



**HONG KONG MONETARY AUTHORITY**  
香港金融管理局

# **Introducing Deposit Insurance in Hong Kong**

Consultation Paper

March 2002

**HONG KONG MONETARY AUTHORITY**

30/F, 3 Garden Road, Hong Kong

Telephone : (852) 2878 8222

Facsimile : (852) 2878 1887

E-mail : [dis@hkma.gov.hk](mailto:dis@hkma.gov.hk)

Website : <http://www.hkma.gov.hk>

## Introduction

1 The question of whether to introduce a deposit insurance scheme (“DIS”) in Hong Kong was the subject of an extensive public consultation in late 2000. The results of the public consultation indicated that there was broad public support for establishing such a scheme in Hong Kong. On 24 April 2001, having considered the results of the consultation exercise, the Chief Executive in Council approved in principle the establishment of a DIS in Hong Kong and requested the Hong Kong Monetary Authority (“HKMA”) to work out the detailed design features of the scheme.

2 The HKMA has now substantially completed consideration of how the DIS should be structured. The purpose of this second consultation paper is to present the HKMA’s proposals on the salient features of the DIS<sup>1</sup> and to seek the views of interested parties on these proposals. After receipt of comments, the HKMA will proceed to prepare the relevant legislation for the implementation of the DIS.

3 The HKMA’s detailed proposals on how to set up the DIS are split into 8 chapters and cover:

Chapter 1: Establishment of the Deposit Insurance Board (P.3 – 8)

Chapter 2: Membership of the DIS (P.9 – 12)

Chapter 3: Coverage under the DIS (P.13 – 20)

Chapter 4: Depositor priority, set-off and assignment of rights (P.21 – 24)

Chapter 5: Funding and premium assessment (P.25 – 30)

Chapter 6: Premium collection, refund and management of the DIS Fund (P.31 – 33)

Chapter 7: Trigger criteria for DIS payout (P.34 – 35)

Chapter 8: Relationship between the Deposit Insurance Board and the HKMA (P.36 – 40)

4 A summary of these proposals is set out in a table at **Annex A** to this paper.

---

<sup>1</sup> This paper does not deal with the detailed organisational and logistical issues relating to the setting up and operation of the DIS such as the management structure of the DIS and the procedures whereby claims would be made under the DIS. These would be a matter for the Deposit Insurance Board subject to the powers provided in the DIS legislation.

5 A set of draft Rules (“Rules”) governing the setting up and operation of the DIS has also been prepared at **Annex B**. These Rules would be used as the basis for preparing the relevant legislation.

6 Members of the public are welcome to submit their comments to the HKMA before 31 May 2002 through any of the following channels:

By mail: Banking Development Department  
Hong Kong Monetary Authority  
30<sup>th</sup> Floor  
3 Garden Road  
Central  
Hong Kong  
(Reference: DIS)

By fax: 2878 1887

By email: [dis@hkma.gov.hk](mailto:dis@hkma.gov.hk)

7 In the interests of transparency, it is the HKMA’s practice, as appropriate, to reproduce, quote from, or summarise the submissions received during its public consultation exercises in its published reports on those exercise. Where appropriate, it is also the HKMA’s practice to attribute such reproductions of, quotations from, or summaries of, views received to the relevant organisations or individuals unless expressly requested in the submissions not to do so.

## **Chapter 1 – Establishment of the Deposit Insurance Board**

**1.1 This Chapter will consider the following in relation to the Deposit Insurance Board:**

- (i) the structure and organisation;**
- (ii) the governance arrangements;**
- (iii) the functions; and**
- (iv) the powers required to discharge the anticipated responsibilities of the Board.**

1.2 The choice of an appropriate structure and organisation for a DIS is heavily influenced by its mandate, roles and responsibilities. The majority of the opinions received from the previous consultation exercise supported the idea that the DIS in Hong Kong should confine its role to that of a “pay-box” to reduce the cost of deposit insurance and to avoid duplication of functions with the regulator. There was also support for the view that the DIS should be administered by a separate legal entity to offer greater accountability and transparency to the public. Care should be taken, however, to ensure that the proposed entity is as lean and cost-effective as possible.

### **The establishment of the Deposit Insurance Board**

1.3 In view of the above, it is proposed that a statutory body should be established by legislation, which might be called the Hong Kong Deposit Insurance Board, to administer the DIS in Hong Kong.

1.4 The functions of the Board should be clearly defined in legislation so that the Board has a clear mandate from the legislature. Given the Board’s role as a “pay-box”, its principal functions should be confined to the following:

- (i) collecting premiums from participating banks in accordance with the rules established pursuant to the DIS legislation;
- (ii) managing the funds of the DIS (“the DIS Fund”);
- (iii) assessing claims made against the DIS Fund and determining the eligibility and entitlement of claimants;
- (iv) making compensation payments to eligible depositors as determined; and

- (v) recovering any amount paid out to a failed participating bank's depositors from the assets of the failed bank.

1.5 The DIS Fund should also be established by legislation, and should, as far as practicable, be financed by the banking industry<sup>2</sup>. The DIS Fund should consist of:

- (i) premiums collected from participating banks;
- (ii) amounts recovered from the estate of a failed participating bank;
- (iii) investment returns;
- (iv) amounts borrowed for the DIS Fund as permitted under the DIS legislation; and
- (v) any other amounts that are lawfully paid into the DIS Fund.

### **Structure and organisation of the Board**

1.6 The Board should comprise not less than 7 but not more than 10 members appointed by the Chief Executive of the HKSAR ("CE/SAR"). Its composition is proposed as follows (with a majority of lay members over ex-officio and executive members to ensure sufficient independence):

- (i) Secretary for Financial Services or his representative (ex-officio member);
- (ii) Monetary Authority ("MA") or his representative (ex-officio member);
- (iii) the Chief Executive Officer of the Board (executive member to act as the link between the policy making process and the implementation process); and
- (iv) 4 to 7 lay members.

1.7 The Chairman of the Board should be appointed by CE/SAR from among the lay members to ensure the Board's independence.

---

<sup>2</sup> This would be consistent with the provisions relating to the establishment of the Investor Compensation Fund under the Securities and Futures ("SF") Ordinance – see clause 236(4) of the SF Ordinance. The intention is to ensure that funding should, as far as practicable, follow the user-pays principle.

1.8 Appointment of members should be for a fixed term of 3 years or a shorter term as CE/SAR thinks appropriate. Each member should be eligible for re-appointment upon expiry of his term.

1.9 If a member is unable to perform his duties for any reason, CE/SAR should be able to appoint another person to take the place of such member.

1.10 The Board should have the power to set up any sub-committees to consider and make recommendations relating to the operations of the Board and the management of the DIS Fund.

## **Governance arrangements**

### Annual accounts / report

1.11 To promote accountability and transparency of the operations of the Board, the Board should be required by law:

- (i) to keep proper books and accounts of the DIS Fund;
- (ii) to prepare an audited statement of accounts for each financial year; and
- (iii) to prepare and publish an Annual Report (including the statement of accounts) within four months after the end of each financial year and to lay this report before the Legislative Council.

### Audit and budget

1.12 The Board should prepare an annual budget for approval by the Financial Secretary (“FS”).

1.13 FS should have the power to approve the appointment of the Director of Audit or an external auditor to perform an audit of the DIS Fund or the operations of the Board.

## **Powers of the Board**

1.14 The Board should have the following powers which are considered necessary for the discharge of its functions:

- (i) to assess premiums payable by each participating bank and to levy such premiums as assessed on the bank;

- (ii) to collect premiums from all participating banks;
- (iii) to borrow from the Government or any third party to discharge the obligations of the Board<sup>3</sup>;
- (iv) to make payments out of the DIS Fund in connection with the exercise of its functions and to recover any payment (or any part thereof) made to any person from the DIS Fund to which such person is not entitled;
- (v) to obtain information from any participating bank that is necessary for the exercise of its functions under the DIS legislation;
- (vi) to demand payment from the liquidator (or provisional liquidator) of a failed participating bank out of such bank's available assets in respect of the amounts it has paid to the eligible depositors of such bank;
- (vii) to give an indemnity to the liquidator (or provisional liquidator) of a failed participating bank with a view to obtaining early repayment after the Board has made payouts to eligible depositors;
- (viii) to accept a compromise from the liquidator (or provisional liquidator) of a failed participating bank or any other party as full payment of the amount claimed by the Board on the relevant bank's assets where the Board thinks fit, and to enter into any agreement or arrangement in respect of the same;
- (ix) to specify the requirements of the information systems to be maintained by all participating banks so as to facilitate payment to eligible depositors;
- (x) to invest the DIS Fund in the manner specified in the DIS legislation;
- (xi) to appoint agents, or authorize any third party, to perform any of the functions of the Board under the DIS legislation;<sup>4</sup>

---

<sup>3</sup> This power is essential to enable the DIS to meet its liquidity needs in a payout as the DIS Fund cannot be self-sufficient in terms of the money required on a temporary basis to effect the necessary payout.

<sup>4</sup> Such a power would help the Board to avoid the need for a large standing staff.



- (xii) to hold, acquire, lease, sell, dispose of or otherwise deal with all kinds of property whether movable or immovable;
- (xiii) to have all the necessary and incidental powers of a commercial entity in respect of its administration and management; and
- (xiv) to make rules<sup>5</sup>, after consultation with the FS, relating to the procedures for making claims and payouts.

## **Confidentiality**

1.15 As the Board would have access to sensitive information about individual participating banks, it would be important for the Board and its staff members to keep confidential any information obtained from the MA and the participating banks in the course of carrying out its functions. Exceptions would be where disclosure of such information is required by law or where such information is framed in a summary form so as to prevent particulars relating to the business of any particular institution or person being ascertained from it.

1.16 This requirement should also apply to any third party appointed or authorized by the Board to perform any of its functions under the DIS legislation.

1.17 Any person who has breached the secrecy provision above should be guilty of an offence.

## **Immunity**

1.18 Like other statutory offices, it is proposed that neither the Board nor any person who is, or is acting as, its board member, member of staff or its agent should be liable in damages for anything done or omitted to be done in the discharge, or purported discharge, of the Board's functions under the DIS legislation unless the act or omission is shown to have been in bad faith.

## **Exemption from taxation**

1.19 Since the Board would not be a profit-making body, it is proposed that the receipts of the Board would not be subject to taxation under the Inland Revenue Ordinance.<sup>6</sup>

---

<sup>5</sup> These rules should be subsidiary legislation which would be subject to negative vetting by the Legislative Council.

<sup>6</sup> Similar exemption is granted to other statutory bodies such as the Hospital Authority and the Securities and Futures Commission under the Hospital Authority Ordinance and the Securities and Futures Commission Ordinance respectively.

## **Appeal**

1.20 The Board's administration of the DIS Fund and, in particular, its decision on payment or refusal to make payment to depositors should be subject to review by a separately constituted tribunal. It is proposed that the tribunal should be presided over by a chairman, preferably a judge (or a retired judge) appointed by CE/SAR sitting with a number of lay members, say, 2-3 persons, who possess the necessary expertise in dealing with the issues that would be likely to be reviewed by them. Appointment should be on a fixed-term basis, but any member of the tribunal should be eligible for re-appointment.

1.21 It is proposed that the tribunal should have the power to confirm, vary or set aside the Board's decision, or substitute it with the tribunal's own decision. The tribunal should have the same powers as the Court of First Instance to punish for contempt. This would strengthen the authority and ability of the tribunal in enforcing its own procedures. It should also have the power to receive and consider any material that would not be admissible in evidence in civil and criminal proceedings in a court of law. Finally, the tribunal's decisions should be final and should not be subject to further appeal except on point of law.

1.22 Detailed rules relating to the setting up and operation of the tribunal should be specified in the DIS legislation.

## Chapter 2 – Membership of the DIS

**2.1 This Chapter will consider:**

- (i) which types of authorized institutions should be required to become members of the DIS;**
- (ii) how membership of the DIS should be granted and terminated; and**
- (iii) whether there should be any exemption from participation in the DIS.**

### **Participation by restricted licence banks (“RLBs”) and deposit-taking companies (“DTCs”)**

2.2 It was proposed in the previous consultation paper that membership of the DIS should be confined to licensed banks, whose participation should be mandatory. During the consultation exercise, the DTC Association suggested that RLBs and DTCs should not be excluded from the scheme but should have the option whether to join. The Association considered that certain RLBs and DTCs would be disadvantaged if they were excluded from the scheme.

2.3 The HKMA remains convinced that there is not a strong case to extend membership of the DIS to these two tiers of authorized institution. Under the current three-tier system of authorization, RLBs and DTCs are not permitted to take small deposits. It is therefore doubtful whether RLBs and DTCs should join a DIS designed to protect only small depositors. Furthermore, participation in the DIS would be mandatory for all licensed banks. This is essential to ensure the viability of the scheme and to avoid the problem of adverse selection. It would therefore be undesirable and unfair to have a scheme in which participation is mandatory for banks but voluntary for RLBs and DTCs. Furthermore, the recent proposed relaxation of the market entry criteria for full licensed banks should reduce the need to cover RLBs and DTCs in the DIS. They may seek to be upgraded to the status of licensed bank should they wish to become protected under the DIS.

### **Granting and termination of membership**

2.4 Following from the above, the HKMA maintains its recommendation that membership of the DIS should be mandatory and should be confined only to licensed banks. However, two issues concerning entry and exit from the scheme need to be addressed:

- (i) whether membership should be automatically granted to all licensed banks without the need for the Board to make a separate determination; and
- (ii) whether the Board should have the power to terminate the membership of any participating bank.

2.5 Given the narrow mandate of the Board, the HKMA sees merit in linking DIS membership directly to an institution's licence. Effectively, this would mean that DIS membership would be automatically granted to an institution which has been granted a banking licence by the MA, and its DIS membership would be automatically withdrawn if its banking licence is revoked. It would thus not be necessary to confer a separate power on the Board to grant or terminate membership of the DIS.<sup>7</sup>

2.6 In view of the above, it is proposed that provisions should be included in the DIS legislation to provide that:

- (i) membership of the DIS would be automatically granted to an institution which is licensed as a bank under the Banking Ordinance;
- (ii) in the case of banks licensed before the establishment of the DIS, the date on which DIS membership is granted would be the date of commencement of the DIS legislation<sup>8</sup>;
- (iii) in the case of banks licensed after the establishment of the DIS, the date on which DIS membership is granted would be the date on which the banking licence is granted<sup>8</sup>; and
- (iv) the DIS membership of a participating bank would be automatically revoked upon revocation of its banking licence<sup>9</sup>.

---

<sup>7</sup> This would be consistent with the advice of the Financial Stability Forum ("FSF") Working Group on Deposit Insurance that the power to control entry and exit is less relevant to a DIS which does not have a broader mandate to ensure insured institutions' compliance with its rules to minimise loss.

<sup>8</sup> Sub-paragraphs (ii) and (iii) would be relevant to the determination of the amount of premiums payable by existing banks in the first year of establishment of the DIS and by new entrants in the future (see para. 2.4 in Schedule 2 of the Rules).

<sup>9</sup> This would be relevant to the calculation of the premium that should be refunded to such an institution (see para. 2.8 in Schedule 2 of the Rules).

## **Exemption of Hong Kong branches of foreign banks covered by a comparable scheme in the home jurisdiction**

2.7 During the previous consultation exercise, some foreign banks suggested that overseas incorporated banks should be exempted from participation in the DIS in Hong Kong if the deposits placed with their Hong Kong branches were already protected by a DIS in their home jurisdictions which provided a comparable level of protection.

2.8 The HKMA has considered whether it would be desirable to introduce an exemption arrangement for such institutions.

2.9 In principle, it would be desirable to introduce an exemption arrangement for foreign bank branches in Hong Kong covered by a comparable scheme in their home jurisdiction. This would avoid double charging of premiums and help to maintain Hong Kong's attractiveness as an international financial centre. It would also be consistent with the recommendation of the FSF Working Group on Deposit Insurance that "the deposit insurance already provided by the home country system should be recognised in the determination of levies and premiums".

2.10 However, introducing an exemption arrangement would entail certain practical problems for the DIS. One problem would be for the DIS to regularly assess the adequacy of funding of the exempted schemes and changes in the coverage policy of such schemes so as to satisfy itself that deposits with the exempted banks in Hong Kong remained adequately protected.

2.11 The HKMA considers that there is a case for introducing an exemption arrangement for Hong Kong branches of the relevant foreign banks given that a similar arrangement exists in other schemes (e.g. in the UK) and that there is clear guidance by the FSF Working Group in favour of recognising the protection offered by home country schemes. The impact of such an exemption arrangement on the DIS in Hong Kong should be minimal.<sup>10</sup> However, given that the proposed arrangement would entail additional recurrent expenses for the DIS, it would be reasonable to require the exempted banks to share some of the cost of processing these applications and monitoring the scope of coverage of the exempted schemes, e.g. by charging the relevant banks an annual exemption fee.

