

REVIEW OF OPERATIONS AND ACHIEVEMENTS IN 2011-2012

Economic situation

Despite an increasingly austere global economic environment, the Hong Kong economy remained sound and stable with a moderate growth of 5.0% over the course of 2011, after a 7.0% growth in 2010. The Hong Kong economy entered 2011 on strong growth momentum. But the economic growth was dampened from the second half of 2011, reflecting a slackening in the external sector amid, in particular, the deepening Eurozone sovereign debt crisis and sluggish recovery in the US and other advanced markets. The domestic sector, however, continued to be resilient with remarkable private consumption growth at 8.6% on account of continued improvement in the labour market conditions, rising household incomes and solid consumer confidence. Government consumption growth remained steady at 1.8%. Growth in the domestic sector had the effect of partially offsetting the drag from the weaker performance of merchandise exports due to faltering demand.

Inflationary pressures continued unabated in the first half of 2011 but began to show signs of easing off towards the end of the year. Inflation averaged at 5.3% for the whole of 2011, up from 1.7% in 2010. The Hong Kong stock market was subject to considerable volatility throughout the year, with prices generally drifting downwards broadly in line with movements in the major global financial markets. The local property market remained buoyant, continuing its uptrend in the first half of 2011 before cooling down in the second half of the year on impact of stabilising policy measures, a weaker global growth outlook, and tighter mortgage loan terms.

Banking environment in Hong Kong

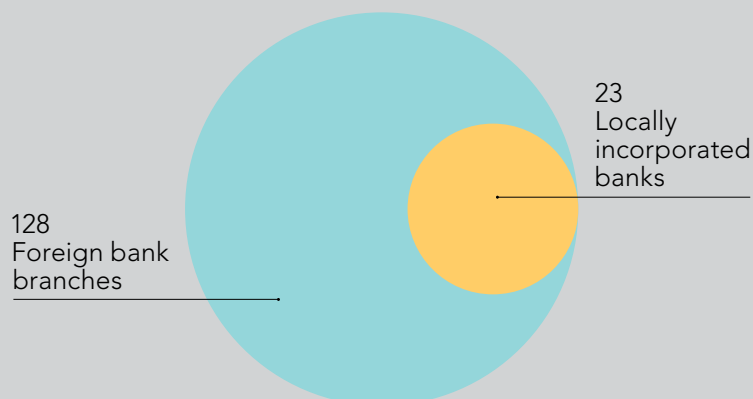
The Hong Kong banking sector remained robust in 2011 in face of a looming European sovereign debt crisis. The average liquidity ratio of retail banks (at 38.0%) was well above the statutory minimum (25%). The asset quality of retail banks was healthy with a low classified loan ratio at 0.59% at the end of 2011, compared with 0.77% at the end of 2010. All locally incorporated authorized institutions were well capitalised with a consolidated capital adequacy ratio of 15.8% at the end of 2011. The tier-1 capital adequacy ratio edged up to 12.4% from 12.2% a year ago. On profitability growth, the aggregate pre-tax operating profits of retail banks' Hong Kong offices grew by 18.0% in 2011; the post-tax return on average assets remained similar to that of the preceding year at 1.01% in 2011.

The accommodative monetary conditions continued in 2011. The Hong Kong dollar interbank interest rates (HIBORs) remained low, with the three-month HIBORs hovering at 0.33% at the end of 2011. Yet the composite interest rate, which reflects the average cost of funds of retail banks, edged up more than double to about 0.5% towards the end of 2011 as retail banks offered higher interest rates to attract larger and longer-term deposits. Under the Linked Exchange Rate System, movements in the Hong Kong dollar exchange rate largely mirrored the US dollar against other major currencies.

Profile of Scheme members

At the end of March 2012, there were 151 Scheme members, compared with 145 a year ago. During the year, seven new members joined the scheme upon being authorized as licensed banks. One member was revoked because of a merger and acquisition. Of the 151 Scheme members, 23 are locally incorporated banks and 128 are foreign bank branches. This is largely in line with the number of retail banks and wholesale banks in Hong Kong respectively.

