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

Report on public consultation on strengthening the operation of the Deposit Protection Scheme

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INTRODUCTION

1. On 18 August 2009, the Hong Kong Deposit Protection Board (the Board) published a consultation paper containing a package of recommendations for strengthening the operation of the Deposit Protection Scheme (DPS). The recommendations were concluded from the second phase of a review of the DPS completed by the Board in July 2009.

2. The recommendations contained in the consultation paper fall into two areas:

   - streamlining proceedings of the Board and processes for determining compensation for depositors to speed up payouts;

   - strengthening the representation regime of the DPS to enhance the transparency of its coverage.

3. In parallel with the consultation on the recommendations arising from the second phase of the review, the Board continued to discuss with the industry changes to be made to the DPS funding arrangements as a result of raising the DPS protection limit proposed in the first phase of the review.

4. As expected, the Board received fewer comments from the general public on the second phase of the review than on the first phase, probably because the subjects under consultation are relatively technical in nature. Nevertheless, the Board actively approached and solicited comments from key stakeholder groups, including industry and professional bodies, consumer interest groups, academics and the legislature.

5. Naturally, the comments received from different stakeholder groups generally reflected the interests that the groups represented. For example, the recommendations on strengthening the representation regime of the DPS were welcomed by the Consumer Council, but the banking industry had concerns about the potential cost and practical difficulties in making additional disclosures. The Board believes that such gaps can be bridged by providing flexibilities in the implementation of the relevant recommendations, to mitigate cost and address practical difficulties, but, at the same time, without compromising the intended policy objectives.

6. This report sets out the outcome of the Board's discussion with the industry on funding arrangements, and summarises the major comments received on the recommendations identified in the second phase of the review, and the responses and conclusions of the Board.

FUNDING ARRANGEMETS FOR THE DEPOSIT PROTECTION SCHEME

The Board's recommendation (in the first phase of the review)

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 of the industry

7. In the second quarter of 2009, the banking industry indicated in its response to the consultation on the first phase of the review of the DPS that a reduction of 75% in the contribution rates for charging build-up levies, instead of the 50% proposed by the Board, would be required to fully offset the cost impact of raising the DPS protection limit on banks. The industry also commented that the size of the DPS Fund should be capped at HK$2.8 billion, the absolute amount of the target size of the DPS Fund under the protection limit of HK$500,000 projected in the consultation paper, rather than set as a percentage of the amount of deposits protected.

The Board's responses and conclusions

Target size of the DPS Fund

8. Setting the target size of the DPS Fund as a percentage of the aggregate amount of deposits it protects is an important design feature of the DPS to ensure that the financial resources available to it are commensurate with its potential obligations as the deposit market changes in size. As the deposit market contracts in size, the target fund size will decrease and funds in excess of a threshold will be refunded to banks as rebates. If the target size of the DPS Fund is set as an absolute amount, the DPS Fund will no longer respond to changes in market conditions, leading the DPS to become either over-funded or under-funded, and it will greatly undermine depositors' confidence in the DPS's ability to provide adequate protection to their deposits. Also, legislative changes will be required each time to change the target size of the DPS Fund to restore equilibrium to the system.

9. Major markets with pre-funded schemes have also set the target of their deposit insurance funds as a percentage of the amount of deposits being protected. The target of the deposit insurance fund in the US was set at 1.25% in 2007 (before the outbreak of the financial crisis) under a protection limit of US$100,000 (equivalent to about HK$780,000). In Canada, the size of its deposit insurance fund is in the range of 0.4% to 0.5% of insured deposits under a protection limit of CAD100,000 (equivalent to about HK$720,000). The target size of the deposit insurance fund in Taiwan is 2% of insured deposits under a protection limit of NT$1,500,000 (equivalent to about HK$360,000). Singapore has set the target size of its deposit insurance fund at 0.3% of insured deposits, under a protection limit of SGD20,000 (equivalent to about HK$104,000).