2.12 Accordingly, it is proposed that the exemption arrangement should be structured along the following lines:

---

<sup>10</sup> According to a recent IMF survey of the 67 explicit protection schemes in the world, only the schemes in Belgium, Denmark, Germany, Greece, Bahrain, Lebanon, Ecuador and El Salvador cover deposits with domestic banks' branches abroad (this does not include those schemes in the EU which only cover domestic banks' branches in other EU member states). Except for Germany and Belgium, banks in these countries do not have a presence in Hong Kong. In addition, since the scheme in Belgium only covers deposits denominated in EU currencies, Belgian banks would not be eligible to seek exemption from the Hong Kong scheme.

- (i) the Board may exempt a foreign incorporated bank from participating in the DIS if it is satisfied that the deposits with the Hong Kong office(s) of the bank are protected by the scheme in the bank's home jurisdiction and the scope and level of protection afforded by the bank's home jurisdiction scheme are not less than that afforded to such deposits by the DIS in Hong Kong;
- (ii) the Board may require a bank applying for exemption to provide relevant information to facilitate the consideration of its application;
- (iii) where an exempted bank becomes aware of any development which may affect its exemption (e.g. change in the protection level of its home jurisdiction scheme), it should forthwith notify the Board of such fact. The Board may require an exempted bank to provide any information so as to allow the Board to determine whether the bank should continue to be exempted;
- (iv) where a bank is exempted from participation in the DIS, it should pay an annual exemption fee as specified by the Board from time to time; and
- (v) a bank exempted from participation in the DIS should inform its depositors:
  - (a) that the bank is not a member of the DIS in Hong Kong and therefore any deposits with the Hong Kong office(s) of the bank are not protected by the DIS; and
  - (b) of the details of the protection offered by the bank's home jurisdiction scheme, including but not limited to, the name of the organisation which provides the protection, the level of protection and the types of deposits protected.

## Chapter 3 – Coverage under the DIS

### 3.1 This Chapter will consider:

- (i) **what an insurable deposit is including, in particular, what types of deposits and depositors should be excluded from coverage under the DIS;**
- (ii) **the appropriate limit of coverage (“coverage limit”) under the DIS;**
- (iii) **whether interest accrued on insurable deposits should be covered by the DIS, and if so, how this should be determined; and**
- (iv) **how the agreed coverage limit should be applied to special types of accounts such as trust accounts, client accounts, foreign currency accounts, etc.**

### Definition of “insurable deposits”

3.2 A clear definition of “insurable deposit” is important as it gives certainty to depositors as to their eligibility for protection under the DIS.

3.3 It is proposed that the following definition should be incorporated into the DIS legislation: “An “*insurable deposit*” is any sum of money denominated in any currency which meets the definition of “*deposit*” under section 2 of the Banking Ordinance<sup>11</sup> and maintained with a participating bank with the exception of the following:

- (i) *a term deposit where the current term agreed to by the depositor at the most recent time it was negotiated<sup>12</sup> exceeds 5 years;*
- (ii) *a deposit charged, mortgaged or pledged (as appropriate) as collateral;*
- (iii) *a deposit that is secured on the assets of the bank;*

---

<sup>11</sup> This would be consistent with the advice of the IMF that the definition of deposits under the deposit insurance legislation of a jurisdiction should preferably be consistent with that adopted under its other banking laws and regulations.

<sup>12</sup> This is consistent with section 265(5D) of the Companies Ordinance. According to the record of the Government, the policy intention is that this refers to the original term to maturity of the deposit.

- (iv) *a bearer instrument;*
- (v) *a deposit booked with a foreign office of the bank;*
- (vi) *a deposit held for the account of the Exchange Fund;*
- (vii) *a deposit held by a multilateral development bank as defined in para. 1 of the Third Schedule to the Banking Ordinance;*
- (viii) *a deposit held by a holding company that holds all of the shares<sup>13</sup> of the bank, a subsidiary of the bank or a subsidiary of the holding company;*
- (ix) *a deposit held by a director, controller, chief executive or manager of the bank, a subsidiary of the bank, a holding company that holds all of the shares of the bank or a subsidiary of the holding company; and*
- (x) *a deposit held by an authorized institution.<sup>14</sup>”*

3.4 The proposed exclusions from the definition of “insurable deposit” are largely the same as those proposed in the previous consultation paper, which were largely based on the exclusions under the priority claim provisions in the Companies Ordinance. Among the items that are not excluded under the Companies Ordinance are “deposits secured on the assets of the bank” and “bearer instruments”. The former is based on a similar exclusion in the UK scheme. The latter is based on the advice of the IMF and the FSF Working Group on Deposit Insurance which support the exclusion of certain instruments such as certificates of deposits so as to avoid abuse of the coverage limit on a per-depositor basis.

### **Coverage limit**

3.5 There was support for the proposed coverage limit of the DIS to be set at \$100,000 per depositor per institution in the previous consultation exercise. It is therefore proposed that this proposed limit should be adopted. As in other schemes, such as the Federal Deposit Insurance Corporation (“FDIC”) and the Canadian Deposit

---

<sup>13</sup> It is for consideration whether the threshold of shareholding of the holding company should be reduced so that the exception would also apply to deposits held by a majority shareholder controller of the participating bank. If so, appropriate amendments would then need to be made to the relevant provision in section 265 of the Companies Ordinance.

<sup>14</sup> Deposits referred to in sub-paragraphs (vii)-(x) are deposits in which any of the parties referred to have beneficial interest, whether such deposits are held in that party’s name or not.



Insurance Corporation (“CDIC”), the coverage limit can be reviewed and adjusted as appropriate in the future.

### **Accrued interest**

3.6 It is proposed that the coverage limit of the DIS should apply to both the principal amount of an insurable deposit and the interest accrued on that deposit. Thus, if the principal is \$95,000 and the accrued interest is \$7,000, the depositor should be entitled to a payment of \$100,000 (the coverage limit) rather than \$102,000. This would be consistent with the treatment of accrued interest and the calculation of priority claims by a bank liquidator under the present insolvency law (see analysis of the relevant provisions in the Companies Ordinance at **Annex C**).

3.7 The next question to decide is the period up to which accrued interest should run. It is proposed that for the purpose of determining the amount covered under the DIS, the interest accruing and payable in relation to a deposit should normally be calculated up to the date of appointment of a provisional liquidator. This would be consistent with the period of interest accrual under the insolvency regime<sup>15</sup> and would avoid any mismatch between the amount paid out by the DIS and the amount that it could recover from the liquidator. However, there may be circumstances where application of this proposal would be inappropriate, e.g., 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 DIS. In such circumstances, it is proposed that the Board should have the discretion to proceed to make payment to eligible depositors, which should cover interest accrued only up to the date on which payout by the DIS is triggered (see Chapter 7 for discussion on the trigger criteria). The first two examples in **Annex D** illustrate how these proposed rules would work.

3.8 In the event that payment has been made by the DIS before the appointment of a provisional liquidator, it would be necessary to determine who – the DIS or the depositor – should be entitled to claim in the liquidation the interest accrued on the amount of the payment made by the DIS between the date on which the DIS payout was triggered and the date on which the provisional liquidator was appointed (the “twilight period”). The HKMA believes that since a depositor is required to assign to the DIS all his rights and remedies in respect of the payment received from the DIS (see Chapter 4 for discussion on assignment of rights), any interest accrued on the deposit (up to the extent of the payment made) during the twilight period should be for the account of the DIS.

---

<sup>15</sup> As shown in Annex C, “the relevant date” for the purpose of calculation of dividend payment in bank liquidations refers to the date of appointment of a provisional liquidator, or if no such appointment was made, the date of the winding-up order issued by the Court. However in this context, the date of the winding-up order is irrelevant because if no provisional liquidator was appointed, it is likely that the DIS payout would be triggered prior to the making of a winding-up order. The payout by the DIS would cover interest accrued only up to that date.

3.9 In the case where the depositor has only one deposit with the failed bank, it is expected that the liquidator would not have any difficulty in determining the respective entitlements of the DIS and the depositor to the interest accrued during the twilight period. However, a complication would arise if the depositor has more than one deposit (each bearing a different interest rate) and the aggregate amount of such deposits and accrued interest exceeds the coverage limit. In these circumstances, it would be necessary to determine how the compensation payment by the DIS (which would be \$100,000 in this case) should be apportioned to the depositor's different accounts so that the liquidator could determine the respective entitlements of the DIS and the depositor in the liquidation. One option to address this problem would be to specify clearly in the DIS legislation that the compensation payment by the DIS should be apportioned among the different deposit accounts of the depositor on a pro-rata basis (Example (iii) in Annex D shows how this would work).

3.10 The above option appears to be fair to depositors, but it might increase the liquidation costs as the liquidator would have to perform additional work in apportioning deposits and calculating interest entitlement. An alternative would be to amend section 227E of the Companies Ordinance so that in the event that payment was made by the DIS before the appointment of a provisional liquidator, the date on which the DIS payout was triggered would be taken to be the "relevant date" for the purpose of that section. This would fully align the respective treatments of accrued interest by the DIS and the liquidator (see Example (iv) in Annex D). The drawback is that this might prejudice the interests of other uninsured depositors (typically large depositors) who would receive a smaller interest payment from the liquidator as a result of this change. However, it could be argued that they would benefit from the cost savings in the liquidation as a result of the alignment of the treatment on interest accrual. The HKMA would welcome views on which of the two options identified above would be a better solution to address the issue.

### **Applying the coverage limit to special types of accounts**

3.11 Providing cover on a per-depositor basis requires consideration of how the limit should be applied to multi-beneficiary accounts such as joint, partnership and trust accounts.

3.12 The crux of the issue is how to balance equitable treatment of depositors against the practical considerations of maintaining a simple and effective system. The proposals in respect of each type of these accounts are set out below.

#### **Trust accounts**

3.13 Where persons are entitled to a deposit as trustees, the Board should treat any claim they make in respect of such a deposit as trustees as being separate from any claim they make in respect of deposits to which they are entitled in their own right.

3.14 In the case of a bare trust<sup>16</sup>, i.e. where a trustee holds property for a beneficiary who is absolutely and solely entitled to that property, the Board should treat the beneficiary, and not the trustee, as the claimant in respect of the trust monies held on deposit.

3.15 If a group of persons has a claim as trustees, the group should be treated as if it were a single entity separate from the individuals constituting the group so that any change in the membership of the group would not affect any such claim.

3.16 If a trustee has a claim as trustee for different trusts, the trustee should be entitled to make separate claims for each of the trusts he represents and the Board should treat those claims as if they were made by different persons.

### **Client accounts<sup>16</sup>**

3.17 If a person (e.g., a solicitors' firm or a brokerage firm) has a claim as agent for one or more principals, the Board should treat the principals as having the claim, not the claimant, provided that the agent -

- (i) has declared to the relevant bank that the relevant accounts are held for the benefit of its principals and that it maintains proper records of the identities and entitlements of its principals in respect of such accounts at all times; and
- (ii) makes an annual disclosure to the relevant bank regarding the number of beneficiaries and their respective entitlements underlying such accounts to facilitate premium assessment in respect of the bank.<sup>17</sup>

3.18 Para. 3.17(ii) above would help the participating banks to calculate the amount of insured deposits they hold for the purpose of premium assessment in each year. However, this may result in some inflation of the size of insured deposits of a participating bank because it might not be possible to aggregate a deposit in a client account with the other deposits made by the same beneficiary in the bank if the information provided by the agent was on an anonymous basis. One way to address this problem would be to allow the bank an option to request the agent to provide information detailing the identities and entitlements of its clients in respect of such accounts and use

---

<sup>16</sup> For bare trust and client accounts, the entitlement of each underlying beneficiary in such accounts would need to be aggregated with the balances in the other accounts of the beneficiary with the same bank to determine the amount covered.

<sup>17</sup> The CDIC has a similar disclosure requirement. For certain specified categories of agents (such as solicitors and stock brokers) whose clients change frequently, the agent is allowed to provide an alpha-numeric code identifying each beneficiary if it maintains records of each beneficiary's identity and proportionate interest.

this information to determine the size of insured deposits for the purpose of premium assessment.

### **Partnership and joint accounts**

3.19 If two or more persons have a joint beneficial claim, the claim should be treated as a claim of the partnership if they are carrying on business together in partnership.<sup>18</sup> Otherwise each of those persons should be taken to have a claim for his share, and in the absence of satisfactory evidence as to their respective shares, the Board should regard each person as entitled to an equal share. The allocated amount would then be aggregated with the balances in any other accounts of each of the persons to determine the amount covered.

### **Consistency with section 265 of the Companies Ordinance**

3.20 The proposals in paragraphs 3.13 to 3.19 above are largely consistent with the approach under the UK scheme. Other schemes may offer a more generous arrangement, e.g. the CDIC treats a joint account deposit as a deposit separate from any deposit of the account holders acting in their own right. However, the HKMA believes that the above proposals strike an appropriate balance between prevention of possible abuses (e.g. persons seeking multiple coverage through setting up a number of joint accounts) and the practical difficulties of obtaining the information required to identify the depositors' shares and performing account aggregations for premium assessment purposes.

3.21 It is noted that the priority claim provisions under section 265 of the Companies Ordinance are silent on these issues. It is therefore unclear whether the liquidator of a failed participating bank would apply similar rules as proposed above in determining the priority claim entitlements of such bank's depositors.<sup>19</sup> It would be preferable if the DIS and the liquidator were to adopt the same set of rules so that the DIS would avoid shortfall risk<sup>20</sup> as a result of any mismatch between the payout rules adopted by each of them. It is proposed therefore that section 265 of the Companies Ordinance should be amended to spell out the treatment that would apply in a bank liquidation to the

---

<sup>18</sup> It is proposed that the deposits of individual partners should not be aggregated with the partnership accounts as the latter are normally held exclusively for the purpose of the business under partnership.

<sup>19</sup> The existing provisions seem to be lacking clarity as indicated by divergent views among the insolvency practitioners as to how they should be interpreted. For example, one firm indicated that it would treat the deposit of a joint account as a deposit separate from any deposit of the individual depositor in his own right. Another firm indicated that it would treat each of the persons owning the joint account as having a claim for his share of the joint deposit and aggregate this share with any other deposits he has with the bank in determining his priority claim entitlements.

<sup>20</sup> Shortfall risk is the risk that the assets realised in a bank liquidation may be insufficient to meet depositors' claims of that failed bank.

relevant types of deposits held by it and to make these consistent with the treatment that would be applied by the DIS.

### **Foreign currency deposit accounts**

3.22 Given the substantial amount of foreign currency deposits in Hong Kong, it would be necessary to include such deposits in the coverage of the DIS.

3.23 Accordingly, two decisions have to be made. The first is whether foreign currency deposits should be repaid in the relevant foreign currency or in Hong Kong dollars. As noted by the FSF Working Group, a scheme that offers to repay depositors in foreign currencies must have access to sufficient foreign assets or other sources of foreign currency funding to make this commitment credible. On the other hand, if the payout is made in local currency, transparent rules should be set out in advance with respect to the choice of the exchange rate used to calculate the amount to be compensated.

3.24 Given that the funding of the DIS and the dividend payment from the liquidator of a failed bank would be in Hong Kong dollars, it is proposed that the DIS should make all payments in Hong Kong dollars, irrespective of the currencies in which the deposits are denominated.<sup>21</sup> This would place some foreign exchange risk on the depositors but they should be no worse off than they would be if they were paid out in a liquidation.

3.25 If this proposal is accepted, the rules should be clear with respect to the exchange rate that would be used for the calculation of the payout. The HKMA believes that it would be appropriate to choose the date on which the DIS payout is triggered as the valuation date since this would be the same for all claimants. Accordingly, it is proposed that the exchange rate to be used for converting a foreign currency deposit into Hong Kong dollars should be the midpoint between the selling and buying telegraphic transfer rates of exchange quoted by the Hong Kong Association of Banks on the day the DIS payout is triggered or, where no such rates are quoted, an exchange rate determined by the Board.<sup>22</sup>

3.26 Under this proposal, the DIS would be exposed to certain level of foreign exchange risk because the exchange rate used by the DIS to convert foreign currency

---

<sup>21</sup> This would be consistent with the insolvency practice in Hong Kong whereby liquidators would generally convert foreign currency debts of the insolvent entity into Hong Kong dollars when making dividend payments.

<sup>22</sup> This would be similar to section 34(3B) of the Bankruptcy Ordinance, which provides that where a debt provable in bankruptcy is payable in a currency other than Hong Kong dollars, the debt shall be converted from the foreign currency into Hong Kong dollars at the midpoint between the selling and buying telegraphic transfer rates of exchange quoted by the Hong Kong Association of Banks on the day the bankruptcy order is made or, where no such rates are quoted, at an exchange rate determined by the Court.

deposits may differ from that used by the liquidator. However, it should be possible for the DIS to hedge this risk.

