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Consultation on the Review of the Deposit Protection Scheme

Hong Kong Deposit Protection Board

Press Release

Consultation on the review of the Deposit Protection Scheme

The Hong Kong Deposit Protection Board (the Board) today (Monday) published a consultation paper on a review of the Deposit Protection Scheme (DPS) conducted by the Board. The consultation paper carries a number of recommendations to enhance the DPS for providing better protection to depositors.

In the light of the experience gained from operating the DPS since its inception and overseas reforms of deposit insurance regime after the outbreak of the US sub-prime crisis, the Board decided in mid-2008 to review the coverage of the DPS. The review commenced in the fourth quarter of 2008 and was completed in the first quarter of 2009 as scheduled. Significant developments in the overseas and local financial markets during the review period were also considered in the review. The review covered protection limit, compensation calculation basis, product coverage, membership and funding arrangements of the DPS.

The review concluded that the existing design features of the DPS in Hong Kong already comply substantially with international best practices. Nevertheless, enhancements that can improve protection to depositors and strengthen the operation of the DPS were identified. The key recommendations and conclusions of the review include:

- the protection limit of the DPS is recommended to be raised from the current HK$100,000 to HK$500,000;

- the product coverage of the DPS is recommended to be expanded to cover secured deposits referable to the provision of banking and financial services;

- the rates for charging contribution on banks are recommended to be halved to neutralise the cost impact of raising the protection limit; and

- no changes are recommended to be made to the basis for calculating deposit compensation , types of institutions covered by the DPS and the current arrangement of excluding structured deposits from protection.

Professor Andrew Chan chi-fai, Chairman of the Board, said that, “The coverage of a deposit protection scheme should be reviewed from time to time to ensure it will remain effective in meeting the objectives intended for it.

Since the DPS commenced operation in 2006, the landscape of the global financial market has undergone significant changes. The proposed enhancements to the DPS are expected to be helpful in enhancing the robustness of the DPS in coping with the changing market conditions and public expectations." Mr Raymond Li, Chief Executive Officer of the Board, added that, "The Board intends to introduce the enhancements as soon as possible, preferably upon the expiry of the full deposit guarantee offered by the Government, so that the public will benefit from an improved DPS as a part of the long term financial infrastructure of Hong Kong".

The full consultation paper can be found at the Board's website (www.dps.org.hk). The Board will take into consideration views received at the consultation in finalising the proposed enhancements to the DPS. Members of the public who have comments on the recommendations in the consultation paper may send them to the Board on or before 26 June 2009 via the following channels:

- by mail to the Board's office at 78/F, Two IFC, 8 Finance Street, Central, Hong Kong marked with reference to DPS Review

- by fax to 2290 5168

- by email to dps_review@dps.org.hk

- by visiting the Board's website

Annex: Executive summary and summary of recommendations

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Hong Kong Deposit Protection Board
27 April 2009

Annex

Enhancing Deposit Protection under the Deposit Protection Scheme

Executive Summary

1. The consultation paper contains a number of recommendations of the Hong Kong Deposit Protection Board (the Board) on enhancing the Deposit Protection Scheme (DPS) to improve protection for depositors in Hong Kong. The recommendations were formulated taking into account experience gained by the Board from operating the DPS since its inception in 2006 and recent developments in international and local financial markets.

2. The recommendations in the consultation paper are, however, subject to the following assumptions and limitations:-

   - the review does not seek changes to the fundamental principle laid by the Deposit Protection Scheme Ordinance (DPSO) that the DPS is to function as a "pay-box", and does not usurp the responsibilities shouldered by other safety net players in regard of banking supervision and lender of last resort, etc.; and

   - as a pre-emptive measure to reinforce confidence in the banking system in Hong Kong, the Hong Kong SAR Government announced in October 2008, the use of the Exchange Fund to guarantee repayment of all customer deposits held in all authorized institutions (AIs) in Hong Kong (Deposit Guarantee), following the principles of the DPS, until the end of 2010. Nothing in the consultation paper will bind the Government's decisions in relation to the Deposit Guarantee.

3. Because of the time expected to be required for consultation on the potential enhancements and effecting the relevant legislative changes, the Board has divided the enhancements into two batches. Priority has been given to handling those that are more fundamental to the effectiveness or efficiency of the DPS. Technical enhancements have been reserved to the second batch, and are expected to be made available for consultation in the second half of 2009.