Reduction in the contribution rates

10. Based on statistics supplied by 21 major retail banks to a survey in late 2008, the Board estimated in the consultation paper that protected deposits in the industry would be slightly more than double in size, from HK$495 billion to HK$1,149 billion, if the DPS protection limit was raised from HK$100,000 to HK$500,000. The Board therefore proposed cutting the contribution rates by half to largely offset the cost impact. To fully offset the increment, the rates should be reduced by 57%.

11. As the industry indicated that the reduction to the contribution rates required would be far greater than the Board's estimation, the Board requested the banks subject to survey in late 2008 to review whether it was necessary to adjust the statistics they had previously submitted. Only a few banks found it necessary to do so. Based on the refreshed statistics and after understanding from the industry task force the basis on which the industry had arrived at its estimation, the difference between the Board's and the industry's estimations was found to be attributable to -

    - deposit growth experienced by the industry since late 2008; and

    - the relatively high percentage increases in protected deposits expected for some wholesale banks.

12. As stated in the consultation paper, the Board is mindful of the impact on banks of the costs of implementing the enhancements to the DPS and that, if substantial, may increase the likelihood of the costs of deposit protection being passed on to depositors. To better eliminate the potential for a cost transfer to depositors, the Board is agreeable to applying a reduction to the contribution rates that can fully offset the cost impact of the expansion in protected deposits.

13. As reported in the consultation paper, the 21 retail banks covered in the

Board's survey accounted for about 75% of all customer deposits in the industry and 98% of protected deposits under the current protection limit of HK$100,000. The result of the Board's survey should, therefore, be sufficiently representative of the increase in protected deposits expected for the industry as a whole after the DPS protection limit is raised. As the estimation of the Board was made with reference to late-2008 positions of banks, the Board finds it reasonable to supplement the estimation with the growth in deposits experienced by the industry since late 2008, which will enlarge the effect of raising the protection limit on the amount of protected deposits. According to the latest statistics published by the HKMA, the total amount of customer deposits held with all licensed banks grew by about 8% from end-October 2008 to end-August 2009[1].

14. The Board, however, does not find it reasonable to cut contribution rates by a magnitude that would offset above-average increases in protected deposits expected for individual wholesale banks. Probably because some wholesale banks have a greater proportion of large depositors than their retail bank counterparts, they may experience a greater percentage increase in protected deposits when the DPS protection limit is raised. However, as wholesale banks generally have a relatively small number of depositors, they account for only a small portion of protected deposits in the industry. If the rates are cut by as much as 75% across-the-board to offset the higher percentage increases in protected deposits expected for some of the wholesale banks, it will risk significantly under-charging the retail banks holding the bulk of the protected deposits. The aggregate amount of annual contributions collectable may fall short of the current level significantly.

15. As it is practically not feasible to set a single reduction rate that can address the increase in the amount of protected deposits expected for each and every bank, it is logical for the Board to make reference to the group most representative of the industry. Taking into consideration the reduction required for fully offsetting the cost impact to the industry as estimated in the consultation paper, i.e. 57%, and the growth in deposits experienced by the industry, i.e. about 8%, since the Board's survey was conducted in late-2008, the Board has decided to set the reduction to contribution rates at 65%. As a result, the rates for charging build-up levies applicable to banks with different supervisory ratings will be as follows:

Supervisory rating	Current rate	Revised rate
1	0.05%	0.0175%
2	0.08%	0.028%
3	0.11%	0.0385%
4 or 5	0.14%	0.049%

[1] HKMA Monthly Statistical Bulletin, November 2009, Issue No. 183

16. Based on the statistics supplied by major retail banks and the industry task force, the reduction in the contribution rates should be sufficient to fully offset the cost impact of raising the DPS protection limit on most of the retail banks. Though some wholesale banks may experience an increase in their contributions, the increments in absolute terms are expected to be small. Even under the most conservative assumption that all wholesale banks will experience a five-fold increase in protected deposits (after the DPS protection limit is increased by five times), a majority of them will continue to pay the minimum annual contribution of HK$50,000, while the average increase in annual contribution for the rest of them is estimated to be about HK$110,000.

