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香港存款保障委員會
HONG KONG DEPOSIT PROTECTION BOARD

Briefing to Bills Committee

on

Deposit Protection Scheme (Amendment) Bill 2010

6 May 2010

香港存款保障委員會
HONG KONG DEPOSIT
PROTECTION BOARD

About the Deposit Protection Scheme

- The Deposit Protection Scheme (DPS) in Hong Kong commenced operation in September 2006

- The DPS was established under the Deposit Protection Scheme Ordinance (DPSO)(Cap. 581), it contributes to banking stability by:

  - providing a measure of protection to depositors and an orderly means of compensating depositors if a bank fails

  - reducing probability of failure by reducing the risk of rumour-driven runs

  - reducing fall-out effects if failure does occur

- The DPS is administered by the Deposit Protection Board (DPB), an independent statutory body established under the DPSO

- The DPS is fully funded by contributions collected from banks

Background on DPS Review (1)

- In the light of relevant developments in international and local financial markets, the DPB completed a review of the DPS in 2009

- The DPB conducted extensive consultation on the proposals for enhancing the DPS identified in the review:

  - publicity campaigns (TV, newspapers, enquiry hotlines, etc.) to invite public comments, and opinion surveys to gauge public responses

  - proactively approached and solicited comments from key stakeholder groups, including the Consumer Council, banking industry, labour unions, academics, professional bodies like Hong Kong Institute of of Certified Public Accountants (HKICPA) and Law Society, Standing Committee on Company Law Reform (SCCLR), and Official Receiver's Office (ORO)

Background on DPS Review (2)

- The proposals received broad public support, as well as the support of the key stakeholder groups

- Briefed LegCo Financial Affairs (FA) Panel (in June 2009 and February 2010) on the proposals and the results of consultation, solicited views from individual LegCo members

- Proposals in the review to be effected by making amendments to:

  - the DPSO through an amendment bill

  - subsidiary legislations (to be submitted for negative vetting after the amendment bill is passed)

- Completed drafting the amendment bill, the "Deposit Protection Scheme (Amendment) Bill 2010" (the Bill)

Objective of the Bill

- The objective of the Bill is to introduce amendments to the DPSO and Companies Ordinance (Cap. 32) (CO) for:
  - providing better protection to depositors
  - minimising the potential for cost transfer to depositors due to providing better deposit protection
  - enabling the Board to make faster payment to depositors in a payout
  - improving the transparency of the coverage of the DPS

- The amendments are targeted to take effect at the start of 2011 to dovetail with the expiry of the full deposit guarantee offered by the Government by the end of 2010, to help minimize the impact of the expiry of the guarantee on the public

Providing better deposit protection (1)

(A) Raising DPS protection limit from $100,000 to $500,000

- Over 90% of depositors will become fully protected (at the higher end of international standards of 80-90%), in absolute terms, the new limit compares favourably to levels in major markets (see the table below)

	US	UK	EU minimum	Singapore	Hong Kong
Limit in home currency ('000)	250[1]	50	50	20[2]	500 (Proposed)
Limit in HK$ equivalent ('000)	2,000	600	500	110	

Note 1: Temporarily raised from US$100,000 in October 2008, to revert to US$100,000 in 2014

Note 2: Recently proposed to raise limit to SGD50,000, or HK$280,000 equivalent, to fully cover **91%** of depositors

