Report on Activities

The Board had a busy but fruitful year in 2005-2006. It completed all necessary preparation for the launch of the deposit protection scheme ("DPS"). The key tasks accomplished by the Board and their details are described below.

(a) Legislative amendments to DPS Ordinance

Treatment of structured products under the DPS

In the course of preparing for the launch of the DPS, the Board has observed that many Scheme members are unclear about the protection status of structured products such as equity-linked deposits, currency-linked deposits, credit-linked deposits, index-linked deposits, inverse floaters and range accruals. The Board notes that whether a financial product constitutes a deposit within the meaning of section 2 of the DPS Ordinance and is thus protected by the DPS needs to be determined on a case by case basis and with regard to the terms and conditions of the product. The ambiguity regarding the protection status of structured products is undesirable. Scheme members will need to incur additional costs in determining the nature of their structured products case by case. Despite the additional costs and efforts, some Scheme members may still 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 in their choice of suitable structured products.

To remove the ambiguity, the Board introduced amendments to Schedule 1 to the DPS Ordinance to clarify that structured products are not protected by the DPS. There are three main reasons for this amendment. Firstly, many structured products offered in the market are not deposits, thus outside the scope of protection by the DPS. Secondly, the DPS in Hong Kong is aimed at protecting small, unsophisticated depositors, and structured products attract mostly large and sophisticated depositors. Excluding structured products from deposit protection is therefore consistent with the original policy objective of establishing a DPS in Hong Kong to protect mainly small depositors. Thirdly, the aggregate amount of structured products, which are likely to be deposits and thus protected by the DPS, is very small. Therefore, the exclusion of structured products from DPS protection is not seen as likely to undermine the ability of the DPS to contribute to banking stability.

Going forward, the Board will keep this issue under review. It has established a set of quantitative benchmarks for triggering a review of this matter. In the unlikely event that the exclusion of structured products materially affects the effectiveness of the DPS, the Board will consider introducing appropriate amendments to the DPS Ordinance to reverse the exclusion.

Report on Activities

Other amendments to DPS Ordinance

In the course of establishing the DPS, the Board also saw the relevance of introducing the following miscellaneous amendments to improve the operation of Schedules 1 and 4 to the Ordinance:

- 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 alleviated the reporting burden of Scheme members who consider that the resources required to identify the amount of such deposits outweigh any savings in their contribution to the DPS Fund;

- 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 public holiday, Scheme members should report the amount of relevant deposits based on the position on the immediate preceding day which is not a public holiday; and

- 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.

The relevant legislative amendments were tabled before the Legislative Council for negative vetting on 24 May 2006 and the vetting process was completed in July.

(b) Rules and guidelines governing operation of the DPS

The Board is empowered under the DPS Ordinance to make rules governing the operation of the DPS. After consultation with the Financial Secretary and the Hong Kong Association of Banks ("HKAB"), the Board issued two sets of rules in the form of subsidiary legislation in May 2006. The negative vetting process of the rules was completed in July.

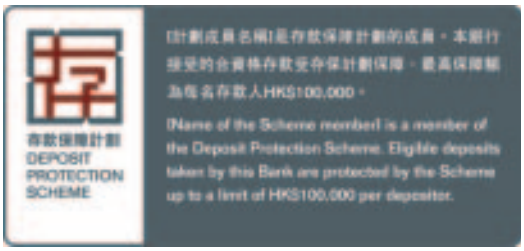
DPS (Representation on Scheme Membership and Protection of Financial Products under Scheme) Rules ("Representation Rules")

The Representation Rules govern the representations Scheme members are to make regarding their membership and the protection status of their financial products. The objective of this set of Rules is to assist members of the public to distinguish between DPS protected and non-DPS protected financial products, so that they can make informed decisions in selecting suitable financial products. In formulating the requirements in the Representation Rules, the Board had referred to the practices of leading deposit insurers in Canada, the UK and the US. It had also taken into account comments from HKAB and the Consumer Council.

Report on Activities

The major requirements contained in the Representation Rules are:

(i) A Scheme member is required to make known to the public that it is a member of the DPS by displaying a DPS membership sign at its relevant places of business;



DPS Membership Sign

(ii) Where a Scheme member shares its website with another person, and the website contains information about the Scheme member's DPS membership or the protection status of its financial products, the Scheme member should display the DPS membership sign on the website in such a manner that any person accessing the website would reasonably be aware that the Scheme member, and not any other person, is a member of the Scheme;

(iii) If a Scheme member refers to its DPS membership or its protected deposits in an advertisement, a standard statement should be included in the advertisement;

(iv) Where a financial product offered by a Scheme member is not protected by the DPS but is described as a deposit in any advertisement, promotional material or document, the Scheme member should notify the customer that the product is not protected by the DPS and request the customer to acknowledge receipt of the notification; and

(v) Where a protected deposit is no longer protected by the DPS because of a variation to the terms and conditions of the deposit or the provision to the customer of a credit facility secured on the deposit or the provision of a service, the Scheme member should notify the customer that the product is not protected by the DPS and request the customer to acknowledge receipt of the notification.

