CPA
Hong Kong Institute of
Certified Public Accountants
香港會計師公會

By email <dps_review@dps.org.hk> and by post

2 July 2009

Our Ref.: C/RIF, M64088

Hong Kong Deposit Protection Board
78/F., Two International Finance Centre
8 Finance Street
Central, Hong Kong
(Reference: DPS Review)

Dear Sirs,

Consultation Paper on Enhancing Deposit Protection under the Deposit Protection Scheme

The Hong Kong Institute of Certified Public Accountants ("the Institute") has considered the above-referenced consultation paper, which makes recommendations to enhance the Deposit Protection Scheme ("DPS") for the better protection of depositors in Hong Kong.

In principle, the Institute welcomes the review, which is timely given the attention that deposit protection arrangements have been given globally since the onset of the financial crisis and the accompanying loss of public confidence in financial institutions.

We welcome the assurances in the consultation paper that, in many respects, the existing design features of the DSP in Hong Kong already comply substantially with international best practices and meet substantially the core principles currently under consultation by the Basel Committee. Notwithstanding this, it is clear that some enhancements to the current scheme are desirable. We believe that it is also important for the enhancements to be introduced before the expiry of the Deposit Guarantee at the end of 2010, so that the public will be protected under an enhanced DPS thereafter.

--- The Institute's comments on the key recommendations set out in the consultation paper are contained in the Appendix to this letter.

We hope that you will find our comments helpful. If you have any questions on our submission or wish to discuss it further, please contact me at the Institute on 2287 7084.

Yours faithfully,

Peter Tisman

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Director, Specialist Practices

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Appendix

Comments from Hong Kong Institute of CPAs in response to the Consultation Paper on Enhancing Deposit Protection under the Deposit Protection Scheme

1. Protection limit

a. It is recommended that the protection limit of the Deposit Protection Scheme (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.

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

Comments:

a. We support the recommendation for the protection limit of the DPS to be increased from the current HK$100,000 to HK$500,000, which will bring the protection for depositors in Hong Kong broadly in line with the protection in other major countries (the US, UK and countries in the European Union) in absolute terms and as a ratio to per capita GDP, as indicated in paragraph 41 of the consultation paper. In addition, in terms of percentage on the number of depositors to be fully covered under the DPS, a protection limit of HK$500,000 provides a 10% buffer over the 80%-benchmark, and this would obviate the need to review the protection limit again in the near future.

b. Clearly, changing the Companies Ordinance ("CO") so that the level of priority claims for depositors under section 265 (1)(db) is consistent with the DPS protection limit or, preferably, links to the DPS protection limit, so that the level of priority claims for depositors under the CO will be adjusted automatically with the DPS protection limit, is desirable from the point of view of containing the shortfall risk to the DPS. We suggest, however, that care be exercised when making revisions to the CO to ensure that the rights of other parties in the case of a liquidation are also taken into account.

2. Compensation calculation basis

a. 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.

Comments:

We accept the reasons set out in the consultation paper for retention of the full netting approach under the DPS for the time being. While there may be arguments for some form of partial netting, and international developments in this area should continue to be monitored, as we suggest above, caution should be exercised when making revisions to the CO to ensure that the rights of other parties in a liquidation are also taken into account. Changing the netting arrangements, and reflecting this in the priority payments under the CO, could result in significant changes to the insolvency regime that unduly favour depositors over other creditors with legitimate claims, and stir up the kind of controversy that the consultation paper notes has occurred in the UK.

3. Product coverage

a. *It is recommended that secured deposits which fall outside the present definition of "deposit" under the Banking Ordinance 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 DPS Ordinance.*

b. *It is recommended that the definition of deposit for the priority claims for depositors under the Companies Ordinance be brought in line with the revised definition of deposit in the DPS Ordinance.*

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

Comments:
a. We support the proposal for 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, to be brought under the protection of the DPS by revising the definition of "deposit" in the DPS Ordinance. This will increase protection to depositors and will make the coverage of the DPS more easily understandable to the public. b. As with the adjustment to the DPS protection limit (see section 1 above), we understand that it is desirable for any adjustment made to the product coverage to be matched by a corresponding change in the priority claims for depositors under the CO. This will enable the DPS to fully subrogate depositors in their priority claims and recover the compensation paid to depositors in bank liquidations, and so contain the shortfall risk to the DPS. We support the proposal for the definition of "deposit" in relation to the priority claims for depositors under the CO, which currently adopts the definition of "deposit" in the BO in defining eligibility to priority claims, to be brought in line with the revised definition of deposit in the DPS Ordinance (to also cover secured deposits). However, we would point out that having different definitions of "deposit" in the BO on the one hand, and the DPS Ordinance and the CO on the other, could cause confusion, and it will need to be made clear which definition applies in which circumstances. c. We accept the reasons set out in the consultation paper for not bringing structured deposits under the protection of the DPS at this stage. However, as suggested in the consultation paper, the popularity of structured deposits should be monitored in order to assess the need to review their protection status if they become more heavily used by retail depositors over time.

4. Types of institution covered

a. *The Board does not recommend extending the coverage of the DPS to deposits held in restricted licence banks and deposit-taking companies.*

Comments:
We accept the reasons set out in the consultation paper for not extending the coverage of the DPS to deposits held in restricted licence banks ("RLBs") and deposit-taking

companies ("DTCs") at this stage. However, we note that RLBs and DTCs are currently covered by the Deposit Guarantee scheme. As such, the fact that deposits in these institutions will no longer enjoy protection after 2010 might attract some negative comment and could potentially affect the public perception of the DPS.

Given the above, we are of the view that public education highlighting the fact that deposits in RLBs and DTCs are not covered by the DPS is important and should be further emphasised, particularly nearer to the expiry of the Deposit Guarantee scheme.

We consider that it is also important, as noted in the consultation paper, for the types of authorized institutions covered by the DPS to be kept under review, taking into account, inter alia, developments in the Hong Kong Monetary Authority's review of the three-tier authorization system.

5. Funding arrangements

a. *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.*

b. *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.*

c. *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.*

Comments:

a. We are of the view that, although this recommendation may be welcomed by some Scheme members, for cost reasons, it may be somewhat confusing when some Scheme members report protected deposits on a gross basis and some on a net basis.

b. We do not have any strong view on the target fund size of the DPS Fund being adjusted from the current 0.3% to 0.25% of total protected deposits so long as it is considered by the Board to be a sufficiently comfortable level.

c. We understand the case for reducing the contribution rates for collecting build-up levies from Scheme members, such that the annual contribution by Scheme members could be maintained largely at the current levels in dollar terms, notwithstanding the increase in the costs due to raising the protection limit from $100,000 to $500,000. We note, however, that as a result of this, the target fund size will not be reached until 2016, which is a bit at odds with the DPS being presented as being pre-funded. We believe that reaching the target size more quickly would engender greater confidence in the DPS and, therefore, that it may be worth giving further thought to alternative ways to achieve the target fund size more quickly (which could include some form of (temporary) government involvement).

   Notwithstanding the fact that the Board has not so far noticed any reports of Scheme members passing on the cost of deposit protection to depositors, we consider that this is an area which should continue to be monitored.