

For information on
6 January 2003

**LEGISLATIVE COUNCIL
PANEL ON FINANCIAL AFFAIRS**

**ESTABLISHMENT OF A DEPOSIT PROTECTION SCHEME
IN HONG KONG**

PURPOSE

This paper presents the Hong Kong Monetary Authority's ("HKMA") latest recommendations on how the proposed Deposit Protection Scheme¹ ("DPS") in Hong Kong should be structured.

BACKGROUND

2. The results of an extensive consultation in late 2000 indicated that there is broad public support for establishing a DPS in Hong Kong. On 13 December 2000, the Legislative Council passed a motion urging the Government to "expeditiously implement a DPS, which is cost effective and easy for depositors to understand, for effectively protecting small depositors, and to formulate appropriate complementary measures aiming at reducing the risk of moral hazard".

3. Having considered the results of the consultation exercise, the Chief Executive in Council approved in principle the establishment of a DPS in Hong Kong on 24 April 2001, and requested the HKMA to work out the detailed designed features of the scheme.

4. Following the Chief Executive in Council's approval, the HKMA has undertaken in-depth studies on how the DPS should be structured, with particular attention to the need to minimise the cost of the scheme and potential moral hazard. In March 2002, a second consultation paper setting out the HKMA's detailed recommendations was released. The consultation exercise closed on 31 May 2002.

5. A total of 20 written submissions were received in the latest consultation from the banking industry, insolvency practitioners, the Consumer

¹ The term deposit insurance scheme was used previously. The Department of Justice, however, has advised that it is more desirable, from a law drafting point of view, to replace it with the term "deposit protection scheme". As a result, the term "insurance premium" will also be changed to "amount of contribution". The change in the terminology will not in any way affect the protection afforded to depositors.

Council and other interested parties. The respondents are generally supportive of the HKMA's proposals. The Hong Kong Association of Banks ("HKAB"), however, has put forward some suggestions aiming at further reducing the cost of the DPS.

PROPOSED MAJOR DESIGN FEATURES

6. The proposed major features of the scheme, which have taken into accounts comments received during the consultation, are described below.

(A) Establishment of the Deposit Protection Board

- (i) The majority of the opinions received from the consultation exercise supported the idea that the DPS in Hong Kong should confine its role to that of a "pay box" to reduce the cost of deposit protection and to avoid duplication of functions with the HKMA as the banking regulator. There was also support for the establishment of a separate legal entity to oversee the operations of the scheme in order to offer greater accountability and transparency to the public.
- (ii) In view of this, it is proposed that a new statutory body should be established by legislation, which should be called the Hong Kong Deposit Protection Board (the "Board") to administer the DPS in Hong Kong. Consistent with the majority views expressed in the public consultation, its functions would be confined to collection of contributions, managing the funds of the DPS, assessing claims made against the fund, making payments to depositors and recovering the payments from the assets of the failed bank. (Detailed functions in [Annex A](#).)
- (iii) It is proposed that the Board would consist of 7 to 10 members appointed by the Chief Executive, comprising lay members (who would be in majority) and three ex-officio members, namely the Secretary for Financial Services and the Treasury (or his representative), the Monetary Authority (or his representative) and the Chief Executive Officer of the Board. The Chairman of the Board would be appointed by the Chief Executive from the lay members.
- (iv) There would be provisions under the DPS legislation that empower the Board to appoint the HKMA as its agent to carry out the day to day administration of the scheme. This is to achieve cost saving as the Board could leverage on the existing IT, staffing and office administration resources of the HKMA.

It would also alleviate the Board of the need to maintain a staff level that is required to handle the workload in the event of a bank failure but otherwise not needed in normal time. Under this arrangement, the HKMA would essentially be acting as an agent of the Board in administering the scheme and would, in this respect, be subject to the oversight of the Board. In keeping with the user-pays principle, the Financial Secretary would be given the power to direct that the costs incurred by the HKMA in administering the scheme should be recovered from the funds of the DPS (DPS Fund) at a rate determined by him. A similar arrangement is also found in the Protection of Wages on Insolvency Fund Scheme. Such arrangement has the support of the Consumer Council and is approved by the Exchange Fund Advisory Committee.

- (v) The Board would observe high standards of corporate governance. Its books and accounts would be subject to regular audits. Its annual budget would need to be approved by the Financial Secretary. The Board would also be required to prepare an annual report and lay it before the Legislative Council every year.
- (vi) The decisions of the Board, particularly those relating to the determination of compensation payments, would be subject to the review of an independent tribunal to be known as the “Deposit Protection Appeals Tribunal”. Members of the tribunal would be appointed by the Chief Executive.