DPS (Payment of Contributions, Late Payment Fees and Rebates) Rules ("Contribution Rules")

The Contribution Rules prescribe the manner in which Scheme members should pay contributions or late payment fees to the Board, as well as the manner in which the Board should pay rebates of contribution to Scheme members. The amount of contribution payable by a Scheme member is determined with reference to its supervisory rating assigned by the Monetary Authority ("MA"). It is a piece of sensitive information, which should not be disclosed to any third party without the consent of the MA. In view of this, the Board has appointed the MA as its collection and payment agent. This arrangement ensures that contributions and rebates of contribution are paid through the inter-bank settlement system instead of the books of a commercial bank.

Report on Activities

The Contribution Rules provide that:

(i) A Scheme member shall pay contribution or any late payment fee through its settlement account opened and maintained with the MA as required under section 3A(1) of the Exchange Fund Ordinance, or where the Scheme member does not maintain such an account, through a settlement account designated by the Scheme member;

(ii) Any contribution payable by a Scheme member should be paid within 21 days after the date of the payment notice given by the Board to the Scheme member; and

(iii) The Board shall pay rebate to a Scheme member through the latter's settlement account maintained with the MA, or where the Scheme member does not maintain such an account, through a settlement account designated by the Scheme member.

Guideline on Information Required for Determining and Paying Compensation

When compensation under the DPS is triggered in respect of a Scheme member, the Board shall determine whether a depositor is entitled to compensation under the DPS, and if yes, the amount of his entitlement. To do so, the Board will rely on the records obtained from the failed Scheme member. To enable the Board to make compensation payments quickly, the Board issued a statutory guideline under section 8(1) of the DPS Ordinance setting out the requirements on information systems and customer records to be followed by Scheme members. In general, Scheme members are required to achieve compliance with the guideline by the end of August 2006. Noting that large Scheme members will need to develop a considerably larger number of data extraction programmes to comply with the guideline, Scheme members having a total number of deposit accounts of more than 500,000 or for a Scheme member belonging to the same group of companies of such a Scheme member are given the flexibility to achieve full compliance by the end of 2007.

The Board organised two rounds of briefings to Scheme members in April and May 2006 to explain to them the above rules and guidelines. These briefings were very well received by the participants who found the information useful in assisting them in achieving compliance with the requirements.

The rules and the guidelines governing the operation of the DPS are accessible on the Board's website: http://www.dps.org.hk

Mr Colin Pou, Senior Manager (Payout System), hosting a briefing on information system requirements to banks

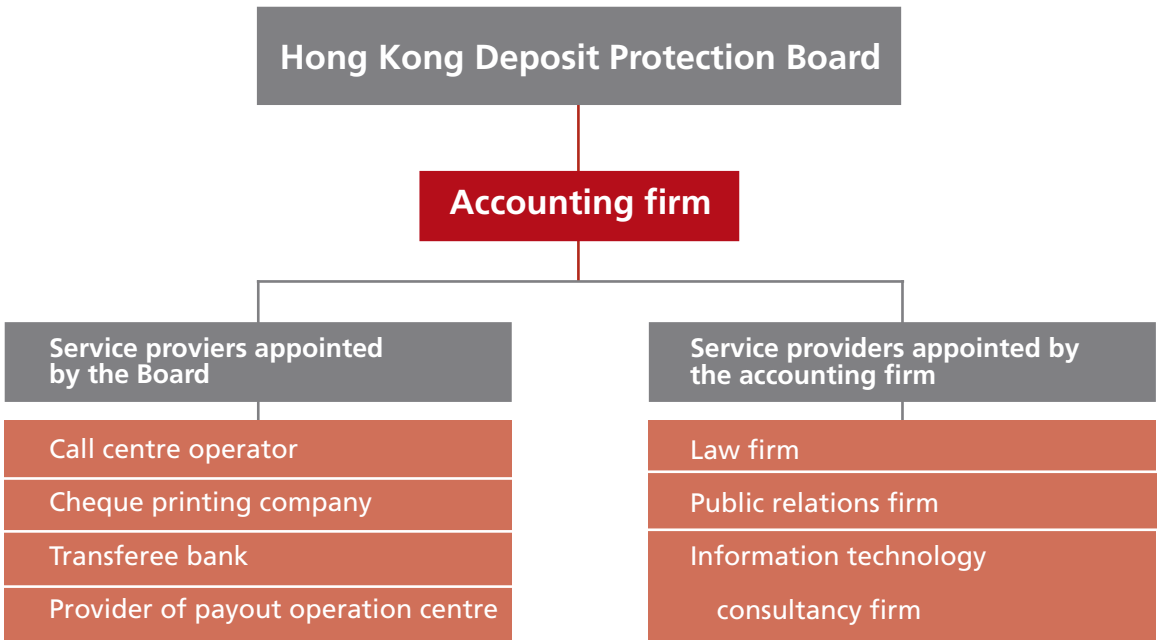
Report on Activities

(c) Payout infrastructure

Payout System and procedures

The development of the Payout System for facilitating payment of compensation to depositors was completed in December 2005 as scheduled. An independent information technology consultancy firm was subsequently engaged to conduct a User Acceptance Test ("UAT") of the Payout System. Three rounds of UAT took place in the first half of 2006 with no major problems identified. Following the completion of the UAT, the Board is planning to conduct a series of simulation tests using data obtained from Scheme members.