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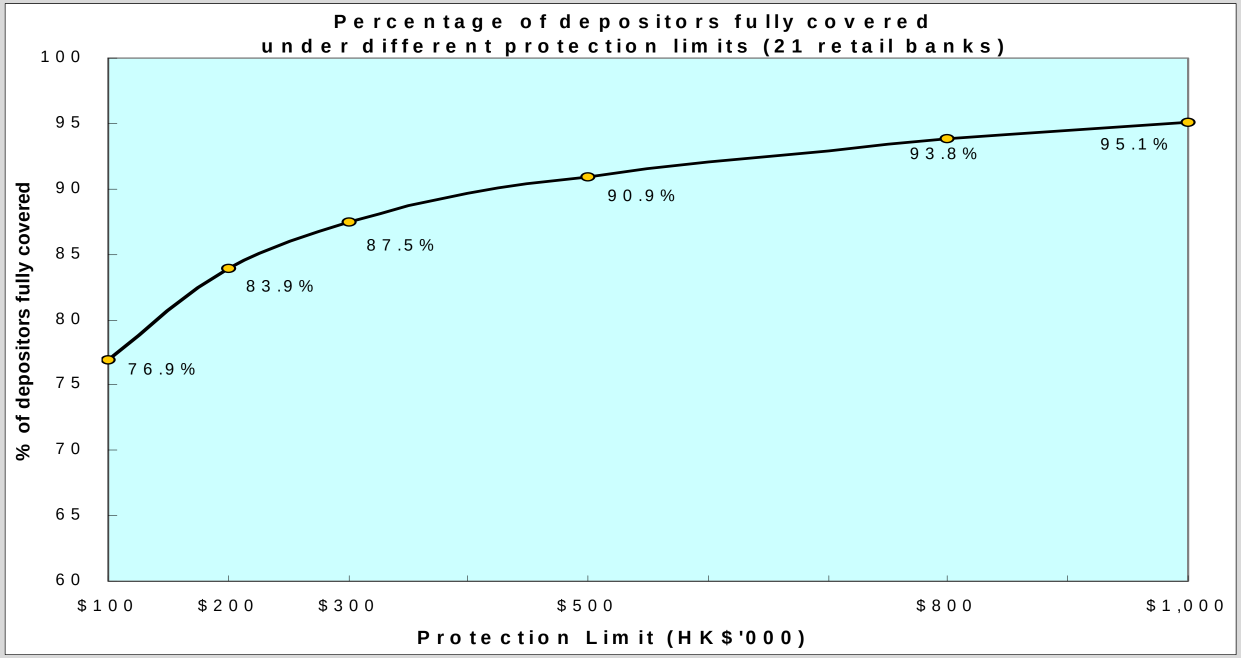
Providing better deposit protection (2)

(A) Raising DPS protection limit from $100,000 to $500,000 (cont'd)

- A lower limit may not be able to meet heightened public expectation for better deposit protection, raising the limit further will add little to effectiveness at disproportionately higher cost and higher moral hazard



Providing better deposit protection (3)

(A) Raising DPS protection limit from $100,000 to $500,000 (cont'd)

- As the new limit is not out of line with the limits in other major markets, and in the light of the robust banking supervision in Hong Kong, the moral hazard should be manageable
- 80% of respondents to the public opinion survey found the new limit acceptable. Key stakeholder groups, including Consumer Council, banking industry, labour unions, professional bodies have indicated support

Providing better deposit protection (4)

(B) Protecting secured deposits

- Secured deposits are currently not protected because they are "loans of money upon terms referable to the provision of services", which have been excluded from the definition of deposit in the DPSO (linked to that in the Banking Ordinance (Cap. 155))
- Increasingly common for banks to bundle banking and financial services together, under which deposits may be pledged or subject to encumbrances, rendering their protection status unclear
- The public, Consumer Council and banking industry requested the DPB to enhance the clarity of DPS coverage
- Proposed to extend protection to secured deposits, supported by Consumer Council, banking industry and professional bodies

Providing better deposit protection (5)

Legislative amendments proposed in the Bill

- To raise DPS protection limit by changing all references to “$100,000” to “$500,000” in the DPSO as proposed in clauses 4, 8 and 13
- To put it beyond doubt that the new limit will apply only to bank failures where the DPS is triggered on or after the effective date of the new limit, not where payments are made on or after the effective date, as proposed in clause 11
- To protect secured deposits by amending the definition of deposit in the DPSO as proposed in clause 3. Banking industry has been consulted on the amendments to ensure appropriateness of the revised definition (confined to secured deposits referable to the provision of banking and financial services only)

Minimising potential for cost transfer (1)

(A) Reducing rates for charging annual and total contribution

- It was estimated that the amount of protected deposits in the industry will increase to $1,149 billion (from $495 billion) after the DPS protection limit is raised to $500,000
- The annual contribution of banks (build-up levy), calculated by multiplying amount of protected deposits by the applicable levy rate, will increase significantly by over 2 times
- Proposed to offset the impact of providing better deposit protection on annual contribution of the industry by cutting levy rates, to minimise any potential for cost transfer to depositors
- Based on the estimation of the DPB and as agreed with the banking industry, the levy rates should be cut by 65% to keep annual contribution of the industry unchanged at the current level

Minimising potential for cost transfer (2)

(A) Reducing rates for charging annual and total contribution (cont'd)

- Contributions collected are accumulated in the DPS Fund, which has a target of 0.3% of protected deposits in the industry

- The DPB estimated that, under the new protection limit, the absolute amount of funds required in the DPS Fund will increase (from \$1.5 billion to \$2.8 billion), but it will drop slightly as a percentage of protected deposits in the industry, to 0.25%

- Due to raising DPS protection limit and cutting annual levy rates, the DPS Fund is expected to require 6 more years (by 2018) to reach target

- This will NOT affect DPS' ability to compensate depositors, which will be funded by borrowings from the Exchange Fund, the DPS Fund is meant to absorb costs and expenses in a payout

Minimising potential for cost transfer (3)

