

LEGISLATIVE COUNCIL BRIEF

Deposit Protection Scheme Ordinance (Chapter 581)

Deposit Protection Scheme (Amendment) Bill 2015

INTRODUCTION

At the meeting of the Executive Council on 10 November 2015, the Council **ADVISED** and the Chief Executive **ORDERED** that the Deposit Protection Scheme (Amendment) Bill 2015 (“the Bill”), at **Annex**, should be introduced into the Legislative Council (“LegCo”) to accelerate both the determination of the amount of compensation payable to affected depositors and the notification to such depositors when the Deposit Protection Scheme (“DPS”) is triggered under the Deposit Protection Scheme Ordinance (“the Ordinance”).

JUSTIFICATIONS

2. The importance of having a sufficiently robust deposit protection regime, being part of the safety net in the banking system, was evident in the global financial crisis in 2007/08. Depositors’ confidence in the banking system hinged on the effectiveness of the deposit protection mechanism, among other safeguards in the market regulatory framework. In the aftermath of the crisis, deposit insurers in major markets have undertaken reforms to strengthen their deposit protection regimes and develop capacity to make prompter payouts so as to mitigate any possible repercussion of the crisis and any future ones. In particular, a number of member jurisdictions of the Financial Stability Board (“FSB”)¹ have adopted a gross payout approach directly or changed to such an approach from a net payout approach in order to speed up the payout process².

¹ The Financial Stability Board (“FSB”), established by the Group of Twenty, is a leading international forum for the promotion of financial stability and financial regulatory reforms. As an international financial centre, Hong Kong is a member jurisdiction of the FSB, and is actively pursuing reforms proposed by the FSB to contribute to global financial stability.

² We understand that 16 major markets out of 24 FSB member jurisdictions are adopting a gross payout approach. These include Argentina, Australia, Brazil, Canada, Mainland China, France, Germany, Italy, Japan, Mexico, the Netherlands, Singapore, Spain, Switzerland, Turkey and the United Kingdom.

The adoption of a gross payout approach will enable depositors to be compensated an amount up to the protection limit, without having to set off against the depositors' assets their liabilities owed to the same bank at the time of the payout determination.

3. Notwithstanding that that Hong Kong has a very resilient banking system and regulatory framework and that the DPS has not been triggered since its launch by the Hong Kong Deposit Protection Board ("HKDPB") in 2006, as noted in the recent assessment by the International Monetary Fund³, the existing set off requirement under the Ordinance⁴ is an impediment to shortening the payout timeframe to seven days, which is a target shared by other deposit insurance schemes in comparable markets (including the United Kingdom and Singapore).

4. We therefore propose switching the compensation determination approach under the Ordinance from a net basis to a gross basis. With the adoption of a gross payout approach (i.e. without setting off the depositors' liabilities against their protected deposits in determining the amount of compensation), it is expected that the HKDPB will be able to make full compensation payments to depositors, in relation to the protected deposits placed with the relevant bank up to the current protection limit (i.e. \$500,000 per person per licensed bank at present), within seven days under most circumstances, as compared to the prevailing target of making an interim payment within two weeks and settling the remaining payment to depositors in six weeks (depending on the complexity of the bank's operation). Consequently, we propose that the HKDPB should be allowed to recover from the relevant bank's assets the gross amount of compensation paid to the depositors and to collect from banks contributions to the Deposit Protection Scheme Fund ("DPS Fund") according to the gross amount of relevant deposits placed with the banks.

5. The adoption of a proposed gross payout approach will not extinguish a depositor's liabilities owed to the relevant bank. Any amount of deposit in

³ In 2013, the Financial Sector Assessment Programme ("FSAP") led by the International Monetary Fund completed a review of the crisis management and bank resolution framework in Hong Kong, including the functioning of the DPS in contributing to financial stability. The FSAP concluded that the DPS was transparent and trusted; and recommended the Hong Kong authorities to consider changing the present net payout approach to a gross payout approach to achieve swifter payouts when the DPS was triggered.

