香港存款保障委員會
HONG KONG DEPOSIT PROTECTION BOARD

Report on the public consultation on enhancing deposit protection under the Deposit Protection Scheme

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INTRODUCTION

1. On 27 April 2009, the Hong Kong Deposit Protection Board (the Board) published a consultation paper containing a package of recommendations for enhancing deposit protection under the Deposit Protection Scheme (DPS). The recommendations were concluded from the first phase of a review of the DPS completed by the Board in the first quarter of 2009.

2. The key recommendations in the consultation paper include:

   - raising the protection limit of the DPS from the current HK$100,000 to HK$500,000;

   - expanding the coverage of the DPS to include secured deposits referable to the provision of banking and financial services;

   - halving the rates for charging contributions on banks to neutralise the cost impact of raising the protection limit; and

   - keeping certain features of the DPS unchanged, including calculating deposit compensation on a net deposit basis; not covering deposits held with institutions other than licensed banks; and the exclusion of structured deposits from protection.

3. During the two-month consultation period, the Board launched an extensive publicity campaign to encourage public participation. Towards the end of the consultation, the Board commissioned an independent research institute to conduct a territory-wide opinion survey to obtain a comprehensive view of the public sentiment towards the recommendations. Apart from soliciting comments from the public, the Board also approached a number of key stakeholder groups to gather their opinions, including industry and professional bodies, consumer interest groups, academics and the legislature.

4. The Board received about 800 responses from the public. Major stakeholder groups also submitted their comments. The keen responses indicate the consultation achieved its objective of triggering extensive community discussion on the subject.

5. In general, the consultation concluded there was broad public support for the Board's recommendations. This report summarises the major comments received for each recommendation, and the responses and the conclusions of the Board.

COMMENTS RECEIVED AND THE BOARD'S RESPONSES

1. Protection limit

The Board's recommendations

It is recommended that the protection limit of the DPS be increased from the current HK$100,000 to HK$500,000, instead of HK$200,000 as indicated by the consultant in the HKMA consultancy report.

It is recommended that the level of priority claims for depositors under the Companies Ordinance (CO) be adjusted to link it to the DPS protection limit. Without this adjustment, an increase in the protection limit will be cost-prohibitive.

Views from the public consultation

6. The public and the major stakeholder groups consulted generally agreed that there is a need to raise the protection limit of the DPS. The public generally welcomed the higher level of protection recommended in the consultation paper. As expected, many indicated a wish to raise the limit even above HK$500,000 or remove the cap entirely. Nevertheless, the findings of the opinion survey indicate that about 80% of the respondents found the proposed limit of HK$500,000 acceptable. The recommendation was also endorsed by major stakeholder groups, including the banking industry and the Consumer Council. The Board also received a few alternative proposals, for example, setting the new limit at below HK$500,000 to better control moral hazard and cost, providing partial protection for all deposits or those in excess of a specified limit.

7. The public was less concerned about the issue of aligning the level of priority claims for depositors under the CO with the DPS protection limit. The arrangement, however, was recognised by many stakeholder groups as essential for keeping the cost of deposit protection manageable. Accounting professionals reminded the Board to take into account the rights of other parties in bank liquidations when making revisions to the CO.

The Board's responses and conclusions

8. The Board fully understands it is natural for depositors to want a higher or even an unlimited amount of protection. However, our analysis indicates that raising the DPS protection limit above HK$500,000 will result in a higher level of moral hazard and a disproportionately higher cost. The Board is glad to note that a large majority of the public responding to the opinion survey indeed found the Board's recommendation acceptable.

9. On the alternative proposal of setting the limit at below HK$500,000, the Board is glad to note that the moral hazard and cost issues were also recognised by the public. As the limit proposed by the Board is generally in line with the level of protection available in other major countries, the Board believes that the moral hazard accompanying the limit would be manageable given the robust prudential banking regulation and supervision in place in Hong Kong. At the same time, cost mitigating measures will be implemented to alleviate the cost impact of raising the limit. On the proposal of providing partial protection, the reform experience in the UK after the Northern Rock incident indicates that, although the co-insurance element under the partial protection arrangement may help mitigate moral hazard, it is not helpful in preventing rumour-driven bank runs.

10. Regarding the impact of the revisions to the CO on other parties in bank liquidations, a higher level of priority claims will have the effect of providing better protection for small depositors at the expense of large depositors and other creditors. Nevertheless, large depositors and creditors are expected to benefit from savings in liquidation costs due to a reduction in the number of creditors as well as faster dividend payouts. As the existing level of priority claims was set almost 15 years ago, there is a strong case for updating its limit to preserve the real value of the protection it affords to small depositors. To bring consistency to the two arrangements that share the same objective of protecting small depositors, it is logical to link the level of priority claims under the CO to the DPS protection limit. In fact, the Board also consulted legal professionals, relevant government departments and advisory committees. No objections were received from these bodies on the proposed consequential amendments to the CO.

