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

Background Brief

Purpose

This paper sets out the background of the implementation of the Deposit Protection Scheme (DPS), and summarizes the major views expressed by Members when the subject was deliberated at the meeting of the Panel on Financial Affairs (FA Panel) on 6 March 2006.

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 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 a consultancy study on enhancing deposit protection in Hong Kong in April 2000. 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 effectively protecting 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. In March 2002, a second round of public consultation was conducted on HKMA's detailed recommendations focusing on the proposed structure for DPS. Responses received were generally supportive of HKMA's proposals, although there were some suggestions on reduction of cost of DPS through a smaller fund size, a longer built-up period and greater Government's commitment.

5. The FA Panel was briefed on 6 January 2003 on the proposed major features of DPS. While members had not raised any objection to the proposal, they raised questions on some aspects of the Scheme, such as the administration of the Scheme and the exemption from participation in the Scheme.

6. On 30 April 2003, the Administration introduced the DPS Bill into LegCo. A Bills Committee was formed to scrutinize the Bill. Following the passage of the Bill, 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.

7. The FA Panel was briefed on 6 March 2006 on the progress on the implementation of DPS by HKDPB, 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 in the form of subsidiary legislation.

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

- (a) Deposit Protection Scheme Ordinance (Amendment of Schedules 1 to 4) Notice 2006 ("Amendment Notice");
- (b) Deposit Protection Scheme (Representation on Scheme Membership and Protection of Financial Products under Scheme) Rules ("Representation Rules");
- (c) Deposit Protection Scheme (Payment of Contributions, Late Payment Fees and Rebates) Rules ("Contribution Rules"); and
- (d) Deposit Protection Scheme Ordinance (Commencement) Notice 2006 ("Commencement Notice").

The above four items of subsidiary legislation were tabled before the LegCo on 24 May 2006 for negative vetting. At the House Committee meeting on 26 May 2006, Members agreed to form a subcommittee to study the four items of subsidiary legislation.

Implementation of the Deposit Protection Scheme

Main features of the Deposit Protection Scheme

9. The DPS Ordinance provides for the establishment of a DPS by the Board for the purpose of providing compensation to depositors under certain circumstances in respect of deposits maintained with banks that are members of DPS; the establishment of a DPS Fund from which such compensation is to be paid; and contributions to the Fund, and entitlement to, and payment of compensation from the Fund.

10. The main features of DPS are as follows:

(a) Functions of the Board

The Board is required to establish and maintain DPS as well as to manage and administer the DPS Fund. The Board performs its functions through HKMA, but the cost incurred by HKMA will be recoverable from the Fund under the “users pay principle”.

(b) Membership of DPS

Unless exemption is granted by the Board, every licensed bank is a member of DPS.

(c) DPS Fund

(i) Every member of DPS is required to make an annual contribution to the Fund. The amount of contribution payable by a member will be assessed by the Board with reference to the amount of relevant deposits held with that member and its supervisory rating^{Note} assigned by the Monetary Authority;

(ii) It is expected that for a coverage limit of \$100,000 on a “per depositor per bank” basis, a target fund size of around \$1.6 billion or 0.3% of total protected deposits is expected to be built up within five years and sufficient to cover most of the losses that will be sustained by DPS. At this level, 84%

^{Note} “CAMEL Rating” is a supervisory rating currently adopted by HKMA to assess the financial strength and overall soundness of an authorized institution in the areas of Capital, Asset quality, Management, Earning and Liquidity.

of depositors will have their total deposits fully protected while 16% of deposits by value will be covered; and

(iii) Compensation from the Fund is payable if a winding up order has been made by the court or HKMA has made a decision that compensation should be paid. The HKMA's decision is subject to review by the Chief Executive in Council.

(d) Appeals tribunal

An independent Deposit Protection Appeals Tribunal is established to hear appeals from depositors and members of DPS against the decisions of the Board and HKMA relating to the entitlement of compensation under the Scheme; application for exemption from participation in the Scheme; and amount of contributions payable by a member of the Scheme.

Subsidiary legislation related to the operation of DPS

11. 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.

12. 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.

13. 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 come into operation shall come into operation.

Major views expressed by Members at the FA Panel meeting on 6 March 2006

14. The FA Panel supported in principle the proposed amendments to Schedules 1 and 4 to the DPS Ordinance, and the main contents of the proposed Representation Rules and the Contribution Rules.