17. Based on the Board's estimation, if the contribution rates were reduced by 65%, it would require two more years (on top of the four years required if the rates were cut by half) for the target size of the DPS Fund to be reached, i.e. by 2018. If the rates were cut by 75%, the target fund size could not be reached before 2020.

COMMENTS RECEIVED ON THE SECOND PHASE OF THE REVIEW AND THE BOARD'S RESPONSES

1. Processes for determining compensation

The Board's recommendations

It is recommended that members of the Board outside Hong Kong be allowed to participate in Board meetings through electronic means.

It is recommended that the Board be given the power to determine the amount of accrued interest on a deposit or customer liability if the Board considers there is uncertainty over the amount of accrued interest, or that the time required to ascertain the amount in accordance with the DPSO would be so long as to unduly delay the payment of compensation.

It is recommended that the Board be given the power to determine the value of an annuity, or future or contingent liability of a depositor, if the Board considers there is uncertainty over the value, or that the time required to ascertain the value according to the DPSO would be so long as to unduly delay the payment of compensation.

It is recommended that the power of the Board to make interim payments to depositors by class and determine the amount of payment for each class be articulated more clearly in the DPSO.

Views from the public consultation

18. No objections were received on the recommendations to streamline the various processes for determining compensation in a payout.

19. Comments received from the public and major stakeholder groups mainly requested that the added flexibilities be implemented in a responsible, fair and transparent manner, and accompanied by proper checks and balances. Some commented that, at the same time as allowing overseas Board members to participate in payout meetings, adequate information should be provided to them so that they can participate meaningfully and effectively. Pre-conditions were suggested to be established for the application of the proxy approach in determining accrued interest and the value of annuities and future and contingent liabilities, and for setting the amounts of interim payment for different classes of depositors. The application of the proxy approach, the classification of depositors for interim payment purposes and the appeal arrangements in place should be disclosed and clearly communicated to depositors.

The Board's responses and conclusions

20. The Board fully recognises that the flexibilities recommended to be added should be administered as prudently as the other procedures set out in the DPS legislation, and be deployed only with strong justifications and a high level of transparency for them to be able to effectively streamline payout processes rather than invite disputes unhelpful to the smooth progress of a payout.

21. In a payout, timely and adequate information will be provided to Board members to assist them in deliberating and deciding on payout-related matters on a well-informed basis, regardless of whether members are present in Hong Kong. The Board has already put in place infrastructure to allow Board members to have uninterrupted access to the Board's information even if they are not in Hong Kong. Board members can access their accounts in the Board's e-mail system from a remote location, which has been tested to be efficient and secure in payout rehearsals.

22. Nevertheless, as the application of some of the flexibilities is anticipated to be highly dependent on circumstances, it may not be appropriate to engrave the pre-conditions for invoking them in the DPS legislation. For example, in an isolated bank failure involving a small number of depositors and with little risk of contagion, the Board may opt to stick to the insolvency principles when determining compensation rather than applying the proxy approach, even for relatively complex products. By contrast, in a highly time critical situation where a delay in payment could severely undermine confidence, the Board may need to consider more actively the application of the flexibilities to maintain stability. In order to ensure that the Board can respond suitably to the circumstances in a payout, it is more advisable to set out the standards and conditions for applying the flexibilities in the Board's payout policies and procedures as guidance, rather than as legally binding statutes in the DPS legislation.