3.27 To address the situation where a depositor has insurable deposits denominated in different currencies, it is proposed that the Board should be given the discretion to decide the order in which deposits in different currencies should be paid out subject to the principle that this would help to minimise the DIS' potential exposure to foreign exchange risk. This means that deposits in Hong Kong dollars and US dollars would normally be paid out first. Examples (v) and (vi) in Annex D show how this proposal would work in practice. The latter example also illustrates how this would interact with the proposal in para. 3.9 above for the purposes of interest accrual (i.e., compensation payment by the DIS should be apportioned among different accounts of a depositor on a pro-rata basis).

## Chapter 4 – Depositor Priority, Set-off and Assignment of Rights

### 4.1 This Chapter will consider:

- (i) **whether the DIS should set off a depositor’s liabilities to a failed participating bank in determining the payout to depositors; and**
- (ii) **measures that would help the DIS minimise its shortfall risk or speed up reimbursement from the liquidator.**

### Netting

4.2 The decision whether to set off a depositor’s liabilities to a failed participating bank in determining his deposit insurance entitlement is an important consideration which not only affects the payout to depositors but also the cost of the DIS.

4.3 This was the subject of a separate consultation in October last year. The relevant Discussion Paper can be accessed from the HKMA’s website. The paper already sets out the detailed arguments for and against different options for netting.

4.4 The two main options that were considered in the Discussion Paper are:

- (i) *Partial netting*<sup>23</sup> - the DIS should only set off contractually due and past due liabilities of a depositor against his deposits in determining the amount of his entitlement; and
- (ii) *Full netting*<sup>24</sup> - a depositor’s liabilities would be completely set off against his deposits before his entitlement is determined.

4.5 The results of the consultation indicated that the banks’ views were mixed on this issue. However, there was greater support from the insolvency practitioners for adopting a full netting approach in determining deposit insurance payouts, which is consistent with the current insolvency law. It would also reduce the risk that the DIS would pay out more to depositors than it could recover in a liquidation (owing to differences in its netting approach from that of the liquidator) .

4.6 Partial netting would probably serve the objectives of a DIS better since it would involve less disruption to depositors’ cash flow (i.e. there would be greater scope

---

<sup>23</sup> This is the approach recommended by the Consultant who undertook the study on Enhancing Deposit Protection in Hong Kong in 2000.

<sup>24</sup> This would be consistent with the insolvency law in Hong Kong whereby mutual credits and debts between the insolvent entity and its creditors/debtors would be set off against each other in a liquidation.

for them to receive payment from the DIS without deductions from their deposits of liabilities that are not yet due). However, for this approach to be feasible, it would appear that changes to the insolvency legislation would be required in order to align the approaches towards netting of the DIS and the liquidator of a failed bank. Otherwise, the DIS would face greater shortfall risk and the costs of the scheme would be likely to be increased. Given the general importance attached to minimising the costs of the DIS, this is not desirable.

4.7 Nor does it seem feasible in this case to amend the insolvency legislation. This would be controversial and is not supported by the insolvency practitioners with whom the HKMA has discussed the issue, or by the Standing Committee on Company Law Reform. In view of this, it is proposed that the DIS should apply full netting in determining the payout to depositors, in accordance with the current insolvency law and practice. This means that the DIS would set off a depositor's liabilities to a failed participating bank (including particularly liabilities arising from any credit facilities) against his deposits with the bank in determining his entitlement under the DIS.

### **Interim payment**

4.8 A related issue to be considered is whether the Board should have the option not to apply netting in certain circumstances. In the UK scheme, such a discretionary power was previously given to the Deposit Protection Board under the UK Banking Act. However, this provision has not been carried forward to the rules promulgated by the Financial Services Authority in relation to the setting up of the Financial Services Compensation Scheme. Instead, a new provision for reduced or interim payments has been added to these rules which would enable the Scheme Manager to pay an appropriate lesser sum in settlement if he considers that immediate payment in full would not be prudent because of the uncertainty as to the amount of the claimant's overall net claim.

4.9 The HKMA believes that it would be desirable for the Board to have a similar flexibility because there might be some uncertainty as to how the liquidators would apply netting in practice.<sup>25</sup> From the perspective of restoring depositors' confidence in the banking system and averting a banking crisis at an early stage, it is also desirable for the Board to be able to make a quick payout to depositors. This might take the form of an interim payment consisting of the lesser of a certain percentage (say 25%) of the principal of an insured deposit or a specified absolute amount. In the interests of speed, adjustments to the principal balance would be kept to a minimum and there would be no accrual of interest. The interim payment might be made within, say, 10 days, with final settlement of the insured claim being made at a later date after all the various adjustments, including interest accrual, had been made. The HKMA is still considering

---

<sup>25</sup> For example, some liquidators may sell off the mortgages of a failed bank as a portfolio of assets whereas others may sell off mortgages only after setting off the deposit balances of the customers concerned.



this proposal in the context of a separate study it is presently conducting on the payout strategy and procedures of the DIS.

### **Assignment of depositors' rights to the DIS**

4.10 As noted, the DIS would pay an insured depositor only after the depositor has assigned all his rights and remedies in relation to the deposit (up to the amount of the payment made) to the DIS. It would be cumbersome, and could undermine the efficiency of payout, if the DIS has to approach all eligible depositors and obtain an assignment in writing from each of them. It would be desirable to include an explicit provision in the DIS legislation to provide for an automatic assignment of rights from the depositors to the DIS. Based on the relevant provisions in the Protection of Wages on Insolvency Ordinance, a provision along the following lines is proposed to be included in the DIS legislation:

“Where the Board makes a payment in respect of any deposit with a participating bank, all the depositor’s rights and remedies with respect to the deposit existing immediately before that payment shall, to the extent of the amount of the payment made, be transferred to and vest in the Board for the benefit of the DIS Fund and the Board may take such steps as it considers necessary to enforce those rights and remedies”.

### **Clarification of the priority claim provisions in the Companies Ordinance**

4.11 The cost of the DIS would be affected significantly by how much and how quickly the DIS would be able to recover from the liquidator of a failed participating bank. It is thus important for the DIS to be able to take over the priority claim status of each of the depositors it has paid out. This would be crucial to the reduction of the shortfall risk and financing cost of the DIS. However, the relevant provisions in the Companies Ordinance do not make it clear whether the DIS would have a priority claim in respect of the whole of the aggregate amount it has paid out to depositors or simply the first HK\$100,000 of such amount as if the Board were one single depositor. A legislative amendment to section 265 of the Companies Ordinance would be necessary to ensure that the Board has a priority claim in respect of the aggregate amount.

### **Asset maintenance requirement for banks**

4.12 It is also necessary to consider whether participating banks should be required to maintain sufficient assets in Hong Kong to cover their insured deposits in the event of a liquidation. Such an asset maintenance requirement would help to minimise the shortfall risk of the DIS. However, such a requirement is not without cost as it could constrain the ability of banks to freely manage the disposition of their assets. In practice, from the previous surveys undertaken by the HKMA, it appears that banks in Hong Kong (including foreign banks) generally maintain more than sufficient assets in Hong Kong to

cover their deposits that have priority under the Companies Ordinance (and those would be insured by the DIS). In view of this, it does not seem necessary to introduce a general requirement on asset maintenance for all banks. However, it would be necessary for the HKMA to have the ability to monitor, on a regular basis, the extent to which banks' insured deposits are covered by assets held in Hong Kong. This could be done through a regular (quarterly or half-yearly) statistical return. In case of need, when there is a risk that the ratio of the assets held in Hong Kong to the insured deposits of a particular bank might become insufficient, the HKMA could step up its monitoring of that bank and, if necessary, require it to take remedial action to maintain an appropriate ratio. While the HKMA could use its existing general powers under the Banking Ordinance to require this, it would make the process more transparent for a specific power to be given to the HKMA, either in the DIS legislation or in the Banking Ordinance.

### **Measures for speeding up reimbursement from liquidators**

4.13 The financing cost of the DIS could be reduced if the DIS could get reimbursement from the liquidator within a shorter period of time. From the HKMA's discussions with the insolvency practitioners, it appears that after a winding-up petition is filed, it would normally take about 3-6 months before a winding-up order is granted by the Court. This means that the DIS would only start to receive payments from the liquidator some months after it has paid out the depositors.

4.14 It would be preferable if this timeframe could be further shortened. One option would be to include an explicit provision in the DIS legislation which would enable, but not oblige, the provisional liquidator to make payment to the DIS, possibly against an indemnity provided by the DIS.<sup>26</sup> This discretionary power of the provisional liquidator would need to be subject to Court approval. It is relevant to note that in fact in 1992 the provisional liquidator of the Bank of Credit and Commerce Hong Kong Ltd was able to make an interim payment to all depositors against an indemnity provided by the Government after obtaining the High Court's approval of such an arrangement.

4.15 Accordingly, it is proposed to include a provision in the DIS legislation which would give a discretionary power to the provisional liquidator of a failed participating bank to make early payments to the DIS subject to approval by the Court.

---

<sup>26</sup> This would reduce the financing cost of the DIS if the interest charged (if any) by the provisional liquidator in respect of early payments to the DIS is less than the interest payable in respect of a loan from the Government or a third party to fund the payout.

## Chapter 5 – Funding and Premium Assessment

### 5.1 This Chapter will consider:

- (i) **what the appropriate size of the DIS Fund should be to cover losses which might be suffered by the DIS;**
- (ii) **how this target fund size should be built up and maintained; and**
- (iii) **how the premium should be assessed on individual participating banks – in particular, whether a differential premium system should be introduced; and, if so, how this should be structured.**

5.2 Detailed proposals on the above issues were the subject of a separate consultation in September last year (the relevant Discussion Paper can be accessed from the HKMA's website). As such, details of the proposals and the relevant considerations will not be repeated here. It is sufficient to recall that the methodology used to derive the target fund size and premium involved the following steps:

- (i) making assumptions about possible shortfall loss and funding costs of the DIS Fund, and the probability of default of participating banks;
- (ii) feeding these assumptions into a statistical model in order to calculate the target size of the DIS Fund and the level of annual premium required to build up the Fund to the target level within a reasonable period of time. The target level of the Fund would be designed to cover both expected and unexpected losses up to a given confidence interval. Upper and lower limits of the Fund would also be set to produce a target range;<sup>27</sup>
- (iii) re-calculating the target level of the DIS Fund each year to take account of deposit growth, changes in the risk profile of participating banks and the funding costs of the DIS;
- (iv) once the target level of the DIS Fund had been reached, basing the annual premium on the expected loss of the DIS;
- (v) paying a rebate or levying a surcharge, when the balance of the DIS Fund rose above the upper limit or fell below the lower limit, as the case may be, of the target range; and

---

<sup>27</sup> In practice, the target fund size and the target range would be expressed as percentages of insured deposits – see para. 5.3 below.

- (vi) differentiating the premium paid by individual participating banks, based on their supervisory (CAMEL) ratings given by the MA.

5.3 This methodology produced the following outcome in terms of target fund size, build-up period and premium level:

- (i) based on the level of insured deposits at May 2001, the target fund size would be set at HK\$1.5bn (or approximately 0.3% of the sector's total insured deposits). The target fund size would grow in absolute terms in line with the growth in insured deposits;
- (ii) based on a flat annual premium of 8 basis points, the target level could be reached within 4 years, taking into account deposit growth;
- (iii) once the target fund size had been achieved, the annual premium would be reduced to a much lower level of about 1 basis point (equivalent to the annual expected loss of the DIS);
- (iv) a rebate or a surcharge would be triggered once the balance of the DIS Fund rose above the upper limit or fell below the lower limit, as the case may be, of the target range. The upper and lower limits were defined as +/-30% of the target fund size; and
- (v) it would be feasible (and desirable) to provide for a differential premium structure linked to an individual bank's CAMEL rating as set out below :

<b>CAMEL Rating</b>	<b>Premium during fund build-up (bp)</b>	<b>Premium after fund build-up (bp)</b>
1	5	0.75
2	8	1.0
3	11	1.5
4 & 5	14	2.0

5.4 Results of the consultation exercise indicated that the respondents largely agreed with the suggested methodology for estimating the target fund size and premium both during and after the fund build-up period. There was also support for a differential premium system and for the use of CAMEL ratings for this purpose. It was considered preferable to adopt a risk-based approach towards calculating the premium so that banks would be rewarded for having strong management and good asset quality.

5.5 The Hong Kong Association of Banks ("HKAB"), however, proposed certain variations aimed at lowering the cost of the DIS further. These included a lower

target fund size, a lower upper fund limit, a longer fund build-up period, a cap on surcharge and government contribution to the DIS Fund.

### **A smaller fund size**

5.6 HKAB considered that the proposed \$1.5 billion target fund size based on a 99.8% confidence interval was overly conservative. It proposed targeting at a lower confidence interval of 98% or even 95% “as recommended in the Consultant’s report”<sup>28</sup>. It considered that a much smaller fund capable of coping with the failure of 2 to 3 small banks or one medium-sized bank would be adequate.

5.7 The HKMA considers that further reduction of the proposed \$1.5 billion target fund size would make it more difficult to meet certain international standards and benchmarks for credibility. The main considerations are as follows:

- the proposed 99.8% confidence interval matches an investment grade rating of BBB (which is also the rating for a typical local bank whose depositors would be insured by the DIS); whereas 98% and 95% confidence intervals correspond to speculative grade ratings of BB- and B respectively;
- a HK\$1.5 billion fund meets the IMF’s benchmark of being able to cope with the failure of 2 medium-sized banks; whereas the fund sizes corresponding to 98% and 95% confidence intervals<sup>29</sup> would be capable of meeting losses arising from the failure of only one typical medium-sized bank and one smaller medium-sized bank respectively;
- at around 0.3% of insured deposits, the target fund size is at the lower end of the range for comparable schemes; and
- to achieve an 8% capital ratio under the New Capital Accord, the DIS would need a fund size of \$1.76 billion (based on the risk-

---

<sup>28</sup> It is true that the original Consultant’s report suggested lower confidence intervals. However, the assumptions used by the Consultant, in particular, on default frequency were much more conservative, hence giving rise to a much higher target fund size notwithstanding the lower confidence intervals. The HKMA has subsequently refined the Consultant’s assumptions, while adopting more conservative confidence intervals. The overall result is a significant reduction in the target fund size.

<sup>29</sup> Confidence intervals of 98% and 95% would correspond to fund sizes of \$730 million and \$384 million respectively.

weighted assets of the DIS of \$22 billion).<sup>30</sup> HKAB's suggested levels would be significantly below this requirement.

5.8 For the above reasons, it is proposed not to reduce the fund size further since this might undermine the credibility of the DIS.

### **Government contribution**

5.9 HKAB proposed that the Government should contribute to the fund build-up, for up to 50% (\$0.5-0.8 billion at the minimum) of the target fund size. It argued that in most countries with a DIS the government is one of the funding sources.

5.10 According to a recent survey by the IMF, governments' support for DISs in most countries is in the form of backup liquidity. This form of support is what the Hong Kong Government has already agreed to provide through the Exchange Fund. Out of the 66 jurisdictions surveyed by the IMF, only one third of the surveyed countries' governments contributed to the start-up capital of their DISs. In view of the above and in line with the user-pays principle, it remains the Government's position that it would be inappropriate for it to provide a direct contribution to the capital of the scheme.

### **A lower upper limit for the target fund**

5.11 HKAB considered that the proposed +/- 30% target range was excessively wide, in particular, the upper limit. In response to this, the HKMA proposes to adopt an asymmetric target range by reducing the upper limit to +15% while maintaining the -30% lower limit. This would increase the likelihood and frequency of rebates.

### **A cap on surcharge**

5.12 HKAB suggested to set a cap on the surcharge to the amount of the premium if the DIS Fund had to be replenished following losses. The HKMA agrees to this proposal. The benefit of introducing a cap would be to reduce the procyclical impact of DIS funding. It would avoid levying too heavy a surcharge at a time when the banking sector might already have been weakened by bank failures. It is proposed therefore that the surcharge and annual premium taken together should not be more than the premium that would be paid in the initial period while the DIS Fund is being built up (see the figures in the table in para. 5.3).

### **Extending the build-up period and reducing the build-up premium**

5.13 HKAB considered that a build-up period of 3-4 years was too short and that it should be extended through lower premium (less than 8 basis points) in the initial

---

<sup>30</sup> This treats the DIS as if it were itself a bank with risk exposure to the banks it insured. The figures take into account the latest proposals from the Basel Committee.

years. However, the premium of 8 basis points is only the central rate applicable to most banks. In the Discussion Paper, the suggested differential premium structure of 5,8,11,14 basis points would actually give a weighted average premium of 7 basis points and hence the target fund size would be reached in 5 years instead of 3-4 years (see Annex F of the Discussion Paper). This seems a reasonable length of time to allow the DIS Fund to build up and thus it is not proposed to extend the period further.