11. Based on the results of the consultation, the Board believes that its recommendation can create a better balance for the effectiveness of the DPS, moral hazard concerns and cost, and, at the same time, make it better able to meet public expectation.

2. Compensation calculation basis

The Board's recommendation

The Board does not recommend changing the netting approach (full netting) applicable to the DPS for the time being. However, international developments should be monitored and the subject should be kept under review.

Views from the public consultation

12. The recommendation on keeping the netting approach unchanged did not attract as many responses from the public as other recommendations in the consultation paper. Most of the comments received on the subject supported the recommendation. A majority of the respondents to the opinion survey also found the recommendation acceptable.

13. The major stakeholder groups consulted generally accepted keeping the netting approach unchanged, but some suggested the Board should continue monitoring international developments in the area. The accounting professionals shared the Board's concern that changing the netting approach for the DPS and effecting a corresponding change to the priority claims for depositors under the CO, could result in significant changes to Hong Kong's insolvency regime, and disturb the balance of interest between depositors and other creditors.

The Board's response and conclusion

14. In the light of the general support for the recommendation in the consultation, the Board concludes that it is appropriate to keep the netting approach for the DPS unchanged. Nevertheless, as suggested by some stakeholder groups, the Board will continue to monitor international developments in this area.

3. Product coverage

The Board's recommendations

It is recommended that secured deposits which fall outside the present definition of "deposit" under the Banking Ordinance (BO) because they are referable to the provision of banking and financial services be brought under the protection of the DPS by revising the definition of "deposit" in the Deposit Protection Scheme Ordinance (DPSO).

It is recommended that the definition of deposit for the priority claims for depositors under the CO be brought in line with the revised definition of deposit in the DPSO.

The Board does not recommend bringing structured deposits under the protection of the DPS.

Views from the public consultation

15. The public in general supported bringing secured deposits under the protection of the DPS. Many also wished the coverage of the DPS to be expanded further to include other types of non-protected deposits, for example, structured deposits, deposits with term to maturity of over 5 years, and even non-deposit investments, for example, stocks, bonds, insurance policies, savings plans and unit trusts. Over half of the respondents to the opinion survey agreed with protecting secured deposits, but not protecting structured deposits.

16. The major stakeholder groups generally agreed with the recommendation of protecting secured deposits as this can enhance clarity and thus the effectiveness of the DPS. Most were also supportive of not bringing structured deposits under the protection of the DPS at this stage, although the Board was reminded to monitor the popularity of such deposits among retail depositors to assess the need to review their protection status. There was also a view that structured deposits should not be brought under the protection of the DPS as this may mislead customers with low risk appetite into buying risky products.

17. The banking industry drew the Board's attention to the preparations required by banks to effect the changes associated with the inclusion of secured deposits under the protection of the DPS. The legal and accounting professionals pointed out the potential complexities in defining secured deposits for conferring protection status, especially in the light of its implications to the definition of "deposit" in various ordinances.

The Board's responses and conclusions

18. In the light of the general support for bringing secured deposits under the protection of the DPS, the Board will take forward the amendment of the definition of "deposit" in the DPSO and CO to effect the change. During the process, legal views will be sought to ensure the amendments can effectively achieve the objective and, at the same time, will not result in inconsistencies to the operation of the relevant ordinances. Once the draft legislation is ready, the industry and other interested bodies will be consulted on its appropriateness. The Board is also prepared to discuss with the industry to understand the preparations required by banks for effecting protection to secured deposits. An appropriate implementation schedule will be drawn up in consultation with the industry.

19. The wish of the public to expand coverage of the DPS further, to include other types of non-protected deposits and even non-deposit investments, is perfectly understandable. The reason for excluding certain types of deposits from the DPS is to align its coverage with that of the priority claims for depositors under the CO, which is important in containing the cost of the DPS to a manageable level. As some of these non-protected deposits are not common in the market, for example, term deposits exceeding 5 years in maturity, their inclusion would add little to the effectiveness of the DPS, but would require adjustments to Hong Kong's insolvency regime. Therefore, the Board does not see any merit in bringing them under the protection of the DPS at this stage. Nevertheless, the Board will continue to monitor the popularity of such deposits, especially among small depositors, to assess whether it is necessary to review their protection status. Due consideration will also be given to the risk of conservative customers being misled into buying high risk products, especially when considering expanding coverage to structured deposits.

20. The protection of non-deposit investments is not consistent with the objective and mandate of the DPS of protecting small and unsophisticated depositors. It is uncommon for deposit insurance schemes in other countries to cover investment products other than deposits. Investors are usually covered by other types of compensation schemes. For example, investors in exchange-traded products in Hong Kong are covered by the Investor Compensation Fund administered by the Securities and Futures Commission.

