

LEGISLATIVE COUNCIL BRIEF

The Secretary for Financial Services and the Treasury submits the following note for Members' information:

<u>Title of the Note</u>	<u>Date of ExCo</u>	<u>Date of Gazette</u>
Deposit Protection Scheme Ordinance (Amendment of Schedules 1 and 4) Notice 2006	9 May 2006	19 May 2006

19 May 2006

Financial Services and the Treasury Bureau

LEGISLATIVE COUNCIL BRIEF

Deposit Protection Scheme Ordinance (Chapter 581)

DEPOSIT PROTECTION SCHEME ORDINANCE (AMENDMENT OF SCHEDULES 1 AND 4) NOTICE 2006

INTRODUCTION

At the meeting of the Executive Council on 9 May 2006, the Council ADVISED and the Chief Executive ORDERED that the Deposit Protection Scheme Ordinance (Amendment of Schedules 1 and 4) Notice 2006 (“the Notice”), at Annex, should be made in accordance with section 54(1) of Cap.581¹ to clarify the treatment of structured products under the Deposit Protection Scheme (DPS) and provide for miscellaneous amendments to certain provisions of the DPS Ordinance to improve their operation.

JUSTIFICATIONS

Treatment of structured products under the DPS

2. In the course of making the necessary preparations for the launch of the DPS in the latter half of 2006, the Hong Kong Deposit Protection Board (“the Board”) observes that a significant number of banks, which are members of the DPS (“Scheme members”), are unclear about the protection status of the structured products they offer to their customers. Structured products are complex financial products the returns of which depend on the performance of a financial asset, an index or the occurrence or non-occurrence of a specified event (e.g. whether a company has defaulted payment). Typical examples include equity-linked deposits, currency-linked deposits, credit-linked deposits, index-linked deposits, inverse floaters and range accruals.

¹ Section 54(1) of Cap.581 provides that the Chief Executive in Council may, by notice published in the Gazette, amend Schedule 1, 2, 3 or 4.

3. The Board has sought legal opinions as to whether structured products are “deposits” within the meaning of section 2(1) of the Banking Ordinance (Cap.155)² and thus are protected by the DPS. The legal opinions received point out that whether a financial product constitutes a deposit needs to be determined on a case by case basis having regard to the terms and conditions of the product.

4. The uncertainty regarding the protection status of structured products under the DPS is undesirable. Scheme members will need to incur additional costs in determining the nature of their structured products on a case by case basis. Despite the additional costs and efforts, some Scheme members may not be able to correctly advise their customers whether a structured product is protected by the DPS. As a result, consumers may make wrong decisions as to whether a structured product is suitable for them.

5. In order to eliminate this uncertainty, the Board proposes not to protect structured products, whether or not they fall within or outside the definition of “deposit” under Cap.155. There are three main reasons for this proposal. Firstly, many common structured products offered in the market are not deposits. They will not be protected by the DPS anyway. Secondly, the DPS in Hong Kong is aimed at protecting small, unsophisticated depositors. On the contrary, most depositors who invest in structured products are large and sophisticated depositors. Excluding structured products from deposit protection is therefore not inconsistent with the original policy objective of establishing a DPS in Hong Kong to protect small depositors. Thirdly, the aggregate amount of structured products which are likely to be deposits and are protected under the DPS Ordinance is very small. Therefore, the proposed exclusion of structured products from DPS protection is unlikely to undermine the effectiveness of the DPS in terms of its ability to contribute to banking stability.

² For a financial product to be protected by the DPS, it must be a “deposit” within the meaning of section 2(1) of Cap.155. That section defines “deposit” to mean:

- “(a) a loan of money –**
(i) at interest, at no interest or at negative interest; or
(ii) repayable at a premium or repayable with any consideration in money or money’s worth; but
(b) does not include a loan of money -
(i) upon terms involving the issue, by any company, of debentures or other securities in respect of which a prospectus has been registered under the Companies Ordinance (Cap.32);
(ii) upon terms referable to the provision of property or services; or
(iii) by one company to another (neither company being an authorised institution) at a time when one is a subsidiary of the other or both are subsidiaries of another company
(iv) and references in this Ordinance to the taking or the making of a deposit shall be construed accordingly.”