### **Rules on funding and premium assessment**

5.14 It is proposed that the target fund size, target range and premium structure should be set out in the DIS legislation at the outset so as to provide greater certainty to banks about their financial commitments. As noted earlier, the target fund size would be set as a percentage of insured deposits (say 0.3% initially). This figure and the other parameters would be subject to change in the light of factors such as changes in the risk profiles of the participating banks and in the DIS' funding costs. For this reason, it is proposed that the relevant rules should be set out in a schedule to the DIS legislation which would be subject to amendment by the Chief Executive in Council. A set of the Rules on Funding and Premium Assessment is given in Schedule 2 of Annex B.

### **Funding of administrative costs**

5.15 The issue of how the administrative costs of the DIS should be funded was not addressed in the Discussion Paper on Funding and Premium Assessment.

5.16 Given the limited functions of a “pay-box” scheme, the administrative costs should be relatively modest.<sup>31</sup> If so, charging the administrative costs to the DIS Fund should not in any significant way affect the ability of the Fund to attain its target level, and there seems no need to impose a separate levy on participating banks to cover administrative costs. It would be specified in the DIS legislation that the administrative costs of the DIS should be charged to the DIS Fund.

### **De minimis premium**

5.17 In some cases, e.g., where a participating bank only has a small amount of insured deposits, the premium charge on the bank would be minimal. The HKMA has considered whether the premium charge on such institutions should be waived if the cost

---

<sup>31</sup> It is expected that a “paybox” scheme would require approximately 12-15 staff members. This would include the Chief Executive Officer, a chief accountant and supporting staff for premium assessment, administration and accounts management. Based on this structure, a rough estimate of the annual administrative costs of the DIS would be in the range of \$12-15 million, around 0.8%-1% of a target fund size of HK\$1.5 billion. The above estimate is proportional to the operating expense of the Hong Kong Mortgage Corporation in 2000 (HK\$98 million), which has a staff force of about 100.

of collection would be disproportionate to the amount received<sup>32</sup> or whether there should be a minimum premium for all participating banks<sup>33</sup>.

5.18 The former approach would give rise to a free-rider problem whereby certain institutions (including new entrants to the DIS) can benefit from free insurance. We therefore prefer the latter approach which would not only help to avoid the free-rider problem, but also contribute to sharing of some of the administrative costs of the DIS. It is proposed therefore that the annual premium payable by a participating bank should be subject to a minimum level of, say, \$10,000. This minimum fee would also be payable by new entrants to the DIS upon being granted a banking licence by the MA.

---

<sup>32</sup> This approach is adopted by the UK scheme.

<sup>33</sup> This approach is adopted by the CDIC.



## Chapter 6 – Premium Collection, Refund & Fund Management

**6.1 This Chapter will consider how:**

- (i) premiums should be collected; and**
- (ii) the DIS Fund should be invested.**

### **Premium collection**

6.2 Premium collection is an important aspect of the work of any DIS. In keeping with the principle of maintaining a lean management structure for the Board, it is proposed that the Board should have the power to appoint an agent to collect insurance premiums. However, given the sensitivity of premium information, which would reflect the risk ratings of individual participating banks, it would not be appropriate for the Board to collect premiums through ordinary bank accounts. Accordingly, it is proposed that the Board should appoint the HKMA as its agent to collect insurance premiums from participating banks via the RTGS system.<sup>34</sup> The relevant HKMA staff would be subject to the secrecy provisions in the DIS legislation.

6.3 To ensure punctual payment of premiums, the Board could serve assessment notices on participating banks requiring them to credit premium payments to the HKMA for the account of the DIS by a specified date. The DIS legislation should empower the Board to specify the manner and timing in which premium payments should be made. The legislation should also specify the penalty for late or non-payment of premiums.

6.4 A related issue is whether premiums should be paid by instalments.<sup>35</sup> Considering that the proposed premium level would not be unduly high, payment by instalments does not seem necessary and would impose unnecessary administrative costs on both participating banks and the DIS. It is therefore proposed that the full annual premium should be collected in one payment.

### **Refund of premium**

6.5 As the premium would be paid in advance, it would be reasonable to refund part of the premium payment made by a participating bank in the year in which it ceases to be a participating bank. Paragraph 2.8 in Schedule 2 of the Rules suggests how the

---

<sup>34</sup> As proposed in Chapter 1 above, the Board should have the power to appoint an agent to discharge any of its functions on its behalf. In practice, the arrangements could be effected by the Board instructing banks to credit its account maintained with the HKMA via the RTGS.

<sup>35</sup> For example, the FDIC and CDIC collect premium on a semi-annual basis.

amount of refund should be determined. Like premium collection, the premium refund could be effected by the Board instructing the HKMA to credit the settlement account of the bank concerned via the RTGS.

## **Fund investment**

6.6 In its Final Report, the FSF Working Group on Deposit Insurance advised that deposit insurers should ensure that funds were well managed and readily available to cover losses as they arose. This emphasises the need for capital preservation and liquidity in the investment of deposit insurance funds.

6.7 A deposit insurer typically only has a limited investment mandate. According to the IMF survey of 67 deposit insurance schemes, about one-third (including the US and UK) invest in only government securities, typically short-term. Several DISs invest in central bank securities or place funds with their own central banks. Some DISs are allowed greater investment choice, but they must have regard to liquidity, risks and returns. Only a small proportion of the 67 DISs are allowed to invest in foreign securities or currencies.

6.8 In keeping with the need for capital preservation and liquidity, it is proposed that the DIS Fund should be allowed to invest in one or more of the following:

- (i) deposits with the Exchange Fund (“EF”);<sup>36</sup>
- (ii) EF bills (i.e. short-term EF paper with maturity of one year or less);
- (iii) US Treasury bills (i.e. short-term US government paper with maturity of one year or less);
- (iv) foreign exchange contracts, including derivative products, which are necessary for hedging purposes<sup>37</sup>; and
- (v) any other investment that may be approved by the FS.<sup>38</sup>

6.9 These options can all meet the two primary investment objectives of the DIS as stated above. Investment in US Treasury bills seems necessary in order to provide

---

<sup>36</sup> Since the DIS is to protect depositors against bank failures, the DIS Fund should not be placed with a bank for investment purposes. The DIS should however be permitted to maintain a commercial bank account to make and receive payments in connection with its operational needs.

<sup>37</sup> This is to enable the Board to hedge its foreign exchange risks in relation to compensation payment made in respect of foreign currency deposits. Please refer to para. 3.26 above.

<sup>38</sup> This is to provide flexibility. A similar provision can be found in the Protection of Wages on Insolvency Ordinance.

a wide enough pool of potential investments and should be acceptable as the exchange rate risk is limited under the linked exchange rate system in Hong Kong. As each investment option has its relative merits, it seems inappropriate to specify that the DIS Fund should only be invested only in one instrument.

6.10 The HKMA believes that the limited investment mandate proposed for the DIS would not require it to maintain a large team of people to manage the DIS Fund. Most of the work could be done through a custodian bank (e.g. purchase and settlement of government securities). Alternatively, the HKMA could be empowered to manage the DIS Fund on the Board's behalf.<sup>39</sup>

---

<sup>39</sup> As noted in Chapter 1 above, it is proposed that the Board should have the power to appoint an agent to perform any of the functions of the Board under the DIS legislation.

## Chapter 7 – Trigger Criteria for DIS Payout

**7.1 This Chapter will consider when and under what conditions the compensation payments to depositors under the DIS should be triggered.**

7.2 The trigger for deposit insurance payout is an important consideration for any DIS because depositors need to know when and under what circumstances the DIS will start the compensation process. The key factors that should be taken into account in designing the appropriate trigger conditions are:

- (i) minimising DIS cost;
- (ii) providing a clear and transparent point of payment; and
- (iii) protecting the interests of depositors.

7.3 Taking the above into account, it is proposed that the Board should make payment to the insured depositors of a participating bank where:

- (i) a court order has been made to wind up the participating bank; or
- (ii) a Manager (as defined in the Banking Ordinance) has been appointed to manage the affairs of the participating bank under section 52 of the Banking Ordinance or a provisional liquidator has been appointed in respect of the bank and the MA, after consultation with the FS, has notified the Board that it is appropriate that payment should be made to insured depositors by the Board because either:
  - (a) the MA believes that the bank is likely to become unable to meet its obligations, or that it is insolvent or about to suspend payment to depositors; or
  - (b) the MA believes that payment to depositors by the Board is necessary to promote the general stability and effective working of the banking system.

7.4 Under the above criteria, payout by the DIS would be automatically triggered if an order were made to wind up the failed bank. However, there may be circumstances in advance of that where payout would be appropriate, in particular the appointment of a Manager by the MA or the appointment of a provisional liquidator. Equally, payout by the DIS in such circumstances should not be automatic. The appointment of a Manager by the MA may, for example, involve only temporary closure of the bank, or the bank may even remain open as a going concern if sufficient liquidity

can be made available. Even the appointment of a provisional liquidator does not rule out the possibility that the bank may be sold as a going concern to a third party. Provided this could be done quickly, this might avoid the need for the DIS to be triggered. This is why the criteria in para. 7.3(ii) above additionally require the MA, after consultation with the FS, to notify the DIS that it is appropriate that the DIS should be triggered on the grounds set out in para. 7.3(ii)(a) or (b).

7.5 It should be noted that the effect of this is that the Board would not have the authority unilaterally to trigger payout. This is consistent with the Board's role as a "pay-box", under which it would not monitor the financial condition of a participating bank or have the power to close a bank. Otherwise, there would be a confusion over the respective roles of the Board and the HKMA in relation to banking stability. Once the MA has notified the Board pursuant to para. 7.3(ii) above, such notification would be made public. When consulting the FS over the exercise of the powers under section 52 of the Banking Ordinance to appoint a Manager, the MA would also consult the FS on the decision to trigger the compensation process under the DIS.

## **Chapter 8 – Relationship between the Deposit Insurance Board and the HKMA**

**8.1** This Chapter will consider how the respective functions and responsibilities of the Deposit Insurance Board and the HKMA should be co-ordinated.

### **Structure of the safety net**

8.2 Deposit insurance is only one component of the safety net for a banking system, which also includes prudential regulation and the lender of last resort (LOLR) function. In Hong Kong, the latter two functions are performed by the HKMA and the former function is proposed to be assigned to the Board.

8.3 As part of the safety net system, the roles of the regulator, the LOLR and the DIS are complementary to each other in achieving the common objective of promoting the stability of a banking system. To the extent that effective banking regulation and availability of LOLR support to banks reduce the incidence of bank failures, this would reduce potential calls on the DIS and minimise its costs. Likewise, to the extent that the existence of a DIS could prevent bank failure caused by rumour driven runs by small depositors, this would avoid the need for unnecessary regulatory intervention or provision of LOLR support. If a bank failure does occur, a DIS can reduce the resulting fall-out effects, by providing an orderly means of compensating small depositors.

8.4 The fact that each safety-net player is held accountable for its own mandate creates checks and balances in the system. But at the same time it also means that the division of responsibilities between the various agencies needs to be made clear and that their work needs to be well co-ordinated. Where appropriate, the existing arrangements should be strengthened to avoid or minimise overlapping of responsibilities or tension among the various agencies.

### **Means to promote smooth co-ordination between the Board and the HKMA**

#### *A clear division of responsibilities*

8.5 As noted by the FSF Working Group on Deposit Insurance, an important way to promote smooth co-operation between the various safety-net players is to have a clear division of powers and responsibilities. It is important for the public at large to agree, through the legislative process, what the respective roles and responsibilities should be for the DIS and the HKMA. The DIS and the HKMA each have a different role to play in achieving the common policy objective of promoting the stability of the banking system. These differences should be recognized by law. As already proposed, the functions of the Board would be confined to collection of premiums, making

compensation payments to insured depositors, and recovering the amount paid out to insured depositors upon a bank's liquidation. Accordingly, the Board's powers should not be more than those that are needed to fulfil those responsibilities. These functions and powers should be clearly set out in the DIS legislation (see Chapter 1) so that the Board and the HKMA could efficiently and effectively carry out their respective functions in a bank crisis.

8.6 As noted earlier, the Board may delegate some of its functions to the HKMA (e.g., premium collection and fund investment). Although it may be considered to be within the functions of the MA under the Banking Ordinance<sup>40</sup> to provide such assistance to the DIS, it would be helpful to include an explicit provision in the Banking Ordinance to make it clear that the MA has the function of co-operating with, and assisting, the Board to the extent permitted by the Banking Ordinance and the DIS legislation. This would put it beyond doubt that the MA may assist the Board in discharging its functions under the DIS legislation.

#### *Review of the existing LOLR policy*

8.7 There is the potential for tension between the DIS and the LOLR, e.g. in the event that a participating bank that has borrowed from the LOLR eventually fails, the LOLR could become a large secured creditor with priority over the DIS. The FSF Working Group on Deposit Insurance advised that a more rule-based LOLR policy would help minimise such problems.

8.8 In fact, the HKMA has already adopted a rule-based policy in relation to the provision of LOLR support. The pre-conditions for access to LOLR support have been codified in a policy statement issued in 1999. These include:

- (i) LOLR support should be provided only when the failure of a troubled institution would damage the stability of the exchange rate, monetary or financial system;
- (ii) only institutions with a sufficient margin of solvency can have access to LOLR support;
- (iii) there should be no prima facie evidence that the management is not fit and proper, or that the liquidity problem is due to fraud;
- (iv) the institution must be prepared to take appropriate remedial action to deal with its liquidity problems; and

---

<sup>40</sup> Section 7 of the Banking Ordinance states that the principal function of the MA shall be to promote the general stability and effective working of the banking system.

- (v) there are limits on the maximum amount of LOLR support that can be provided to an individual institution. For institutions with a capital adequacy ratio (“CAR”) above 6%, the limit is set at 100% of its capital base. For institutions with a CAR above its statutory minimum, the limit is set at 200% of its capital base. On top of these limits, there is also an absolute cap of HK\$10 billion per institution.

8.9 Where the above pre-conditions are not met, funding support can only be granted with the specific prior approval of the FS. The HKMA therefore believes that there are already sufficient checks and balances in the existing LOLR policy which would help minimise tension between the HKMA and the Board.

#### *Prompt corrective action*

8.10 There is also the potential for tension between the DIS and the regulator, e.g. if the regulator’s action is not swift enough to prevent losses to the DIS.

8.11 This raises the question of whether a system of prompt corrective action, similar to that which exists in the US should be introduced in Hong Kong. Such a system would define a series of trigger points based on a bank’s capital strength and would mandate a set of enforcement actions for the supervisor to implement at each point.

8.12 Such a system can be helpful to limit undue supervisory forbearance. On the other hand, it can be unhelpful if it pre-commits the supervisor to a set of actions that might not be appropriate in particular cases.

8.13 In practice, the system in Hong Kong already incorporates certain features of a system of prompt corrective action. Under section 99 of the Banking Ordinance, the MA must notify the FS when he becomes aware that an authorized institution has failed to meet the minimum capital adequacy ratio set for it. The MA and the institution must then go into discussions to determine what remedial action should be taken. The MA may then require the institution to take appropriate remedial action. Failure on the part of the institution to do so is a criminal offence. Similar arrangements in relation to notification to the FS and requirement to take remedial action apply in relation to failure to keep to the minimum liquidity ratio.

8.14 The remedial action to be taken by the authorized institution concerned is not specified in the legislation in recognition that it will vary from case to case, but the broad scope of the necessary measures is quite clear, e.g. a breach of the capital ratio would require one or more of the following: injection of fresh capital, restriction of dividends, sale of assets, shrinkage of the balance sheet, etc.

8.15 The question is whether additional trigger points should be specified for the MA to take further action (e.g. to appoint a Manager under section 52 of the Banking



Ordinance) if an institution's capital (or liquidity) position becomes increasingly impaired.

8.16 However, to a large extent, the Policy Statement on LOLR has already catered for such situation. As noted above, under the Policy Statement, where the pre-conditions for LOLR support are not met, the MA must seek the specific prior approval of the FS if further funding support from the Exchange Fund is to be provided. This would include a situation where the capital adequacy ratio of the institution has fallen below 6%. In addition, in those circumstances, the MA is committed to "consider whether to appoint a Manager under section 52 of the Banking Ordinance to safeguard the assets of the institution and to protect the interest of depositors and other creditors."

8.17 In the HKMA's view, therefore, there are already sufficient checks and balances built into the system to ensure that appropriate action would be taken by the regulator before a problem institution becomes critically under-capitalised. To go further down the rule-based approach would risk introducing undue rigidities into the regulatory regime.

#### *Information co-ordination between the DIS and the HKMA*

8.18 For a simple "pay-box" system, the DIS should have less need for information compared with a DIS with a broader mandate. It should have access to information about the level of insured deposits and other relevant information for the purpose of premium assessment and collection. In the case of a failed participating bank, it should also have access to specific information such as the amount and size distribution of insured deposits at the bank for the purpose of effecting timely payout to depositors.