4. Types of institution covered

The Board's recommendation

The Board does not recommend extending the coverage of the DPS to deposits held in restricted licence banks (RLBs) and deposit-taking companies (DTCs).

Views from the public consultation

21. Quite unexpectedly, few members of the public requested an expansion of the coverage of the DPS to include deposits at RLBs and DTCs. Indeed, the majority of public comments received on this issue agreed with the continued exclusion of RLBs and DTCs from DPS membership. This is consistent with the readings registered at the opinion survey which showed that over half of the respondents found the recommendation of the Board acceptable. The relatively limited public attention perhaps reflects that RLBs and DTCs have very few retail depositors.

22. While most stakeholder groups also supported the continued exclusion of RLBs and DTCs at this stage, they requested that the arrangement be reviewed in view of the results of the HKMA's review of the three-tier authorization system. The DTC Association, however, disagreed at the exclusion of all RLBs and DTCs, and requested that at least those that could demonstrate the use of deposits in the normal course of banking business be allowed to join. A request for joining the DPS was also received from an association of credit unions.

23. The DTC Association noted that if the DPS protection limit was raised to HK$500,000, the reason for excluding DTCs, because they could not take deposits below HK$100,000, would become void. The Association pointed out that some of its members were increasingly relying on retail deposits for funding as certain funding channels available to them in the past had become less accessible due to changes in market conditions. The Association was of the opinion that their members had not and would not present moral hazard to the system because they were under the prudential supervision of the HKMA, the same as licensed banks (LBs) are. Allowing RLBs and DTCs to join the DPS would help foster competition, which would be beneficial to depositors. This view was shared by the Consumer Council. The Association also doubted the validity of evaluating the effectiveness of the protection over an institution on the percentage of depositors fully covered, as both large and small depositors might pull out from an institution in times of stress.

The Board's responses and conclusions

24. The Board is fully aware that RLBs and DTCs, like the LBs, are under the quality prudential supervision of the HKMA. The Board does not feel they would present a higher moral hazard to the financial system than LBs. The recommendation for not covering RLBs and DTCs at this stage was made mainly from the perspective of whether the protection would be effective in meeting the objectives of the DPS.

25. It is an internationally agreed principle that a deposit insurance scheme must be able to cover a large majority of depositors if it is to be effective in preventing rumour-driven bank runs. The focus of protection should also fall on those who are generally not in a position to make an informed assessment of the risk that the bank to which their funds are entrusted may fail. Institutions with few small depositors are naturally not the targets of deposit insurance schemes. Separately, though the operation of a deposit insurance scheme may contribute to a more competitive environment, fostering competition is usually not the primary objective of a deposit insurance scheme. By design, deposit insurance is a safety net arrangement for protecting depositors from bank failures, thereby contributing to confidence and stability in the banking system.

26. According to statistics collected by the Board in June 2009, only around 40% of depositors at DTCs had a deposit balance of less than HK$500,000. It is therefore doubtful that extending DPS coverage to DTCs would add much to banking stability. Nevertheless, the Board notes that the review of the three-tier authorization system by the HKMA may have an impact on the mode of operation of RLBs and DTCs. The Board, therefore, commits to review membership of the DPS if the HKMA's review concludes changes that would adversely affect the effectiveness of the DPS due to the exclusion of non-bank deposit-takers.

27. On the request of the credit unions to join the DPS, the Board understands that such credit unions are not allowed to take deposits from the public. They are usually formed by pooling financial resources from a restricted group of members, for example, members of labour unions, for making loans to one another. They are not part of the banking system and, unlike some overseas credit unions, are not subject to prudential regulation and supervision. Therefore, the Board does not see any merit, in terms of enhancing banking stability, in bringing them under the protection of the DPS.

5. Funding arrangements

The Board's recommendations

It is recommended that Scheme members be offered an option to report protected deposits for contribution assessment purposes on a net deposit basis to the extent that they see appropriate.

It is recommended that the target fund size of the DPS Fund be adjusted from the current 0.3% to 0.25% of total protected deposits

It is recommended that the annual contribution by Scheme members be maintained largely at the current level in absolute terms. This will mean the contribution rates for collecting build-up levies from Scheme members are to be reduced by half.

Views from the public consultation

28. Few comments were received from the public on the cost mitigating measures recommended by the Board, perhaps because the issue is more technical in nature. When asked about their views in the opinion survey, over half of the respondents agreed with the Board's recommendations.