(B) Providing an option to banks to report protected deposits on a net basis for contribution assessment purposes

- Compensation under the DPS is calculated on a net basis, i.e. after deducting liabilities from protected deposits of depositors
- Banks now report protected deposits to the DPB for contribution assessment purposes on a gross basis, i.e. without deducting depositors' liabilities, which may overstate the amount of deposits to be compensated
- Proposed to align the basis of contribution assessment with compensation assessment by providing <u>an option</u> to banks to report protected deposits on a net basis, to the extent that they find it cost effective to do so

Minimising potential for cost transfer (4)

(C) Linking the level and scope of priority claims for depositors under the CO to the level set in the DPSO

- The DPS relies on subrogating into the priority claims of depositors under the CO to recover the compensation it has paid
- Without making corresponding changes to the level and scope of priority claims, the DPS will only be able to recover $100,000 on insolvency of the bank and may experience shortfall of up to $400,000 plus interest
- As the priority claims arrangement and the DPS share the same objective of protecting depositors, proposed linking the level and scope of priority claims to those of the DPS
- No objection was received from the relevant stakeholder groups consulted, including SCCLR, HKICPA, Law Society and ORO

Minimising potential for cost transfer (5)

<u>Legislative amendments proposed in the Bill (1)</u>

- As proposed in clause 13, to reduce the rates for charging annual build-up levies and the target size of the DPS Fund by adjusting the relevant figures in the DPSO
- To provide an option to banks to report protected deposits on a net deposit basis by revising the reporting methodology in the DPSO, as proposed in clause 13 (consulted and agreed by the banking industry)
- To empower the DPB to obtain information essential for assessing contributions under the new reporting methodology by revising the enabling provision, as proposed in clause 9

Minimising potential for cost transfer (6)

Legislative amendments proposed in the Bill (2)

- To link the scope and level of priority claims in the CO to the level set in the DPSO as proposed in the Schedule
- Contribution of a bank for a year is assessed with reference to its position on 20 October in the preceding year, the new definition of deposit and reporting basis have to be made effective on 20 October 2010, as proposed in clause 2
- Transitional arrangement to apply the new limit and scope to a bank winding-up with the relevant date for determining priority claims falling on a day before the Bill takes effect, but the DPS is triggered after the Bill takes effect, to avoid the DPS from suffering shortfall losses, as proposed in the Schedule

Enabling the DPB to make fast payment (1)

(A) Empowering the DPB to make reasonable estimates when determining compensation

- The DPS must be able to make fast payment to dismiss worries of depositors and address their immediate liquidity needs
- Determination of compensation under the DPS involves calculation of accrued interests on deposits and customer liabilities, and valuation of future and contingent liabilities in accordance with insolvency rules (s. 27(4)(*b*) of the DPSO)
- Based on simulation experience of the DPB:
  - essential information may not be available (when DPS is not triggered on interest accrual days or contract-end days)
  - it can be apparently cost ineffective to perform precise calculation
  - may cause delays in compensating depositors

Enabling the DPB to make fast payment (2)

(A) Empowering the DPB to make reasonable estimates when determining compensation (cont'd)

- Proposed to empower the DPB to make reasonable estimates under certain conditions:
  - there is uncertainty over the relevant values;
  - it may cause an undue delay in payment of compensation; or
  - the cost would outweigh the benefits of making precise calculation
- In case the DPB has underestimated compensation, the DPS is still obliged to pay the shortfall, depositors are still entitled to priority claims in respect of the shortfall. An appeal mechanism is available
- In case the DPS has overestimated compensation, it can claw back the excess from depositors if it is cost effective to do so

Enabling the DPB to make fast payment (3)

(B) Enabling the DPB to make different amounts of interim payment to different groups of depositors

- The DPB has the power under DPSO (s. 36) to make an amount of interim payment to a depositor that the DPS considers appropriate
- Based on simulation experience, the DPB finds it beneficial, in terms of efficiency and cost effectiveness, to pay different amounts of interim payments to different groups of depositors, e.g. to better address the liquidity needs of small depositors first
- There was concern whether s.36 of the DPSO allows the DPB to apply different treatments to different groups of depositors
- Proposed to specify this power of the DPB more clearly

Enabling the DPB to make fast payment (4)

(C) Allowing DPB's businesses to be conducted by electronic means

- In a payout, time critical decisions have to be made by the DPB
- Businesses of the DPB are now conducted through members attending meetings in person, or physical circulation of papers to members present in Hong Kong
- Based on simulation experience, it may not be able to gather sufficient number of members for meetings in Hong Kong, or physically circulate papers, in time for time urgent decisions
- Proposed to allow businesses of the DPB to be conducted by electronic means, <u>without</u> changing the quorum required for passing any resolutions