8.19 While it is important for the Board to have the necessary powers to obtain relevant information for the discharge of its "pay-box" function effectively, it would also be useful for the Board to co-ordinate the collection of such information with the HKMA. For example, the HKMA could collect the relevant information on behalf of the Board. This would have the advantage of leveraging on the HKMA's existing systems for information collection from authorized institutions and help maintain a lean management structure for the Board.

8.20 In certain circumstances, the Board should also have direct access to supervisory information provided by the MA (e.g. CAMEL ratings of institutions) for the purpose of premium assessment. It is therefore proposed that an additional gateway should be included in section 120 of the Banking Ordinance so that the MA may disclose information to the Board if such disclosure will enable or assist the Board to discharge its functions.

### *Petition for the winding up of a bank*

8.21 After taking over the rights and interests of the depositors it has paid out, the DIS would become a creditor of a failed participating bank and would be able to file a petition for the winding up of the bank under section 179 of the Companies Ordinance. It is conceivable that the DIS might prefer to take this course of action under certain circumstances in order to protect its own interests. This could happen, for example, if the Board believes that, given its entitlement to priority claims status, the amount of money that it could recover from the liquidation of the failed bank would be larger than the amount that a potential buyer of the bank would be willing to pay to satisfy its claims. While the grant of any winding-up petition would ultimately be subject to the leave of the Court, such action by the Board would not be desirable in cases where liquidation is not the best option to resolve the problem bank. To prevent such a dilemma, it is proposed that the DIS should co-ordinate any action in this regard with the Government, e.g., it should seek the consent of the FS before presenting any winding-up petition to the Court. The FS should refuse consent only when he considers that it would be in the public interest to do so.

## ANNEX A

### Summary of HKMA's Proposals on the Detailed Design of the DIS

Design features	HKMA's proposals
Structure and administration of DIS	<p>The DIS should be run by a new statutory body called the "Hong Kong Deposit Insurance Board" operating as a "pay-box" with a lean structure. The Board should consist of at least 7 but not more than 10 members appointed by CE/SAR. The number of lay members should be more than the total number of ex-officio and executive members.</p> <p>The Board's functions should be confined to collection of premiums, management of the DIS Fund, assessment of claims, making compensation payments and recovering payments from the estate of the failed participating bank. It should be given the necessary powers to discharge those functions.</p> <p>The Board should be able to appoint agents, or authorize third parties, to perform any of its functions. This would help to maintain a lean structure for the DIS.</p> <p>The Board should be required to maintain proper accounts which should be audited every year by an external auditor or the Director of Audit. An annual report should be prepared and laid before the Legislative Council every year. The Board's annual budget should be approved by the Financial Secretary ("FS").</p> <p>The Board and its staff members and agents should be subject to confidentiality provisions in the DIS legislation.</p> <p>As a non-profit making organisation, the Board should be exempt from taxation.</p>
Membership	<p>Participation should be compulsory for full licensed banks (both locally and overseas incorporated). Membership should be automatically granted to an institution which has been granted a banking licence and withdrawn if its banking licence is revoked.</p> <p>However, foreign incorporated banks may be exempted from participation if the deposits with the Hong Kong offices of the bank 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 DIS in Hong Kong.</p>
Coverage	<p><u>Coverage limit</u> should initially be set at <u>HK\$100,000 per depositor per bank</u>. It should be reviewed and adjusted as appropriate from time to time.</p>

Design features	HKMA's proposals
Coverage (continued)	<p>Coverage should include the principal amount of an insurable deposit and any <u>interest</u> accrued thereon (at the relevant contractual rates) up to the date of appointment of a provisional liquidator. However, where it is uncertain whether a provisional liquidator will be appointed or where to wait for such appointment would unduly delay compensation payment by the Board, the Board may determine that the compensation payment should cover interest accrued only up to the date on which DIS payout is triggered.</p> <p>For <u>trust accounts</u>, the trustee(s) should be treated as a separate depositor. For <u>bare trusts</u> (i.e. where a trustee holds property for a beneficiary who is absolutely and solely entitled to that property), each beneficiary should be allowed to claim according to his entitlement to the account but such claim should be aggregated with the balances in his other accounts in determining the amounts insured.</p> <p>For <u>client accounts</u>, the underlying principals (rather than the agent who holds the accounts) should be regarded as the claimants provided that the agent (i) has declared to the bank that the account is held for the benefit of its principals and that it maintains proper records of the identities and entitlements of its principals in respect of the account at all times; and (ii) makes an annual disclosure to the bank regarding the number of principals and their respective entitlements underlying such accounts. The entitlement of each principal in such accounts should then be aggregated with the balances in the other accounts of the principal in determining the amounts insured.</p> <p><u>Joint accounts</u> should be deemed to be equally owned by all the account-holders unless there is satisfactory evidence as to their otherwise respective shares. The deemed share of each of the account-holders should then be aggregated with their respective other claims in determining the amounts insured.</p> <p><u>Partnership accounts</u> should be treated as a joint beneficial claim separate from those of the individual partners.</p> <p>Both HK\$ and foreign currency deposits should be protected to the same extent. All payouts should be made in HK\$ irrespective of the currencies in which the deposits are denominated. The applicable exchange rate should be the market rate as at the date on which DIS payout is triggered.</p> <p>The Board should have the power to determine the order in which deposits in different currencies should be paid compensation subject to the principle that this would help to minimise the Board's potential exposure to foreign exchange risk.</p>

Design features	HKMA's proposals
Exclusion from coverage	<p>The following should be excluded from protection:-</p> <ul style="list-style-type: none"> <li>(i) Term deposits where the current term agreed to by the depositor at the most recent time it was negotiated exceeds 5 years;</li> <li>(ii) Deposits that serve as collateral;</li> <li>(iii) Deposits secured on the assets of the failed participating bank;</li> <li>(iv) Bearer instruments such as certificates of deposits;</li> <li>(v) Deposits booked with a foreign office of the failed participating bank;</li> <li>(vi) Deposits held for the account of the Exchange Fund;</li> <li>(vii) Deposits held by a multilateral development bank;</li> <li>(viii) Deposits held by a holding company that holds all of the shares of the bank, a subsidiary of the bank, or a subsidiary of the holding company;</li> <li>(ix) Deposits held by a director, controller, chief executive or manager of the bank, a subsidiary of the bank, a holding company that holds all of the shares of the bank or a subsidiary of the holding company; and</li> <li>(x) Deposits held by an authorized institution.</li> </ul>
Netting approach	<p>A depositor's liabilities to the failed participating bank should be completely set off against his deposits before his entitlement is determined.</p> <p>A lesser sum may be paid to a depositor as interim settlement where there is uncertainty as to the depositor's overall net claim and/or in the interests of a speedy payout.</p>
Assignment	<p>The rights and remedies of a depositor, including his right to priority payments, should, to the extent of the amount of the compensation payment received by him, be transferred to, and vest in, the DIS.</p>
Trigger criteria	<p>The Board should make payment to the insured depositors of a participating bank where-</p> <ul style="list-style-type: none"> <li>(i) a court order has been made to wind up the bank; or</li> <li>(ii) a Manager (as defined in the Banking Ordinance) has been appointed to manage the affairs of the bank under section 52 of the Banking Ordinance or a provisional liquidator has been appointed in respect of the bank and the Monetary Authority ("MA"), after consultation with the FS, has notified the Board that it is appropriate that payment should be made to insured depositors by the Board because either: <ul style="list-style-type: none"> <li>(a) the MA believes that the bank is likely to become unable to meet its obligations, or that it is insolvent or about to suspend payment to depositors; or</li> <li>(b) the MA believes that payment to depositors by the Board is necessary to promote the general stability and effective working of the banking system.</li> </ul> </li> </ul>

Design features	HKMA's proposals																				
Funding	<p>An ex ante fund should be built up within approximately 5 years.</p> <p>The target fund size should be set at 0.3% of the total balance of insured deposits of all participating banks (approximately HK\$1.5bn based on the level of insured deposits as at May 2001). The target fund range should be set at +15% and –30% of the target fund size. A rebate or surcharge will be triggered if the balance of the DIS Fund is outside the target fund range.</p> <p>The Hong Kong Government has indicated that, if necessary, backup liquidity should be provided through the Exchange Fund, but the DIS Fund should, as far as practicable, be financed by the banking industry.</p>																				
Premium	<p>A differential premium system based on the CAMEL ratings of individual participating banks should be used to calculate the premiums for individual banks.</p> <p>Until the first year in which the target fund size has been reached, the following annual premiums for participating banks should be charged depending on their CAMEL ratings:</p> <table data-bbox="619 1077 1442 1294"> <thead> <tr> <th data-bbox="619 1077 831 1149">Institutions with CAMEL rating</th> <th data-bbox="874 1077 1442 1149">Premium charged (basis points of balance of insured deposits)</th> </tr> </thead> <tbody> <tr> <td data-bbox="715 1149 735 1178">1</td> <td data-bbox="1145 1149 1166 1178">5</td> </tr> <tr> <td data-bbox="715 1178 735 1207">2</td> <td data-bbox="1145 1178 1166 1207">8</td> </tr> <tr> <td data-bbox="715 1207 735 1236">3</td> <td data-bbox="1145 1207 1166 1236">11</td> </tr> <tr> <td data-bbox="683 1236 767 1265">4 &amp; 5</td> <td data-bbox="1145 1236 1166 1265">14</td> </tr> </tbody> </table> <p>After the first year in which the target fund size has been reached, the following annual premiums for participating banks should be charged depending on their CAMEL ratings:</p> <table data-bbox="619 1480 1442 1697"> <thead> <tr> <th data-bbox="619 1480 831 1552">Institutions with CAMEL rating</th> <th data-bbox="874 1480 1442 1552">Premium charged (basis points of balance of insured deposits)</th> </tr> </thead> <tbody> <tr> <td data-bbox="715 1552 735 1581">1</td> <td data-bbox="1129 1552 1182 1581">0.75</td> </tr> <tr> <td data-bbox="715 1581 735 1610">2</td> <td data-bbox="1145 1581 1166 1610">1.0</td> </tr> <tr> <td data-bbox="715 1610 735 1639">3</td> <td data-bbox="1145 1610 1166 1639">1.5</td> </tr> <tr> <td data-bbox="683 1639 767 1668">4 &amp; 5</td> <td data-bbox="1145 1639 1166 1668">2.0</td> </tr> </tbody> </table> <p>Participating banks should be required not to disclose any information which may reveal their CAMEL ratings.</p>	Institutions with CAMEL rating	Premium charged (basis points of balance of insured deposits)	1	5	2	8	3	11	4 & 5	14	Institutions with CAMEL rating	Premium charged (basis points of balance of insured deposits)	1	0.75	2	1.0	3	1.5	4 & 5	2.0
Institutions with CAMEL rating	Premium charged (basis points of balance of insured deposits)																				
1	5																				
2	8																				
3	11																				
4 & 5	14																				
Institutions with CAMEL rating	Premium charged (basis points of balance of insured deposits)																				
1	0.75																				
2	1.0																				
3	1.5																				
4 & 5	2.0																				
Premium collection	<p>The Board should have the power to make rules specifying the manner and timing for payment of premiums. It is intended that the HKMA will collect the premiums on behalf of the DIS via the RTGS system.</p>																				

Design features	HKMA's proposals
Fund investment	<p>The DIS Fund should be invested in only the following instruments:-</p> <ul style="list-style-type: none"> <li>(i) deposits with the Exchange Fund;</li> <li>(ii) Exchange Fund bills;</li> <li>(iii) US Treasury bills;</li> <li>(iv) foreign exchange contracts, including derivative products, which are necessary for hedging purposes; and</li> <li>(v) any other investment approved by the FS.</li> </ul>
Appeal system	<p>An independent tribunal, with members appointed by CE/SAR, should be set up to review the Board's decisions relating to payment of compensation. The powers and procedures of the tribunal should be set out in legislation.</p>
Information needs of DIS	<p>The Board should be empowered to require participating banks to submit relevant information which is necessary for it to discharge its functions, e.g., in relation to premium assessment and collection and payment of compensation.</p> <p>The HKMA should be permitted to provide information to the Board (e.g., information about the supervisory ratings of participating banks) to enable or assist the Board to discharge its functions.</p>
Miscellaneous	<p>Administrative costs of the DIS should be charged to the DIS Fund.</p> <p>Like other statutory bodies, the Board, its members, members of staff and agents should only be liable for any act or omission that has been shown to involve bad faith.</p> <p>The provisional liquidator may, subject to Court approval, make payments to the DIS. This would enable the financing costs of the DIS payout to be reduced if such costs would be higher than the interest charged by the provisional liquidator. Where necessary, the Board should be able to provide an indemnity to the provisional liquidator in respect of such payments.</p> <p>Appropriate amendments should be made to the Companies Ordinance:</p> <ul style="list-style-type: none"> <li>(i) to clarify the treatment of multi-beneficiary accounts under the present priority claims system; and</li> <li>(ii) to clarify that the Board would not be regarded as a single depositor in calculating the aggregate amount of its priority claim entitlement transferred from insured depositors.</li> </ul>

**Draft Rules Governing the  
Establishment and Operation of the DIS<sup>1</sup>**

**I. Establishment of the Hong Kong Deposit Insurance Board**

1.1 There shall be established a board, to be known as the Hong Kong Deposit Insurance Board (“Board”), to administer a deposit insurance scheme (“DIS”) in Hong Kong.

*Functions of the Board*

1.2 The principal function of the Board shall be to provide insurance against the loss of deposits to the extent that protection is made available under this legislation.

1.3 Without limiting the generality of para. 1.2 above, the Board shall also have the following functions:

- (i) collecting premiums from member institutions in accordance with rules established pursuant to this legislation;
- (ii) managing the DIS Fund<sup>2</sup> in accordance with the provisions of this legislation;
- (iii) assessing claims made against the DIS Fund by depositors and determining the eligibility and entitlement of claimants in accordance with the provisions of this legislation;
- (iv) making compensation payments to eligible depositors and paying rebates, or refunding premiums, to member institutions in accordance with the provisions of this legislation; and
- (v) recovering any amount paid out to a failed member institution’s depositors from the estate of the failed institution.

---

<sup>1</sup> These Rules are only intended to form the basis of the DIS legislation and may not be incorporated into the legislation in their present form.

<sup>2</sup> See para. 1.9 below.



### *Powers of the Board*

1.4 The Board shall have the powers to do all things as are necessary for, or incidental or conducive to, the discharge of the functions of the Board and shall in particular, but without prejudice to the foregoing, have the powers to:

- (i) assess the premiums payable by each member institution and levy such premiums as assessed on the institution;
- (ii) collect premiums from member institutions;
- (iii) borrow from the Government or any third party to discharge the obligations of the Board under this legislation;
- (iv) make payments out of the DIS Fund in connection with the exercise of its functions and recover any payment (or any part thereof) made to any person from the DIS Fund to which such person is not entitled;
- (v) obtain information from member institutions that is necessary for the exercise of its functions under this legislation;
- (vi) demand payment from the liquidator (or provisional liquidator) of a failed member institution out of such institution's available assets for the amount paid to all the eligible depositors of such institution;
- (vii) provide an indemnity to the liquidator (or provisional liquidator) of a failed member institution for the purpose of obtaining an early payment by the liquidator (or provisional liquidator) from the estate of the institution;
- (viii) accept a compromise from the liquidator (or provisional liquidator) of a failed member institution or any other party as full payment of the amount claimed by the Board on the relevant institution's assets where the Board thinks fit, and enter into any agreement or arrangement in respect of the same;
- (ix) specify the requirements of the information systems to be maintained by all member institutions so as to facilitate payments to eligible depositors;
- (x) invest the DIS Fund in accordance with the provisions of this legislation;

- (xi) appoint agents, or authorize third parties, to perform any of its functions under this legislation;
- (xii) hold, acquire, lease, sell, dispose of or otherwise deal with all kinds of property whether removable or immovable;
- (xiii) have all the necessary and incidental powers of a commercial entity in respect of its administration and management; and
- (xiv) make rules<sup>3</sup>, after consultation with the FS, relating to the procedures for making claims and payouts.

#### *Composition of the Board*

1.5 The Board shall consist of not less than 7 but not more than 10 members appointed by CE/SAR as follows (with the number of lay members more than the number of ex-officio and executive members to ensure sufficient independence of the Board):

- (i) SFS or his representative (ex-officio member);
- (ii) MA or his representative (ex-officio member);
- (iii) the Chief Executive Officer of the Board (executive member to act as the link between the policy making process and the implementation process); and
- (iv) 4 to 7 lay members.

1.6 The Chairman of the Board shall be appointed by CE/SAR from among the lay members.

1.7 CE/SAR shall give notice of each appointment by notice in the Gazette.

1.8 Schedule 1 below shall have effect with respect to the Board. The Chief Executive in Council may by notice in the Gazette amend this Schedule.<sup>4</sup>

#### *Establishment of the Deposit Insurance Scheme Fund*

1.9 A fund, to be known as the Deposit Insurance Scheme Fund (“DIS Fund”), shall be established and shall consist of –

---

<sup>3</sup> These rules should be subsidiary legislation which would be subject to negative vetting by the Legislative Council.