4. Subject to the progress of the consultation, the Board intends to introduce the agreed enhancements under both batches as soon as possible, preferably before the end of 2010 so that the public will benefit from an enhanced deposit protection scheme when the Deposit Guarantee expires. The main conclusions and recommendations in the consultation paper are summarised in the following paragraphs.

Protection limit

5. To assess the need to adjust the protection limit of the DPS and the appropriate level for the limit to be adjusted to, the Board conducted a survey on 21 retail banks on the percentage of depositors fully covered and value of deposits covered under different limits. The Board also estimated the cost of raising the protection limit to different levels by re-running the statistical model employed by the Hong Kong Monetary Authority (HKMA) in designing the DPS.

6. The Board has considered the option of raising the DPS protection limit to HK$200,000 as indicated in the consultancy report on the HKMA's work on banking stability (HKMA consultancy report) issued by the HKMA in July 2008. However, as this would bring the percentage of depositors fully covered to just about 84%, which is not far from the reference benchmark for review (80%) set by the Board, the limit might need to be reviewed again in the near term. Also, it might not meet the higher public expectations after the recent financial crisis. The Board therefore does not find this option preferable.

7. In view of the findings of the analyses conducted by it and after carefully considering the comments of the public, the industry, the Consumer Council and other interested parties, the Board concluded that a higher protection limit of HK$500,000 is more appropriate. At this level, the DPS can deliver a reasonably high level of protection (about 90% of depositors would be fully covered, as compared to about 84% under the limit of HK$200,000 and international benchmark of 80-90%) that is cost effective to provide, accompanied by a manageable level of moral hazard and easily understandable by the public. The Board believes the moral hazard associated with the proposed increase is manageable in the light of the sound corporate governance standards being practised by banks in Hong Kong as well as the robust prudential banking regulation and supervision in place. It can avoid the need to review the limit again in the near term (a 10% margin is available as compared to the reference benchmark for review of 80%). Raising the limit to HK$500,000 will also bring the protection for depositors in Hong Kong in line with protection in major countries. Alternatively, raising the limit beyond HK$500,000 will result in a steep increase in cost and higher moral hazard, but with minimal marginal benefits.

Compensation calculation basis

8. In the light of a recommendation in the HKMA consultancy report for the Board to study the UK proposal of changing the basis for calculating deposit compensation from net to gross basis for speeding up payment of compensation, the Board has considered the merits of changing the netting approach for the DPS in the review.

9. Netting for deposit insurance purposes refers to the process whereby the deposit claims of a depositor on a failed bank are set-off against the depositor's liabilities to the bank in determining entitlement to compensation. The decision whether or not to net and, if so, to what extent, will affect the compensation payable to

depositors and the cost of providing deposit protection. If netting can be eliminated, a lesser amount of time will be required for the determination and payment of compensation.

10. The actual practices on netting vary from country to country, a certain degree of netting is usually applied in the schemes in other countries. The choice of the netting approach generally involve trade-offs among public policy objectives, requiring country-specific solutions. In Hong Kong, full netting was adopted for the DPS to bring it in line with Hong Kong's insolvency regime, so the DPS would not experience a shortfall loss on its claims in bank liquidations.

11. Based on the findings of the review, the Board does not recommend changing the netting approach (full netting) applicable to the DPS because:

    (i) gross payment will accelerate payouts by only a few days (from 2 weeks to 7 days) in the Hong Kong context. The benefit is not as substantial as that envisaged in the UK (from 6 months to 7 days);

    (ii) gross payout is arguably unfair in certain circumstances. Partial netting may be fairer but may not facilitate quick payouts;

    (iii) many Hong Kong depositors seem to be borrowing from banks other than those in which they put their deposits as savings. If this is the case, gross payout will not have material benefits on enhancing the liquidity position of depositors and, hence, effectiveness of the DPS; and

    (iv) to make gross payout cost viable for the DPS, the insolvency regime for banks needs to be changed. This is the UK's proposal which is giving rise to substantial controversy. It may be useful to monitor the developments in the UK. In the meantime, such a fundamental change does not seem to be warranted.

Product coverage

12. According to the DPSO, except a few types of deposit, all deposits meeting the definition of deposit in the Banking Ordinance (BO) are eligible for protection under the DPS. Indeed, the product coverage of the DPS is very comprehensive. In addition, banks have been required to notify customers of non-protected deposits since the DPS commenced operation in 2006.