6. If the above proposal is adopted, there will be absolute clarity to Scheme members and depositors regarding the protection status of structured products under the DPS. The Board will require Scheme members to make clear representations to consumers before they purchase structured products. Consumers will be required to acknowledge that they have received and understand the representation.

7. Moreover, the Board will keep this issue under constant review. It has established a set of quantitative benchmarks for triggering a review of this matter³. In the unlikely event that the exclusion of structured products would materially affect the effectiveness of the DPS, the Board will consider reversing the exclusion by introducing appropriate amendments to the DPS Ordinance.

Other amendments to the DPS Ordinance

8. In the light of the experience obtained by the Board in the establishment of the DPS, the Board proposes the following miscellaneous amendments to Schedules 1 and 4 of the DPS Ordinance -

- (a) amending the definition of “excluded person” in section 3 of Schedule 1 to the DPS Ordinance so that Scheme members need not exclude the deposits held by officers of Scheme members and their related companies for the purpose of calculating the amount of contribution to be paid into the DPS Fund. This amendment aims at alleviating the reporting burden of Scheme members which consider that the resources required to identify the amount of such deposits outweigh any saving in their contribution to be paid to the Board;
- (b) amending Schedule 4 to provide that if 20 October (the date for Scheme members to report the amount of relevant deposits each year) of any year is a general holiday, Scheme members should report the amount of relevant deposits based on the position of the immediate preceding day which is not a general holiday; and
- (c) amending section 3 of Schedule 4 to allow the calculation of the build-up levy for the first year of operation of the DPS to be made on a pro rata basis as the DPS is expected to come into operation on a date other than 1 January.

³ The quantitative benchmarks are:

- (i) Number of depositors holding principal-linked or interest-linked products and having an aggregate deposit balance \leq \$100,000 with banks constitutes 3% or more of the total number of depositors in Hong Kong;
- (ii) Number of depositors holding either type of structured products and having an aggregate deposit balance \leq \$100,000 with banks constitutes 2% or more of the total number of depositors in Hong Kong;
or
- (iii) 24 months have lapsed after the launch of the DPS.

9. The Notice effecting the above amendments is proposed to be made under section 54(1) of the DPS Ordinance. Section 54(2) of the same Ordinance states that in amending Schedule 4, the Chief Executive in Council shall ensure that the DPS Fund should, so far as practicable, be made up of money derived from the banking industry. Members are invited to note that the Notice will not affect the fact that the DPS Fund will be made up of money derived from the banking industry (also see paragraph 18).

THE SUBSIDIARY LEGISLATION

10. The proposed amendments to the DPS Ordinance under the Notice, in general terms, provide for the exclusion of structured deposits from DPS protection and improving the operation of the DPS.

11. The main provisions of the Notice are as follows –

- (a) **Clause 2** introduces a construction clause on “structured deposit” and excludes a structured deposit from the definitions of “protected deposit” and “relevant deposit”. It also amends the definition of “excluded person” to leave out the officers of a Scheme member or its related company in so far as the definition of “relevant deposit” is concerned;
- (b) **Clause 3** amends Schedule 4 to the DPS Ordinance to allow Scheme members to report the amount of relevant deposits based on the day immediately preceding 20 October if 20 October is a general holiday and to allow the calculation of the build-up levy for the first year of operation of the DPS to be made on a pro rata basis as the DPS is expected to come into operation on a day other than 1 January.

LEGISLATIVE TIMETABLE

12. The legislative timetable for the Notice will be as follows –

Publication in the Gazette	19 May 2006
Tabling in the Legislative Council	24 May 2006
Completion of negative vetting by the Legislative Council	12 July 2006

IMPLICATIONS OF THE PROPOSAL

13. The Notice is in conformity with the Basic Law, including the provisions concerning human rights. It has no economic, productivity, environmental, financial, civil service or sustainability implications. The amendments proposed in the Notice will not affect the current binding effect of the DPS Ordinance.

PUBLIC CONSULTATION

14. The Board has consulted the banking industry and other interested parties including the Consumer Council, the Securities and Futures Commission, the Hong Kong Institute of Certified Public Accountants, the Law Society of Hong Kong and the Hong Kong Bar Association. The Hong Kong Association of Banks, the Consumer Council, the Law Society of Hong Kong and the Securities and Futures Commission supported the proposed amendments to the DPS Ordinance. The Consumer Council also agreed with the Board's quantitative benchmarks for triggering a review of the treatment of structured products as mentioned in paragraph 7 above. The other organizations did not have any comments on the proposed amendments.

