

**Self-assessment on compliance with the
Core Principles for Effective Deposit Insurance System
recommended by the Basel Committee on Banking Supervision (BCBS)**

BCBS's Recommendations	Compliance status of the Deposit Protection Scheme in Hong Kong
<i>Setting Objectives</i>	
<p>Principle 1 – Public-policy objectives</p> <p>The first step in adopting a deposit insurance system or reforming an existing system is to specify appropriate public-policy objectives that it is expected to achieve. These objectives should be formally specified and well integrated into the design of the deposit insurance system. The principal objectives for deposit insurance systems are to contribute to the stability of the financial system and protect depositors.</p>	<p>Compliant.</p> <p>The objectives of the Deposit Protection Scheme (DPS) in Hong Kong are to protect depositors and to help maintain the stability of Hong Kong's banking system. The objectives are formally specified in the mission statement of the Hong Kong Deposit Protection Board (the Board) and have been reflected in the design and operation of the DPS.</p>
<p>Principle 2 – Mitigating moral hazard</p> <p>Moral hazard should be mitigated by ensuring that the deposit insurance system contains appropriate design features (such as limiting on the amounts insured, excluding certain categories of depositors, and implementing differential premium systems) and through other elements of the financial system safety net.</p>	<p>Compliant.</p> <p>The design of the DPS has incorporated a number of features to mitigate moral hazard: compensation is subject to a cap; a differential premium system is implemented; persons connected with a failed bank; and professional players are excluded from protection.</p>
<i>Mandates and Powers</i>	
<p>Principle 3 – Mandate</p> <p>It is critical that the mandate selected for a deposit insurer be clear and formally specified and that there be consistency between the stated public-policy objectives and the powers and responsibilities given to the deposit insurer.</p>	<p>Compliant.</p> <p>The mandates for the DPS and the Board are clearly and formally specified in the legislation (the Deposit Protection Scheme Ordinance (Cap.581)). According to the Ordinance, the DPS should generally function as a “pay-box” type system. It is mainly responsible for the collection of premium and payment of compensation. The powers conferred to it are consistent with the functions intended for it.</p>

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<p>Principle 4 – Powers</p> <p>A deposit insurer should have all powers necessary to fulfil its mandate and these powers should be formally specified. All deposit insurers require the power to finance reimbursements, enter into contracts, set internal operating budgets and procedures, and access timely and accurate information to ensure that they can meet their obligations to depositors promptly.</p>	<p>Compliant.</p> <p>The powers exercisable by the Board are specified in the legislation, including power to borrow money, power to employ persons and appoint agents, power to acquire assets, power to obtain required information for the performance of its functions as well as powers for administration and management. The Board can set its internal operating budgets, which are subject to the approval of the Financial Secretary (FS).</p>
Governance	
<p>Principle 5 – Governance</p> <p>The deposit insurer should be operationally independent, transparent, accountable and insulated from undue political and industry influence.</p>	<p>Compliant.</p> <p>The Board is a statutory body independent of the Government, the banking regulator and the banking industry. The Board consists of 6 independent members appointed by the Chief Executive and 2 ex-officio members. No existing bankers can be appointed as a member.</p> <p>The annual budgets of the DPS Fund are subject to the approval of the FS. The Board maintains a website and publishes annual reports which have to be tabled to the Legislative Council.</p>
Relationship with other safety-net participants and cross-border issues	
<p>Principle 6 – Relationships with other safety-net participants</p> <p>A framework should be in place for the close coordination and information sharing, on a routine basis as well as in relation to particular banks, among the deposit insurer and other financial system safety-net participants. Such information should be accurate and timely (subject to confidentiality when required). Information-sharing and coordination arrangements should be formalised.</p>	<p>Compliant.</p> <p>The scope of cooperation and information sharing between the Board and other safety-net players (e.g. the Hong Kong Monetary Authority and the Securities and Futures Commission) has been documented in memoranda of understanding (MoUs). The MoUs cover cooperation and information sharing during both day-to-day operation as well as in a payout scenario.</p>

