

Hong Kong Deposit Protection Board

Questions and Answers

A. General Issues about the Review

Q1. Why did the Board review the DPS?

A1. The scope of a deposit protection scheme should be reviewed from time to time to ensure that it will remain effective in achieving its objectives. The DPS has been effective in protecting depositors and helping to maintain banking stability. The review is an initiative to enhance its effectiveness in the light of market developments.

Q2. Was the review conducted in response to the bank run occurred last year, introduction of the Deposit Guarantee by the Government, the recent public concern about integrated accounts?

A2. The Board decided to conduct the review (June 2008) well before the occurrence of the bank run last year (September 2008), the introduction of Deposit Guarantee (October 2008) and the recent public concern about integrated accounts emerged (Q1 2009). Nevertheless, the Board has fully considered such developments when conducting the review.

Q3. How did the Board determine the scope of the review?

A3. The Board has considered the following factors and developments since the inception of the DPS in setting the scope of the review:

- experience gained by the Board in operating the DPS;
- local and overseas reform proposals, and new international principles for deposit insurance; and
- developments in the banking industry.

Q4. Why does the Board divide the items subject to review into two batches?

A4. The items under review carry different degrees of complexity and may require different amounts of time for consultation. Priority is given

to handling those items more fundamental to the effectiveness and efficiency of the DPS in the first batch to ensure that their implementations will not be delayed due to the need to cover all items at the same time.

Q5. What does the first batch of items under review cover?

A5. Protection limit, compensation calculation basis, product coverage, types of institutions covered and funding arrangements.

Q6. What will be covered in the second batch of items? When will the changes proposed become available for public consultation?

A6. The second batch of items will mainly contain technical enhancements, e.g. administrative arrangements in a payout, powers of the Board to enforce DPS rules and guideline. They are expected to be made available for public consultation in the second half of 2009.

Q7. When will be the proposed changes take effect?

A7. After collecting views from the public, the Board intends to introduce the proposed legislation for effecting changes to the Scheme in early 2010. Subject to the progress of the legislative process, the Board hopes that the enhancement proposals will be in effect before the end of 2010, such that the public will benefit from an enhanced DPS when the Deposit Guarantee expires.

Q8. What are the major enhancements recommended in the consultation paper?

A8. The consultation paper carries two major recommendations for enhancing the DPS:

- raising the protection limit of the DPS from the current HK\$100,000 to HK\$500,000; and
- expanding the scope of the DPS to cover secured deposits.

Q9. Despite the cost mitigating measures proposed by the Board, will banks pass the cost of deposit protection to depositors?

A9. It is a commercial decision of banks whether to pass the cost of deposit protection on to depositors. Banks will be constrained by competition to do so.

As the annual cost of protecting each dollar of deposit will be lower

after the premium rates are cut, it should not add any pressure on banks to pass the cost on to depositors. Indeed, since the inception of the DPS in 2006, the Board has not noticed any reports of banks passing on the cost of deposit protection to depositors.

Q10. How would the Board engage the public in the consultation?

A10. A publicity campaign will be launched to draw the public's attention to the consultation exercise and the channels for providing their comments. All major mass communication channels like TV, newspaper, radio, internet and public transportations will be covered in the campaign. The Board will actively engage all interested and concerned parties and listen to their views on the issues covered by the consultation.

B. Protection Limit

Q11. What will be the impact on the effectiveness of the DPS if the limit is raised to HK\$500,000?

A11. According to the statistics collected from a survey on 21 major retail banks, raising the protection limit to HK\$500,000 will bring the percentage of depositors fully covered from the current 77% (under a limit of HK\$100,000) to about 90%.

Q12. What would be the additional amount of deposits protected if the protection limit is raised to HK\$500,000?

A12. The amount of deposits protected will increase from the current of about HK\$500 bn (under a protection limit of HK\$100,000) to HK\$1,150 bn. About 20% of the deposits in the industry will become protected.

Q13. Why does the Board recommend raising the protection limit to \$500,000?

A13. The Board intends to provide the best possible protection to depositors to the extent that it is viable in terms of cost and moral hazard.

At this level, the DPS can deliver a reasonably high level of protection (90% of depositors fully covered) that is cost effective to provide, accompanied by a manageable level of moral hazard and easily understandable by the public. It will also provide a sufficient buffer (over the reference benchmark for review of 80%) for avoiding the need to conduct another review in the near term. The level is in line

with international benchmarks (80-90% as recommended by the IMF) and is also comparable to the protection in major countries, in absolute terms as well as a ratio to per capita GDP.