(B) Membership of the DPS

- (i) Participation by licensed banks in the DPS would be mandatory. This is an essential design feature to ensure the viability of the scheme and to avoid the problem of adverse selection whereby only riskier banks would choose to join the scheme.
- (ii) The HKMA has assessed the DTC Association’s suggestion that restricted licence banks (RLBs) and deposit-taking companies (DTCs) should not be excluded from the scheme but should have the option whether to join. Given that RLBs and DTCs are not allowed to take small deposits under the three-tier authorization system, it is considered that there is not a strong case for including these two tiers of institutions in a scheme designed to protect only small depositors. In any case, the entry criteria for a banking licence have recently been relaxed. An RLB or DTC which wishes to take deposits protected under the DPS may seek to upgrade to licensed bank status. For these

reasons, the HKMA remains convinced that membership of the DPS should be confined to licensed banks.

- (iii) An overseas incorporated bank may apply for exemption from participating in the scheme if the deposits taken by the bank's Hong Kong offices are protected by a scheme in the bank's home jurisdiction and the scope and level of protection afforded by that scheme are not less than those afforded to such deposits by the DPS in Hong Kong. However, an exempted bank is required to inform its depositors or prospective depositors that it is not a member of the scheme and therefore any deposits with it are not protected by the DPS in Hong Kong. The bank should also provide details of the protection offered by its home jurisdiction scheme including the level of protection and the types of deposits protected.

(C) Coverage

- (i) Both Hong Kong dollar and foreign currency deposits would be protected by the scheme. The coverage limit would initially be set at \$100,000 per depositor per bank, and would apply to the principal amount of a protected deposit and the interest accrued on that deposit, normally up to the date of appointment of a provisional liquidator for the failed bank². The coverage limit would be reviewed and adjusted as appropriate in the future. There was support from the public consultation (e.g. the banks and the Consumer Council) for the coverage limit to be initially set at HK\$100,000. It is estimated that 84% of the depositors in Hong Kong would have their total deposits fully protected under the scheme.
- (ii) In line with the existing priority claim system, certain deposits such as inter-bank deposits and connected deposits (e.g. those taken by the directors and managers of the failed bank) would be excluded from the protection of the scheme. Details of these excluded deposits are listed in **Annex B**.
- (iii) There would be provisions under the DPS legislation governing how multi-beneficiary accounts such as joint, trust and client accounts would be dealt with under the scheme (please refer to **Annex C**).

² However, there may be situation where this may not be appropriate, e.g. where the Court has decided not to appoint a provisional liquidator, or when the Board is uncertain whether a provisional liquidator will be appointed, or where to wait for such appointment would unduly delay payment by the DPS. In such circumstances, the interest would be accrued up to the date on which payout by the DPS is triggered (see section D).

(D) Trigger criteria

- (i) Payment under the DPS would automatically be triggered where a court order has been made to wind up the bank. It would also be triggered if (a) either the Monetary Authority has appointed a Manager under section 52 of the Banking Ordinance to take over the bank or the court has appointed a provisional liquidator in respect of the bank; and (b) the Monetary Authority, after consultation with the Financial Secretary, has served a written notice on the Board informing the Board of its opinion that the bank is likely to become unable to meet its obligations, or that it is insolvent or about to suspend payment to depositors.

(E) Netting and payout to depositors

- (i) The DPS would be entitled to recover the amount paid to the depositor of a failed bank out of the depositor's ultimate net claim on the assets of the bank in a liquidation. The DPS would have the benefit of the priority status afforded in the liquidation to the deposits in respect of which it had made a payment.
- (ii) In determining the amount of deposit protection payouts, it is proposed that a depositor's liabilities to the failed bank would be fully netted off ("full netting") against his protected deposits in determining his entitlement to compensation under the scheme. This is consistent with the current insolvency law and would reduce the risk that the DPS would pay out more to depositors than it could recover in a liquidation (owing to potential differences in its netting approach from that of the liquidator). The full netting approach is supported by the Standing Committee on Company Law Reform, the Department of Justice, the Official Receiver and major insolvency practitioners.
- (iii) From the perspective of restoring depositor's confidence in the banking system and averting a banking crisis at an early stage, it is proposed that the Board would be given the power to make interim payments to depositors where there is uncertainty as to the exact amount of compensation payable to a depositor or where the time required to ascertain such amount would be so long as to unduly delay the payment to the depositor.