13. The Board noted that public attention to the coverage of the DPS has risen noticeably after the introduction of the Deposit Guarantee by the Government. There has been some recent public concern about deposits held in integrated accounts being secured for services bundled with the accounts and becoming unprotected without the knowledge of customers. Secured deposits are not covered by the DPS because they do not fit in with the definition of deposit in the BO. The way in which banking and financial services are now offered probably makes it less straightforward for depositors to tell whether a deposit has

been taken as security. The issue also triggered unfounded speculation that customers' deposits could become unprotected due to other business relationships with banks. The industry also commented that protected deposit under the DPS had been defined in a complex way which made it difficult to understand, and suggested its definition be refined.

14. The Board is mindful of the risk that the misunderstandings and suspicions may cause an erosion of public confidence in the DPS and impair its effectiveness, especially during a crisis. The Board therefore considers that it is in the public interest to extend coverage of the DPS to deposits referable to the provision of banking and financial services to eliminate any potential for misunderstanding and suspicion.

15. After considering various options, the Board believes it is appropriate to change the definition of deposit in the DPSO to bring secured deposits referable to the provision of banking and financial services under protection. Improving the robustness of the definition of deposit in the DPSO is expected to be helpful to eliminate the uncertainties, and should contribute to the quality, and promote acceptance, of the representations made by banks on the protection status of their financial products.

16. Apart from secured deposits, the Board has also reviewed whether structured deposits should be brought under the protection of the DPS. Given that structured deposits are more akin to investment, they are not popular with small depositors, and it is difficult to make fast payments on them, the Board does not recommend bringing these products under the protection of the DPS at this stage. However, the Board will continue to monitor the popularity of these products among small depositors to assess the need to review their protection status.

Types of institution covered

17. According to the DPSO, it is mandatory for licensed banks (LB) to participate as members of the DPS. Restricted licence bank (RLB) and deposit-taking company (DTC), the two other types of authorized institution (AI) authorized by the Monetary Authority under the BO to carry on a banking business or a business of taking deposits in Hong Kong (commonly known as the three-tier authorization system), are not members of the DPS.

18. Under the three-tier authorization system, the deposits that RLBs and DTCs can take from the public are subject to restrictions. RLBs may take call, notice or time deposits from the public in the amounts of HK$500,000 or above without restriction on maturity. DTCs are restricted to taking deposits of HK$100,000 or above with a term to maturity, or call or notice period, of at least three months. RLBs and DTCs are generally involved in specialised activities, such as merchant banking, capital market operations, consumer finance, trade finance or securities business. Except for a couple of DTCs engaged in consumer finance, accessibility of ordinary retail depositors to RLBs and DTCs is generally very limited. At the end of 2008, there were 145 LBs, 27 RLBs and 28 DTCs in Hong Kong.

19. The issue of whether RLBs and DTCs should be brought under the protection of the DPS has arisen as a result of the introduction of the Deposit Guarantee, which covers all three types of AIs, that is, LBs, RLBs and DTCs. As the Guarantee is scheduled to expire by the end of 2010, there is concern over the impact of the removal of the protection status from the RLBs and DTCs after the Guarantee expires.

20. Based on the findings of the review, the Board concluded that the merits of extending protection to RLBs and DTCs are not apparent and, hence, does not recommend bringing these institutions under the protection of the DPS at this stage. RLBs and DTCs are not allowed to take deposits from small depositors (deposits of an amount below HK$100,000). Even if the protection limit were increased to HK$500,000, only very few of their depositors would become fully protected, and this would not be helpful in preventing rumour-driven runs on these institutions. In fact, RLBs and DTCs have been relying heavily on funding from banks and other professional players (customer deposits account for less than 20% of their fundings, compared with about 60% for LBs). The total amount of customer deposits held with these institutions is some 0.5% of the entire banking industry. Extending protection to RLBs and DTCs is expected to add little to the overall effectiveness of the DPS.

21. The Board will keep in view the HKMA's review of the three-tier authorization system recommended in the HKMA consultancy report. If any changes to the system are anticipated to have significant impacts on the effectiveness of the DPS, and the associated cost and moral hazard, the Board will initiate a review of the membership of the DPS with a view to restore the balance.