Alternatively, raising the limit above HK\$500,000 will not add materially to the effectiveness of the DPS but will create disproportionately higher cost. The resultant moral hazard is more difficult to contain.

Though a protection limit of HK\$200,000 will give rise to lower cost and moral hazard, it may not be able to meet the higher public expectation and the improved international standards. Also, the percentage of depositors fully covered (84%) will be close to the benchmark for review (80%), the Board may need to review the limit again in the near term, which is not conducive to cultivate public confidence in the DPS.

Q14. Why does the Board think that the moral hazard under the proposed limit of HK\$500,000 is manageable?

A14. As the proposed limit of HK\$500,000 will provide a level of protection similar to the levels in major countries, the moral hazard should generally be comparable. In the light of quality banking supervision standards in Hong Kong and robustness of the banking sector in withstanding the financial crisis, the Board believes that the banking sector of Hong Kong is in a better position to manage the moral hazard associated with the proposed limit.

Q15. Why is it important to adjust the level of the priority claims of depositors under the Companies Ordinance with the DPS protection limit?

A15. The DPS relies on the backing of the priority claims of depositors to ensure that it can recover the compensation paid to depositors from the liquidation of banks. Without the full backing of the priority claims, the DPS will risk suffer substantial shortfall losses which will be charged to banks and, if significant, increase the likelihood of the cost being passed on to depositors.

The priority claims and the DPS are important building blocks of deposit protection arrangements in Hong Kong. As they share the same objective of protecting depositors, it is logical to bring their levels of protection in line with each other.

Q16. Who will be affected if the level of priority claims of depositors under the Companies Ordinance is raised?

A16. Raising the level of priority claims of depositors will increase the amount of claims that depositors can recover with priority in bank liquidations. This means that less value of the liquidated assets of the failed bank will be available for distribution to larger depositors and creditors as dividends.

Nevertheless, raising the level of priority claims should help reduce the creditor population in bank liquidations. Larger depositors and creditors should benefit from a reduction in administration costs and faster dividend payments.

C. Compensation Calculation Basis

Q17. Why did the Board review the compensation calculation basis of the DPS? Is there a problem with the existing full netting approach?

A17. The DPS is well prepared to provide compensation on a net deposit basis.

The HKMA consultancy report carries a recommendation for the DPS to study the UK reform proposals, a major one being to change the basis of netting from full netting to no netting (gross payout).

Q18. Why was the full netting approach adopted for the DPS in Hong Kong?

A18. The major reason for adopting full netting approach for the DPS was to bring it in line with Hong Kong's insolvency regime, which also governs how the priority claims of depositors should be determined. This arrangement ensures that the DPS can subrogate fully into the priority claims of depositors and recover the amount of compensation paid to them in bank liquidations, thereby reducing the risk of suffering shortfall losses.

Q19. Why doesn't the Board recommend changing the netting approach for the DPS?

A19. The adoption of the gross payout has the potential of creating unfair situations, and requires fundamental changes to the insolvency regime of Hong Kong. The justification for adopting gross payout in the UK, that is, speed of payment (expected to be improved from 6 months to 7 days), does not apply in Hong Kong as the Board has already implemented effective measures to ensure fast and efficient payouts (within 2 weeks in respect of an average small to medium-sized banks).

Q20. If the netting approach of the DPS is not changed, will depositors in Hong Kong be put in a disadvantaged position?

A20. Internationally, there does not seem to be a consensus on the preferred netting approach. Gross payout is not a common practice. In fact, the UK is unique in proposing gross payout. Countries will generally adopt a netting approach suitable to their circumstances.

The consultation of the UK's proposal on shifting to gross payout for speeding up the determination of compensation just ended in early April and the way forward is unclear. Comments received in the previous round of public consultation in the UK indicate little public support for changing the UK insolvency regime.

D. Product Coverage

Q21. What are the reasons for expanding the scope of the DPS to cover secured deposits? Is it because the current scope of the DPS fails to provide adequate protection?

A21. The existing coverage of the DPS is very comprehensive. Only under exceptional circumstances will a deposit become unprotected. Moreover, banks have been required to notify customers of non-protected deposits.

However, the Board noted that some depositors have found it difficult to tell whether the protection status of their deposits will be affected due to the linkage of deposits to other banking and financial services offered by banks, which has become an increasingly popular banking practice. To eliminate this uncertainty and provide maximum clarity to depositors, the Board considers it appropriate to bring secured deposits under the protection of the DPS.