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Enabling the DPB to make fast payment (5)

Legislative amendments proposed in the Bill (1)

- To add power to the DPB in the DPSO to make reasonable estimates of values of annuities and future and contingent liabilities, and interest under specified conditions, as proposed in clause 4
- To provide that the maximum amount of compensation to a depositor is not to exceed the priority claim under the CO or the amount payable under the DPSO including any reasonable estimates, as proposed in clause 5
- To allow the DPB to claw back any excessive payment due to reasonable estimates made by the DPB, by making the excess an amount that can be clawed back in the DPSO, as proposed in clause 7

Enabling the DPB to make fast payment (6)

Legislative amendments proposed in the Bill (2)

- To enable the DPB to determine the amount of interim payment for different groups of depositors by adding a provision in the DPSO, as proposed in clause 6
- To enable the DPB to transact businesses through electronic means by amending the proceedings of the DPB in the DPSO, as proposed in clause 12

Improving transparency of DPS coverage (1)

Enabling DPB to revise and make additional disclosure rules

- During public consultation, the DPB received requests from the public, Consumer Council and FA Panel members, to improve disclosures on protection status of deposit products:
  - improve negative disclosures
  - introduce positive disclosures
  - enhance legibility of disclosures
  - improve disclosures on structured deposits
- Currently, banks are required to make disclosure on products named deposit but not protected by the DPS (negative disclosure), which can be made on one-off basis at account opening
- There is no requirements on disclosure for protected deposits (positive disclosure) or on legibility of disclosure statements

Improving transparency of DPS coverage (2)

Enabling DPB to revise and make additional disclosure rules (cont'd)

- There is no restriction on how banks should name their deposit products. Some have named their protected deposits as a structured deposit, which is a category of non-protected deposits in the DPSO (however, this will not render it unprotected)

- Proposed to add powers to the DPB to make additional rules to improve the DPS disclosure regime

- The rules would be made in the form of subsidiary legislations and submitted to the LegCo for negative vetting after the Bill (which contains the relevant enabling provisions) is passed

Improving transparency of DPS coverage (3)

Enabling DPB to revise and make additional disclosure rules (cont'd)

- Rules to be made as concluded in the consultation on the DPS review

  - except for disclosures to institutions and on automatically rolled over transactions, negative disclosures should be made on a transaction basis, institutions will receive regular reminders

  - banks are required to make positive disclosures, and in specified format and within specified timeframe upon request

  - banks are required to display disclosure statements prominently, according to specified standards on size and location

  - banks should name a deposit a structured deposit only if it fits in with the definition for the term in the DPSO (applicable to new deposits only, existing deposits will be allowed to mature gradually over time)

Improving transparency of DPS coverage (4)

Enabling DPB to revise and make additional disclosure rules (cont'd)

- The rules to be made received board support from the public and the Consumer Council
- The banking industry shared that it is important to keep depositors properly informed but had concerns about the cost and effort involved in implementing the new requirements
- The DPB commits to implement the relevant requirements as cost effective as possible
- The relevant parties, including the banking industry, will be consulted on the detailed rules before they are submitted to the LegCo for negative vetting

Improving transparency of DPS coverage (5)

Legislative amendments proposed in the Bill

- To add power to the DPB to make additional disclosure rules by revising and adding relevant enabling provisions in the DPSO, as proposed in clause 10
- To clarify whether the rules made under the revised and new enabling provisions will apply to deposits in existence when the rules commence operation by adding a transitional provision in the DPSO, as proposed in clause 11
- To make the revised and added enabling provisions effective on the date of gazette of the Bill (so that negative vetting for the rules can commence immediately), as proposed in clause 2

Summary of legislative amendments in the Bill

Objective	Relevant clause in the Bill
Providing better deposit protection	Clauses 2*, 3, 4, 8, 11 and 13
Minimising potential for cost transfer	Clauses 2*, 9 and 13, and the Schedule (under clause 14)
Enabling the DPB to make fast payment	Clauses 2*, 4, 5, 6, 7 and 12
Improving transparency of DPS coverage	Clauses 2*, 10 and 11

*Clause 2 is the commencement provision

Commencement of the Bill

- The majority of the amendments in the Bill are set to commence operation on 1 January 2011
- The clauses on reporting protected deposits for contribution assessment and making new rules have to commence operation early, otherwise their commencements have to be deferred
- The earlier that the Bill can be passed, the earlier that
  - the Board can publicise the changes
  - the public can get ready for the transition
  - banks can make preparations, e.g. adjusting systems, printing new deposit documentation, training front-line staff, etc.
- The DPB and the FSB will render full support to the LegCo to facilitate an early passage of the Bill

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Thank you