15. The extract of the minutes of the FA Panel meeting on 6 March 2006 is in **Appendix I**.

Reference

16. A list of relevant papers is in **Appendix II**.

Council Business Division
Legislative Council Secretariat
9 June 2006

**Extract from the minutes of meeting
of the Panel on Financial Affairs on 6 March 2006**

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VI. Progress on the implementation of the Deposit Protection Scheme

(LC Paper No. CB(1)997/05-06(06) — Paper provided by the Hong Kong Deposit Protection Board

LC Paper No. CB(1)997/05-06(07) — Background brief prepared by the Legislative Council Secretariat)

Briefing by the Hong Kong Deposit Protection Board (HKDPB)

47. At the invitation of the Chairman, the Chief Executive Officer, Hong Kong Deposit Protection Board (CEO/HKDPB) gave a power-point presentation on the progress made by HKDPB in its preparation for the launch of the Deposit Protection Scheme (DPS). He highlighted progress made in the following major preparatory tasks:

- (a) System for assessment of contributions
 - HKDPB had developed a system for assessing the amount of annual contributions payable by a member of DPS with reference to the amount of relevant deposits held by the member and its supervisory rating assigned by HKMA.
 - DPS members had submitted the first return of relevant deposits to HKDPB, and HKMA had also provided the relevant supervisory ratings of DPS members. With these information, HKDPB was ready to assess the amount of contributions payable by DPS members in 2006.

- (b) Development of rules and guidelines governing the operation of DPS
 - HKDPB and the Monetary Authority (MA) were empowered under the DPS Ordinance to make rules governing the operation of DPS. The two sets of rules to be issued by HKDPB were rules on payment of contributions and rules on representations. The asset maintenance rules would be issued by MA. These rules would be promulgated in the form of subsidiary legislation which was subject to the negative vetting of LegCo.

- Apart from the rules, HKDPB had also issued an information system guideline in February 2006. The guideline required DPS members to keep and provide information to HKDPB in specified formats so as to ensure that HKDPB could determine entitlement to compensation and arrange payment to eligible depositors in a speedy manner.

(c) Payout infrastructure

- The development of the payout system was progressing well and the user-acceptance tests were now underway.
- The payout procedures were being written in the form of a comprehensive manual, which would set out the key payout processes and various payout activities.

(d) Publicity campaign

- The effectiveness of DPS to contribute to banking stability hinged on the level of public confidence in DPS. In this connection, promotional activities would start shortly before the official launch of DPS, such as TV and radio commercials, information leaflets distributed through the branch networks of DPS members, and exhibitions at major shopping malls and MTR stations.
- HKDPB would develop an on-going strategy for maintaining a high level of public awareness of DPS.

(e) Others

- HKDPB proposed to amend Schedule 1 to the DPS Ordinance to exclude all structured products from DPS protection initially. It had also established a set of quantitative benchmarks for triggering a review of this matter and would reverse the exclusion if the review showed that the exclusion would materially affect the effectiveness of DPS.
- HKDPB also proposed to amend Schedule 1 and 4 to the DPS Ordinance to allow DPS members not to exclude deposits held by certain excluded persons in the assessment of contributions; to clarify that contributions for the first year would be assessed on a time pro-rata basis; and to specify that DPS members should report their deposit positions on the preceding day if 20 October of the year was a general holiday.

48. On the way forward, CEO/HKDPB advised that the remaining tasks were expected to be completed in the next six months and, if everything went smoothly, DPS would commence in the second half of 2006.

Discussion

Transfer of costs to customers

49. Noting that the DPS Fund would be established by means of contributions from member banks, Mr Ronny TONG was concerned whether the banks would try to recoup cost for the implementation of DPS from customers through fee increases. In this connection, Mr TONG enquired whether measures and guidelines would be in place to ensure that banks would not transfer the costs for DPS to their clients. Ms Emily LAU shared his concern.

50. In response, CEO/HKDPB advised that how banks charged their clients was a commercial decision and it was inappropriate for HKDPB or HKMA to interfere with such decisions. However, he pointed out that the cost implications on member banks would not be significant given the low average rate of contribution payable by the banks at only 0.08% of the protected deposits per annum during the fund built-up period, which was expected to take approximately five years, with reduction of the rate to 0.01% thereafter. Furthermore, it was envisaged that after the implementation of DPS, banks would tend to be more active in competing for small deposits. As such, market competition would exert pressure on banks to refrain from transferring the costs. The Principal Assistant Secretary for Financial Services and the Treasury (Financial Services)⁵ added that the Administration had been actively involved in the preparatory work for DPS through the representation of the Permanent Secretary for Financial Services and the Treasury (Financial Services) on HKDPB as an ex-officio member. She advised that the Administration shared CEO/HKDPB's view that it would be unlikely for banks to transfer their costs for DPS to customers.

Management of the DPS Fund

51. Ms Emily LAU expressed concern about the management of the DPS Fund. In particular, she was concerned how the operating cost of DPS would be covered, how the investment strategy of the Fund would be determined, and who would be responsible for undertaking the investment activities.

52. In response, CEO/HKDPB advised that the DPS Fund would be managed by HKDPB. With the proposed target fund size at 0.3% of the banking sector's total amount of protected deposits (which was equivalent to approximately \$1.6 billion based on the level of protected deposits as at August 2002), it was expected that the investment return of the Fund would be adequate to cover the operating cost of DPS. An investment committee under HKDPB would be responsible for the investment arrangement for the Fund. He also advised that the range of investment products was governed by the relevant provisions in the DPS Ordinance, such as investment in deposits with the Exchange Fund, Exchange Fund Bills, US Treasury Bills and exchange rate and interest rate contracts. In the event that the investment returns

were inadequate to cover the operating cost, the contributions made by DPS members would make up the difference.