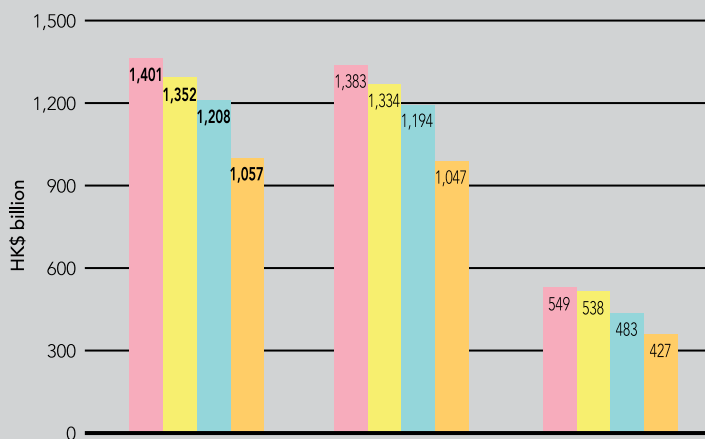
Number of Scheme members as at 31 March 2012



Based on the returns of relevant deposits submitted by Scheme members, the aggregate amount of relevant deposits increased by 1.3% to HK\$1,401 billion in 2011, compared with HK\$1,383 billion in 2010. According to statistics provided by Scheme members, about 90% of depositors were fully protected by the DPS.

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Relevant deposits held with Scheme members




% of Total	2011	2010	2009
Top 5	75%	76%	78%
Top 10	86%	86%	88%
Top 20	97%	96%	98%
Total	100%	100%	100%

The distribution of relevant deposits among Scheme members remained similar to that of last year, with large retail banks holding 85% of the industry's aggregate relevant deposits, small-to-medium-sized retail banks holding 12% of the industry total and the wholesale banks holding the remaining 3%. Similar to previous years, the top 20 Scheme members continued to account for more than 95% of the total relevant deposits in the industry. In terms of growth, the small-to-medium-sized retail banks recorded a much higher growth of relevant deposits (at 5%) than their large counterparts (at 1%).

Relevant deposits held with large retail banks and small-to-medium-sized retail banks

(in HK\$ billion)	2011	2010	±%
Large retail banks	1,197	1,187	1%
Small-to-medium-sized retail banks	160	153	5%



Contributing to better protection

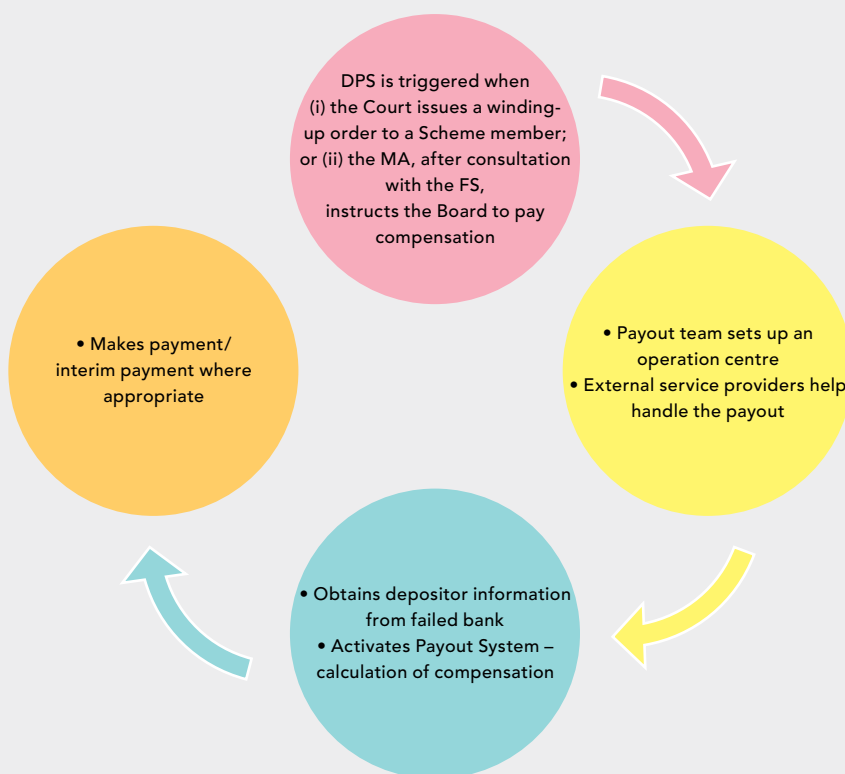
The Board actively participated in a peer review of deposit insurance systems of the FSB member jurisdictions under the FSB framework for strengthening adherence to international standards. The peer review used the Core Principles jointly developed by the Basel Committee on Banking Supervision and the International Association of Deposit Insurers (IADI) as a benchmark to take stock of deposit insurance systems in FSB member jurisdictions and draw lessons about the effectiveness of reforms in response to the 2008 global financial crisis. Through participation in the work of the FSB peer review team, the Board contributed to the promotion of greater compliance with the Core Principles internationally, and to the identification of areas requiring further guidance to achieve more effective compliance or to better reflect leading practices. The Board also consolidated the experience gained from the peer review exercise to prepare for a comprehensive assessment of the design of the DPS in Hong Kong against the Core Principles.

