FEATURE ARTICLE

Deposit Protection Scheme Bill

by the Banking Development Department

The Hong Kong Monetary Authority has developed a set of proposals on how the proposed deposit protection scheme in Hong Kong should be structured. These proposals are reflected in the Deposit Protection Scheme Bill, which was introduced into the Legislative Council on 30 April 2003. This article describes the major provisions of the Bill and the rationale behind them.

BACKGROUND

The results of an extensive consultation exercise in late 2000 indicated there was broad public support for establishing a deposit protection scheme (DPS) in Hong Kong. On 13 December 2000, the Legislative Council adopted 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".

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

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 to its members and potential moral hazard. In March 2002, a second consultation paper, setting out the HKMA's detailed recommendations, was released and received general support for its proposals.

Taking into account the results of the studies and the comments received, the HKMA developed a set of proposals that now form part of the Deposit Protection Scheme Bill. A copy of the Bill can be downloaded from the HKMA' s website at www.hkma.gov.hk.

The following paragraphs describe the major provisions of the Bill and the rationale behind them.

ESTABLISHMENT OF DEPOSIT PROTECTION BOARD

Structure and Composition of the Board

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.

In view of this, it is proposed that a Deposit Protection Board should be established by legislation to administer the DPS. Consistent with the majority views expressed in the public consultation, the Board's functions would be confined to collection of contributions, managing the funds of the DPS (DPS Fund), assessing claims made against the Fund, making payments to depositors and recovering the payments from the assets of the failed bank.

The Board would consist of seven to 10 members appointed by the Chief Executive, comprising the Secretary for Financial Services and the Treasury (or his representative), the Monetary Authority (or his representative), the Chief Executive Officer of the Board and four to seven unofficial members, giving the latter members a majority weighting. The Chairman of the Board would be appointed by the Chief Executive from the unofficial members. These arrangements are intended to enhance the independence of the Board.

Governance and Accountability Arrangements

As a statutory body, the Board is expected to observe high standards of corporate governance. Its books and accounts would be subject to regular audit. Its annual budget would need to be approved by the Financial Secretary. The Board would also be required to prepare an annual report and statement of accounts and lay them before the Legislative Council every year.

Performance of Functions

In view of the public and the banking industry's concern about the cost of the DPS, it is proposed that the Board should perform its functions through the HKMA. This is to achieve cost saving from the Board leveraging on the existing IT, staffing and office administration resources of the HKMA. It would also alleviate the need to maintain a staff level that is required to handle the peak workload in the event of a bank failure but otherwise not needed in normal times. 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 DPS Fund at a rate determined by him. A similar arrangement is also found in the Protection of Wages on Insolvency Fund Scheme.

Detailed provisions relating to the Deposit Protection Board are set out in Part 2 and Schedule 2 of the Bill.

MEMBERSHIP OF THE DPS

Mandatory participation is an essential design feature to ensure the viability of the scheme and to avoid the problem of adverse selection whereby only riskier banks, and those perceived to be risky, would choose to join the scheme. Thus all licensed banks would be required to participate in the DPS.

The HKMA has also considered the suggestion of the DTC Association that restricted licence banks (RLBs) and deposit-taking companies (DTCs) should not be excluded from the scheme, but should have the option to decide whether to join. Given that RLBs and DTCs are not allowed to take small deposits under the three-tier authorization system, there is no 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 that wishes to take deposits protected under the DPS could do so if it upgraded to licensed bank status. For these reasons, the HKMA remains convinced that membership of the DPS should be confined to licensed banks.

It is proposed that an overseas incorporated bank should be allowed to seek 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. This would avoid double charging of premiums and help to maintain Hong Kong's attractiveness as an international financial centre. However, an exempted bank would be 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. The exempted bank should also publish details of the protection offered by its home jurisdiction scheme including the level of protection and the types of deposits protected.

Part 3 of the Bill deals with membership of the scheme and the exemption arrangement.

ESTABLISHMENT OF DPS FUND

Funding of the DPS

The DPS would be funded by contributions from its members through the establishment of a DPS Fund. The proposed target fund size of 0.3% of the banking sector's total amount of protected deposits is equivalent to approximately $1.6 billion at current deposit levels. In considering the appropriate size of the fund, the aim is to cover potential losses that might be suffered by the scheme[1], not the liquidity required for making payouts to depositors. In this regard, 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 rate of interest.

