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**Legislative Council**

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**Paper for the House Committee meeting on 22 January 2016**

**Report of the Bills Committee on  
Deposit Protection Scheme (Amendment) Bill 2015**

**Purpose**

This paper reports on the deliberations of the Bills Committee on Deposit Protection Scheme (Amendment) Bill 2015 ("the Bills Committee").

**Background**

Deposit Protection Scheme Ordinance and the Deposit Protection Scheme

2. The Deposit Protection Scheme Ordinance (Cap. 581) ("DPSO") was enacted in May 2004, and the Hong Kong Deposit Protection Board<sup>1</sup> ("HKDPB") was formed in July 2004. The Deposit Protection Scheme ("DPS") commenced operation in September 2006 with a view to providing compensation to depositors under certain circumstances in respect of deposits maintained with banks that are members of DPS and contributing to general banking stability by reducing the risks of bank runs and potential contagion during a banking crisis.

3. The salient features of DPS are as follows –

- (a) all licensed banks are DPS members unless exempted by HKDPB<sup>2</sup>;
- (b) a Deposit Protection Scheme Fund ("DPS Fund") is established through contributions collected from DPS members. The target size of the DPS Fund is 0.25% of the total amount of protected

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<sup>1</sup> HKDPB is a statutory body established under DPSO to establish and maintain DPS.

<sup>2</sup> Restricted licence banks and deposit-taking companies are not members of DPS.

deposits maintained with all DPS members, or approximately \$4.3 billion based on the current level of total protected deposits;

- (c) deposits denominated in Hong Kong dollar, Renminbi or any other currencies are protected<sup>3</sup>;
- (d) the compensation limit under DPS, at \$500,000<sup>4</sup> per depositor per bank, provides full coverage for around 90% of depositors in Hong Kong. Compensation from the DPS Fund should be paid to depositors of a DPS member if a winding-up order has been made by the Court of First Instance in respect of the DPS member or the Hong Kong Monetary Authority ("HKMA") has decided that compensation should be paid from the DPS Fund to the depositors of the DPS member and has served a notice of its decision on HKDPB accordingly; and
- (e) a depositor's entitlement to compensation, upon the triggering of DPS pursuant to (d), will be calculated on a net basis, that is, the liability of the depositor to a bank will be deducted from the protected deposits he or she maintains with the bank in determining compensation (i.e. the net payout approach).

DPS has not been triggered since its launch in 2006.

#### Review of the Deposit Protection Scheme

4. Depositors' confidence in the banking system hinges on the effectiveness of the deposit protection mechanism among other safeguards in the market regulatory framework. According to the Administration, since the global financial crisis in 2007-2008, there has been a trend for more member jurisdictions of the Financial Stability Board (e.g. the Mainland, the United Kingdom, the Netherlands, Singapore and Australia), to adopt directly or change from a net payout to a gross payout approach to speed up the payout process when making compensation to depositors. In 2013, the Financial Sector Assessment Program led by the International Monetary Fund completed a review of crisis management and bank resolution framework in Hong Kong

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<sup>3</sup> According to section 34 of DPSO, compensation payable shall be paid in Hong Kong dollars regardless of the currency in which the protected deposit concerned is denominated. Certain types of deposit are not protected by DPS, including time deposits with a maturity longer than five years, structured deposits (such as foreign currency-linked and equity-linked deposits), bearer instruments (such as bearer certificates of deposit) and offshore deposits. DPS members are required to notify customers if a financial product has been described as a deposit but is not protected by DPS.

<sup>4</sup> The protection limit of DPS was originally \$100,000 and was raised to \$500,000 with effect from 1 January 2011 with enactment of the Deposit Protection Scheme (Amendment) Ordinance 2010.

and recommended Hong Kong to consider, among other things, changing the present rule of netting in compensation determination to achieve a swifter payout.

5. The Financial Services and the Treasury Bureau and HKMA consulted the public in September 2014 on the proposals for enhancing the operation of DPS to achieve a faster and more effective payout for depositors. According to the Administration, responses received during the consultation indicated broad support for the proposals.

#### Proposed amendments to DPSO

6. Against the above-mentioned background, the Administration proposes to amend DPSO with a view to –

- (a) adopting a gross payout approach to determine the amount of DPS compensation payable to a depositor (i.e. a depositor will be compensated an amount up to the DPS protection limit without setting off the depositor's liabilities to the same bank);
- (b) providing more certainty for the determination of the quantification date<sup>5</sup> to facilitate the calculation of the deposit compensation amount; and
- (c) enabling the use of electronic communication by HKDPB, in addition to the conventional paper-form communication, to notify depositors of the compensation arrangements, in case DPS is triggered.