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Ensuring payout readiness of the DPS

Background on Payout Readiness

“Payout readiness” refers to the Board’s ability to deliver on its mandate of making compensation payments to affected depositors promptly in the event of a bank failure (a process that is commonly referred to as a payout). This generally relates to having the appropriate people, processes and systems in place to be brought into action on short notice if payment of compensation from the DPS Fund is triggered. As depicted in the diagram below, the payout process requires a number of elements to be in place for promptly starting and completing a payout.



Payout framework

The Board adopts a virtual organisation structure. It retains a small number of core staff with in-depth knowledge to administer the DPS, and develops flexibility, by contractual arrangements, to call upon a network of external service providers (collectively referred to as payout agents) to form a payout team to assist with calculation and payment of compensation to depositors should there be a bank failure.

Payout policies and a comprehensive set of procedures are developed and maintained to guide the payout team to effectively manage and undertake the payout to meet the Board’s operational objectives. The payout system is designed according to the payout processes and

is built to a capacity to enable the processing of a large volume of depositors' records and calculate their compensation payment.

Central to payout readiness is the guideline on information system requirements which require Scheme members to maintain depositors' records in their information systems and to promptly provide the required information to the Board for payment determination.

A significant achievement during the year was the Board's successful completion of a major revision to the payout policies and procedures to enhance its payout efficiency, based on the experience gained from conducting payout rehearsals and simulations. As part of the revision, guidance notes were developed to set out the principles and approaches on applying the new powers conferred on the Board by the enhanced DPS for the purpose of streamlining payment calculations.

Payout policies, procedures and processes

A payout is a multi-disciplinary operation involving various payout agents working concurrently on a series of interrelated activities. When the DPS is triggered, the Board's goal is to calculate the compensation payment and pay depositors as quickly and accurately as practicable. The payout agents are guided by the payout policies and a comprehensive set of procedures, documented in the Payout Procedure Manual as well as other reference materials, to achieve a seamless payout operation. Leveraging on the experience gained from previously conducted rehearsals, the Board has endeavoured to develop an event management plan to guide the time-critical activities immediately before and after the DPS is triggered, and set out the key management control at essential stages of a payout. The Board has also conducted several simulations focusing on payout processes, which are technically complex in terms of the collection of supplementary information and the identification of persons entitled to receive payment. Based on the results of the simulations, new procedures have been developed to define the additional steps necessary for compensation determination of trust accounts, client deposits, and depositors providing guarantees.

To achieve accountability and transparency in exercising the Board's new powers given under the enhanced DPS, two guidance notes have been developed to set out the principles and approaches to be taken by the Board in making reasonable estimates of accrued interest and contingent liabilities to streamline the compensation determination process. The Board consulted the banking industry and insolvency practitioners before finalising the guidance notes for incorporation into the Board's policies and procedure manual.

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Ensuring payout readiness of the DPS

Payout infrastructure

The effective use of information technology is an important element of a robust payout infrastructure. Therefore, the payout system is reviewed regularly to ensure it has adequate capacity, processing power and up-to-date operating software. During the year, system enhancements were implemented to accelerate the data loading function, provide more reporting features, and improve its usability to facilitate the Board in expediting the calculation process of compensation payments.

