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Panel on Financial Affairs
Meeting on 1 June 2009

Background Brief on enhancing deposit protection under the Deposit Protection Scheme

Purpose

This paper sets out the background of the implementation of the Deposit Protection Scheme (DPS), and summarizes the views and concerns expressed by Members when the subject was deliberated at meetings of the Legislative Council (LegCo) and its committees.

Background

2. 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, 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.

3. 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 to reduce the cost of DPS such as a smaller fund size, a longer built-up period and greater commitment from the Government.

4. The Panel on Financial Affairs (FA Panel) was briefed on 6 January 2003 on the proposed major features of DPS. The DPS Ordinance (Cap. 581) was enacted

in May 2004 and the Hong Kong Deposit Protection Board was formed in July 2004.

5. The FA Panel was updated on the progress of the preparatory work when briefed on the work of HKMA at the meetings on 7 November 2005 and 6 February 2006. The Panel noted that the drafting of the rules governing the operation of DPS had been substantially completed, the payout system was being tested, and a publicity strategy for the launch of DPS had been formulated. The Hong Kong Deposit Protection Board commenced operation in September 2006.

Main features of the Deposit Protection Scheme

6. The main features of DPS are as follows:

(a) Unless exempted by the Board, all licensed banks are DPS members. Restricted licence banks and deposit-taking companies are not members of DPS.

(b) DPS is funded by contributions collected from Scheme members. A Deposit Protection Scheme Fund (DPS Fund) has been established from the contributions collected. The target size of the DPS Fund is 0.3% of the total amount of protected deposits maintained with all Scheme members (approximately HK$1.5 billion). The latest projection of the Board indicates the target fund size would be reached by 2012.

(c) The contribution payable by a Scheme member for a year is determined by the amount of protected deposits held with the Scheme member as of 20 October of the preceding year and the supervisory rating[1] assigned by the Monetary Authority (MA) to the member.

(d) Certain types of deposit are not protected by DPS, such as time deposits with a maturity longer than five years, structured deposits (such as foreign currency-linked and equity-linked deposits), secured deposits (such as deposits used as collateral to secure a banking facility), bearer instruments (such as bearer certificates of deposit) and offshore deposits. Scheme members are required to notify customers if a financial product has been described as a deposit but is not protected by DPS.

(e) The compensation limit under DPS is HK$100,000 per depositor per bank. Compensation from the DPS Fund should be paid to depositors of a Scheme member if a winding up order has been made

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1 "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 **C**apital, **A**sset quality, **M**anagement, **E**arning and **L**iquidity.

against the Scheme member or MA has decided that compensation should be paid by DPS and has served notice on the Board accordingly.

(f) When compensation under DPS becomes payable in respect of a Scheme member, DPS will borrow from the Exchange Fund under a standby liquidity facility to pay compensation to depositors. The size of the facility offered by the Exchange Fund to DPS is HK$40 billion. DPS will seek reimbursement from the liquidation of the failed Scheme member for the compensation paid to depositors and repay the borrowings from the Exchange Fund. The cost of borrowing from the Exchange Fund, any compensation paid that cannot be recovered from the liquidation, and the administrative cost incurred by DPS in making compensation payments, will be charged to the DPS Fund.

7. Members have expressed the following views and concerns during previous discussions in 2003 to 2006 on the DPS before it commenced operation:

(a) the appointment of HKMA as the agent for day-to-day administration of DPS might have the possible negative impact of undermining the credibility and independence of the Scheme, and might result in a conflict of roles for HKMA, which was the regulator of banks;

(b) the exemption from the participation in DPS of an overseas incorporated bank that had a comparable scheme in the bank's home jurisdiction which protects deposits taken by its Hong Kong office might encourage depositors in Hong Kong to move their deposits to overseas banks. An exempted bank should be required to inform its depositors or prospective depositors that it was not a DPS member;

(c) as contributions to the DPS Fund would be based on the supervisory ratings of banks and banks with higher ratings would pay lower rates to the Fund, lower rated banks might be forced to undertake businesses with higher risks in order to recover the higher cost involved;

(d) whether the banks would try to recoup cost for the implementation of DPS from customers through fee increases and the measures in place to ensure that banks would not transfer the costs for DPS to their clients;

(e) the coverage limit of $100,000 was relatively low. While members noted that the higher the coverage limit was, the greater the risk of moral hazard became, some of them were concerned whether the protection offered under DPS was comparable to similar schemes in overseas jurisdictions; and

(f) compensation should be paid out as soon as possible, and it was necessary to put in place contingency arrangements, such as retrieval of necessary information and provision of enquiry services to the public, to avoid possible confusion in the event of a bank failure.

Measures to enhance deposit protection

<u>Recommendations related to DPS in HKMA's consultancy report on banking stability</u>

8. HKMA released a consultancy report on its work on banking stability in July 2008, which contains two recommendations in relation to DPS:

(a) the Board should review the level of deposit protection provided in Hong Kong and the potential for raising the protection limit without increasing the annual premium; and

(b) the Board should study the changes that are made to the United Kingdom scheme in the wake of Northern Rock and the new international principles for deposit insurance when they emerge to consider what application they may have to Hong Kong.

9. The consultant engaged by HKMA briefed the FA Panel on the findings and recommendations of the study at the meeting on 5 January 2009.

<u>Temporary full deposit protection</u>

10. As a pre-emptive measure to reinforce confidence in the banking system in Hong Kong, the Financial Secretary announced on 14 October 2008 the use of the Exchange Fund to guarantee repayment of all customer deposits held in all authorized institutions in Hong Kong following the principles of DPS, until the end of 2010.

11. The FA Panel was briefed on the full deposit protection at the special meeting on 17 October 2008. While Panel members supported the introduction of the measure to safeguard banking stability, some of them expressed concern about the moral hazards involved as it might dampen banks' incentives for prudent risk management. Some Panel members were also concerned about the impact of the cessation of the new measures in 2010 on Hong Kong's credit ratings in the international financial market and possible capital outflow from Hong Kong. At meetings of the FA Panel held on 5 January 2009 and 2 February 2009, Panel members expressed concern about the scope of coverage of the temporary full deposit protection, noting that some deposits (such as saving accounts with overdraft facilities) were not covered. Similar concern was also raised at the

special meeting of the Finance Committee to examine the 2009-2010 Estimates of Expenditure.

Recent developments

12. The Hong Kong Deposit Protection Board launched a two-month public consultation on "Enhancing Deposit Protection under the Deposit Protection Scheme" in late April 2009. The Board proposes to consult the FA Panel on the recommendations in the consultation paper at the meeting on 1 June 2009.

Relevant papers

13. The relevant papers are available at the following link: http://www.legco.gov.hk/yr07-08/english/panels/fa/papers/fa_m2e.htm#0708

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