15. The Board also briefed the Legislative Council Panel on Financial Affairs on 6 March 2006 on the latest implementation progress of the DPS and the proposed amendments to the DPS Ordinance. Members of the Panel were supportive of the proposed amendments.

PUBLICITY

16. A press release will be issued, and a government spokesman will be available to answer media and public enquiries.

ENQUIRY

17. Enquiries on this brief can be directed to Mrs Millie Ng, Principal Assistant Secretary for Financial Services and the Treasury (Financial Services) (telephone no. 2529 0121), and Mr Raymond Chan, Head (Banking Development), Hong Kong Monetary Authority (telephone no. 2878 8111).

BACKGROUND

18. The DPS Ordinance was enacted in May 2004. It provides for the establishment of a DPS in Hong Kong with a compensation limit of \$100,000 per depositor per bank. A DPS Fund with a target fund size of 0.3% of the aggregate amount of relevant deposits maintained with all Scheme members will be built up through the collection of contributions from the Scheme members.

19. The Board was formed in July 2004 to establish and administer the DPS. It is required under law to perform functions through the Monetary Authority (MA). Executive Director (Banking Development) of the Hong Kong Monetary Authority is assigned to assist the Board and has been authorized to discharge his duties as the Chief Executive Officer of the Board.

20. The Board is now progressing on a number of key tasks, such as the development of rules and guidelines and payout infrastructure, to prepare for the launch of the DPS. It is expected that the DPS will start providing deposit protection in the second half of 2006.

21. Under the DPS Ordinance, certain decisions of the Board and the MA can be the subject of a review by the Deposit Protection Appeals Tribunal. These include the Board's decisions regarding whether a foreign bank branch can be exempted from participation in the DPS, the amount of contribution payable by a Scheme member, and the amount of compensation payable to a depositor, as well as the MA's decision to impose an asset maintenance requirement on a Scheme member. The Tribunal was established in January 2005.

Financial Services and the Treasury Bureau
19 May 2006

**DEPOSIT PROTECTION SCHEME ORDINANCE
(AMENDMENT OF SCHEDULES 1 AND 4) NOTICE
2006**

(Made by the Chief Executive in Council under section 54 of the Deposit Protection Scheme Ordinance (Cap. 581))

1. Commencement

This Notice shall come into operation on the day appointed for the commencement of Schedule 4 to the Deposit Protection Scheme Ordinance (Cap. 581).

2. Deposits specified for purposes of definitions of “protected deposit” and “relevant deposit” in section 2(1) of this Ordinance

(1) Schedule 1 to the Deposit Protection Scheme Ordinance (Cap. 581) is amended, in section 1, by adding –

“(aa) a structured deposit;”.

(2) Schedule 1 is amended, in section 2, by adding –

“(aa) a structured deposit;”.

(3) Schedule 1 is amended by adding –

“2A. For the purposes of this Schedule, a deposit is a structured deposit if –

(a) the loan of money, or any part of the loan, may be repaid –

(i) in a currency that is different from that in which the loan of money was made; or

(ii) in the form of any property other than money;

(b) the interest on the loan of money, or the premium at which the loan of money is repayable, or any part of the interest or premium, may be paid in a currency that is

- different from that in which the loan of money was made;
- (c) any amount of the loan of money to be repaid is determined by reference to –
- (i) the price or value of a financial product, commodity, non-local currency or property;
 - (ii) the level of an index;
 - (iii) the fact that a relevant figure –
 - (A) is above, below or equal to a specified level; or
 - (B) is within or outside a specified range;
 - (iv) the difference calculated by subtracting a relevant figure from a specified percentage;
 - (v) the result of a mathematical operation that involves more than one relevant figure; or
 - (vi) the occurrence or non-occurrence of an event in relation to a person other than the depositor who holds, or the Scheme member that takes, the deposit; or
- (d) any amount of the interest on the loan of money, or of the premium at which the loan of money is repayable, is determined by reference to –
- (i) the price or value of a financial product, commodity, non-local currency or property;

- (ii) the level of an index;
- (iii) the fact that a relevant figure –
 - (A) is above, below or equal to a specified level; or
 - (B) is within or outside a specified range;
- (iv) the difference calculated by subtracting a relevant figure from a specified percentage;
- (v) the result of a mathematical operation that involves more than one relevant figure; or
- (vi) the occurrence or non-occurrence of an event in relation to a person other than the depositor who holds, or the Scheme member that takes, the deposit.”.