One of the methods for paying depositors is by mailing a cheque to them accompanied by a statement listing the accounts used for the calculation. The readiness and co-ordination arrangements of cheque and statement printing firms have been reviewed and strengthened by ensuring that they have the capability of handling large volumes of printing and mailing in a secure and prompt manner within short notice.

The Board further improved the network of payout agents available to be engaged in a payout by establishing contractual arrangements with several accounting firms and law firms. This arrangement mitigates the risk of the unavailability of resources for the provision of services to the Board.

Rehearsal and procedure walkthrough activities

The Board conducted two subject-specific rehearsals in 2011, which focused on the event management immediately before and after the DPS trigger, the process to decide and distribute an interim payment to depositors, and the co-ordination required between the Board and the payout agents. The rehearsals involved new payout agents such as accounting firms, statement printing firms, as well as other payout agents which had participated in previous rehearsals (for example, the IT firms, call centres, and business continuity service providers). Procedures and system training were given to the participants in advance. The rehearsals provided an opportunity for the payout agents to act on crisis-simulated scenarios, and the results verified that the Board is capable of operating a payout with its network of payout agents in accordance with the Board's standard policies and procedures.

As an accounting firm will take the overall project management role in a payout under the guidance of the Board to supervise other payout agents, it is important to ensure accounting firms are familiar with the payout policies and procedures. During the year, the Board conducted a payout walkthrough for an accounting firm that did not participate in last year's rehearsals, to refresh its understanding of responsibilities and key processes of a payout.



The Chairperson and the Chief Executive Officer participate in the rehearsal

Compliance reviews and simulation tests

The capability of the Board to make compensation payment effectively places great reliance on the timeliness of obtaining the complete set of accurate depositor records from a failed Scheme member. The Board uses regular compliance reviews to verify the ability of Scheme members to comply with the information system requirements. Six compliance reviews were conducted during the year and the scope of each review covered the verification of the correctness of data format, and the completeness and accuracy in which Scheme members made the required information available to the Board. Based on the reviews conducted so far, the level of compliance was generally satisfactory. Scheme members were required to provide action plans to resolve any variance from the guideline identified in the reviews. The Board monitored the progress of implementation of the remedial actions by the Scheme members to ensure gaps were duly filled.

Full sets of customer records obtained from Scheme members for compliance reviews were concurrently used in conducting simulation tests. The simulations ensure the payout infrastructure is continuously maintained at a ready state to process the volume and specific combination of products and depositors of any Scheme members, as well as providing a platform to verify the detailed execution of certain payout procedures by payout agents. For example, an accounting firm was involved in one of the simulation tests to assess the effectiveness of procedures on applying the new guidance note on accrued interest estimations.



Regular simulation exercises help to ensure payout readiness

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Ensuring payout readiness of the DPS

Access to pre-established funding facilities

Once payment is triggered under the DPS, the Board is obliged to make compensation to the depositors of the failed Scheme members as soon as practicable. To this end, the Board has secured a standby credit facility with the Exchange Fund of an amount up to HK\$120 billion to meet the funding requirements of the DPS in a payout. The costs and losses that may be incurred in the payout process will be absorbed by the DPS Fund.

Building up the DPS Fund

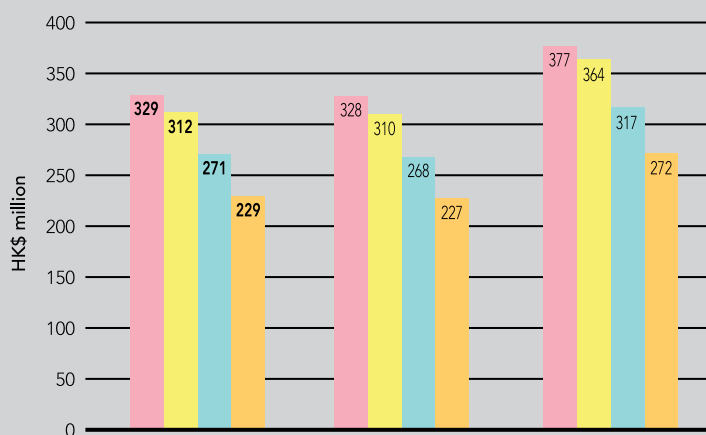
Composition of the DPS Fund

The DPS Fund mainly consists of two components, namely the annual contributions made by Scheme members to the Board, and the returns generated from the investments of the DPS Fund.

