places of business at which it carries on banking business; and
 - (ii) by displaying a Membership Sign on the website on which it carries on banking business or advertises its banking business under certain circumstances;
- (b) to make known to the public that it is a member of the DPS by including a membership representation statement in advertisements and promotional materials under specified circumstances;
- (c) to notify customers of financial products not within the meaning of “protected deposit” in writing that the financial products are not protected by the DPS, and to request the customers concerned to acknowledge receipt of the notification; and
- (d) to notify depositors of protected deposits in writing, before the Scheme member varies certain term or condition of the deposits or varies certain right or obligation of the depositors or Scheme member, that on the variation, the deposits are no longer protected by the DPS, and to request the depositors concerned to acknowledge receipt of the notification.

Display of Membership Sign

24. Regarding the requirement mentioned in paragraph 23(a) above, the Subcommittee notes that the expression “relevant place of business” is defined in section 2 of the Representation Rules to mean any place of business of a Scheme member in Hong Kong, other than any automated teller machine, at which it carries on banking business and to which members of the public ordinarily have physical access for the purposes of that business. On the question of whether the definition covers

offices of private banking, the Subcommittee is advised by the Administration that the definition covers such offices, as clients of private banking, who are members of the public, ordinarily have physical access to the offices. As regards the question of whether a Scheme member is required to display a Membership Sign at each entrance on different floors of the same branch office, the Administration points out that under section 3(1)(a) of the Representation Rules, the display should be made in such a manner that the Membership Sign is reasonably visible to any person entering the place. In the earlier briefing for the banking industry on the Representation Rules, HKDPB has already explained to Scheme members the relevant requirements. HKDPB believes that the relevant requirements should not give rise to any implementation problems. Nevertheless, it would closely monitor the situation after the launch of the DPS.

25. Noting that the Membership Sign set out in the Schedule to the Representation Rules is small in size (21.5 cm x 10 cm) and the logo of the DPS is not attractive, the Subcommittee is concerned whether the Sign displayed will be reasonably visible to any person entering a bank branch as required under section 3(1)(a) of the Representation Rules. On the suggestion that reference be made to the practice in the United States where a member of the deposit protection scheme is required to display a Membership Sign at each counter, the Subcommittee is advised by HKDPB that different jurisdictions have their own considerations in designing the features and requirements of their deposit protection schemes, and that the practice adopted by US mentioned above is not commonly found in other jurisdictions. HKDPB considers the current proposal under the Representation Rules appropriate for Hong Kong. As regards the logo of the DPS, HKDPB may consider improving the design when necessary in future.

Notification in writing

26. On the requirement for the notifications mentioned in paragraph 23(c) and (d) above to be in writing, a concern was raised as to whether notification by email or on-line notification would satisfy the requirement. The Subcommittee is advised by the Administration that the two forms of notification would satisfy the requirement if the relevant provisions in the Electronic Transactions Ordinance (Cap. 553) are complied with. For example, section 5(1) of the Ordinance provides that if a rule of law requires information to be or given in writing or provides for certain consequences if it is not, an electronic record satisfies that rule of law if the information contained in the electronic record is accessible so as to be usable for subsequent reference. In this connection, section 15(1) of the Ordinance provides that section 5(1) applies only if the person to whom the information is to be given consents to it being given in the form of an electronic record. The Subcommittee is assured by HKDPB that it would make sure that Scheme members would keep proper records to prove that they have satisfied the requirement.

Offence provision

27. The Subcommittee notes that a contravention of the Representation Rules by a Scheme member is a criminal offence punishable on indictment with a fine up to \$100,000 and imprisonment up to 2 years. A defence is afforded to a person charged if he could prove that he has taken reasonable precaution and exercised due diligence to avoid the commission of the offence by himself or any person under his control. On the question of who would be charged with the offence, the Subcommittee is advised by the Administration that under section 101E of the Criminal Procedure Ordinance (Cap. 221), where a person by whom an offence under any Ordinance has been committed is a company and it is proved that the offence was committed with the consent or connivance of a director or other officer concerned in the management of the company, or any person purporting to act as such director or officer, the director or other officer shall be guilty of the like offence.

Contribution Rules

28. The Subcommittee notes that the Contribution Rules prescribe the manner in which Scheme members should pay contributions or late payment fees to HKDPB, as well as the manner in which HKDPB should pay rebates of contribution to Scheme members. The Contribution Rules shall come into operation on the day appointed for the commencement of Part 5 of the Ordinance (i.e. 25 September 2006).

