HONG KONG MONETARY AUTHORITY
香港金融管理局

# Enhancing Deposit Protection in Hong Kong

## The Key Issues

# ENHANCING DEPOSIT PROTECTION IN HONG KONG: THE KEY ISSUES

The Hong Kong Monetary Authority ("HKMA") is embarking on a public consultation exercise on whether an enhanced system of deposit protection should be introduced in Hong Kong. This will be based on a Consultancy Study produced by Arthur Andersen ("the Consultant") and a Consultation Paper issued by the HKMA. The key issues that will be addressed during the public consultation are set out below.

### *What is a "deposit protection scheme"?*

This is a general term used to describe a formalised system designed to protect depositors if a bank fails. A deposit protection scheme can take a number of different forms, including insurance-based systems (see below).

### *What is a "deposit insurance scheme"?*

This is a scheme where the protection is offered to depositors by a third party that bears the risks and costs of guaranteeing or insuring the deposits covered by the scheme.

### *What should be the objectives of a deposit protection scheme?*

A deposit protection scheme can serve a number of different objectives. In the Hong Kong context, the HKMA believes that the primary objectives should be to provide a measure of protection to small depositors and to contribute to the stability of the financial system.

### *What are the present arrangements for deposit protection in Hong Kong?*

Under the Companies Ordinance, eligible depositors are entitled to receive priority of payment in the liquidation of a failed bank, up to a maximum of HK$100,000 of their total deposits with the bank.

### *Do we need to change the present system?*

The Consultant considers that there are limitations to the current arrangements. Although small depositors have priority of payment in a liquidation, whether they will receive full payment is dependent on the value of the assets in the failed bank being sufficient to meet their claims. Moreover, it may take some time to begin a formal liquidation and realise the assets of the failed bank.

Depositors are therefore subject to the risk that their claims may not be fully met and that the payout of their claims may be delayed.

***What are the options for change?***

The Consultant has identified the following options to change the current arrangements:

- Basic enhancement of the current arrangements
- A claims advance scheme
- A government guarantee scheme
- A privately administered and funded deposit insurance scheme
- A publicly administered but privately funded deposit insurance scheme

The first two would involve different degrees of enhancement of the current arrangements. The other three are different types of deposit insurance scheme.

***Is it sufficient simply to enhance the current arrangements?***

The Consultant considers that some useful changes could be made to the current arrangements. In particular, under a claims advance scheme, the Exchange Fund might be used to make a quick advance payment to depositors of a certain portion of the amounts that would be eventually due to them in the liquidation of a failed bank. This would help to overcome the lack of liquidity in the current arrangements, but the eventual payout would still be dependent on the value of the assets of the failed bank. The Consultant considers therefore that the objectives of deposit protection would still not be fully met.

***Is deposit insurance a more suitable form of protection?***

The Consultant considers that a deposit insurance scheme would offer the best protection for the small depositor and best help to maintain system stability. Under such a scheme, a third party guarantees the payment of the covered deposit. If properly designed, it should have the necessary qualities of ***credibility*** in the eyes of the public and ***liquidity*** to enable a speedy payout.

***What are the drawbacks of deposit insurance?***

Deposit insurance is not without its drawbacks. In particular, it may give rise to increased ***moral hazard***, i.e. banks and their depositors may be tempted to take bigger risks in the knowledge that they are insured. The Consultant considers, however, that the risk of moral hazard can be reduced through means such as proper design of a deposit insurance scheme, effective banking supervision and high levels of financial disclosure by banks.

***Who should bear the costs and risks of underwriting the insurance?***

Under a government guarantee scheme, the Government would pay for the insurance. It seems wrong in principle, however, that the Government should provide what would be free insurance for the banks and their depositors. As is the case with most deposit insurance schemes around the world, it seems more appropriate that the private sector (i.e. the banks themselves) should pay for the cost of insurance. Whether banks choose to absorb this cost or to pass it on to depositors, e.g. in the form of lower interest rates on deposits, would depend on the competitive environment.

***Who should control and administer the insurance scheme?***

The Consultant considers that it would be impractical for the scheme to be run by the banks themselves. The recommendation is for the scheme to be run by the public sector in some form, either as a division of the HKMA or as a separate entity with close links to the HKMA. It is not envisaged that the deposit insurance scheme would act as a regulator in its own right. Rather, it would act only as a "***paybox***", assessing and collecting insurance premia and organising the payout to depositors. Given this limited role, the deposit insurance scheme would not need to be a large body and would not cost much to run.

***How should the insurance scheme be funded?***

There are two broad options. Either banks would make regular contributions upfront to a fund (the "***ex ante***" approach) or they would only be called upon to pay if a bank actually fails (the "***ex post***" approach). There are possible variants of either approach. Under either approach, it is envisaged that the Exchange Fund would be used to provide back-up liquidity to the deposit insurance scheme to enable it to make a speedy payout. This would take the form of a loan repayable with interest by the deposit insurance scheme from the assets of the failed bank.

***How much would an insurance scheme cost?***

Under the ex ante approach, the banks would make regular contributions to the deposit insurance fund in the form of an annual premium. It is difficult to estimate this with precision, but the Consultant has indicated that a premium of 10 basis points may be feasible. This means that for every HK$100 of covered deposits, the banks would pay a premium of 10 cents.

***What level of deposits would be covered under a deposit insurance scheme?***

The Consultant has recommended that deposits up to HK$100,000 should be covered (i.e. insured). This would provide protection to 84% of depositors by number and 20% by value, which is close to the relevant international benchmarks. However, a higher level of coverage, of up to HK$200,000, is not ruled out.

***What should be the other main design features of a deposit insurance scheme?***

There are many points of detail that would need to be decided about the design of a deposit insurance scheme if the decision were taken to go ahead. Some of the principal recommendations of the Consultant are summarised below:

- Only fully licensed banks would be members of the scheme
- Branches of foreign banks would be included
- Membership would be compulsory for all banks
- Foreign currency deposits would be covered
- Eligible claims up to the coverage cap (i.e. HK$100, 000 or HK$200,000) would be paid in full
- Coverage would be on a depositor rather than on an account basis
- The premium paid by the banks would initially be at a flat rate (rather than varying according to the risk of each bank).

***What are the next steps?***

There will be a public consultation on the Consultant's recommendations that will last until 17 January 2001. All interested parties are invited to comment. Taking into account the comments received, the HKMA will recommend to the Government whether and how to proceed. If the decision is taken to introduce a deposit insurance scheme, further consultation may be required on the detailed arrangements. It is also likely that legislation would be required to implement the scheme.

Hong Kong Monetary Authority
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