(4) Schedule 1 is amended, in section 3, in the definition of “excluded person”, in paragraph (e)(ii), by repealing “and to the definition of “relevant deposit” in that section”.

(5) Schedule 1 is amended, in section 3, in the definition of “non-excluded person” –

- (a) in paragraph (b), by repealing “and to the definition of “relevant deposit” in that section”;
- (b) by adding –
 - “(c) in relation to the definition of “relevant deposit” in section 2(1) of this Ordinance, a person who is not an excluded person within the meaning of paragraph (a), (b), (c) or (d) of the definition of “excluded person”;

(6) Schedule 1 is amended, in the English text, in section 3, in the definition of “related company”, in paragraph (c), by repealing the full stop and substituting a semicolon.

(7) Schedule 1 is amended, in section 3, by adding –

““commodity” (商品) means any item which is listed in the Schedule to the Commodity Exchanges (Prohibition) Ordinance (Cap. 82);

“financial product” (金融產品) means any securities, futures contract, collective investment scheme or leveraged foreign exchange contract within the meaning of section 1 of Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571);

“relevant figure” (有關數字) means –

(a) a rate of interest, quoted or published from time to time, that is offered by a person or government on a loan of money that –

(i) the person or government makes to, or proposes to make to, another person or government; or

(ii) the person or government raises from, or proposes to raise from, another person or government;

(b) a rate of interest, quoted or published from time to time, that is offered by a person or government, for entering into a swap contract with another person or government, as the rate of interest at which payments to be made under that contract are to be calculated;

(c) a rate of return, quoted or published from time to time, on an investment of moneys made by a person or government; or

- (d) a figure, quoted or published from time to time, that represents the result of a mathematical operation that involves more than one rate of interest or return mentioned in paragraph (a), (b) or (c);

“swap contract” (掉期合約) means a contract made between two parties whereby each party agrees to make payments, calculated at a rate of interest on a specified amount of money, to the other party in a particular period.”.

3. Contributions to Fund

- (1) Schedule 4 is amended, in section 1(1), by adding –

““specified date” (指明日期), in relation to a year, means –

- (a) 20 October of that year; or
(b) where 20 October of that year is a general holiday, the day (not being a general holiday) immediately preceding that date;

“start-up year” (啟動年) means the year in which this Schedule commences;”.

- (2) Schedule 4 is amended, in section 1(3)(b), by repealing “20 October” and substituting “the specified date”.

- (3) Schedule 4 is amended, in section 2(1) and (2), by repealing “20 October” and substituting “the specified date”.

- (4) Schedule 4 is amended, in section 3(2) and (3), by repealing “20 October” and substituting “the specified date”.

- (5) Schedule 4 is amended, in section 3(5) –

- (a) in the Chinese text, by repealing “在不抵觸第 (6) 及 (7) 款和第 6 條的規定下” and substituting “除第 (6) 及 (7) 款和第 6 條另有規定外”;

- (b) by adding “(other than the start-up year)” after “any year”;
 - (c) by repealing “20 October” and substituting “the specified date”.
- (6) Schedule 4 is amended, in section 3, by adding –
- “(5A) Subject to section 6, the amount of build-up levy payable by a Scheme member for the start-up year is such portion of the amount of build-up levy that would have been payable by the Scheme member for the start-up year if that Scheme member had been a member of the Scheme during the whole of the year that the number of days during which this Schedule is in operation in the start-up year bears to 365.
- (5B) That amount of build-up levy that would have been payable for the start-up year is the sum calculated by multiplying the amount of relevant deposits maintained with the Scheme member as at –
- (a) if the Scheme member becomes a member of the Scheme on or before the specified date in the year immediately preceding the start-up year, that specified date; or
 - (b) if the Scheme member becomes a member of the Scheme after that specified date, the date on which it becomes a member of the Scheme,
- by the percentage specified in column 2 of the Table set out in subsection (5) opposite the MA supervisory rating of the Scheme member specified in column 1 of that Table.”.
- (7) Schedule 4 is amended, in section 3(6) and (7), by repealing “20 October” and substituting “the specified date”.
- (8) Schedule 4 is amended, in section 4(3) –
- (a) in the Chinese text, by repealing “在不抵觸第 6 條的規定下” and substituting “除第 6 條另有規定外”;

(b) by repealing “20 October” and substituting “the specified date”.