23. It is the Board's intention to maintain a high level of transparency in the application of any of the flexibilities in the processes for determining compensation. In the course of a payout, the Board will regularly update the public on the progress made in the determination and payment of compensation. The Board will make known to the public in public announcements the flexibilities applied by the Board in the payout process, for example, the methodology for approximating accrued interest on complex products, and the amounts of interim payments applicable to different classes of depositors. The relevant information will also be carried in the compensation advice that the Board issues to depositors.

24. An appeal mechanism has been in place since the DPS commenced

operation in 2006. The compensation entitlement of a depositor determined by the Board is appealable to an independent Deposit Protection Appeals Tribunal. Checks and balances are therefore available to ensure that the compensation paid to depositors is being properly assessed.

2. Representation Arrangements

The Board's recommendations

It is recommended that Scheme members be required to make negative disclosures and obtain customer acknowledgements on a transaction basis, except for automatic rollovers.

It is recommended that Scheme members be required to make positive disclosures on the protection status of their deposits. Disclosures for deposits covered by an account can be made on an account basis. For deposits not covered by an account, the disclosures have to be made on a transaction basis. For existing accounts or deposits, a one-off disclosure should be made.

It is recommended that Scheme members be obliged to respond to depositors' requests for positive disclosure within a specified time frame and in a specified manner.

It is recommended that the positive and negative disclosures made by Scheme members be required to meet certain standards in terms of size and location to ensure they are sufficiently prominent and easily identifiable by depositors.

It is recommended that Scheme members be prohibited to call financial products not meeting the definition of structured deposit in the DPSO a structured deposit.

Views from the public consultation

25. The package of recommendations to strengthen the representation regime of the DPS was well received by the public and consumer interest groups. There were also proposals to further enhance the regime. The importance of keeping depositors properly informed of the protection status of their deposits was shared by the industry. Nevertheless, the industry also pointed out the practical difficulties and the cost expected for implementing some of the new requirements, and suggested alternatives for the Board's consideration.

26. On the abolishment of the flexibility of making negative disclosure on an account basis, the industry pointed out that the disclosure and acknowledgement process could be potentially difficult to administer on a transaction basis for customers engaged in highly frequent and time-critical transactions, for example, investment related transactions of institutional investors. It was suggested the option of making negative

disclosure on an account basis be retained, but to be supplemented by regular reminders to customers, say on an annual or semi-annual basis.

27. Though the industry was of the opinion that it would be impractical to set a single timeframe for Scheme members to respond to customers' enquiries on the protection status of their deposits, which can be of different levels of complexity, the industry found it agreeable to follow the principles set out in the Code of Banking Practice in handling such enquiries.

28. The industry also agreed that written disclosures on protection status should be clearly legible and sufficiently prominent in print, but it was concerned the specified standards could be costly to implement. The industry therefore requested to be consulted on the formulation of the detailed requirements to ensure effectiveness and workability. On the other hand, the Consumer Council recommended that the disclosures should be written in simple and easily understandable terms and preferably be put on the front page of product documentation.

29. The industry did not object to imposing restrictions on the use of the term "structured deposit", but requested the restrictions be imposed only on new products as substantial cost and effort may be involved in making adjustments to the infrastructure supporting the existing products to effect a name change.

30. On the introduction of positive disclosures, the industry opined that such disclosures should continue to be made voluntarily by banks as the publicity activities undertaken by the Board since the inception of the DPS had already fostered a good level of public awareness of deposit protection. The industry commented that the objective of bringing to the attention of depositors the protection status of their deposits could be achieved by continued publicity, especially when explaining the impending changes to the DPS. The industry committed to assist the Board in implementing the relevant publicity initiatives. In addition, the industry's commitment to respond in a timely manner to customers' requests would also help enhance the clarity of deposit protection coverage.

31. In addition to comments directly related to the recommendations, the Board also received other suggestions, mainly from the public, on further improving the regime. For example, the Board was reminded to put in place an effective surveillance mechanism to monitor Scheme members' compliance with the relevant requirements. The Consumer Council further reminded that Scheme members should be advised to use the term "deposit" cautiously to avoid causing confusion. There were also suggestions on promulgating unified product nomenclature to signify protection status, and setting selling practices for non-protected deposits.