Reporting of relevant deposits

Scheme members are required to report the amount of relevant deposits held with them in the fourth quarter each year and the reported figure, together with the supervisory rating provided by the HKMA, serves as the basis for determination of the amount of contribution payable by a Scheme member in the coming year.

Contribution paid by Scheme members by relevant deposits held



% of Total	2012	2011	2010
Top 5	70%	69%	72%
Top 10	82%	82%	84%
Top 20	95%	95%	97%
Total	100%	100%	100%

Assessment and collection of contributions

The amount of contributions collected from Scheme members for the year amounted to HK\$329 million, reflecting an increase of 0.6% over the previous year. All contributions were paid by Scheme members in accordance with the DPS Contribution Rules in the first quarter of 2012. Similar to the distribution of relevant deposits, the amount of contributions collected from the top 20 Scheme members continued to account for 95% of the total contributions.

To ensure the relevant deposit data reported in the returns submitted by Scheme members are correctly compiled, the Board has been requesting Scheme members since 2007 to conduct regular audit reviews of their Returns of Relevant Deposits in accordance with the policy for reviewing returns. As a result of the change in the deposit profile of Scheme members under the increased protection limit of HK\$500,000 and the basis for reporting the amount of relevant deposits, the Board re-examined the policy on review of returns of relevant deposits in 2011 and updated the policy to ensure that an appropriate basis be used for commissioning audit reviews to verify the correctness of the returns.

A total of 40 Scheme members were requested to submit an audit report to the Board on the correctness of their returns in 2012. The results of the review were generally satisfactory and no reporting error leading to a material impact on the amount of contributions collected by the Board was noted. After the completion of the review, over 99% of the relevant deposits reported based on the HK\$500,000 protection limit have been verified by an auditor. This assurance gives the Board confidence in the correctness of the total amount of contributions payable by the industry.

Investment of the DPS Fund

Given the volatility of financial markets and the primary investment objective of the Fund being capital preservation, the Board was fully mindful of the need to exercise extra caution during the year. A conservative investment strategy was adopted in accordance with the investment restrictions set out in the DPSO and investment policies of the DPS Fund to guard against any possible losses that might arise from any sudden change in market sentiment. The investment operation was in strict accordance with the investment control policies, which set out clear guidelines on risk assessment and control measures, and the segregation of duties required for investment activities.

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Ensuring payout readiness of the DPS

As the Hong Kong dollar moved on the weak side of the Convertibility Undertaking for most of the year, and in view of the persistently low interest rates offered by the short-term Exchange Fund and US Treasury papers, the DPS Fund's assets were predominantly held as deposits and almost all were denominated in Hong Kong dollars with only minimal balance in US dollars. For the year as a whole, the DPS Fund managed to make a positive investment return of 0.2%, despite the highly volatile investment environment.

Mix of cash and investments of the DPS Fund (as at 31 March)

(in HK\$ million)	2012	2011
Cash and deposit balance	1,811.3	1,535.9
Investment securities	0.0	0.0
Total	1,811.3	1,535.9

Currency mix of cash and investments of the DPS Fund (as at 31 March)

(in HK\$ million)	2012	2011
HK dollar	1,810.9	1,535.5
US dollar	0.4	0.4
Total	1,811.3	1,535.9

Enhancing public awareness and understanding

Establishment of the Advisory Panel on Communication and Public Education

A high level of public awareness and understanding of the features of the DPS is crucial to gaining depositors' confidence in the DPS and thus the effectiveness of the DPS in contributing to general banking stability.

Based on the foundation built in the last few years, there is a high recognition of the availability of protection under the DPS by the public. Nevertheless, to extend this to audiences not readily accessible to mass advertising media and, at the same time, to raise awareness and understanding of specific messages that may not be so readily known, the Board has initiated new measures to reach out to the community.

As part of this approach, the Board established an Advisory Panel comprising experts with experience in the relevant fields to advise the Board on its communication and public education strategy and implementation. The Panel also advises to the Board on the effective allocation of its resources in delivering its messages to the widest possible audience, including the target population.