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<p>Principle 7 – Cross-border issues</p> <p>Provided confidentiality is ensured, all relevant information should be exchanged between deposit insurers in different jurisdictions and possibly between deposit insurers and other foreign safety-net participants when appropriate. In circumstances where more than one deposit insurer will be responsible for coverage, it is important to determine which deposit insurer or insurers will be responsible for the reimbursement process. The deposit insurance already provided by the home country system should be recognised in the determination of levies and premiums.</p>	<p>Compliant.</p> <p>The implementation of this principle requires concerted effort of deposit insurers in different countries. The Board has been participating actively in international forums to foster cooperation with overseas deposit insurers in developing solutions to deal with cross-border issues. If deposits taken by a foreign bank branch in Hong Kong are also covered by the deposit insurance system of its home country and the level of protection provided is at least as good as the DPS's, the foreign bank branch can apply to be exempted from joining the scheme in Hong Kong.</p>
Membership and Coverage	
<p>Principle 8 – Compulsory membership</p> <p>Membership in the deposit insurance system should be compulsory for all financial institutions accepting deposits from those deemed most in need of protection (e.g. retail and small business depositors) to avoid adverse selection.</p>	<p>Compliant.</p> <p>In Hong Kong, only licensed banks are allowed to take small deposits. Licensed banks' participation in the DPS is mandatory. Only two foreign bank branches are exempted from joining the DPS.</p>
<p>Principle 9 – Coverage</p> <p>Policymakers should define clearly in law, prudential regulations or by-laws what an insurable deposit is. The level of coverage should be limited but credible and be capable of being quickly determined. It should cover adequately the large majority of depositors to meet the public-policy objectives of the system and be internally consistent with other deposit insurance system design features.</p>	<p>Compliant.</p> <p>The types of deposit covered by the DPS and the protection limit of the DPS are clearly specified in the legislation. According to the statistics of the Board, about 80% of depositors are fully covered under the current protection limit of HK\$100,000. The coverage of the DPS, including protection limit and product coverage, is currently under review.</p>

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<p>Principle 10 – Transitioning from a blanket guarantee to a limited coverage deposit insurance system</p> <p>When a country decides to transition from a blanket guarantee to a limited coverage deposit insurance system, or to change a given blanket guarantee, the transition should be as rapid as a country's circumstances permit. Blanket guarantees can have a number of adverse effects if retained too long, notably an increase in moral hazard. Policymakers should pay particular attention to public attitudes and expectations during the transition period.</p>	<p>Not applicable to the DPS.</p> <p>The DPS in Hong Kong was not introduced for transitioning from a blanket guarantee to a limited insurance system.</p> <p>A blanket guarantee, however, was introduced by the Hong Kong SAR Government on 14 October 2008. The guarantee will expire by the end of 2010. The Board is reviewing the coverage of the DPS. In conducting the review, due consideration will be given to its interactions with the blanket guarantee. The public will be thoroughly consulted and will have ample time to get ready for the expiry of the guarantee.</p>
Funding	
<p>Principle 11 – Funding</p> <p>A deposit insurance system should have available all funding mechanisms necessary to ensure the prompt reimbursement of depositors' claims including a means of obtaining supplementary back-up funding for liquidity purposes when required. Primary responsibility for paying the cost of deposit insurance should be borne by banks since they and their clients directly benefit from having an effective deposit insurance system.</p> <p>For deposit insurance systems (whether ex-ante, ex-post or hybrid) utilising risk-adjusted differential premium systems, the criteria used in the risk-adjusted differential premium system should be transparent to all participants. As well, all necessary resources should be in place to administer the risk-adjusted differential premium system appropriately.</p>	<p>Compliant.</p> <p>The DPS has obtained a standby funding facility from the Exchange Fund to meet its payment obligations in a payout. The cost incurred by the DPS in a payout, e.g. financing cost, shortfall loss and administrative cost, will be charged to the DPS Fund established through collection of premiums from Scheme members.</p> <p>The DPS adopts an ex-ante funding approach. A differential premium system is adopted for determining the premium payable by individual Scheme members. The premium charging rates applicable to Scheme members are determined by the supervisory ratings assigned to them by the HKMA. The premium rates applicable to different rating classes are set out in the legislation. Scheme members will be advised of their supervisory ratings by the HKMA.</p>

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Public awareness	
<p>Principle 12 - Public awareness</p> <p>In order for a deposit insurance system to be effective it is essential that the public be informed on an ongoing basis about the benefits and limitations of the deposit insurance system.</p>	<p>Compliant.</p> <p>Since the DPS in Hong Kong commenced operation, the Board has been undertaking on-going publicity activities to promote awareness and understanding of the DPS. Half-yearly opinion surveys are conducted to monitor the level of public awareness and understanding.</p>
Selected legal issues	
<p>Principle 13 - Legal protection</p> <p>The deposit insurer and individuals working for the deposit insurer should be protected against lawsuits for their decisions and actions taken in "good faith" while discharging their mandates. However, individuals must be required to follow appropriate conflict-of-interest rules and codes of conduct to ensure they remain accountable. Legal protection should be defined in legislation and administrative procedures, and under appropriate circumstances, cover legal costs for those indemnified.</p>	<p>Compliant.</p> <p>The DPS Ordinance has in place immunity clauses to provide protection to persons acting in good faith in the performance of the functions of the Board.</p> <p>Officers carrying out the functions of the Board are required to follow a code of conduct and relevant provisions in the legislation to avoid conflicts of interests or misuse of confidential information.</p> <p>The existing legal protection may be further enhanced to explicitly cover legal costs that may be incurred by the Board's officers or its agents.</p>
<p>Principle 14 – Dealing with parties at fault in a bank failure</p> <p>A deposit insurer, or other relevant authority, should be provided with the power to seek legal redress against those parties at fault in a bank failure.</p>	<p>Compliant.</p> <p>The HKDPB has the power to sue under the DPS Ordinance and can seek legal redress against parties at fault who cause losses to the DPS.</p>