Considering that the incidence of bank failures in Hong Kong is low, the Board has adopted a virtual organisation structure. It will retain a core team of staff to administer the DPS during normal times, and has the flexibility to call upon a network of external service providers to assist with calculation and payment of compensation to depositors should payout be required. In this connection, the Board conducted a series of tenders in the second half of 2005 and identified suitable payout agents, including accounting firms, an information technology consultancy firm, a cheque printing company, a call centre operator and a business recovery service provider. The Board also identified a number of Scheme members that can help it disburse compensation payments to depositors in a payout. When a bank failure occurs, the Board will mobilise the network of payout agents to handle the payout. Regular payout rehearsals involving the payout agents will be conducted to familiarise them with the Board's payout procedures.



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Standby facility

When payment under the DPS is triggered, the Board is obliged to make compensation to the depositors of the failed Scheme member as soon as practicable. Since the DPS Fund is only intended to cover the shortfall loss[1] and the financing cost associated with the payout, the Board has secured a standby facility from the Exchange Fund to provide the necessary liquidity required for payment of compensation.

(d) Memorandum of Understanding (MoU) with the Monetary Authority

The Board and the MA are two important players in the financial safety net in Hong Kong. They share a common objective, which is to promote the stability of the banking system in Hong Kong. In order to ensure that this important objective is accomplished, the Board and the MA agree to set out in the form of an MoU how the two organisations are to cooperate both during normal times and when there is a banking crisis, and the support the MA will provide to the Board for it to perform its functions. The Board and the MA have agreed on the key principles to be set out in the MoU, which will be finalised soon.

(e) System for assessment of contributions

Every Scheme member is required to make an annual contribution to the DPS Fund in the manner prescribed by the Contribution Rules issued by the Board. The amount of contribution payable by a Scheme member will be assessed by the Board with reference to the amount of relevant deposits held with that Scheme member and its supervisory rating assigned by the MA. In this regard, Scheme members have submitted their first annual return on their amount of relevant deposits and the HKMA has also provided the Board with the supervisory ratings of individual Scheme members. The Board is thus ready to collect contributions from Scheme members upon the launch of the DPS.

According to the returns submitted by Scheme members, the total amount of relevant deposits was HK$440 billion in October 2005. The Board expects to collect HK$90 million in 2006, representing the contribution from Scheme members for the period from the launch of the DPS to 31 December 2006. The target DPS Fund size, at 0.3% of relevant deposits held by Scheme members (around HK$1.3 billion), is expected to be reached in about four years, i.e. by 2010.

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[1] Shortfall loss refers to the loss suffered by the Board as a result of the payout amount to a depositor exceeding the amount recovered from the liquidation of the failed Scheme member.

Report on Activities

(f) Promotion of the DPS

Maintaining a high level of public awareness about the DPS is critical to ensuring its effectiveness. To promote public understanding of the DPS, the Board has developed a publicity campaign to support the launch of the DPS. The series of publicity measures to be rolled out near the launch date will include an information leaflet about the DPS to be distributed through the branch networks of Scheme members, TV and radio commercials, exhibitions at shopping malls and railway stations, etc. The Board has also engaged a public relations consultancy firm to advise it on the development of a long-term strategy for promoting the DPS.

LAUNCH OF THE DPS

As most of the preparatory tasks for launching the DPS have been completed, the Secretary for Financial Services and the Treasury has selected 25 September 2006 as the effective date for those provisions of the DPS Ordinance that have not come into operation. The Board will make a formal announcement regarding when the DPS will start providing deposit protection nearer the date.

PLAN FOR 2006-2007

After the launch of the DPS, the Board will monitor the effectiveness of the DPS taking into account latest market developments, including the popularity of structured products among depositors. In relation to the payout infrastructure, the Board will conduct a series of simulation tests with Scheme members using data obtained from Scheme members and assess their compliance with the *Guideline on Information Required for Determining and Paying Compensation*. The Board will also carry out a payout rehearsal involving the payout agents to familiarise them with the Board's payout procedures. The Board will learn from the simulation and rehearsal exercises and continue to improve the efficiency of the payout process.

Report on Activities

PARTICIPATION IN INTERNATIONAL FORUMS

The Board has taken active participation in international forums to benefit from the experiences of its international counterparts as well as to keep abreast of development in deposit protection worldwide. In the past year, the Board's representatives had participated in a number of forums and conferences organised by the International Association of Deposit Insurers ("IADI") and other deposit insurers.

Mr Raymond Li (1st from left), Chief Executive Officer, moderating in the Deposit Insurance International Forum at Dalian, China

Mr Gregory Zimnicki (5th from left in the back row), Payout Consultant, attending the 4th Annual Conference of the IADI in Taipei

Ms Aster Cheung (6th from right in the second row), Deputy Chief Executive Officer (Legal), attending a meeting of the IADI in Manila, The Philippines