(9) Schedule 4 is amended, in section 5(1)(b) and (4)(b), by repealing “20 October” and substituting “the specified date”.

(10) Schedule 4 is amended, in the Chinese text, in section 5(3), by repealing “在不抵觸第 6 條的規定下” and substituting “除第 6 條另有規定外”.

(11) Schedule 4 is amended, in section 6, by adding immediately before subsection (1) –

“(1A) This section applies to a Scheme member that becomes a member of the Scheme by virtue of section 12(3) of this Ordinance on or after the commencement of this Schedule.”.

(12) Schedule 4 is amended, in section 6(1), by repealing “by virtue of section 12(3) of this Ordinance”.

(13) Schedule 4 is amended, in section 6(1)(a), by repealing “but not 20 October of the immediately preceding year”.

(14) Schedule 4 is amended, in section 6(2) –

(a) by repealing “by virtue of section 12(3) of this Ordinance after 20 October” and substituting “after the specified date”;

(b) by repealing “but not 20 October of that particular year”.

(15) Schedule 4 is amended, in section 6(3), by repealing “by virtue of section 12(3) of this Ordinance”.

(16) Schedule 4 is amended, in section 7, by repealing everything after “of \$50,000” and substituting –

“that –

(a) in the case of the start-up year –

(i) where the Scheme member becomes a member of the Scheme before the commencement of this Schedule, the number of days during which this Schedule is in operation in that year bears to 365;

- (ii) where the Scheme member becomes a member of the Scheme on or after the commencement of this Schedule, the number of days during which the Scheme member is a member of the Scheme in that year bears to 365; or
- (b) in the case of any other year, the number of days during which the Scheme member is a member of the Scheme in that year bears to 365,

is payable by the Scheme member for that year.”.

(17) Schedule 4 is amended, in section 8(1) and (3), by repealing “20 October” and substituting “the specified date”.

(18) Schedule 4 is amended, in section 9(2), by repealing everything after “days” and substituting “within the relevant period in the year bears to the number of days within the contribution period in that year.”.

(19) Schedule 4 is amended, in section 9, by adding –

“(3) In this section –
“contribution period” (供款期間) –

- (a) in relation to the start-up year –
 - (i) in the case where the Scheme member becomes a member of the Scheme before the commencement of this Schedule, means the period during which this Schedule is in operation in that year; or
 - (ii) in the case where the Scheme member becomes a member of the Scheme on or after the commencement of this Schedule, means the period that begins on the

date on which the Scheme member becomes a member of the Scheme and expires on 31 December of that year;

(b) in relation to any other year –

(i) in the case where the Scheme member is a member of the Scheme on 1 January of that year, means the period that begins on 1 January and expires on 31 December of that year;

or

(ii) in the case where the Scheme member becomes a member of the Scheme after 1 January of that year, means the period that begins on the date on which the Scheme member becomes a member of the Scheme and expires on 31 December of that year;

“relevant period” (有關期間), in relation to a year, means the period that begins on the date on which a Scheme member ceases to be a member of the Scheme and expires on 31 December of that year.”.

Clerk to the Executive Council

2006

Explanatory Note

This Notice amends Schedules 1 and 4 to the Deposit Protection Scheme Ordinance (Cap. 581) to –

- (a) exclude a structured deposit from the definitions of “protected deposit” and “relevant deposit”;
- (b) amend the definition of “excluded person” to exclude an officer of a member of the Deposit Protection Scheme or its related company in so far as the definition of “relevant deposit” is concerned;
- (c) provide an alternative date for the purposes of Schedule 4 to the Ordinance where the date currently specified in the Schedule is a general holiday; and
- (d) introduce the build-up levy for the start-up year and make consequential amendments.