29. The major stakeholder groups consulted generally agreed with the recommendations. Nevertheless, some had shown a concern over the impact of the reduction in the target fund size, from 0.3% to 0.25% of total protected deposits, and the delay in achieving the target fund size on the effectiveness of the DPS, especially in the current volatile economic conditions. There were also concerns about the potential confusion caused by the option to report protected deposits on a net basis for contribution assessment, and the fairness of the arrangement to banks less capable of performing netting.

30. The banking industry appreciated the Board's intention to contain costs to banks, but indicated that the premium rates should be reduced by 75% instead of 50%, as recommended in the paper, to fully offset the cost impact of implementing the enhancements to the level and coverage of the DPS. The industry requested the size of the DPS Fund be capped at HK$2.8 billion. The industry also sought further transparency on the methodology and mechanism applied in determining the proposed funding arrangements in the paper, and requested the Board to engage the industry in future revisions to the target fund size.

The Board's responses and conclusions

31. Although the target size of the DPS Fund is proposed to be adjusted from 0.3% to 0.25% of the total amount of protected deposits, it is estimated to grow from HK$1.5 billion to HK$2.8 billion in absolute terms due to a larger base of protected deposits. In terms of effectiveness, it will deliver the same level of capital adequacy for meeting payout expenses under the new protection limit. Nevertheless, the Board is fully aware that a prolonged time frame for the completion of the accumulation of the required capital in the DPS Fund can erode confidence in the DPS.

32. As the arrangement for reporting protected deposits on a net deposit basis is an option rather than a mandatory requirement, Scheme members finding it not economical to perform netting can stay with the existing gross reporting approach. Clear guidance will be given to Scheme members adopting the net approach to avoid confusion.

33. The Board notes the industry's concern that the cost-mitigation measures proposed in the consultation paper may not fully offset the cost of implementing the recommendations. As mentioned in the consultation paper, the Board is mindful of the impact of the costs on banks and that these costs, if substantial, may increase the likelihood of the cost of protection being passed on to depositors. If it turns out that the actual costs due to the enhancements will be more significant than expected, the Board is prepared to explore with the industry ways to further contain the cost impact, subject to the condition that the accumulation of the capital required for backing the DPS will not be unduly delayed.

34. The Board, however, does not find the request of the industry to cap the size of the DPS Fund at the absolute level of HK$2.8 billion logical. Setting the target size of the DPS Fund as a percentage of the total amount of protected deposits is to ensure that the financial resources accumulated in the Fund can change in pace with the potential financial obligations of the DPS arising from the amount of deposits it protects. Capping the size of the DPS Fund at an absolute amount will result in the DPS being under-funded as the deposit market grows in size.

35. At the time of publishing the consultation paper, the Board also published on its website the specifications and assumptions of the funding model for estimating the target fund size of the DPS Fund. Annual reports of the Board containing information on income and expenditure of the DPS Fund are also accessible on the website. Save for confidential information, the Board is prepared to share with the banking industry information deemed useful for the industry to understand how the funding requirements of the DPS have been estimated.

6. Other comments

Views from the public consultation

36. The Consumer Council pointed out that a few types of structured deposits in the market were, indeed, protected by the DPS. The fact that they were being referred to as structured deposits by banks might cause confusion to the public. The Council therefore requested the Board to provide better certainty to depositors regarding the protection status of structured deposits offered by banks.

37. The Board was also reminded to undertake appropriate public education activities to draw attention to the fact that while RLBs and DTCs are currently covered by the full deposit guarantee offered by the Government, they will not be covered by the DPS after the guarantee expires at the end of 2010.

The Board's responses and conclusions

38. The Board shares the Consumer Council's views that the representation arrangements for structured deposits should be enhanced. Separate recommendations will be made by the Board.

39. The Board shares the view that it is important to draw to the attention of the public, at an early stage, that RLBs and DTCs will not come under the protection of the DPS after the full deposit guarantee expires. This will enable the public and financial institutions to get fully ready for the transition. The issue will be appropriately highlighted in the Board's publicity campaign in explaining the changes to the DPS.

THE WAY FORWARD

40. In the light of the general support concluded in the public consultation, the Board will proceed with the development of the legislative amendments to raise the DPS protection limit, extend its coverage to secured deposits and effect corresponding changes to the priority claims for depositors under the CO. For the funding arrangements, the Board will start to draft legal rules to provide guidance on the election of reporting protected deposits on a net deposit basis for contribution assessment purposes. The Board will collect further statistics to assess the cost impact on banks of implementing the proposed enhancements to the DPS, and have further discussions with the industry to try to agree on the appropriate changes to the charging scheme of the DPS.

41. The Board intends to submit the legislative proposals for effecting all the changes concluded in the consultation to the Legislative Council in the first quarter of 2010.

42. For the design features of the DPS that the Board does not recommend changing at this stage, the Board will continue to monitor relevant developments in the local and international markets, and assess the need for initiating a review of them in due course.

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