#### **The Deposit Protection Scheme (Amendment) Bill 2015**

7. The Bill was published in the Gazette on 13 November 2015 and received the First Reading at the Legislative Council ("LegCo") meeting on 25 November 2015. The main provisions of the Bill are as follows –

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<sup>5</sup> The quantification date is currently defined in section 25 of DPSO as the date of the appointment of a provisional liquidator in respect of a failed bank, unless HKDPB specifies the DPS trigger date as the quantification date on the basis that HKDPB –

- (a) has knowledge that a provisional liquidator will not be appointed;
- (b) is of the opinion that it is uncertain whether a provisional liquidator will be appointed; or
- (c) is of the opinion that an appointment of a provisional liquidator will take so long as to unduly delay the payment of compensation to the depositors of the Scheme member by HKDPB.

- (a) Clause 3 amends section 25 of DPSO to revise the definition of "quantification date" to mean the date of the "specified event";
- (b) Clause 4 amends section 27 of DPSO 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;
- (c) Clause 5 amends section 32 of DPSO to enable HKDPB to issue electronic notices to affected depositors;
- (d) Clause 8 amends section 38 of DPSO so that 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 HKDPB is subrogated, up to that aggregate amount;
- (e) Clauses 6 to 9 and 11 contain consequential amendments to sections 35, 37, 38 and 48 of, and Schedule 4 to, DPSO; and
- (f) Clause 10 provides for transitional matters.

The Bill contains no commencement provision. By virtue of section 20(2)(a) of the Interpretation and General Clauses Ordinance (Cap. 1), the Bill, if enacted, will come into operation on the day the enacted ordinance is published in the Gazette.

### **The Bills Committee**

8. The House Committee agreed at its meeting on 27 November 2015 to form a Bills Committee to study the Bill. The membership list of the Bills Committee is in **Appendix I**. Under the chairmanship of Hon Christopher CHEUNG Wah-fung, the Bills Committee has held one meeting to discuss the Bill with the Administration. It has invited relevant organizations, the public and the 18 District Councils to give written views on the Bill. A list of organizations which have given views to the Bills Committee is in **Appendix II**.

## **Deliberations of the Bills Committee**

9. The Bills Committee supports the Bill. The major deliberations of the Bills Committee are set out in the ensuing paragraphs.

### Banking sector's views on the gross payout approach

10. Members note that it is possible that the amount of annual contribution of some banks to the DPS Fund might increase as a result of a higher level of protected deposits when calculated on a gross basis. To ascertain the extent to which the banking sector supports the Bill, Mr NG Leung-sing has sought information on the views expressed by licensed banks during the Administration's consultation with them on the proposed gross payout approach.

11. The Administration has advised that during its public consultation 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 DPSO. 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 also result in streamlining banks' work on record management as they would no longer need to provide information of depositors' liabilities to HKDPB. According to the Administration, HKAB was content with the provisions contained in the Bill.

12. The Administration has further advised that there would not be any adjustment to the level of premium rates currently applicable to banks<sup>6</sup> under the gross payout approach. The Administration considers 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 DPS Fund reaching its target fund size. Regarding the possibility 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 Administration has estimated that such increase, if any, would be moderate, on average being about 10% more than that under the existing net payout approach. That said, there would be possible reduction in information technology and compliance costs for banks as a result of the simplified data maintenance, reporting and verification requirements.

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<sup>6</sup> In accordance with Schedule 4 to DPSO, 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 HKMA. At present, the DPS Fund stands at about \$2.8 billion.

According to Administration, the overall cost impact of the gross payout approach on banks should not be material.

### Impact on depositors

13. The Bills Committee has studied the impact that the liquidation of a bank would have on its debtors under the proposed gross payout approach. Mr Steven HO has expressed concern whether and how the adoption of the proposed gross payout approach would affect the rights of the depositors who are also debtors (e.g. mortgagors) of a failed bank. Mr Andrew LEUNG has pointed out that in the case debtors of a failed bank are required to repay their debts immediately to the liquidator, it will not be easy particularly for young flat owners, who have rather limited cash, and small and medium enterprises as well. The reason is that those debtors may need to secure loans from other financial institutions for the repayment hence facing the additional interest burden incurred. In this connection, the Bills Committee has sought information on the possible situations that depositors, particularly those also having debts owed to the bank (e.g. mortgagors), would face if the proposed legislative amendments are enacted.