Publicity campaigns to reach mass audiences

Two successive large-scale multi-media publicity programmes were launched during the year to maintain high public awareness of the DPS and its key features, using television as the major advertising media. A new thematic TV commercial was produced focusing on the protection of deposits denominated in different currencies. This was considered an important message and one that was less well known as revealed in the findings of an opinion survey. In addition, a series of advertisements in a popular quiz-show format was broadcast concurrently to supplement the thematic TV commercial in providing a comprehensive picture of the enhanced DPS.



A snapshot of the TV commercial reminding the public about the key features of the DPS

Other mass media outlets, including radio, newspapers and print material, public transport and the internet, were used to promote the DPS.



Iron piggy bank, the icon of the DPS, is widely used in different advertising media

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Enhancing public awareness and understanding

Outreach activities in dialogue with the public

With the advice of the Panel, a series of public education and outreach activities were organised during the year. The activities included lively short dramas, community talks, the distribution of education kits to schools, textbook publishers and newspaper editors, and sponsoring different RTHK channels for the broadcast of DPS messages in the form of short dramas specially designed for more targeted audiences, such as young people and students, new immigrants and the elderly. In addition, advertorial publications were included in selected circulars issued by labour unions and non-government organisations (NGOs) to allow more detailed DPS messages to be disseminated to different groups within the community to deepen their knowledge of the DPS.



Different outreach activities are held in schools and at the community level

The Board is also in the process of establishing a new team to carry out community education and outreach activities directed at different target groups in a bid to deepen their understanding of the DPS.



Advertisements placed on the NGO publications to extend the reach to different niche groups

To further expand the reach of the DPS, the Board also collaborated with Scheme members to promote the DPS to their customers. Indeed, there has been strong support from Scheme members to make the information leaflets and other seasonal souvenirs available for distribution at their branches.



Festive souvenirs distributed to the public through Scheme members

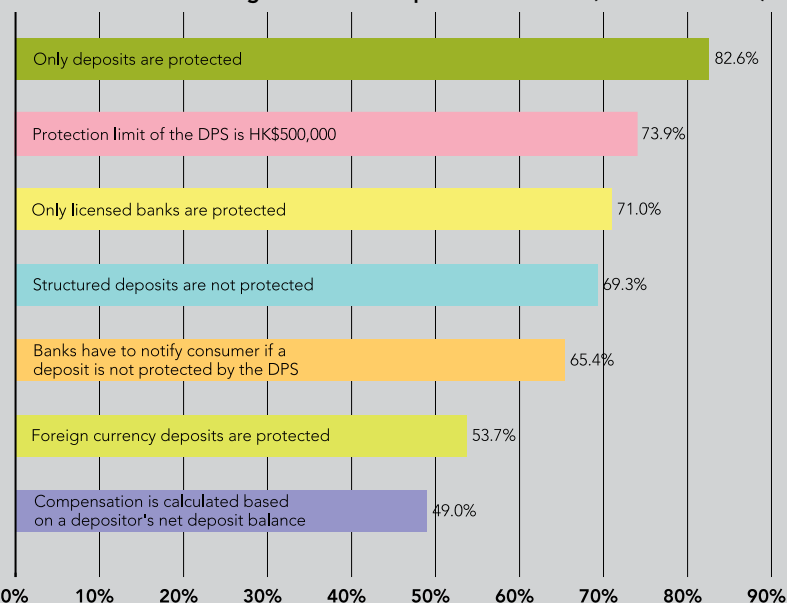
Effectiveness of the publicity campaign

Since the DPS commenced operation in 2006, the Board has engaged the services of an independent research agency to conduct opinion surveys to measure the level of public awareness and understanding of the DPS, to assess the effectiveness of its publicity campaigns.

The findings of the survey conducted in December 2011 were encouraging with over 75% of the respondents indicating their awareness of the scheme. More than 70% of the respondents who were aware of the enhanced DPS also had knowledge of the new HK\$500,000 protection limit, which became effective in January 2011. The awareness levels of various key features were also kept at good levels. Going forward, more focus will be put on publicising the scope and coverage of the DPS to provide depositors with a more comprehensive understanding of the scheme. The Board will continue to make use of the findings of surveys to revise and enhance its future communications and publicity strategies.