29. The Subcommittee is advised by HKDPB that the amount of contribution payable by a Scheme member is determined with reference to its supervisory rating assigned by the Monetary Authority (MA). It is a piece of sensitive information, which should not be disclosed to any third party without the consent of the MA. In view of this, HKDPB has appointed the MA as its collection and payment agent. This arrangement ensures that contributions and rebates of contribution are paid through the inter-bank settlement system instead of the books of a commercial bank. In this connection, Contribution Rules prescribes that:

- (a) contributions and late payment fees payable by a Scheme member are to be paid by an entry made in the settlement account maintained by an authorized institution with the MA;
- (b) a contribution is payable during the specified time on a day (other than a public holiday or Saturday) that falls within the period of 21 days after the date on which the relevant notice in relation to the contribution is given to the Scheme member; and
- (c) rebates payable by HKDPB under section 8 of Schedule 4 to the DPS Ordinance are to be paid by a credit entry made in the settlement account maintained with the MA designated by the Scheme member by notice in writing to HKDPB.

30. On paragraph 29(b) above, the Subcommittee notes that “specified time” is defined in section 3(5) of the Contribution Rules to mean the time between 9 am and 12:30 pm on a day. Regarding the reason why afternoon time is not covered by the definition, the Subcommittee is advised by HKDPB that the arrangement is proposed to allow sufficient time for the MA to recycle within the same day contributions received from Scheme members back to the inter-bank market under the Currency Board system in Hong Kong. HKDPB confirms that the arrangement is accepted by Scheme members during consultation.

Commencement Notice

31. The Subcommittee supports the Commencement Notice.

Public consultation

32. On the proposed amendments to the DPS Ordinance set out in the Amendment Notice, the Subcommittee is advised that HKDPB has consulted the banking industry and other interested parties including the Consumer Council, the Securities and Futures Commission, the Hong Kong Institute of Certified Public Accountants, the Law Society of Hong Kong and the Hong Kong Bar Association. The Hong Kong Association of Banks (HKAB), the Consumer Council, the Law Society of Hong Kong and the Securities and Futures Commission supported the proposed amendments. The other organizations did not have any comments on the proposed amendments.

33. The Subcommittee is also advised that in accordance with section 51 of the DPS Ordinance, HKDPB has consulted the Financial Secretary and HKAB on the Representation Rules and the Contribution Rules. Considering that the requirements in the Representation Rules may affect the interests of consumers, HKDPB has also consulted the Consumer Council on the Representation Rules. The Subcommittee is assured by HKDPB that all comments have been properly addressed.

Recommendation of the Subcommittee

34. The Subcommittee supports the four items of subsidiary legislation and the proposed amendments to be moved by the Administration to the Amendment Notice at the Council meeting on 12 July 2006 (paragraphs 19 and 21 above). The proposed amendments are in **Appendix II**.

Advice sought

35. The House Committee is invited to note the deliberations of the Subcommittee.

Council Business Division 1
Legislative Council Secretariat
29 June 2006

研究《存款保障計劃條例》下4項附屬法例的小組委員會
Subcommittee to Study Four Items of Subsidiary Legislation
under the Deposit Protection Scheme Ordinance

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日期 Date	2006年6月12日 12 June 2006	

(DRAFT)

INTERPRETATION AND GENERAL CLAUSES
ORDINANCE

RESOLUTION OF THE LEGISLATIVE COUNCIL

DEPOSIT PROTECTION SCHEME ORDINANCE
(AMENDMENT OF SCHEDULES 1 AND 4) NOTICE
2006

Resolution made and passed by the Legislative Council under section 34(2) of the Interpretation and General Clauses Ordinance (Cap. 1) on 2006.

RESOLVED that the Deposit Protection Scheme Ordinance (Amendment of Schedules 1 and 4) Notice 2006, published in the Gazette as Legal Notice No. 107 of 2006 and laid on the table of the Legislative Council on 24 May 2006, be amended –

- (a) in section 2(3), by repealing the new section 2A(a)(i) and substituting –
 - “(i) in another currency to be converted, at an exchange rate specified in terms of a ratio at the time when the loan of money was made, from the currency in which that loan was made; or”;
- (b) in section 2(3), in the new section 2A(b), by repealing “a currency that is different from that in which the loan of money was made” and substituting “another currency to be converted, at an exchange rate specified in terms of a ratio at the time when the loan of money was made, from the currency in which that loan was made”;

- (c) in section 3(1), in the English text, in the new definition of “specified date”, in paragraph (b), by repealing “general” where it twice appears and substituting “public”.

Clerk to the Legislative Council

2006

INTERPRETATION AND GENERAL CLAUSES
ORDINANCE

RESOLUTION

(Under section 34(2) of the Interpretation and General Clauses
Ordinance (Cap. 1))

DEPOSIT PROTECTION SCHEME ORDINANCE
(AMENDMENT OF SCHEDULES 1 AND 4) NOTICE
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be converted, at an exchange rate specified in terms of a ratio at the time when the loan of money was made, from the currency in which that loan was made”;

- (c) in section 3(1), in the English text, in the new definition of “specified date”, in paragraph (b), by repealing “general” where it twice appears and substituting “public”.