⁴ Under section 27 of the Ordinance, when the DPS is triggered in Hong Kong, the amount of compensation payable to a depositor is determined by calculating the aggregate amount of protected deposits after setting off liabilities owed by the depositor to the relevant bank and contingent liabilities, plus or minus any accrued interest on deposits or liabilities. Under section 38 of the Ordinance, after paying out the compensation to a depositor, the HKDPB will be subrogated to all the rights and remedies of the depositor in relation to the deposits with the relevant bank (to the extent of the net amount of compensation and the interest accrued thereon); and will be entitled to an reimbursement in full in relation to the paid compensation from the relevant bank or its liquidator out of the assets of that bank. In other words, the determination of the compensation payable to depositors and the reimbursement of the compensation paid by the HKDPB are both carried out on a net basis.

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 bank or its liquidator after receiving the deposit compensation from the HKDPB. The current creditor hierarchy in the insolvency of a bank under the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Chapter 32) will remain unchanged⁵.

6. With a simpler and easily comprehensible compensation determination process under the gross payout approach, depositors will have quicker access to compensation payment in relation to the protected deposits and be assured of deposit compensation in case the DPS is triggered. This in turn can reinforce the effectiveness of the DPS as part of the safety net to maintain banking stability and reduce any contagion effect resulting from a banking crisis. While no adjustment to the level of premium rates currently applicable to banks is proposed⁶, contributions to be paid by some banks may increase as the amount of relevant deposits is to be calculated on a gross basis, although the magnitude should not be significant. Individual banks are expected to benefit from lower IT maintenance and compliance costs because of the streamlined data maintenance requirements under the gross payout approach.

7. In addition, we propose taking this opportunity to make certain refinements to the operation of the DPS as follows –

- (a) providing more certainty to the determination of the reference date used for calculating the deposit compensation amount (as explained in paragraph 8 below); and
- (b) enabling the use of electronic communication by the HKDPB, in addition to the conventional paper-form communication, to notify depositors of the compensation arrangements (as explained in paragraph 9 below).

8. Regarding paragraph 7(a) above, we propose aligning the “quantification

⁵ It is theoretically possible that, if a compensated depositor subsequently defaults on his or her liabilities owed to a failed bank, there could be a potential reduction in liquidated assets to be recovered by a liquidator of the bank for distribution to creditors. But statistics collected from major retail banks in Hong Kong show that most deposits are unencumbered and therefore not subject to set off. Together with the chronically low charge off rates of liabilities, it is envisaged that such potential reduction in liquidated assets under a gross payout approach would be marginal.

⁶ 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.

date”⁷ with the date of the “specified event” that triggers the DPS. This will remove any unnecessary uncertainty in connection with the determination of the amount of compensation during a payout process which may be complicated by the administrative and legal procedures in relation to the appointment of a provisional liquidator in respect of the failed bank. Under section 22 of the Ordinance, a “specified event” occurs when (a) a winding-up order is made by the Court of First Instance in respect of a bank; or (b) the Monetary Authority serves on the HKDPB a notice of its decision that the DPS should be triggered⁸, whichever is the earlier.

9. Regarding paragraph 7(b) above, we propose empowering the HKDPB to send notices to depositors on the compensation decisions in electronic form as this can improve operational efficiency and shorten the timeframe for compensation payouts to the depositors. Such electronic notices will be issued to those depositors who are used to receiving electronic communication from the bank concerned. Conventional paper notices will be issued to the rest of the affected depositors⁹.

THE BILL

10. The main provisions of the Bill are as follows –

- (a) **Clause 3** amends section 25 of the Ordinance to revise the definition of “quantification date” to mean the date of the “specified event” (paragraph 8 above);

⁷ The DPS compensation covers both the principal balance and interest accrued on the protected deposits. Where deposits are denominated in currencies other than the Hong Kong dollar, the compensation payable to depositors will be converted into Hong Kong dollars. The interest will be accrued up to the quantification date, and the exchange rate used to convert a non-Hong Kong dollar deposit is the market exchange rate on the quantification date.