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Failure resolution	
<p>Principle 15 – Early detection and timely intervention and resolution</p> <p>The deposit insurer should be part of a framework within the financial system safety net that provides for the early detection and timely intervention and resolution of troubled banks. The determination and recognition of when a bank is or is expected to be in serious financial difficulty should be made early and on the basis of well defined criteria by safety-net participants with the operational independence and power to act.</p>	<p>Compliant.</p> <p>While the DPS has little role in early detection and resolution of troubled bank given its mandate as a pay-box, the DPS has a clearly defined role in the timely intervention of a troubled bank. The triggers of the DPS are specified in the legislation. The Board has reached an agreement with the banking regulator (HKMA) to ensure that the Board will be given early warnings on the triggering of compensation under the DPS. The arrangement of early warning and scope of information and cooperation between the two parties are documented in an MoU.</p>
<p>Principle 16 – Effective resolution processes</p> <p>Effective failure-resolution processes should: facilitate the ability of the deposit insurer to meet its obligations including reimbursement of depositors promptly and accurately and on an equitable basis; minimise resolution costs and disruption of markets; maximise recoveries on assets; and, reinforce discipline through legal actions in cases of negligence or other wrongdoings. In addition, the deposit insurer or other relevant financial system safety-net participant should have the authority to establish a flexible mechanism to help preserve critical banking functions by facilitating the acquisition by an appropriate body of the assets and the assumption of the liabilities of a failed bank (e.g. providing depositors with continuous access to their funds and maintaining clearing and settlement activities).</p>	<p>Compliant.</p> <p>In so far as the functions of the DPS as a pay-box are concerned, the Board has undertaken measures to ensure that the DPS can make compensation payments to depositors in an expeditious manner. The Board has obtained a standby funding facility from the Exchange Fund for financing compensation payments. The Board has developed a set of payout policies and procedures, and a proprietary computer system for compensation determinations. It has engaged a network of service providers (payout agents) to assist in determining and paying compensation to depositors. The procedures, system and payout agents are subject to regular rehearsals and simulations to ensure their readiness. The bases for compensation determinations are set out in the legislation and were formulated after thorough consultation.</p>

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<i>Reimbursing depositors and recoveries</i>	
<p>Principle 17 – Reimbursing depositors</p> <p>The deposit insurance system should give depositors prompt access to their insured funds. Therefore, the deposit insurer should be notified or informed sufficiently in advance of the conditions under which a reimbursement may be required and be provided with access to depositor information in advance.</p> <p>Depositors should have a legal right to compensation up to the coverage limit and should know when and under what conditions the deposit insurer will start the payment process, the time frame over which payments will take place, whether any advance or interim payments will be made as well as the applicable coverage limits.</p>	<p>Compliant.</p> <p>The conditions under which compensation under the DPS will be triggered are specified in the legislation and there is an early warning arrangement to ensure that the banking regulator will give an early warning to the Board to prepare for a payout.</p> <p>The compensation limit entitled by depositors is specified in the legislation. According to the legislation, the Board has to make announcements to notify depositors when compensation is triggered in respect of a bank. The Board will make compensation to depositors as soon as possible. Where necessary, an interim payment can be made. The Board will keep depositors informed of the progress through public announcements.</p>
<p>Principle 18 – Recoveries</p> <p>The deposit insurer should share in the proceeds of recoveries from the estate of the failed bank. The management of the assets of the failed bank and the recovery process (by the deposit insurer or other party carrying out this role) should be guided by commercial considerations and their economic merits.</p>	<p>Compliant.</p> <p>In so far as the functions of the DPS as a pay-box are concerned, the Board is empowered by law to subrogate into the priority claims of depositors in bank liquidations to the extent of compensation paid and recover the compensation paid from the liquidated estates of banks.</p>

Hong Kong Deposit Protection Board
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