Funding arrangements

22. The Board is mindful of the cost impacts on Scheme members because of the proposals on protecting secured deposits and raising protection limit, which, if substantial, can increase the likelihood of being passed on to depositors. The concern has also been raised in the HKMA consultancy report and in various public responses to the report. In view of these concerns, the Board considers it appropriate to supplement the implementation of the two proposals by cost mitigating measures to alleviate burden on Scheme members, thus reducing the potential for cost transfer to depositors.

23. To contain the cost impact due to protecting secured deposits, the Board recommends allowing Scheme members to report protected deposits for contribution assessment purpose on a net deposit basis (currently on a gross deposit basis). The Board sees that it is more equitable as Scheme members should only be required to pay a contribution on the amount of protected deposits payable as compensation, which is determined on a net deposit basis. It is estimated that the reduction in the amount of protected deposits reported for

contribution assessment should largely offset the increase in the amount due to the inclusion of secured deposits (estimated to be much less than 10%) and hence neutralising the impact on contributions.

24. To contain the cost impact due to raising the protection limit, the Board proposes cutting the rates for charging build-up levies[1] by half (from an average of about 0.08% of protected deposits to 0.04%) to keep the absolute amount of annual contributions payable by Scheme members largely unchanged. The Board believes that by halving the rates, the increase in the protection limit will not add materially to the financial burden of Scheme members. As the annual cost of protecting each dollar of deposit will actually be lower, it should not add any pressure on Scheme members to pass the cost on to depositors. Indeed, since the inception of the DPS in 2006, the Board has not noticed any reports of Scheme members passing on the cost of deposit protection to depositors.

Consequential amendments to the priority claims of depositors

25. When the DPS was designed about ten years ago, its key design features were intentionally brought in line with those of the priority claims of depositors under the Companies Ordinance (CO), including the level of protection and product coverage. This is to ensure that the DPS can subrogate fully into the priority status of depositors in bank liquidations, thereby minimising the risk of the DPS failing to recover the compensation paid and, hence, suffering shortfall losses. Without the protection afforded by the priority claims under the CO, the DPS would not have been cost viable.

26. Raising the protection limit and expanding the coverage to include secured deposits without making corresponding adjustments to the level of priority claims for depositors in the CO will be prohibitively expensive (in terms of shortfall losses to the DPS due to failure to recover fully the compensation paid to depositors). The Board therefore also recommends corresponding changes be made to the priority claims of depositors under the CO.

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April 2009

[1] Build-up levies refer to the contributions payable by Scheme members for accumulating sufficient funds (in the DPS Fund) to meet the cost of payout during the initial "build-up" phase of the fund accumulation period.

Summary of recommendations

1. Protection limit

- *It is recommended that the protection limit of the Deposit Protection Scheme (DPS) be increased from the current HK$100,000 to HK$500,000, instead of HK$200,000 as indicated by the consultant in the HKMA consultancy report.*

- *It is recommended that the level of priority claims for depositors under the Companies Ordinance be adjusted to link it to the DPS protection limit. Without this adjustment, an increase in the protection limit will be cost-prohibitive.*

2. Compensation calculation basis

- *The Board does not recommend changing the netting approach (full netting) applicable to the DPS for the time being. However, international developments should be monitored and the subject should be kept under review.*

3. Product coverage

- *It is recommended that secured deposits which fall outside the present definition of "deposit" under the Banking Ordinance because they are referable to the provision of banking and financial services be brought under the protection of the DPS by revising the definition of "deposit" in the DPS Ordinance.*

- *It is recommended that the definition of deposit for the priority claims for depositors under the Companies Ordinance be brought in line with the revised definition of deposit in the DPS Ordinance.*

- *The Board does not recommend bringing structured deposits under the protection of the DPS.*

4. Types of institution covered

- *The Board does not recommend extending the coverage of the DPS to deposits held in restricted licence banks and deposit-taking companies.*

5. Funding arrangements

- *It is recommended that Scheme members be offered an option to report protected deposits for contribution assessment purposes on a net deposit basis to the extent that they see appropriate.*

- *It is recommended that the target fund size of the DPS Fund be adjusted from the current 0.3% to 0.25% of total protected deposits*

- *It is recommended that the annual contribution by Scheme members be maintained largely at the current level in absolute terms. This will mean the contribution rates for collecting build-up levies from Scheme members are to be reduced by half.*