14. The Administration has advised that 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.

15. 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).

16. The Administration has further advised 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 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. 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.

#### Impact on winding-up procedures of a bank

17. The Bills Committee has examined the extent to which the proposed gross payout approach may impact on the winding-up procedures of a bank, and noted that 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. Mr Andrew LEUNG has suggested that the Administration put in place policy and guidelines for regulating liquidators' handling of debts owed to a failed bank.

18. The Administration has advised that the purpose of introducing the gross payout approach is to speed up the compensation process under 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. The Administration has further advised that 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.

#### Drafting issues

##### *Drafting of section 38(1)(a) of DPSO (Clause 8 of the Bill)*

19. Under the existing section 38(1)(a) of DPSO, 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 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 HKDPB's subrogation, to such rights and remedies of the depositor in question. While Mr Alan LEONG is content with the arrangement for HKDPB's subrogation, he considers that the expression "despite any rule of law" in the proposed section 38(1)(a) (amended by Clause 8(1) of the Bill) appears to override all other laws in Hong Kong. He has requested the Administration to review the appropriateness of the expression in the context of the proposed section.

20. The Administration has advised that the expression "notwithstanding any rule of law" in the existing subsection 38(1)(a) of DPSO has, at present, the effect of ensuring that HKDPB'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. Clause 8(1) of the Bill seeks to amend the existing section to reflect the extent of 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).

21. The Administration has explained that, in drafting the Bill, it has taken the opportunity 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 above-mentioned intent. As such, the Administration has advised that it does not see the need to amend Clause 8(1) of the Bill.

#### *Other drafting issues*

22. The Bills Committee has examined Bill clause by clause and noted the enquiries raised by the Legal Adviser to Bills Committee<sup>7</sup> on certain drafting issues and the Administration's response on those issues<sup>8</sup>.

#### Future reviews

23. The Bills Committee has also noted the views of the Consumer Council that the DPS protection limit should be reviewed periodically to ensure its effectiveness in safeguarding the interests of depositors and that DPS should be extended to cover deposits placed with restricted licence banks ("RLBs") and

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<sup>7</sup> Issued vide LC Paper No. CB(1)320/15-16(01).

<sup>8</sup> Issued vide LC Paper No. CB(1)377/15-16(01).



deposit-taking companies ("DTCs"). The Administration has responded that the DPS protection limit is kept under review from time to time to ensure the on-going efficiency and effectiveness of the DPS. As a result of the last review, the DPS protection limit was raised from \$100,000 to \$500,000 with effect from 2011. Currently, about 90% of depositors are fully protected by DPS, in line with the policy objective based on current international best practices that the vast majority of depositors should be fully covered. The Administration has further advised that as most RLBs and DTCs are not engaged in the retail business and their aggregate deposit base is less than 1% of the market total, the extension of DPS to their depositors would not contribute materially to increasing the percentage of depositors protected. HKDPB will continue to educate the public about the scope of the protection offered by the DPS.

### **Resumption of Second Reading debate on the Bill**

24. The Bills Committee will not propose any Committee Stage amendments to the Bill and raises no objection to the resumption of the Second Reading debate on the Bill at the Council meeting of 3 February 2016.

### **Advice sought**

25. Members are invited to note the Bills Committee's deliberations set out above.

Council Business Division 1  
Legislative Council Secretariat  
21 January 2016

**Bills Committee on Deposit Protection Scheme (Amendment) Bill 2015**

**Membership List**

**Chairman** Hon Christopher CHEUNG Wah-fung, SBS, JP

**Members** Hon CHAN Kam-lam, SBS, JP  
Hon Jeffrey LAM Kin-fung, GBS, JP  
Hon Andrew LEUNG Kwan-yuen, GBS, JP  
Hon Cyd HO Sau-lan, JP  
Hon Alan LEONG Kah-kit, SC  
Hon Albert CHAN Wai-yip  
Hon NG Leung-sing, SBS, JP  
Hon Steven HO Chun-yin, BBS  
Hon SIN Chung-kai, SBS, JP  
Hon CHUNG Kwok-pan

(Total : 11 members)

**Clerk** Mr Derek LO

**Legal Adviser** Miss Rachel DAI

**Bills Committee on Deposit Protection Scheme (Amendment) Bill 2015**

**List of organizations which have given views to  
the Bills Committee**

1. Consumer Council
2. Hong Kong Bar Association
3. The DTC Association
4. The Hong Kong Association of Banks