⁸ Under section 22(2) of the Ordinance, the Monetary Authority may, after consultation with the Financial Secretary, decide that compensation should be paid from the DPS Fund to the depositors of a Scheme member and shall serve on the HKDPB a written notice of his decision, if –

- (a) in respect of the Scheme member –
- (i) a Manager has been appointed under section 52 of the Banking Ordinance (Chapter 155);
or
 - (ii) a provisional liquidator has been appointed; and
- (b) the Monetary Authority is of the opinion that the Scheme member –
- (i) is likely to become unable to meet its obligations;
 - (ii) is about to suspend payment to its depositors; or
 - (iii) is insolvent, has ceased to pay its debts in the ordinary course of business, or cannot pay its debts as they become due.

⁹ In determining whether to issue electronic notices to the affected depositors, the HKDPB will take reasonable steps to satisfy itself that any electronic notices so sent will reasonably come to the attention of the relevant depositors. For depositors who are not identified by the HKDPB for notification by electronic means (including those affected depositors who do not use electronic banking services), the HKDPB will maintain the existing established practice to send them paper-form notices. Also, the HKDPB will provide a paper notice to depositors who have received an electronic notice after the disbursement of compensation for record purposes.

- (b) **Clause 4** amends section 27 of the Ordinance so that, in determining the amount of compensation a person is entitled to from the DPS Fund, liabilities owed by a person to the bank are not taken into account (paragraph 4 above);
- (c) **Clause 5** amends section 32 of the Ordinance to enable the HKDPB to issue electronic notices to affected depositors (paragraph 9 above);
- (d) **Clause 8** amends section 38 of the Ordinance so that the HKDPB is entitled to recover from, or out of the assets of, the bank the aggregate amount of compensation already paid to a depositor under the gross payout approach. Any law, right or obligation with regard to, or having the effect of, set off is dis-applied, in relation to the rights and remedies of the depositor, to which the HKDPB is subrogated, up to that aggregate amount (paragraphs 4-5 above);
- (e) **Clauses 6 to 9 and 11** contain consequential amendments to sections 35, 37, 38 and 48 of, and Schedule 4 to, the Ordinance; and
- (f) **Clause 10** provides for transitional matters¹⁰.

LEGISLATIVE TIMETABLE

11. The legislative timetable will be –

Publication in the Gazette	13 November 2015
First Reading and commencement of Second Reading debate	25 November 2015
Resumption of Second Reading debate, committee stage and Third Reading	to be notified

¹⁰ We propose that the provisions contained in the Bill, subject to the passage by LegCo, should come into operation on the day when the Amendment Ordinance is published in the Gazette (i.e. the commencement date). In relation to the transitional arrangement, the existing provisions in the Ordinance concerning the net payout approach will still apply to (a) all matters arising from, in relation to or as a consequence of a “specified event” that has occurred before the commencement date; (b) the determination of the amount of build-up levy payable by a bank for the year of 2016; and (c) the calculation of the amount of contribution payable by a new Scheme member for the year of 2016.

IMPLICATIONS OF THE PROPOSALS

14. The Bill is in conformity with the Basic Law, including the provisions concerning human rights. It has no productivity, environmental, civil service, financial, family or gender implications. The amendments proposed in the Bill will not affect the current binding effect of the Ordinance.

Economic and sustainability implications

15. On economic implications, the proposed adoption of the gross payout approach and other measures to achieve speedier payouts can further enhance the effectiveness and efficiency of the DPS as a key component of the financial safety net. While contributions to be paid by some banks may increase as a result of the switch to the gross payout approach, the proposal would help contribute to the stability and resilience of the banking and financial systems and strengthen the status of Hong Kong as an international financial centre.

16. It has no sustainability implication other than those set out above.

PUBLIC CONSULTATION

17. We conducted a public consultation on the proposals contained in paragraphs 4 to 9 above from September to December 2014, and received 17 submissions. The submissions indicated broad support for the proposals. In particular, the banking industry notes that the proposed adoption of the gross payout approach will increase the payout efficiency and accelerate the compensation process. It will also streamline banks' work on information management regarding depositors' liabilities. Some respondents acknowledge that the impact of the gross payout approach on the liquidation regime for banks would be minimal. We issued the Consultation Conclusions on 8 May 2015.