<sup>4</sup> This would be consistent with section 28 of the Protection of Wages on Insolvency Ordinance.

- (i) premiums collected from member institutions;
- (ii) amounts recovered from the estate of a failed member institution;
- (iii) investment returns;
- (iv) amounts borrowed for the DIS Fund as permitted under this legislation; and
- (v) any other amounts that are lawfully paid into the DIS Fund.

*Payments out of the DIS Fund*

1.10 There shall from time to time be paid out of the DIS Fund, as required, and in such order as the Board may determine, one or more of the following amounts –

- (i) all legal and other expenses incurred –
  - (a) in investigating or defending claims for compensation made under this legislation;
  - (b) in relation to the DIS;
  - (c) in the exercise by the Board of the rights, powers, and authorities vested in it by this legislation or rules made under this legislation;
- (ii) the expenses incurred in the management or administration of the DIS;
- (iii) the expenses incurred in obtaining insurance, surety, guarantee or other security, or in making any financial arrangement, in respect of claims for compensation made under this legislation;
- (iv) interest on any sum borrowed by the Board;
- (v) the amounts of claims for compensation, costs of and incidental to the making and proving of such claims and interest on compensation, as allowed under this legislation;
- (vi) the amounts of rebate or refund of premiums as determined in accordance with the provisions of this legislation;

- (vii) the expenses incurred by the tribunal which is established in accordance with paras. 1.24-1.28 below; and
- (viii) all other money payable out of the DIS Fund in accordance with the provisions of this legislation.

#### *Directions of the Chief Executive in Council*

1.11 The Chief Executive in Council may give to the Board such directions as he thinks fit with respect to the exercise of its functions under this legislation and the Board shall comply with any such direction.

#### *Financial year and estimates*

1.12 The Board may, with the prior approval of the FS, fix a period to be the financial year of the DIS Fund.

1.13 In each financial year, before a date to be fixed by the FS, the Board shall submit to the FS, for his approval, estimates of the income and expenditure of the DIS Fund for the next financial year.

#### *Accounts*

1.14 The Board shall keep and maintain proper accounts and records of all transactions of the DIS Fund.

1.15 After the end of each financial year, the Board shall cause to be prepared a statement of accounts of the DIS Fund, which shall include an income and expenditure account and balance sheet and shall be signed by the Chairman of the Board.

#### *Auditors*

1.16 The Board shall, with the prior approval of the FS, appoint an auditor (which may be the Director of Audit), who shall have access to all the books of account and other records kept by the Board.

1.17 The auditor shall audit the statement of accounts prepared under para. 1.15 above and report thereon to the Board.

#### *Statements and reports to be laid before the Legislative Council*

1.18 The Board shall, within 4 months after the end of each financial year or such further time as the FS may for any particular year allow, submit to the FS a report

on the activities of the Board for that financial year including copies of the statement of accounts prepared under para. 1.15 and the report made under para. 1.17.

1.19 The FS shall cause the reports and statements received by him under para. 1.18 to be laid on the table of the Legislative Council.

#### *Confidentiality*

1.20 Any member of the Board and any person employed, appointed as agent or authorized by the Board shall preserve and aid in preserving secrecy with regard to all matters relating to the affairs of any person that may come to his knowledge in the exercise of any function under this legislation except where the disclosure of such information is required by law or where the disclosure of information is in summary form which is so framed as to prevent particulars relating to the business of any particular member institution or person from being ascertained from it.

#### *Immunity*

1.21 Neither the Board nor any person who is, or is acting as, its member, member of staff or agent shall be liable in damages for anything done or omitted to be done in the discharge, or purported discharge, of the functions conferred on the Board by or under this legislation unless the act or omission is shown to have been in bad faith.

#### *Exemption from taxation*

1.22 The receipts of the Board shall not be subject to taxation under the Inland Revenue Ordinance.

#### *Petition for the winding up of a member institution*

1.23 The Board may only present a petition to the Court of First Instance for the winding up of a member institution with the consent of the FS.

#### *Review of the Board's decisions*

1.24 Any person aggrieved by the decision of the Board on payment of compensation may request the Board to refer the matter to a tribunal set up by CE/SAR.

1.25 The tribunal shall consist of a Chairman and two members appointed by CE/SAR.

1.26 CE/SAR may determine the remuneration of the members, which shall be charged to the DIS Fund.

1.27 The proceedings of the tribunal shall be as follows:

- (i) in reviewing the decisions of the Board, the tribunal shall give the parties concerned a reasonable opportunity of being heard;
- (ii) the tribunal may confirm, vary or set aside the decision of the Board or remit the matter to the Board with any direction that the tribunal considers appropriate;
- (iii) the tribunal may reach a determination of any matter of fact before it on the civil standard of proof;
- (iv) the tribunal shall deliver the determination as soon as reasonably practicable after the review is completed with the reasons therefor;
- (v) the tribunal shall record the determination in writing and such determination shall be registered in the Court of First Instance and shall become an order of the Court upon registration; and
- (vi) the determination of the tribunal shall be final and not be subject to appeal except on point of law.

1.28 The tribunal shall have the following powers:

- (i) to receive and consider any material in any form even if the material would not be admissible in evidence in proceedings in a court;
- (ii) to require a person to appear before the tribunal in relation to a review and to give evidence and produce any article, record or document in his possession or control relating to the subject matter of the review except where the person is the banker or financial adviser of an applicant for review, such person will not be required to disclose any information relating to the affairs of any person other than the applicant;
- (iii) to administer oaths and affirmations;
- (iv) to take evidence from a person under oath, affirmation or otherwise and to require such person to answer truthfully any question which the tribunal considers appropriate for the purposes of the review;
- (v) to take evidence in the form of affidavit or affirmation;

- (vi) to order a person not to publish or otherwise disclose any material that the tribunal receives;
- (vii) to determine the manner in which any relevant material is received;
- (viii) to stay any review proceedings on such grounds and on such terms and conditions as the tribunal considers appropriate having regard to the interests of justice;
- (ix) to determine the procedure to be followed in connection with the review;
- (x) to exercise such other powers or make such other orders as may be necessary for or ancillary to the conduct of the review or the carrying out of the tribunal's functions;
- (xi) to have the same powers as those of the Court of First Instance to punish for contempt;
- (xii) to order award of costs to any party to the review or any person who is required to appear before the tribunal for the purpose of the relevant review; and
- (xiii) to hear an application for stay for proceedings for a review by the applicant at any time before a determination is made.

## **II. Membership of DIS**

### *Compulsory and automatic membership for licensed banks*

2.1 Subject to para. 2.5 below, all banks licensed under the Banking Ordinance shall be required to join the DIS and become members of the DIS (“member institutions”).

2.2 In the case of banks licensed before the commencement of this legislation, the date on which DIS membership is granted shall be the date of commencement of this legislation.

2.3 In the case of banks licensed after the commencement of this legislation, the date on which DIS membership is granted shall be the date on which the banking licence is granted.

2.4 The DIS membership of a member institution shall be automatically revoked upon the revocation of its banking licence.

*Exemption for certain foreign banks*

2.5 The Board may exempt an overseas incorporated bank from the provisions of para. 2.1 above if it is satisfied that the deposits with the Hong Kong offices of the bank are covered by a deposit insurance scheme in the home jurisdiction of the bank and the scope and level of protection afforded by that scheme are not less than those afforded to such deposits by the DIS in Hong Kong.

2.6 The Board may require an institution to provide it with any information to facilitate the consideration of an application for exemption under para. 2.5 above.

2.7 Where an exempted institution becomes aware of any development which may affect its exemption, it shall forthwith notify the Board of that fact. The Board may also require an exempted institution to provide any further information so as to allow the Board to determine whether the institution should continue to be exempted.

2.8 Where an institution is exempted under para. 2.5 above, it shall pay an annual exemption fee as may be specified by the Board from time to time.

2.9 An institution exempted under para. 2.5 above shall inform its depositors –

- (i) that the institution is not a member of the DIS in Hong Kong and therefore any deposit with the Hong Kong offices of the institution is not protected under the DIS; and
- (ii) of the details of the protection offered by the institution's home jurisdiction scheme which shall include, but shall not be limited to, the name of the organisation which provides the protection, the level of protection in Hong Kong dollar equivalent and the types of deposits protected.

### **III Coverage under the DIS**

*Depositors' entitlement to protection*

3.1 Where DIS payout is triggered under Section VII below, and subject to the provisions in this Section and Section IV, each depositor of the member institution shall be entitled to compensation by the Board of an aggregate amount held on insurable deposit and any interest accrued thereon, up to a maximum of \$100,000, regardless of the number of his deposits with that institution.



3.2 An “insurable deposit” is defined as “any sum of money denominated in any currency which meets the definition of “deposit” under section 2 of the Banking Ordinance and maintained with a member institution, with the exception of the following:

- (i) a term deposit where the current term agreed to by the depositor at the most recent time it was negotiated exceeds 5 years;
- (ii) a deposit charged, mortgaged or pledged (as appropriate) as collateral;
- (iii) a deposit that is secured on the assets of the institution;
- (iv) a bearer instrument;
- (v) a deposit booked with a foreign office of the institution;
- (vi) a deposit held for the account of the Exchange Fund;
- (vii) a deposit held by a multilateral development bank as defined in para. 1 of the Third Schedule to the Banking Ordinance;
- (viii) a deposit held by a holding company that holds all of the shares of the institution, a subsidiary of the institution or a subsidiary of the holding company;
- (ix) a deposit held by a director, controller, chief executive or manager of the institution, a subsidiary of the institution, a holding company that holds all of the shares of the institution or a subsidiary of the holding company;
- (x) a deposit held by an authorized institution.<sup>5</sup>

3.3 For the purpose of calculating the payment of compensation by the Board in respect of any insurable deposit, the interest accruing and payable in relation to the deposit shall be calculated up to the date of the appointment of a provisional liquidator. However, where it is uncertain whether a provisional liquidator will be appointed or where, in the opinion of the Board, to wait for such appointment would unduly delay compensation payment by the Board, the Board may determine that the compensation payment should cover interest accrued only up to the date on which DIS payout is triggered as provided under Section VII below.

---

<sup>5</sup> Deposits referred to in sub-paragraphs (vii)-(x) are deposits in which any of the parties referred to have beneficial interest, whether such deposits are held in that party’s name or not.

3.4 In respect of any insurable deposit denominated in foreign currencies, compensation shall be payable in Hong Kong dollars, using the foreign exchange rate which is the midpoint between the selling and buying telegraphic transfer rates of exchange quoted by the Hong Kong Association of Banks on the date on which DIS payout is triggered as provided under Section VII below or, where no such rates are quoted, at an exchange rate determined by the Board.

3.5 The Board may determine the order in which insurable deposits in different currencies should be paid compensation subject to the principle that this would help to minimise the Board's potential exposure to foreign exchange risk.

3.6 Where a depositor has more than one insurable deposit in the same currency and to pay compensation in respect all such deposits would make the aggregate amount of the compensation payment to the depositor exceed the coverage limit, the compensation payment in respect of such deposits shall be deemed to be apportioned among them on a pro-rata basis.

#### *Treatment of multi-beneficiary accounts*

#### *Trust accounts*

3.7 Where persons are entitled to a deposit as trustees, the Board shall treat any claim they make in respect of such a deposit as trustees as being separate from any claim they make in respect of deposits to which they are entitled in their own right.

3.8 In the case of a bare trust, i.e., where a trustee holds property for a beneficiary who is absolutely and solely entitled to that property, the Board shall treat the beneficiary and not the trustee as the claimant in respect of the trust monies held on deposit.

3.9 If a group of persons has a claim as trustees, the group shall be treated as if it were a single entity separate from the individuals constituting the group so that any change in the membership of the group will not affect any such claim.

3.10 If a trustee has a claim as trustee for different trusts, the trustee shall be entitled to make separate claims for each of the trusts he represents and the Board shall treat those claims as if they were made by different persons.

#### *Client accounts*

3.11 If a person has a claim as agent for one or more principals, the Board shall treat the principals as having the claim, not the claimant, provided that the agent -

- (i) has declared to the relevant member institution that the relevant accounts are held for the benefit of its principals and that it maintains proper records of the identities and entitlements of its principals in respect of such accounts at all times; and
- (ii) makes an annual disclosure<sup>6</sup> to the relevant member institution regarding the number of beneficiaries and their respective entitlements underlying such accounts to facilitate premium assessment in respect of the institution.

### *Partnership and joint accounts*

3.12 If two or more persons have a joint beneficial claim, the claim shall be treated as a claim of the partnership if they are carrying on business together in partnership. Otherwise each of those persons shall be taken to have a claim for his share, and in the absence of satisfactory evidence as to their respective shares, the Board shall regard each person as entitled to an equal share.

## **IV Priority claim, set-off and assignment of rights**

### *Netting*

4.1 For the purpose of calculating the amount of compensation to any claimant, the Board shall take into account the amount of his overall net claim against the member institution.

4.2 In determining a claimant's overall net claim, section 35 of the Bankruptcy Ordinance (which is applicable in the liquidation of a company by virtue of section 264 of the Companies Ordinance) is deemed to be applicable so that a claimant's overall net claim is the aggregate amount of his insurable deposits with the member institution less the amount which is due from the claimant to the member institution in respect of any mutual dealings between them, plus or minus, as the case may be, the net amount of interest accrued due by or to the member institution on the said deposits or dealings up to the same date used by the Board for the purpose of determining the amount of accrued interest in para. 3.3 above.

4.3 If the Board is satisfied that compensation is payable in principle, but considers that immediate payment in full would not be appropriate because of uncertainty as to the amount of the claimant's overall net claim or because of the time that would be

---

<sup>6</sup> This annual disclosure should reflect the position of these accounts as at 15 October of each year to tie in with the "relevant date" as set out in Schedule 2 of these Rules and should be made within 30 days of the "relevant date".

required to determine the amount of payment in full, it may decide to pay an appropriate lesser sum as interim settlement with the claimant.<sup>7</sup>

#### *Assignment of depositors' rights to the Board*

4.4 Where the Board makes a payment in respect of any deposit with a member institution, all the depositor's rights and remedies with respect to the deposit existing immediately before that payment shall, to the extent of the amount of the payment made, be transferred to and vest in the Board for the benefit of the DIS Fund and the Board may take such steps as it considers necessary to enforce those rights and remedies.

4.5 The rights and remedies of a depositor in respect of a deposit transferred to the Board shall include the rights and remedies of the depositor in respect of so much of that deposit as the depositor would, on the winding up of the institution, be entitled to priority under section 265(1)(db) of the Companies Ordinance.

#### *Early reimbursement from the provisional liquidator*

4.6 The provisional liquidator of a failed member institution may, subject to the approval of the court, make payments to the Board out of the estate of the institution.

## **V Funding and premium assessment**

5.1 The Board shall follow the rules in Schedule 2 below in making levies on and paying rebates to member institutions. For the avoidance of doubt, all premiums paid to the DIS Fund shall cease to be the property of the member institution which makes the payment and shall become the property of the Board.

5.2 The Chief Executive in Council may by notice in the Gazette amend Schedule 2.

5.3 In amending any rules under Schedule 2, the Chief Executive in Council shall ensure that the DIS Fund should, so far as practicable, be derived from the banking industry.

5.4 A member institution shall not disclose to any third party any information regarding the premium which it pays or its CAMEL rating or any other information that

---

<sup>7</sup> Such a provision for reduced or interim payment is consistent with a similar provision recently added to the Final Rules of the Financial Services Compensation Scheme in the UK, in place of a former provision in the UK Banking Act, providing a discretionary power to the Scheme Manager not to apply full netting in certain circumstances.

would, by itself or together with other information, enable the premium or rating of the member institution to be ascertained or inferred.<sup>8</sup>

## **VI Premium collection, refund and Fund management**

### *Premium collection and refund*

6.1 The Board shall have the power to make rules specifying the manner and timing in which premiums shall be paid by member institutions.

### *Fund investment*

6.2 All moneys of the DIS Fund that are not immediately required by the Board for the discharge of its functions shall be placed in one or more of the following –

- (i) deposits with the Exchange Fund;
- (ii) Exchange Fund bills;
- (iii) US Treasury bills;
- (iv) foreign exchange contracts, including derivative products, which are necessary for hedging purposes; and
- (v) any other investment approved by the FS.

## **VII Trigger criteria for deposit insurance payout**

7.1 The Board shall make payment to the insured depositors of a member institution where:-

- (i) a court order has been made to wind up the member institution; or
- (ii) a Manager (as defined in the Banking Ordinance) has been appointed to manage the affairs of the member institution under section 52 of the Banking Ordinance or a provisional liquidator has been appointed in respect of the institution and the MA, after consultation with the FS, has notified the Board that it is appropriate that payment should be made to insured depositors by the Board because either:

---

<sup>8</sup> Similar provision exists in the By-laws of the CDIC Act.