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Level of understanding of different aspects of the DPS (December 2011)



Note: As a percentage of those who were aware of the DPS

DPS membership and strengthened product representations by Scheme members

The DPS Representation Rules governing the representations made by Scheme members about their DPS membership and the protection status of the financial products offered by them were first issued by the Board in 2006. The enhancements to the DPS Representation Rules took effect on 1 January 2011 when the increased protection limit was introduced. The major enhancements include:

- requiring Scheme members to give notification to customers of non-protected deposits on a transaction basis;
- making positive disclosures in respect of the deposits protected by the DPS;
- restricting the use of the term “structured deposit”; and
- responding to customers’ enquiries on the protection status of financial products in a specified manner and within a specified timeframe.

To monitor Scheme members’ compliance with the enhanced representation requirements, a self-assessment review covering the period from 1 January 2011 to 30 June 2011 was conducted by Scheme members. In addition, a series of on-site examinations was also undertaken during the year to ascertain the level of Scheme members’ compliance with the Representation Rules in greater detail. The Board reviewed the self-assessment reports and on-site examination findings. The results indicated that the overall compliance level of Scheme members was satisfactory in general and, so far, no significant incidence of non-compliance was identified.

Relationship with other safety net players

Co-operation with the Hong Kong Monetary Authority

Both the Board and the HKMA are financial safety net players in Hong Kong and share a common objective of promoting the stability of the banking system. To ensure this is accomplished, the Board and the HKMA have signed a MoU setting out how the two organisations are to co-operate with each other in the performance of their respective functions. In addition, as the Board is required by the DPSO to perform functions through the HKMA, the Board and the HKMA have agreed on the extent of support provided by the HKMA to the Board on a day-to-day basis. The Board has also secured a standby facility from the Exchange Fund to provide the necessary liquidity required for payment of compensation in the event of a bank failure. During the year, the Board and the HKMA closely co-operated with each other in accordance with the terms of the MoU.

Relationship with the Securities and Futures Commission and the Investor Compensation Company

Under certain circumstances in the event of a bank failure, the funds of a depositor or a portion of those funds may be simultaneously covered by the DPS and the Investor Compensation Fund (ICF) established under the Securities and Futures Ordinance for compensating securities or futures investors. To ensure that no person receives double compensation, the Board and the Securities and Futures Commission (SFC) have agreed on a set of arrangements to co-ordinate and exchange information between the parties. The detailed arrangements have been documented in a MoU between the Board, the SFC and the Investor Compensation Company (ICC), the company recognised by the SFC for administering the ICF. Specifically, the MoU recognises that the DPS will normally pay the depositors first in the event of a bank failure and, to avoid double compensation, the parties should exchange relevant information.

International cooperation

As a member of the IADI, the Board actively participated in conferences and seminars organized by the IADI, its member deposit insurers and other international organizations, and exchanged knowledge and views on issues relevant to deposit protection in the international forum. This is particularly important for keeping up-to-date with the international developments, for better coordination both in times of financial crisis as well as in the aftermath of the crisis where sharing of experience on the effectiveness of reform measures overseas provides insights and an impetus for change to ensure a robust DPS in Hong Kong.

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International cooperation

In 2011-2012, the Board's personnel took part in a number of international meetings including:

- a seminar on methodology for assessing Core Principles for Effective Deposit Insurance Systems organised by the IADI and the Financial Stability Institute in Basel, Switzerland;



CEO Meena Datwani (sixth from left, first row) at the seminar in Basel, Switzerland

- the IADI 10th Annual Conference and Annual General Meeting in Warsaw, Poland;
- a seminar on deposit insurance assessments and fund management organised by the IADI in Taipei, Taiwan;



CEO Meena Datwani (third from left) is a moderator at the event

- the Deposit Insurance Corporation of Japan 6th Round Table in Osaka, Japan; and
- a seminar on assessment of compliance with the Core Principles for Effective Deposit Insurance System organised by the Malaysia Deposit Insurance Corporation in Kuala Lumpur, Malaysia



Chariperson Pamela Chan (fifth from left, first row) and CEO Meena Datwani (fourth from left, first row) at the seminar in Kuala Lumpur, Malaysia