18. We briefed the LegCo Panel on Financial Affairs on these proposals on 4 May 2015. The Panel supported the proposals contained in this Bill. Questions were raised in relation to the impact of the gross payout approach on the insolvency of a bank, the operational detail of the electronic notices, and the compensation coverage of the DPS.

PUBLICITY

19. We will issue a press release upon the gazettal of the Bill, and arrange a spokesperson to answer media enquiries.

BACKGROUND

20. The DPS was fully launched in 2006 to provide protection for depositors and contribute to banking stability by reducing the risks of any bank runs and potential contagion during a banking crisis. The DPS is operated by the HKDPB, a statutory body established under the Ordinance. All licensed banks, unless exempt by the HKDPB, are Scheme members of the DPS. The current compensation limit of the DPS, at \$500,000 per depositor per bank, provides full coverage for around 90% of depositors in Hong Kong. In general, most types of deposits, including deposits denominated in Renminbi or foreign currencies, are covered by the DPS as “protected deposits”. Structured deposits, offshore deposits, bearer form deposits, and time deposits with an original term to maturity longer than five years, are not covered. The DPS is funded by contributions from Scheme members. The DPS has not been triggered since its establishment.

ENQUIRIES

21. Enquiries relating to the brief can be directed to Mr Jackie Liu, Principal Assistant Secretary for Financial Services and the Treasury (Financial Services), at 2810 2067.

Financial Services and the Treasury Bureau
11 November 2015

Deposit Protection Scheme (Amendment) Bill 2015

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A BILL

To

Amend the Deposit Protection Scheme Ordinance to adopt a gross payout approach to determine the amount of compensation payable to a depositor and to recover the amount of compensation paid; to revise the definition of *quantification date*; to enable the Board to notify affected depositors by electronic means; and to make consequential and minor technical amendments.

Enacted by the Legislative Council.

1. Short title

This Ordinance may be cited as the Deposit Protection Scheme (Amendment) Ordinance 2015.

2. Deposit Protection Scheme Ordinance amended

The Deposit Protection Scheme Ordinance (Cap. 581) is amended as set out in sections 3 to 11.

3. Section 25 substituted

Section 25—

Repeal the section

Substitute

“25. Quantification date

In this Part—

quantification date (截算日), in relation to a Scheme member, means the date on which the specified event

occurred in relation to the Scheme member under section 22(1).”.

4. **Section 27 amended (entitlement to compensation: general)**

(1) Section 27—

Repeal subsection (3)

Substitute

“(3) In subsections (1) and (2)—

specified amount (指明款額), in relation to compensation to which a person is entitled from the Fund, means the aggregate of—

- (a) the total amount of protected deposits to which the person is entitled as at the quantification date; and
- (b) the interest accrued on that amount calculated up to and including the quantification date.”.

(2) Section 27(4)(a)—

Repeal

“or liabilities are not”

Substitute

“is not”.

(3) Section 27(4)(a)—

Repeal

“or liabilities shall”

Substitute

“is to”.

(4) Section 27(4)(a), after “Board;”—

Add

“and”.

(5) Section 27(4)—

Repeal paragraphs (b) and (c).

(6) Section 27(4)(d)—

Repeal

“, or liabilities,”.

5. **Section 32 amended (Board’s duties and powers on occurrence of specified event)**

(1) After section 32(7)—

Add

“(7A) Subject to subsection (7B), the Board may comply with subsection (7)(a) by issuing the notice to the depositor in hard copy form or in electronic form.

(7B) The Board must—

- (a) have regard to the matters the Board considers relevant in the circumstances in deciding whether to issue to the depositor a notice in hard copy form or in electronic form; and
- (b) take reasonable steps to satisfy itself that a notice in electronic form will come to the attention of the depositor.”.