Q22. Which types of deposit will be brought under protection due to the proposed expansion in the coverage of the DPS? Will it cover deposits pledged for OD facility under integrated accounts and money held in securities settlement accounts?

A22. Under the proposed expansion, secured deposits referable to the provision of any types of banking and financial service would be brought under the protection of the DPS. Deposits pledged for credit facilities, including OD line under integrated accounts, and for financial services like securities settlement service will be covered. The detailed scope, however, will be worked out when the relevant legislative amendments are drafted and consulted.

Q23. Will it be unfair to protect secured deposits since the depositors should have enjoyed the benefits of pledging the deposits?

A23. As compensation under the DPS is calculated on a net basis, depositors pledging a deposit for a credit facility or a service will be compensated only for the amount of the deposit in excess of the drawn facility amount or the liabilities of the depositor under the relevant service. Normally, depositors can arrange to withdraw the amount of deposit in excess of the portion required for supporting the utilised facility, say by reducing the facility amount or cancelling the facility.

Q24. What would be the additional amount of deposits protected if secured deposits are protected?

A24. The Board estimated that the increase in the amount of protected deposits should be less than 10%. The actual amount required to be paid out as compensation should be much smaller as such deposits may exceed HK\$500,000 in value, are held with protected deposits and subject to netting when determining compensation.

Though the additional amount of deposits protected may not be significant, protecting secured deposits will have a significant effect in terms of enhancing the clarity and certainty of the coverage of the DPS.

Q25. There were comments that banks should be required to make positive disclosures about the protection status of their deposits. Does the Board intend to introduce such requirements?

A25. By improving the clarity and certainty of the definition of the deposit for the DPS, the quality of disclosures made by banks and public acceptance of the disclosures will be improved accordingly.

Nevertheless, the Board will consider the appropriateness of introducing supplementary representation requirements when the new definition of deposit for the DPS takes effect.

Q26. Why doesn't the DPB consider protecting structured deposits?

A26. Structured deposits are more akin to investment than deposit and they are not popular with small depositors. Moreover, it is difficult to determine their values quickly for payout. Hence, the DPB does not recommend bringing these products under the protection of the DPS at this stage.

Q27. If structured deposits turn out to be popular with depositors under the protection limit of HK\$500,000, will the Board consider protecting them?

A27. The DPB will continue to monitor the popularity of structured products through regular surveys. The Board will collect statistics on the popularity of such deposits under the new protection limit and consider whether the continued exclusion of such deposits will materially affect the effectiveness of the DPS.

E. Types of Institution Covered

Q28. Why the Board does not recommend extending the coverage of the DPS to include RLBs and DTCs?

A28. Covering these institutions will add little to the effectiveness of the DPS in protecting small depositors and maintaining banking stability.

The types of institution covered by a deposit insurance scheme should be consistent with its objectives. The objective of the DPS is to help maintain banking stability through fully protecting a large majority of small depositors. RLBs and DTCs account for a very small portion (0.5%) of customer deposits in the banking industry and few of their depositors will become fully protected.

Q29. The HKMA consultancy report carries a recommendation to review the three-tier authorization system. How would the system be changed? How will it affect the types of institution covered by the DPS?

A29. It is a decision of the HKMA on how the three-tier authorization system should be changed.

If any changes to the three-tier authorization system are anticipated to have significant impacts on the effectiveness of the DPS, and the associated costs and moral hazard, the DPB will review whether any amendments to the membership of the DPS are warranted to restore the balance.

F. Funding Arrangements

Q30. What will be the cost impact of raising the protection limit to HK\$500,000?

- A30. As more deposits will come under the protection of the DPS and become payable as compensation to depositors, the cost of providing protection will be higher. A larger amount of funds is therefore required to be accumulated (as the DPS Fund) for meeting the cost of providing protection. The size of the DPS Fund is expected to increase from HK\$1.5 bn (under a protection limit of HK\$100,000) to HK\$2.8 bn.
- Q31. Will the proposals add significant financial burdens on banks, especially under the present difficult operating environment?*
- A31. The Board believes that by halving the rates for build-up levies, the absolute amount of annual contributions payable by Scheme members will be maintained more or less at the current level. Hence, it should not add materially to the financial burden of banks.
- Q32. What will be the cost impact of expanding the coverage of the DPS to protect secured deposits?*
- A32. The Board anticipates that the additional amount of compensation payable due to protecting secured deposits is relatively small (much less than 10% of protected deposits). Subject to the assumption that the scope of the priority claims of depositors can be adjusted accordingly, the additional cost (mainly financing cost) should not be significant.

Hong Kong Deposit Protection Board
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