The Board's responses and conclusions

32. The Board is glad to note that the importance of keeping depositors well informed of the protection status of their deposits is recognised by the public and stakeholder groups consulted. It is understandable that the implementation of the recommendations may have a different impact on the various parties involved, and it is natural for them to have different views and concerns.

33. On the abolishment of the flexibility of making negative disclosures on an account basis, the Board notes that individual banks may encounter genuine practical difficulties in making such disclosures on a transaction basis in certain areas of their operations and to certain types of customers. However, leaving the option of making such disclosures on an account basis open generally may create greater confusion rather than clarity, as depositors may end up receiving different treatment from different banks. To address the industry's concern and, at the same time, preserve the effectiveness of the recommendation, the Board suggests confining the option of making negative disclosure on an account basis to disclosures made to institutional clients who are generally in a better position than ordinary retail depositors to understand the risks of their investments, including bank deposits. As suggested by the industry, annual reminders can be sent to institutional clients to better alert them on the non-protected deposits they hold.

34. Similar to the rationale for imposing unified negative disclosure standards, different positive disclosures that may be practised by different banks in the absence of a set of unified standards may not be helpful in improving the clarity of the coverage of the DPS and promoting confidence, especially in times of crisis. The Board notes the industry's concerns about the cost and effort required to implement the enhanced disclosures. Due consideration has already been given to containing implementation costs in formulating the recommendations in the consultation paper, which mainly require the disclosures to be delivered through existing channels, rather than new ones, for example, printing the disclosures in deposit documentation for new transactions, and in regular account statements for existing transactions.

35. The Board appreciates the industry's proposal of following the standards in the Code of Banking Practice in handling enquiries on deposit protection. However, unlike the standards in the Code, which cover enquiries on a wide range of issues, the standards intended to be promulgated by the Board are narrowly focused on confirming the protection status of a financial product. Given that banks should be well aware of which types of their products are eligible for protection, especially after secured deposits are brought under the protection of the DPS as proposed in the

first phase of the review, and it is not the intention of the Board to require banks to find out whether a depositor is an excluded person, it is doubtful whether banks would require as much as 30 days, as specified in the Code, to be able to confirm whether a deposit product is eligible for protection. The Board believes that banks would be able to meet better standards in replying to customers on the protection status of the deposit products offered by them.

36. The Board will consult the relevant parties, including the industry and the Consumer Council, when ironing out the detailed standards on the size and location of DPS disclosures and the restrictions on the use of the term "structured deposit" to ensure the requirements are effective, practical and cost-amicable to implement. In fact, the amended or new representation requirements proposed in the review will be promulgated in the form of statutory rules which, according to the DPS legislation, have to be made in consultation with the Hong Kong Association of Banks.

37. The Board welcomes the comments made by the public and other stakeholder groups on further enhancing the representation regime of the DPS. Some of the recommendations have already been implemented by the Board, for example, the Board has already implemented a review mechanism for monitoring Scheme members' compliance with the representation requirements. The Board will continue to monitor the operation of the DPS and relevant developments in the local and international markets, to assess the need for introducing other new measures.

WAY FORWARD

38. Following the conclusion of the consultation on the second phase of the review, the two-phase review of the DPS commenced by the Board in the fourth quarter of 2008 was completed. The Board has already commenced drafting the legislative amendments for effecting the enhancements concluded in both phases of the review. In the course of drafting the amendments, the Board will consult the relevant parties, including the industry and the Consumer Council, to ensure the detailed requirements can meet their intended objectives and at the same time, not be too costly or burdensome to implement.

39. The Board intends to submit the legislative proposals for effecting all the changes concluded in the consultation on both phases of the review to the Legislative Council in the first quarter of 2010.

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