(2) Section 32(8), Chinese text, definition of ~~經理~~—

Repeal the full stop

Substitute a semicolon.

(3) Section 32(8)—

Add in alphabetical order

“*in electronic form* (電子形式) means in the form of an electronic record, being a record generated in digital form by an information system, which can be—

- (a) transmitted within an information system or from one information system to another; and
- (b) stored in an information system or other medium;

in hard copy form (印本形式) means in a paper form or similar form capable of being read;”.

6. **Section 35 amended (maximum amount of compensation payable to a depositor)**

Section 35(b)—

Repeal

“27(4)(c) or (d)”

Substitute

“27(4)(d)”.

7. **Section 37 amended (recovery of payment by Board)**

Section 37(5)—

Repeal

“27(4)(c) or (d)”

Substitute

“27(4)(d)”.

8. **Section 38 amended (subrogation)**

(1) Section 38(1)—

Repeal paragraph (a)

Substitute

“(a) subject to subsection (2) and despite any rule of law, the Board is subrogated, to the extent of the aggregate amount, to all the rights and remedies of the depositor in

relation to all the depositor’s deposits with the Scheme member, in priority over—

- (i) the rights and remedies of the depositor in relation to those deposits; and
- (ii) the rights and remedies of any person who is subrogated, whether or not before the Board’s subrogation, to the rights and remedies mentioned in subparagraph (i); and”.

(2) Section 38(1)(b)—

Repeal

“net amount of that payment and any interest accrued on that net amount in accordance with this section”

Substitute

“aggregate amount”.

(3) Section 38(1)(b)—

Repeal

“of the depositor in relation to those deposits”

Substitute

“mentioned in paragraph (a)(i)”.

(4) After section 38(1)—

Add

“(1A) Subsections (1B) and (1C) apply in relation to the recovery by the Board of a payment of compensation made to a depositor of a Scheme member from the Fund, whether or not the Scheme member is wound up.

(1B) Without limiting section 37, the Board is entitled to recover from, or out of the assets of, the Scheme member the aggregate amount in accordance with subsection (1C).

(1C) For the purposes of subsection (1B), the following do not apply in relation to the rights and remedies of the depositor, to which the Board is subrogated, up to the aggregate amount—

- (a) any law relating to set off (including section 35 of the Bankruptcy Ordinance (Cap. 6) or that section as applied under section 264 of the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32)); and
- (b) any right or obligation (however arising) with regard to set off or that has the effect of set off.”

(5) Section 38(5)—

Repeal

“subsection (1)(a)”

Substitute

“this section”.

(6) Section 38(5)(c)—

Repeal

“net amount of that payment and the interest accrued on that net amount in accordance with this section”

Substitute

“aggregate amount”.

(7) After section 38(6)—

Add

“(6A) This section applies to all the depositor’s deposits with the Scheme member, whether or not they are protected deposits.”.

(8) Section 38—

Repeal subsection (7)

Substitute

“(7) In this section—

aggregate amount (合計總額) means—

- (a) the net amount; and
- (b) any interest accrued on that amount calculated in accordance with subsection (5);

net amount (淨額), in relation to a payment of compensation made to a depositor of a Scheme member from the Fund, means the amount of the payment less the amount of excess, if any, that has been recovered by the Board from the depositor under section 37(3).”.

9. **Section 48 amended (power of Board to obtain information)**

(1) Section 48(2)(a), after “member;”—

Add

“and”.

(2) Section 48(2)—

Repeal paragraph (b).

(3) Section 48(2)(c)—

Repeal

“and liabilities (if any)”.

10. **Section 57 added**

After section 56—

Add

“57. **Transitional provisions in relation to Deposit Protection Scheme (Amendment) Ordinance 2015**

(1) In this section—

commencement date (生效日期) means the date of commencement of the Deposit Protection Scheme (Amendment) Ordinance 2015 (of 2015);

former Ordinance (《原有條例》) means this Ordinance as in force immediately before the commencement date;

specified event (指明事件) means a specified event within the meaning of section 22(1).

