Bills Committee on
Deposit Protection Scheme (Amendment) Bill 2015

Government's Responses to the Follow-up Actions
Arising from the Discussion at the Meeting on 16 December 2015

This paper sets out the Government's responses to the issues raised by Members at the meeting held on 16 December 2015.

I. Banking sector's views on the gross payout approach

2. During the consultation conducted by the Government in September-December 2014, the banking sector expressed support for the proposed gross payout approach in the determination of the amount of deposit compensation under the Deposit Protection Scheme Ordinance ("the Ordinance"). In particular, the Hong Kong Association of Banks ("HKAB") noted that the gross payout approach would simplify and speed up the payout process, and increase the payout efficiency. The proposed change would streamline banks' work on record management so that they would no longer need to provide information of depositors' liabilities to the Hong Kong Deposit Protection Board ("HKDPB"). HKAB was content with the provisions contained in the Bill.

3. In addition, during the consultation, HKAB sought clarification on whether there would be any adjustment to the level of premium rates currently applicable to banks[1] under the gross payout approach. As mentioned in the consultation conclusion issued in May 2015 by the Government, we consider it appropriate to proceed with the adoption of the gross payout approach without any adjustment to the premium rates, having regard to the consideration that any reduction of the premium rates would lead to the delay in the Deposit Protection Scheme ("DPS") Fund reaching its target fund size. Although it is

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[1] In accordance with Schedule 4 to the Ordinance, the build-up levy and expected loss levy payable by a bank range from 0.0175% to 0.049% and from 0.0075% to 0.02% of the relevant deposits respectively, and are divided into four tiers corresponding to the supervisory rating assigned to the bank by the Hong Kong Monetary Authority. At present, the DPS Fund stands at about $2.8 billion.

possible that the amount of annual contribution of some banks might increase as a result of a higher level of protected deposits when calculated on a gross basis, the increase is estimated to be moderate (on average about 10% more than that under the existing net payout approach). That said, there would be possible reduction in IT and compliance costs for banks as a result of the simplified data maintenance, reporting and verification requirements. We believe that the overall cost impact of the gross payout approach on banks should not be material.

II. Impact of the gross payout approach on the winding-up procedures of a bank and possible scenarios on depositors with debts owed to the bank

Impact on winding-up procedures of a bank

4. The purpose of introducing the gross payout approach is to speed up the compensation process under the DPS. While there will be no need to set off a depositor's deposits (up to the prevailing DPS compensation limit) against his/her liabilities owed to a failed bank, the current credit hierarchy in the insolvency of, and the insolvency proceedings applicable to, a bank under the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32) will remain unchanged. Theoretically, it is possible that, if a compensated depositor subsequently defaults on his/her liabilities owed to the failed bank, there could be a potential reduction in liquidated assets to be recovered by a liquidator of the bank for distribution to creditors. However, statistics collected from major retail banks in Hong Kong show that most deposits are unencumbered and not subject to set off. Together with the chronically low charge-off rates on liabilities, it is expected that the potential impact of the gross payout approach on the liquidated assets of a failed bank should be marginal.

Impact on depositors

5. The adoption of the gross payout approach will not extinguish a depositor's liabilities owed to the relevant bank. Any amount of deposit in excess of the DPS compensation limit will continue to be subject to set off against the depositor's liabilities owed to the bank under

the relevant law. The depositor is still obliged to settle any outstanding debt owed to the failed bank, in accordance with the terms of the loans, after receiving any deposit compensation from HKDPB.

6. Upon the triggering of DPS under the gross payout approach, each relevant depositor will be entitled to receiving compensation from DPS of up to the prevailing DPS protection limit (currently HK$500,000) for all protected deposits held with the failed bank, regardless of whether the depositor owes any outstanding liabilities to the bank. Generally speaking, the winding-up of a bank does not affect the validity of any existing contracts (e.g. loans or mortgages) entered into by the bank with its customers. In the case of a mortgage, a mortgagor, whether or not he/she is simultaneously a depositor of the bank, is still obliged to repay his/her mortgage to the liquidator of a failed bank, pursuant to the contract terms of the mortgage. The liquidator of the failed bank cannot call in the mortgage unless the relevant terms and conditions of the mortgage governing non-compliance or breach of the mortgage by the mortgagor are invoked (such as where the mortgagor fails to repay instalments). We understand that, in practice, given that mortgages usually have a lengthy repayment period, it is likely that the liquidator of the failed bank would, in the interests of the bank's creditors, seek to sell off[2] any existing mortgages within the terms of the mortgage deed. In these circumstances, the rights and obligations of a mortgagor will not be affected, and a mortgagor will repay the mortgage pursuant to the terms of the mortgage to the new mortgagee. Also, we understand that the liquidation of a failed bank will not prevent a mortgagor from repaying in full the mortgage early, or seeking a new mortgage from another bank to pay off the mortgage of the failed bank, as long as it is permitted under the relevant contract of the mortgage.

III. Drafting of section 38(1)(a) of the Ordinance

7. Under the existing section 38(1)(a) of the Ordinance, HKDPB is subrogated, to the extent of the amount of compensation, to all the rights and remedies of the depositor in relation to all the depositor's

[2] We understand that, under a typical mortgage deed, the mortgagee bank has the express right to sell or novate the mortgage to a third party without requiring the consent of the mortgagor.

deposits with a bank, in priority over the rights and remedies of (a) the depositor in relation to those deposits and (b) any person who is subrogated, whether or not before the Board's subrogation, to such rights and remedies of the depositor in question. The expression "*notwithstanding any rule of law*"[3] in the said subsection has, at present, the effect of ensuring that the Board's subrogation is not affected by any rule of law which covers any statute law, rules of common law and rules of equity, such that HKDPB can have the priority to recover from, or out of the assets of, the bank the amount of compensation already paid to the depositor.

8. Clause 8(1) of the Bill amends the existing section 38(1)(a) of the Ordinance to reflect that the extent of the HKDPB's subrogation under the gross payout approach with reference to the "aggregate amount" of compensation as defined in the new subsection (7) (as added by Clause 8(8) of the Bill). The opportunity is taken to change the word "*notwithstanding*" to "*despite*", in accordance with the latest drafting conventions adopted by the Department of Justice. The proposed expression "*despite any rule of law*" in clause 8(1) does not affect in any way the concept of subrogation under section 38(1)(a) as it was before the amendment. Having reviewed the drafting of the provision, the Department of Justice is of the view that the current formulation is the most appropriate in reflecting the intent as mentioned in paragraph 7 above. We do not see the need to amend clause 8(1) of the Bill.

Financial Services and the Treasury Bureau
Hong Kong Monetary Authority
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3 The expression "*notwithstanding any rule of law*" also appears in other legislation of Hong Kong, for example, in sections 54(2) and 56(2)(b) of Criminal Procedure Ordinance (Cap. 221).