Amount of deposit protection and payment of compensation

53. Ms Emily LAU and Mr Ronny TONG expressed concern about the amount of deposit protection under DPS. Noting the coverage limit of \$100,000 per depositor per bank, Ms LAU was concerned whether the protection offered under DPS was comparable to similar schemes in overseas jurisdictions. In reply, CEO/HKDPB advised that the coverage limit of \$100,000 was considered acceptable since 84% of depositors would have their total deposits fully protected in the event of a bank failure.

54. Ms Emily LAU also expressed concern over the time required for making compensation payments to depositors in the event of a bank failure. She was of the view that expeditious payout under DPS was important for restoring depositors' confidence in the banking system. CEO/HKDPB advised that the actual time required would vary according to the quality of the information system and comprehensiveness of the database of the bank concerned, which would have impact on HKDPB's assessment of depositors' claims. The target of HKDPB was to provide an interim payment of up to 25% of the depositors' entitlements within two weeks, with full entitlements paid out within six weeks after the collapse of a bank. He pointed out that these timeframes for payment were targets instead of performance pledges of HKDPB.

Exemption from DPS

55. In response to the Chairman's concern about exemption of overseas incorporated banks from DPS, CEO/HKDPB explained that participation by licensed banks in DPS was mandatory. However, an overseas incorporated bank could apply for exemption from participating in DPS if the deposits taken by the bank's Hong Kong offices were protected by a scheme in the bank's home jurisdiction and the scope and level of protection afforded by that scheme were not less than those offered to such deposits by DPS in Hong Kong. He however envisaged that few overseas banks operating in Hong Kong would be eligible for exemption from DPS.

56. On the requirement of displaying the DPS membership sign in member banks' local branches, Ms Emily LAU was concerned about the possible confusion of the public that their deposits in banks exempted from DPS would have no protection at all. CEO/HKDPB advised that exempted banks were required to inform their depositors or prospective depositors that they were not members of DPS and to provide details of the protection offered by their home jurisdiction scheme including the level of protection and the types of deposits protected.

Complaint/Appeal mechanism

57. Miss TAM Heung-man enquired about the mechanisms under DPS for handling complaints and/or appeals from small depositors. CEO/HKDPB responded that depositors might lodge complaints on scheme members directly to HKDPB. Moreover, depositors and member banks might appeal to an independent Deposit Protection Appeals Tribunal (the Tribunal) for review of the decisions made by HKDPB. The Deputy Chief Executive Officer (Operations), HKDPB supplemented that the Tribunal was established in January 2005 with a former Vice-President of the Court of Appeal of the High Court appointed as the Chairman and a panel of six persons coming from different professions from which the Financial Secretary might appoint as members of the Tribunal.

Conclusion

58. There being no further questions from members, the Chairman concluded the discussion. He said that the Panel supported in principle the proposed rules governing the operation of DPS and the proposed amendments to Schedules 1 and 4 to the DPS Ordinance. On the timing for tabling the three sets of rules before LegCo for negative vetting, members noted that HKDPB aimed at proceeding with the legislative procedures as soon as practicable.

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Implementation of the Deposit Protection Scheme

List of relevant papers
(Position as at 9 June 2006)

| Paper | LC Paper No. |
|---|---|
| LegCo Brief on “Enhancing deposit protection in Hong Kong” | — <i>(discussed at the FA Panel meeting on 6 November 2000)</i> |
| Consultation Paper on Enhancing Deposit Protection in Hong Kong | CB(1)111/00-01 <i>(discussed at the FA Panel meeting on 6 November 2000)</i> |
| Minutes of the FA Panel meeting on 6 November 2000 | CB(1)295/00-01 |
| Information paper on “Progress on the Deposit Insurance Scheme” provided by HKMA | CB(1)1114/01-02(02) <i>(issued for FA Panel members’ information in February 2002)</i> |
| Information paper on “Establishment of a Deposit Protection Scheme in Hong Kong” provided by HKMA | CB(1)588/02-03(03) <i>(discussed at the FA Panel meeting on 6 January 2003)</i> |
| Minutes of the FA Panel meeting on 6 January 2003 | CB(1)919/02-03 |
| Letter dated 30 October 2002 from the Consumer Council to HKMA on the Deposit Insurance Scheme | CB(1)655/02-03 <i>(circulated to FA Panel members on 8 January 2003)</i> |
| LegCo Brief on “Deposit Protection Scheme Bill” | — |
| Paper on “Progress on the implementation of the Deposit Protection Scheme” provided by the Hong Kong Deposit Protection Board | CB(1)997/05-06(06) <i>(discussed at the FA Panel meeting on 6 March 2006)</i> |
| Background brief on “Progress on the implementation of the Deposit Protection Scheme” prepared by the LegCo Secretariat | CB(1)997/05-06(07) <i>(for the FA Panel meeting on 6 March 2006)</i> |
| Minutes of the FA Panel meeting on 6 March 2006 | CB(1)1337/05-06 <i>(Agenda Item VI)</i> |