- (2) The former Ordinance applies to all matters arising from, in relation to, or as a consequence of, a specified event that has occurred before the commencement date.
- (3) The provisions of the former Ordinance specified in subsection (4) continue to apply—
 - (a) for determining the amount of build-up levy payable by a Scheme member under section 3(5) of Schedule 4 for the year of 2016; and
 - (b) for calculating the amount of contribution payable by a new Scheme member under section 6(1) of that Schedule for the year of 2016.
- (4) The provisions of the former Ordinance specified for the purposes of subsection (3) are—
 - (a) section 48(2);
 - (b) the definition of *amount of relevant deposits* in section 1(1) of Schedule 4; and
 - (c) section 1(2) of that Schedule.”.

11. Schedule 4 amended (contributions to Fund)

- (1) Schedule 4—

Repeal

“& 54]”

Substitute

“, 54 & 57]”.

- (2) Schedule 4, section 1(1), definition of *amount of relevant deposits*—

Repeal

“the amount by which” (wherever appearing).

- (3) Schedule 4, section 1(1), definition of *amount of relevant deposits*, paragraph (a)—

Repeal

“exceeds the amount of relevant liabilities owed by the person to the Scheme member (if any)”.

- (4) Schedule 4, section 1(1), definition of *amount of relevant deposits*, paragraph (b)—

Repeal

“exceeds the amount of relevant liabilities owed by the depositor, as the bare trustee under that bare trust, to the Scheme member (if any)”.

- (5) Schedule 4, section 1(1), definition of *amount of relevant deposits*, paragraph (c)—

Repeal

“exceeds the amount of relevant liabilities owed by the depositor to the Scheme member under that client account (if any)”.

- (6) Schedule 4, section 1(1), definition of *amount of relevant deposits*, paragraph (d)—

Repeal

“exceeds the amount of relevant liabilities owed by the depositor, as the trustee under that trust, to the Scheme member (if any)”.

- (7) Schedule 4, section 1(2)(b)(ii), after “partnership;”—

Add

“and”.

- (8) Schedule 4, section 1(2)(c)—

Repeal the semicolon

Substitute a full stop.

- (9) Schedule 4, section 1(2)—

Repeal paragraphs (d), (e) and (f).

Explanatory Memorandum

The main object of this Bill is to amend the Deposit Protection Scheme Ordinance (Cap. 581) (*Ordinance*) to enhance the Deposit Protection Scheme by adopting a gross payout approach in determining the amount of compensation payable to depositors and in recovering the amount of compensation paid. The Bill also proposes to revise the definition of *quantification date* and to enable the Hong Kong Deposit Protection Board (*Board*) to issue electronic notices to affected depositors.

2. Clause 1 sets out the short title.
3. Clause 3 amends section 25 of the Ordinance to revise the definition of *quantification date* to mean the date of the specified event.
4. Clause 4 amends section 27 of the Ordinance so that, in determining the amount of compensation to which a person is entitled from the Deposit Protection Scheme Fund, liabilities owed by the person to the failed Scheme member are not taken into account.
5. Clause 5 amends section 32 of the Ordinance to enable the Board to issue electronic notices to affected depositors.
6. Clause 8 adds section 38(1A), (1B) and (1C) to the Ordinance to provide for the amount recoverable by the Board from, or out of the assets of, the Scheme member under the gross payout approach. The Board is entitled to recover any net amount of compensation payment made to the depositor and any interest accrued on that amount. For that purpose, any law relating to, or right or obligation with regard to, set off is disappplied. Clause 8 also adds section 38(6A) to the Ordinance to provide that section 38 applies to all the depositor's deposits with the Scheme member.

7. Clauses 6, 7, 8, 9 and 11 contain consequential amendments to sections 35, 37, 38 and 48 of, and Schedule 4 to, the Ordinance respectively.
8. Clauses 4 and 8 contain minor technical amendments.
9. Clause 10 adds section 57 to the Ordinance to provide for transitional matters.