- (a) the MA believes that the institution is likely to become unable to meet its obligations, or that it is insolvent or about to suspend payment to depositors; or
- (b) the MA believes that payment to depositors by the Board is necessary to promote the general stability and effective working of the banking system.

7.2 The MA shall publish by notice in the Gazette any notification given to the Board under para. 7.1 above.

### **VIII Information needs of the DIS**

8.1 The Board may require a member institution to submit (including periodically submit) such information as it may reasonably require for the exercise of its functions, and such information shall be submitted within such period and in such manner as the Board may specify.

8.2 Without prejudice to the generality of para. 8.1 above, the Board may require a member institution to submit returns showing the amount of insured deposits of the institution and the breakdown of such deposits in such manner as the Board may require.

8.3 The Board may require a member institution to submit a report prepared by an auditor or auditors appointed by the institution and approved by the Board as to whether or not, in the opinion of the auditor or auditors, a return submitted pursuant to para. 8.2 above or information submitted pursuant to para. 8.1 above, is correctly compiled in all material respects.

8.4 The Board may specify the requirements of the information systems to be maintained by a member institution so as to facilitate compensation payment to eligible depositors, and require a member institution to submit a report prepared by an auditor or auditors appointed by the institution and approved by the Board as to whether or not, in the opinion of the auditor or auditors, the institution has in place adequate systems of control for such purpose.

8.5 The Board may appoint or authorize the MA to exercise any of the above powers on its behalf.<sup>9</sup>

---

<sup>9</sup> This would have the advantage of allowing the Board to leverage on the HKMA's resources and systems for collection of the relevant information, which could help maintaining a lean structure for the Board.

8.6 Where DIS payout has been triggered as provided under Section VII above, the Board shall have access to the relevant books, transactions and systems of the relevant member institution for the purpose of effecting the compensation payment to eligible depositors.

8.7 The Board may appoint an agent or authorize a third party (which may include the MA) to access the relevant books, transactions and systems of the relevant member institution for the purpose of effecting compensation payment to eligible depositors under para. 8.6 above.

## **Schedule 1 - Provisions with respect to the Board**

(These rules may be amended by the Chief Executive in Council by Gazette Notice)

### **1.1 Status of the Board**

1.1.1 The Board shall not be a servant or agent of the Government nor shall it enjoy any status, immunity or privilege of the Government.

### **1.2 Seal**

1.2.1 The Board shall be a body corporate having perpetual succession and a common seal, the affixing of which shall be authenticated by the signature of any 2 members of the Board.

1.2.2 Any document purporting to be a document duly executed under the seal of the Board shall be received in evidence and shall, unless the contrary is proved, be deemed to be a document so executed.

### **1.3 Tenure of members**

1.3.1 A member of the Board shall be appointed for a term not exceeding three years.

1.3.2 On the expiry of his period of appointment or re-appointment, any member to whom para. 1.3.1 applies shall be eligible for re-appointment for such further term as CE/SAR may specify.

1.3.3 Any member to whom para. 1.3.1 applies may at any time resign from office by giving notice in writing to CE/SAR, and he shall cease to be a member from the date specified in the notice or, if no date is specified, from the date of the receipt by CE/SAR of the notice.

1.3.4 If any member of the Board, including the Chairman, is absent from Hong Kong or is for any other reason unable to exercise the powers or perform the duties of his office as member or Chairman, as the case may be, CE/SAR may appoint another person to be a temporary member or Chairman, as the case may be, in his place during his absence or incapacity.

### **1.4 Terms and conditions of appointment of members**

1.4.1 All matters relating to the terms and conditions of the appointment of the Chairman and other members shall be determined by CE/SAR.



## **1.5 Meetings and proceedings of the Board**

1.5.1 Meetings of the Board shall be held at such times and places as the Chairman or person acting as the Chairman may decide.

1.5.2 The quorum for meetings of the Board shall be 5.

1.5.3 Subject to the provisions of this Schedule, the Board may determine its own procedures.

1.5.4 At any meeting of the Board, the Chairman shall have a casting vote in addition to a deciding vote where there is a tie in the voting result.

## **1.6 Transaction of business by circulation of papers**

1.6.1 The Board may transact any of its business by circulation of papers, and a resolution in writing which is approved by a majority of the members shall be valid and effectual as if it had been duly passed at a meeting of the Board by the votes of its members so approving the resolution.

## **1.7 Committees**

1.7.1 The Board may create and appoint such committees for any general or special purposes as it thinks fit and, in relation to such committees, -

- (i) the chairman shall be appointed by the Board; and
- (ii) the chairman and at least 2 out of every 3 persons appointed to a committee shall be members of the Board.

## **1.8 Conflict of interests**

1.8.1 A member of the Board who is in any way directly or indirectly interested in a contract made or proposed to be made by the Board, shall disclose the nature of his interest at a meeting of the Board. The disclosure shall be recorded in the minutes of the Board, and the member shall not without the permission of the Chairman take any part in any deliberation of the Board with respect to that contract and shall not in any event vote on any question concerning it.

1.8.2 For the purposes of para. 1.8.1 above, a general notice given at a meeting of the Board by a member thereof to the effect that he is a member of a specified company or firm and is to be regarded as interested in any contract which may, after the date of the notice, be made with the company or firm shall be regarded as a sufficient disclosure of his interest in relation to any contract so made or proposed to be so made.

1.8.3 A member of the Board need not attend in person at a meeting of the Board in order to make a disclosure which he is required to make under para. 1.8.1 above if he takes reasonable steps to secure that the disclosure is made by a notice which is brought up and read at the meeting.

## Schedule 2 - Rules on Funding and Premium Assessment

(These rules may be amended by the Chief Executive in Council by Gazette Notice)

*Text in italic print and illustrative examples are to provide guidance for reference only.*

### **Introduction**

*For the purpose of the following rules, it is assumed that insurance premiums will begin to be levied and insurance coverage will take effect at the beginning of the first year following the establishment of the DIS Board.*

### **2.1 Application**

2.1.1 The rules hereunder are applicable to:

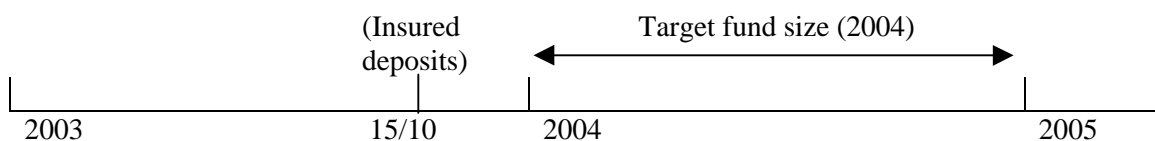
- (a) the Deposit Insurance Board (“Board”); and
- (b) member institutions.

### **2.2 Target fund size for the DIS Fund**

2.2.1 The Board shall set the target fund size for each financial year<sup>10</sup> based on the aggregate balance of insured deposits of all member institutions as at 15 October<sup>11</sup> of the immediately preceding year (“relevant date”).

#### Example 1

*Assume 2003 is the year in which the DIS Board is established. The provisions providing for insurance coverage and levying of premiums would then take effect from 1/1/2004. The target fund size for year 2004 would be set on the basis of the total balance of insured deposits as at 15/10/2003.*



2.2.2 The target fund size for each year shall be set at 0.30% of the total balance of insured deposits of all member institutions as at the relevant date.

<sup>10</sup> It is assumed that the Board would select the calendar year to be the financial year for the DIS Fund. Otherwise, the relevant date in this paragraph would need to be adjusted accordingly.

<sup>11</sup> Using the mid-point of the month has the benefit of avoiding dates where the balance of insured deposits may be temporarily inflated, in particular at month-end when payroll is credited into bank accounts.

## Example 2

*Target fund size for year 2004 = total balance of insured deposits as at 15/10/2003 x 0.3%.*

2.2.3 The balance of insured deposits of a member institution means the total amount of deposits, including any interest accrued thereon, which are protected under the DIS in respect of that institution.

2.2.4 For the purpose of calculation of the balance of insured deposits in para. 2.2.3 above:

- (a) no deduction shall be made of any amount which is due from any depositor to the member institution in respect of any mutual dealings between them; and
- (b) in relation to deposits held on client accounts -
  - (i) a member institution shall use the information provided by the agents holding such accounts pursuant to para. 3.11 of the Rules to calculate the balance of insured deposits. It shall not be required to aggregate the entitlement of a beneficiary in such an account with the other deposits made by the same beneficiary in the same institution for the purpose of calculation of the balance of insured deposits; or
  - (ii) if the institution has requested the agents holding such accounts to provide information detailing the identities and entitlements of the beneficiaries in such accounts, it may choose to aggregate the entitlement of a beneficiary in such an account with the other deposits made by the same beneficiary in the same institution for the purpose of calculation of the balance of insured deposits.

## 2.3 Fund accumulation and maintenance

### *Premium levy*

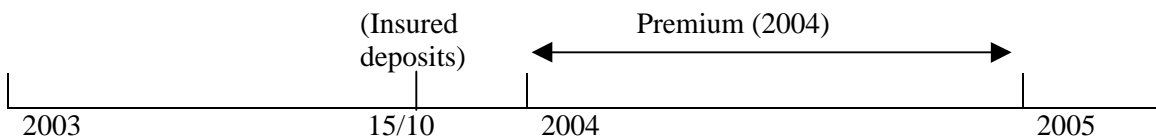
2.3.1 Subject to para. 2.4 below, the Board shall assess the premiums for each member institution for each year on the basis of the institution's balance of insured deposits as at the relevant date.

2.3.2 Until the first year in which the target fund size has been reached, the following annual premiums for a member institution shall be charged ("build-up premiums") depending on the CAMEL rating given by the MA to the institution.

<u>Institutions with CAMEL rating</u>	<u>Premium charged (basis points of insured deposits)</u>
1	5
2	8
3	11
4 & 5	14

Example 3

*Premium payable by Institution X with a CAMEL rating of 2 for year 2004 = Balance of insured deposits of Institution X as at 15/10/2003 x 8 basis points.*



2.3.3 If for a particular year the required amount of premiums to be charged on all member institutions to bring the DIS Fund to the target fund size (amount “A”) is smaller than the aggregate amount of build-up premiums payable by all member institutions according to the scale set out in para 2.3.2 (amount “B”), then the premium payable by a member institution according to the scale set out in para. 2.3.2 shall be reduced proportionately in the ratio of A to B.

Example 4

*If, for example, for year 2008 the target fund size is HK\$2,300 million and balance of the DIS Fund as at 15/10/2007 is HK\$2,100 million, the total premium required to reach the target level for year 2008 would therefore be HK\$200 million (amount “A”). If the projected total annual build-up premiums for year 2008 is, say, HK\$540 million (amount “B”), then the premium payable by Institution X with a CAMEL rating of 2 would be:*

*Premium payable by Institution X for year 2008 = Balance of insured deposits of Institution X as at 15/10/2007 x 8 basis points x 200 million/540 million.*

2.3.4 After the first year in which the target fund size has been reached, the following annual premiums for a member institution shall be charged (“expected loss premiums”) depending on the CAMEL rating given by the MA to the institution:

<u>CAMEL rating</u>	<u>Premium charged (basis points of insured deposits)</u>
1	0.75
2	1.0
3	1.5
4 & 5	2.0

#### Example 5

*If, for example, for the year immediately after the fund size has reached its target (i.e. Year 2009 following from Example 4 above), the premium payable by Institution X would be:*

*Premium payable by Institution X for year 2009 = Balance of insured deposits of Institution X as at 15/10/2008 x 1 basis point.*

2.3.5 Where the amount of annual premium and any surcharge (see para. 2.5 below) assessed on a member institution for any year is less than HK\$10,000, a minimum annual premium of HK\$10,000, pro-rated to the number of days during which the institution is a member in that year, shall be payable by the member institution for that year.

#### Example 6

*If the premium payable by Institution X for year 2009 as calculated in Example 5 above is HK\$6,500, Institution X would pay HK\$10,000 as the annual premium for year 2009.*

2.3.6 The premiums specified in paras. 2.3.2 and 2.3.4 above shall be capable of being amended, both before and after the end of the build-up period (e.g., for the purposes of calculating surcharge in accordance with para. 2.5).

### **2.4 Calculation of premium for new members**

2.4.1 Subject to para. 2.3.5 above, the premium and any surcharge (see para. 2.5 below) payable by a new member for the year in which it becomes a member shall be levied on the basis of the institution's balance of insured deposits as at the date it becomes a member and shall be proportional to the number of days during which it is a member in that year.

2.4.2 Subject to para. 2.4.3, the premium and any surcharge payable by a new member for subsequent years shall be levied on the basis of the institution's balance of insured deposits as at the relevant date.

2.4.3 Where an institution becomes a new member after 15 October in any one year, the premium and any surcharge payable for the subsequent year shall be levied on the basis of the institution's balance of insured deposits as at the date it becomes a member.

### Example 7

Assume that a new member Institution N joins on 1/7/2004. The balance of insured deposits of Institution N as at this date is HK\$0\* and the balance increases to HK\$50 million as at 15/10/2004. Assume further that a CAMEL rating of 2 is assigned to Institution N.

Premium payable by Institution N for 2004 = the greater of

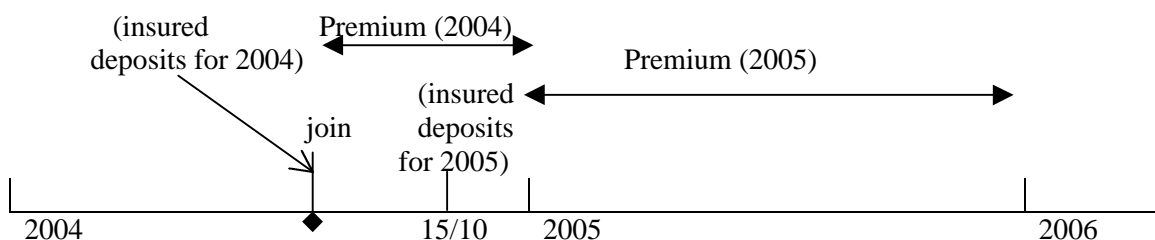
- Balance of insured deposits of Institution N as at 1/7/2004 x 8 basis points x 184/365 = HK\$0; and
- $HK\$10,000 \times 184/365 = HK\$5,041$

Accordingly, premium payable = HK\$5,041

Premium payable by Institution N for 2005 = the greater of

- Balance of insured deposits of Institution N as at 15/10/2004 i.e. HK\$50 million x 8 basis points = HK\$40,000; and
- HK\$10,000

Accordingly, premium payable = HK\$40,000



\* For a brand new entrant (i.e. not previously present in Hong Kong as a RLB or DTC), this amount is expected to be zero because such an institution is unlikely to have any deposits on the first day of its membership. Effectively this would mean that such institutions will be required to pay the pro-rated minimum annual premium for the first year of membership.

### Example 8

Assume Institution N joins on 1/11/2004. The balance of insured deposits as at this date is HK\$0\* and the balance increases to HK\$200 million as at 15/10/2005. Assume further that a CAMEL rating of 2 is assigned to Institution N.

Premium payable by Institution N for 2004 = the greater of

- Balance of insured deposits of Institution N as at 1/11/2004 x 8 basis points x 61/365 = HK\$0; and
- $HK\$10,000 \times 61/365 = HK\$1,671$

Accordingly, premium payable = HK\$1,671

Premium payable by Institution N for 2005 = the greater of

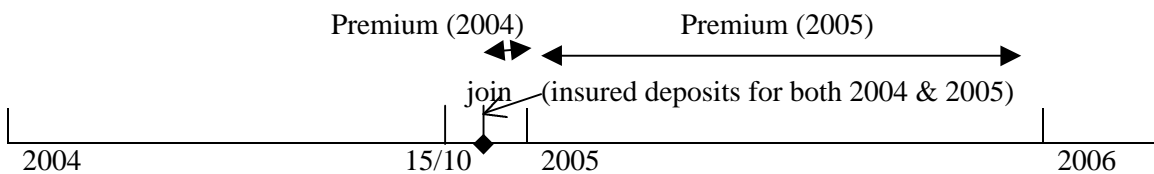
- Balance of insured deposits of Institution N as at 1/11/2004 x 8 basis points =HK\$0; and
- HK\$10,000

Accordingly, premium payable = HK\$10,000

Premium payable by Institution N for 2006 = the greater of

- Balance of insured deposits of Institution N as at 15/10/2005 x 8 basis points =HK\$160,000; and
- HK\$10,000

Accordingly, premium payable = HK\$160,000



\* For a brand new entrant (i.e. not previously present in Hong Kong as a RLB or DTC), this amount is expected to be zero because such an institution is unlikely to have any deposits on the first day of its membership. Effectively this would mean that such institutions will be required to pay the pro-rated minimum annual premium for the first year and the minimum annual premium for the second year of membership.