(F) Funding

- (i) An ex ante fund would be established. The target fund size is proposed to be set at 0.3% of the banking sector's total amount of protected deposits, which is equivalent to approximately \$1.6 billion based on the level of protected deposits as at August 2002. In considering the appropriate size of the fund, the aim is to cover potential losses that might be suffered by the scheme³, not the liquidity required for making payouts to depositors. The latter would be met by borrowings from the Exchange Fund (see point (iv) of this section below) or the market.
- (ii) Faced with increasing pressure on bank profitability, HKAB has queried whether there is scope for the target fund size to be reduced. The HKMA has considered HKAB's comment and decided to maintain the target fund size. The reason is that according to HKMA's estimate, the proposed target fund size is consistent with international standards on the adequacy of deposit protection funds. Any significant reduction of the target fund size might undermine the credibility of the scheme.
- (iii) The range of the target fund would be set at +15% and – 30% of the target fund size. Where the balance of the DPS Fund is outside the target fund range, a rebate or surcharge would be triggered in order to bring the fund back within the target range.
- (iv) The Exchange Fund would provide back-up funding to enable the Board to make prompt payment to depositors. The funding provided by the Exchange Fund would represent a loan which would be repaid by the Board and would carry a market-related rate of interest.

(G) Assessment of contributions

- (i) A differential system based on “CAMEL rating⁴” would be used to assess the amount of contributions payable by individual banks. The rates of contribution payable by banks before and after the first year in which the target fund size has been reached would be as follows:-

³ Losses will mainly come from two sources: recovery shortfall, i.e. inability to recover amounts paid to depositors from the estate of the failed bank; and finance cost on the borrowing the DPS has undertaken to finance the payout for the period until the funds are recovered from the failed bank's estate.

⁴ The “CAMEL Rating” is a supervisory rating currently adopted by the HKMA to assess the financial strength and overall soundness of an authorized institution in the areas of Capital, Asset quality, Management, Earning, and Liquidity.

Banks with CAMEL Rating	Rate of contribution payable (as percentage of the balance of protected deposits)	
	Until the 1 st year in which the target fund size is reached	After the 1 st year in which the target fund size is reached
1	0.05%	0.0075%
2	0.08%	0.01%
3	0.11%	0.015%
4 & 5	0.14%	0.02%

- (ii) Given the above schedule of contribution rates, it is expected that the proposed target fund size of \$1.6 billion would be reached in approximately 5 years.
- (iii) There was support from the public consultation for the adoption of a differential system for assessment of contributions so that banks would be rewarded for having strong management and good asset quality, thus helping to address the potential moral hazard risks associated with a DPS.

(H) Investment of DPS Fund

- (i) In keeping with the need for capital preservation and liquidity, the DPS Fund would be allowed to invest only in (a) deposits with the Exchange Fund; (b) Exchange Fund bills; (c) US Treasury bills; and (d) exchange rate and interest rate contracts, including derivative products, which are necessary for hedging purposes.

IMPLEMENTATION

7. In collaboration with the Department of Justice and the Financial Services and the Treasury Bureau, the HKMA has produced a draft Bill for implementing the proposed DPS. The draft Bill is currently under consultation with the industry. Subject to any further comments of the industry and the approval of the Chief Executive in Council, it is expected that the Bill would be introduced into the Legislative Council in the first half of 2003.

8. If the Bill is enacted by the Legislative Council, the DPS project will enter the start-up phase. The Deposit Protection Board will be established to oversee the progress of the whole project. The main preparatory work needed during this start-up phase will include the following:-

- (i) development of a set of rules⁵ governing the detailed operations of the Board in relation to matters such as assessment and collection of contributions and payment of compensation if bank failures occur;
- (ii) specification of the minimum information system requirements for banks to enable the Board to make speedy payment to depositors; and
- (iii) establishment of an effective payout system for the scheme.

9. It is expected that the start-up phase would last for about 12-18 months⁶ before the Board is in a position to provide deposit protection. Assuming the DPS Bill is enacted before the end of 2003, it is expected that the Board could be established in the first half of 2004 and the scheme could commence operations in 2005.

*Hong Kong Monetary Authority
December 2002*

⁵ Most of these rules would be in the form of subsidiary legislation. Sufficient time should be allowed for the law drafting process.

⁶ The HKMA commissioned the Canada Deposit Insurance Corporation to help develop a payout system for the scheme in early 2002. Based on the advice of the Canadian insurer, the development of a payout system for the scheme would take about 12-18 months to complete. This would be the most time consuming part of the preparatory work.