Faced with increasing pressure on bank profitability, the banking industry has queried whether there is scope for the target fund size to be reduced. The HKMA considers the size of the proposed fund to be consistent with international standards and any significant reduction might undermine the scheme's credibility. For this reason, the target fund size has not been lowered.

There is scope for the balance of the DPS Fund to fluctuate in a range between +15% and -30% of the target fund size. Where the balance of the Fund falls outside this range, a rebate or surcharge would be triggered in order to bring the balance of the Fund back within the range.

Assessment of Contributions

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 problem. In view of this, it is proposed that a differential system based on "CAMEL ratings"[2] 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:

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

The HKMA has also considered whether the Government should provide an initial contribution to the DPS Fund and absorb the administration cost of the scheme. In keeping with the user-pays principle, it is considered inappropriate for the Government to provide direct subsidies to the scheme. This is consistent with the approach adopted by other leading schemes such as the Canada Deposit Insurance Corporation, where government support for the deposit protection scheme is confined mainly to the provision of back-up liquidity in the event of a bank failure. Nevertheless, in view of the concern about cost, the industry's suggestion that the DPS should outsource the day-to-day administration of the scheme to the HKMA, as a means of cost saving, has been taken on board.

[1] Losses will mainly come from two sources: (i) recovery shortfall, i.e. inability to recover amounts paid to depositors from the assets of the failed bank; and (ii) the interest cost of the borrowing the DPS has undertaken to finance the payout for the period until the funds are recovered from the failed bank's assets.

[2] 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 **C**apital, **A**sset quality, **M**anagement, **E**arning, and **L**iquidity.

Investment of the DPS Fund

In keeping with the need for capital preservation and liquidity, the DPS Fund should only be invested 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.

The above proposals relating to the DPS Fund are contained in Part 4 and Schedule 4 of the Bill.

PROTECTION

Scope and Level of Compensation

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 bank[3]. The coverage limit would be reviewed and adjusted as appropriate in the future. Results from the public consultation supported the proposal that the coverage limit should 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.

Certain deposits such as interbank deposits and connected deposits, for example those taken by the directors and managers of the failed bank, would be excluded from the protection of the scheme.

The DPS legislation would also contain provisions governing how multi-beneficiary accounts such as joint, trust, agent and client accounts would be dealt with under the scheme.

[3] However, there may be situations where this would 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.

Trigger Criteria

Payment under the DPS would automatically be triggered where a court order has been made to wind up a failed bank. It would also be triggered where 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 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.

Netting and Payout to Depositors

Depositors' liabilities to the failed bank would be netted off against their protected deposits in determining 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).

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.

The DPS would be entitled to recover the amount paid to the depositor of a failed bank out of the depositor's 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 paid compensation.

The above proposals relating to the calculation and payment of compensation are set out in Part 5 and Schedule 1 of the Bill.

ESTABLISHMENT OF DEPOSIT PROTECTION APPEALS TRIBUNAL

The decisions and assessments 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". The Tribunal would be chaired by a judge or a retired judge. All members of the Tribunal would be appointed by the Chief Executive. The decisions of the Tribunal would be final except on a point of law. These proposals are contained in Part 6 and Schedule 3 of the Bill.

IMPLEMENTATION

As noted above, the DPS Bill was introduced into the Legislative Council on 30 April 2003. If the Bill is enacted by the Legislative Council, the implementation of the DPS will commence. The Deposit Protection Board will be established to oversee the implementation details. The main preparatory work during the initial start-up phase will include

(a) development of a set of rules to specify, inter alia, the manner in which compensation is to be paid to depositors;

(b) specification of the minimum information system requirements for banks to enable the Board to make speedy payment to depositors; and

(c) establishment of an effective payout system for the scheme (including the related computer system requirements).

It is expected that the start-up phase would last for about 12-18 months[4] before the Board would be in a position to begin to provide deposit protection. If the DPS Bill were to be 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 operation in 2005. The precise timing will, however, be kept under review.

4 The HKMA commissioned the Canada Deposit Insurance Corporation (CDIC) to help develop a payout system for the scheme in early 2002. Based on the advice of CDIC, 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.