## 2.5 Surcharge

2.5.1 Subject to para. 2.5.4 below, a surcharge shall be levied by the Board for any year (current year) in which the balance of the DIS Fund as at 15 October of the immediately preceding year has fallen below 70% of the target fund size for the current year as determined in accordance with para. 2.2 above.

### Example 9

If the aggregate balance of insured deposits of all member institutions as at 15/10/2008 is HK\$838,000 million, the target fund size for year 2009 would be 0.3% x HK\$838,000 million i.e. HK\$2,514 million. If, however, the balance of the DIS Fund as at 15/10/2008 is HK\$800 million i.e. 32% of the target fund size, then a surcharge would be levied for year 2009.

2.5.2 The aggregate amount of surcharge levied on all member institutions shall be calculated at a rate of 30% of the difference between the balance of the DIS Fund as at 15 October of the immediately preceding year and the target fund size for the current year as determined in accordance with para. 2.2 above. Such aggregate amount of surcharge shall not exceed the aggregate amount of “build-up” premiums calculated in accordance



with para. 2.3.2 less the aggregate amount of “expected loss” premiums calculated in accordance with para. 2.3.4 above.

Example 10

*Following from Example 9 above, the aggregate amount of surcharge levied on all member institutions would be:*

$$\begin{aligned} \text{Aggregate surcharge} &= 30\% \times (\text{HK\$2,514 million} - \text{HK\$800 million}) \\ &= \underline{\underline{\text{HK\$514.2 million}}} \end{aligned}$$

*However if the aggregate amount of build up premiums and expected loss premiums (calculated in accordance with 2.3.2 and 2.3.4) are HK\$587 million and HK\$82 million respectively, then the aggregate amount of surcharge for that year would be capped at HK\$505 million (being HK\$587 million less HK\$82 million).*

2.5.3 For each member institution, the amount of surcharge shall be assessed as if it were subject to the “build-up” premium rates set out in para. 2.3.2 above, but the amount so assessed shall be adjusted proportionately in the ratio of (A) the aggregate amount of surcharge payable by all member institutions as determined in accordance with para. 2.5.2 above to (B) the aggregate amount of “build-up” premiums payable by all member institutions according to the scale set out in para. 2.3.2 above.

Example 11

*Using the figures from Example 10 above, “A” and “B” would amount to HK\$505 million and HK\$587 million respectively. The amount of surcharge and annual premium payable by Institution S with a CAMEL rating of 2 would be:*

*Surcharge payable by Institution S for year 2009 = Balance of insured deposits of Institution S as at 15/10/2008 x 8 basis points x 505 million/587 million.*

*Annual premium (at expected loss level) payable by Institution S for year 2009 = Balance of insured deposits of Institution S as at 15/10/2008 x 1 basis point.*

2.5.4 No surcharge shall be levied before the first year in which the target fund size has been reached.

## 2.6 **Rebates**

2.6.1 A rebate shall be made by the Board in any year (current year) in which the balance of the DIS Fund as at 15 October of the immediately preceding year has exceeded 115% of the target fund size for the current year as determined in accordance with para. 2.2 above.

Example 12

If the aggregate balance of insured deposits of all member institutions as at 15/10/2008 is HK\$838,000 million, the target fund size for year 2009 would be  $0.3\% \times \text{HK\$}838,000$  million i.e. HK\$2,514 million. If, however, the balance of the DIS Fund as at 15/10/2008 is HK\$3,000 million i.e. equivalent to 119% of the target fund size, then a rebate would be made in year 2009.

2.6.2 The aggregate amount of rebate to all member institutions shall be calculated at a rate of 30% between the balance of the DIS Fund as at 15 October of the immediately preceding year and the target fund size for the current year as determined in accordance with para. 2.2 above.

Example 13

Following from Example 12 above, the aggregate amount of rebate payable to all member institutions would be:

$$\begin{aligned} \text{Aggregate rebate} &= 30\% \times (\text{HK\$}3,000 \text{ million} - \text{HK\$}2,514 \text{ million}) \\ &= \underline{\underline{\text{HK\$}145.8 \text{ million}}} \end{aligned}$$

2.6.3 This aggregate amount of rebate shall be allocated to individual member institutions in proportion to each institution's net contributions (defined as the total premiums and surcharges paid less any rebates received) during the past 10 years or the period since the DIS has commenced operations, whichever is shorter.

Example 14

Following from Example 13 above, if a member Institution A over the immediate past 10 years paid premium amounting to HK\$95 million, surcharges totaling HK\$20 million and received rebates totaling HK\$16 million, the net contribution made by Institution A over the immediate past 10 years would be HK\$99 million. Assume also that the net contributions from other member institutions were as follows:

Institution B = HK\$120 million  
Institution C = HK\$65 million  
Institution D = HK\$132 million  
Institution E = HK\$38 million  
Others = HK\$1,980 million

Total net contributions from all member institutions including Institution A = HK\$2,434 million

$$\begin{aligned} \text{Rebates payable to A} &= \text{HK\$}145.8 \text{ million} \times 99 \text{ million} / 2,434 \text{ million} \\ &= \underline{\underline{\text{HK\$}5.9 \text{ million}}} \end{aligned}$$

2.6.4 Net contributions shall be calculated on a nominal basis. No time cost shall be taken into account.

## **2.7 Calculation of balance of DIS Fund in any one year**

2.7.1 The balance of the DIS Fund of any one year shall be calculated as at 15 October after taking into consideration all accumulated premiums and surcharges received and investment income and deducting any accumulated rebates paid, and expenses and losses incurred.

## **2.8 Refund of premium to institutions whose membership was revoked**

2.8.1 The premium and any surcharge paid by a member institution for the year in which its membership of DIS is revoked shall be refunded to that institution in proportion to the number of days during which it is not a member in that year (including the date of revocation of membership).

### Example 15

*If Institution F's membership was revoked on, say, 1 November 2010, then the refund to Institution F would be:*

*Refund to Institution F for year 2010 = premium and any surcharge already paid for year 2010 x 61/365.*

### **Schedule 3 - Rules on procedures for claims**

3.1 The Board shall, after consultation with the FS, make rules relating to the following practical matters regarding claims made under the DIS<sup>12</sup>:

- (i) the procedures whereby claims are to be made;
- (ii) the manner in which the Board may call for claims;
- (iii) the circumstances and manner in which the Board may determine, deal with and pay a claim; and
- (iv) the information or documents to be supplied to the Board for the purpose of assessing a claim.

---

<sup>12</sup> As these rules relate to the logistics of the operations of the DIS, they should be left to the Board once it is established. It is proposed that these rules should be promulgated as subsidiary legislation which would be subject to negative vetting by the Legislative Council.

**Treatment of accrued interest under present insolvency law**

The provisions governing the winding up of a company are laid down in Part V of the Companies Ordinance. Sections 227E and 265(6) are pertinent to the treatment of accrued interest in the winding up of a bank.

2. Section 227E provides that –

*“In the case of a bank, any creditor who is a depositor, whether on current, savings, deposit, fixed deposit or other account, shall, unless and until the Official Receiver or liquidator by notice in writing requires him to make a formal proof of debt, be deemed to have proved his debt –*

*(a) for voting purposes, for the net balance to his credit in the books of the bank on all his accounts taken together, at the relevant date,*

*(b) for dividend purposes, for the said balance plus or minus, as the case may be, the net amount of interest accrued due by or to the bank on the said accounts at the relevant date.”*

3. Section 265(6) defines “the relevant date” to be –

*“the relevant date means –*

*(a) in the case of a company ordered to be wound up compulsorily, the date of the appointment of a provisional liquidator, or if no such appointment was made, the date of the winding-up order, unless in either case the company had commenced to be wound up voluntarily before that date; and*

*(b) in any case where paragraph (a) does not apply, the date of the commencement of the winding up;”*

4. In respect of banks, only the first limb of the definition of “the relevant date” is applicable. This is because an insolvent bank can only be wound up compulsorily pursuant to section 122(1) of the Banking Ordinance, which provides that the provisions of the Companies Ordinance with regard to a creditors’ voluntary winding up shall not apply to authorized institutions.

5. In essence, these provisions mean that under the present insolvency regime, a depositor is entitled to claim in the liquidation of a failed bank the principal amount of his deposits plus any interest accrued thereon up to the date of the appointment of a provisional liquidator or, if no such appointment was made, the date of the winding-up order. This amount should however be offset against any liabilities that the depositor owes to the failed bank plus any interest accrued on such liabilities up to the relevant date.

**Illustrative examples of interest accrual**

**Example (i)**

- Suppose that the following sequence of events happened:

<u>Date</u>	<u>Events</u>
1 Jan 02	Mr A made a 6-mth deposit of \$10,000 with Bank X at 12%pa
1 Feb 02	Payout by the DIS was triggered
14 Feb 02	A provisional liquidator was appointed
1 Mar 02	Payments by the DIS were made.
1 May 02	A winding-up order was issued

- In this scenario, payout by the DIS was triggered on 1 Feb 02. Since the Board expected that a provisional liquidator would shortly be appointed by the court, it therefore waited for the appointment of the provisional liquidator before making payments to eligible depositors.
- In respect of Mr A, the payment by the DIS would cover the principal amount of the 6-month deposit (i.e., \$10,000) plus the interest accrued between 1 Jan 02 and 14 Feb 02, which would be \$150 ( $\$10,000 \times 12\% \times 1.5/12$ ). The aggregate amount of compensation payment to Mr A would thus be \$10,150. The DIS would claim the same amount from the liquidator.

**Example (ii)**

- Now suppose that the sequence of events was slightly changed as follows:

<u>Date</u>	<u>Events</u>
1 Jan 02	Mr A made a 6-mth deposit of \$10,000 with Bank X at 12%pa
1 Feb 02	Payout by the DIS was triggered
15 Feb 02	Payments by the DIS were made
1 May 02	A provisional liquidator was appointed
1 Jul 02	A winding-up order was issued

- In this scenario, it was uncertain whether a provisional liquidator would be appointed by the court when the DIS payout was triggered. In order to restore depositors' confidence in the banking system, the Board decided to make payments to eligible depositors on 15 Feb 02.
- In respect of Mr A, payment by the DIS would cover the interest accrued between 1 Jan 02 and 1 Feb 02, which would be \$100 ( $\$10,000 \times 12\% \times 1/12$ ). The aggregate amount of compensation to Mr A would therefore be \$10,100. (Note that although this is less than what the depositor would receive if interest was accrued until 1 May 2002, he is compensated by receiving his money earlier than would be the case in a liquidation.)

- Since Mr A had assigned all his rights in respect of the 6-month deposit to the DIS, any interest accrued for the period from 1 Feb 02 to 1 May 02 would be for the account of the DIS. Therefore, the amount that the DIS would be entitled to claim in the liquidation would be \$10,100 plus the interest accrued for the period from 1 Feb 02 to 1 May 02, which would be \$300 ( $\$10,000 \times 12\% \times 3/12$ ). This would add up to a total of \$10,400.

### Example (iii)

- Suppose that Mr B had more than one insurable deposit, each bearing a different interest rate, and the aggregate amount of such deposits exceeded \$100,000:

<u>Date</u>	<u>Events</u>
1 Feb 02	Mr B made a saving deposit of \$120,000 with Bank X at 2%pa. He also had a balance of \$80,000 in his current account which did not bear any interest
1 Feb 02	Payout by the DIS was triggered
15 Feb 02	Payments by the DIS were made
1 May 02	A provisional liquidator was appointed
1 Jul 02	A winding-up order was issued

- In this scenario, payments by the DIS were made before the appointment of the provisional liquidator.
- As of 1 Feb 02, the aggregate amount of insurable deposits in respect of Mr B was \$200,000 (C/A: \$80,000 and S/A: \$120,000). Since this exceeds the coverage limit, a payment of \$100,000 would be made to Mr B on 15 Feb 02.
- As mentioned in the consultation paper, it would be necessary to apportion the compensation payment by the DIS to the two deposit accounts of Mr B. Otherwise it would be unclear how the respective entitlements to accrued interest of the DIS and Mr B should be calculated.
- If a pro-rata approach as proposed in the consultation paper were adopted, then the respective positions of the DIS and Mr B as of 1 Feb 02 would be:

DIS	-	S/A: \$60,000	- ( $\$100,000 \times 120,000 / 200,000$ )
		C/A: \$40,000	- ( $\$100,000 \times 80,000 / 200,000$ )
		Total: \$100,000	
Mr B	-	S/A: \$60,000	- ( $\$120,000 - \$60,000$ )
		C/A: \$40,000	- ( $\$80,000 - \$40,000$ )
		Total: \$100,000	

- The respective amounts of claims of the DIS and Mr B as of 1 May 02 would be:

DIS	-	S/A: \$60,300	- (\$300 being interest accrued from 1 Feb to 1 May)
		C/A: \$40,000	
		Total: \$100,300	



Mr B	-	S/A:	\$60,300	- (\$300 being interest accrued from 1 Feb to 1 May)
		C/A:	\$40,000	
		Total:	\$100,300	

- Although the DIS had an aggregate claim of \$100,300, only the first \$100,000 would receive preferential treatment under the present priority claims system.

**Example (iv)**

- Suppose that section 227E of the Companies Ordinance had been amended so that in the event that payment was made by the DIS before the appointment of a provisional liquidator, the date on which the DIS payout was triggered would be taken to be the “relevant date” for the purpose of that section.
- If the above amendment were made, in calculating the dividend entitlement of Mr A in Example (ii) above, the liquidator would include interest accrued only up to the date on which the DIS payout was triggered (i.e., 1 Feb 2002), rather than the date on which the provisional liquidator was appointed (i.e., 1 May 2002). The dividend that would be paid to the DIS in respect of Mr A’s deposit would therefore be \$10,100 (\$100 being interest accrued between 1 Jan 2002 and 1 Feb 2002), as opposed to \$10,400 in Example (ii). This would be exactly the same amount that the DIS had paid to Mr A.
- In the case of Mr B in Example (iii) above, since no interest would accrue after the DIS payout was triggered (i.e., 1 Feb 2002), it would no longer be necessary to determine how the compensation payment made by the DIS should be apportioned to Mr B’s deposit accounts. The liquidator would simply take into account the positions of the DIS and Mr B as of 1 Feb 2002 in determining their respective entitlements to dividend payments. As a result, both the DIS and Mr B would be entitled to a claim of \$100,000 in the liquidation, as opposed to \$100,300 in Example (iii). (Note however that only the claim of the DIS would receive preferential treatment.)

**Example (v)**

- Suppose that Mr C had insurable deposits denominated in different currencies with Bank X:

Mr C	-	HK\$ deposit:	\$40,000	
		US\$ deposit:	\$40,000	] (amount in HK dollar
		GBP deposit:	\$40,000	] equivalent)
		Total:	\$120,000	

- As mentioned in the consultation paper, the Board should be given the discretion to decide the order in which the compensation payments in respect of a depositor’s deposits in different currencies should be paid out subject to the principle that this would help to minimise the Board’s potential exposure to foreign exchange risk. This means that deposits in Hong Kong dollars and US dollars would normally be paid off first.

- After the compensation payment was made, the respective positions of the DIS and Mr C would become:

DIS	-	HK\$ deposit:	\$40,000
		US\$ deposit:	\$40,000
		GBP deposit:	\$20,000
		Total:	\$100,000

Mr C	-	HK\$ deposit:	\$0
		US\$ deposit:	\$0
		GBP deposit:	\$20,000
		Total:	\$20,000

- Interest accrual would be calculated accordingly.

### **Example (vi)**

- Suppose that Mr C had the following insurable deposits with Bank X:

Mr C	-	HK\$ deposit:	\$40,000
		US\$ C/A:	\$40,000 ] (amount in HK dollar
		US\$ S/A:	\$60,000 ] equivalent)
		GBP deposit:	\$40,000 ]
		Total:	\$180,000

- According to the principle illustrated in Example (v) above, the Hong Kong dollar deposit (\$40,000) would be paid out first, then followed by the US dollar deposits. However, to pay out all the US\$ deposits would make the aggregate amount of compensation payment to Mr C exceed the coverage limit. Therefore, the US\$ deposits would be paid out on a pro-rata basis.
- After the compensation payment was made, the respective positions of the DIS and Mr C would become:

DIS	-	HK\$ deposit:	\$40,000	
		US\$ C/A:	\$24,000	- (40,000/100,000*60,000)
		US\$ S/A:	\$36,000	- (60,000/100,000*60,000)
		Total:	\$100,000	

Mr C	-	HK\$ deposit:	\$0	
		US\$ C/A:	\$16,000	- (40,000-24,000)
		US\$ S/A:	\$24,000	- (60,000-36,000)
		GBP deposit:	\$40,000	
		Total:	\$80,000	

- Interest accrual would be calculated accordingly.