IFPHK's Response to the Hong Kong Deposit Protection Board's Consultation Paper on Enhancement to the Deposit Protection Scheme in Hong Kong

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Institute of Financial Planners of Hong Kong (IFPHK) Profile

About IFPHK

IFPHK was established in June 2000 as a non-profit organization for the fast–growing financial services industry. It aims to be recognized in the region as the premier professional body representing financial planners dedicated to upholding the highest professional standards.

The Institute is the sole licensing body in Hong Kong authorized by Financial Planning Standards Board Limited to grant the much-coveted and internationally-recognized CFP® Certification and AFP® Certification to qualified financial planning professionals in Hong Kong and Macau.

Currently there are more than 213,000 CFP certificants in 27 territories; the majority of these professionals are in the U.S., China, Japan, Canada and Brazil, with approximately 4,000 CFP certificants in Hong Kong.

IFPHK has 7,100 members in Hong Kong including 1,200 Qualified Retirement Adviser (QRA) holders; and represents financial planning practitioners in diverse professional backgrounds such as banking, insurance, independent financial advisory, stock broking, accounting, and legal services.

IFPHK's interest in this consultation

In the past decades, a number of systemically important financial institutions (SIFIs) that were deemed "too big to fail" during the financial crisis were compelled to get special help from some nations due to the lack of a structure for orderly resolution of disputes. Although none of the failing financial institutions are located in Hong Kong, the collapse of Lehman Brothers and the Minibond Saga that followed had a significant impact on consumer confidence.

As the leading professional body for the welfare of the financial planning industry, the IFPHK actively responds to policy changes that affect the industry or the financial system as a whole. In 2009, we commented on the Securities and Futures Commission (SFC) proposal put forward in the wake of the Lehman Brothers Minibond Saga that suggested ways to better protect the investing public. In June 2009, the IFPHK submitted its response to the consultation paper on enhancing deposit protection under the Deposit Protection Scheme ("DPS"). In 2010, the IFPHK submitted a response to the consultation paper on establishing an Investor Education Council and a Financial Dispute Resolution Centre. In April 2014, the IFPHK also submitted its response to the Consultation Document on an Effective Resolution Regime for Financial Institutions in Hong Kong. In the same year, we also submitted our opinion on the enhancement of the Deposit Protection Scheme.

In light of the above, the IFPHK has a vested interest in the Consultation Paper and wishes to express its views on the proposed changes.

The DPB Consultation

On 13 July 2023, the Hong Kong Deposit Protection Board (the DPB) launched a 3-month public consultation on enhancements to the Deposit Protection Scheme (DPS). Proposed enhancements to the DPS are highlighted below:

- **Protection limit** – raising the protection limit from the current HK$500,000 to HK$800,000.
- **Levy system** – switching back to the build-up levy to cater for a higher protection limit, with the build-up levy rates kept unchanged.
- **Deposit protection arrangements in the event of a bank merger** – providing enhanced coverage to affected depositors for six months upon a bank merger.
- **Representation regime** – requiring the display of the DPS membership sign on the digital channel of Scheme members, and streamlining negative disclosure requirements on non-protected deposits for private banking customers.

The proposals do not entail any fundamental changes to the funding requirement or structure of the DPS Fund. The Consultation Paper contains 5 questions in 5 chapters. The questions are as follows:

1. Do you agree with the proposal to increase the protection limit of the DPS from the current HK$500,000 to HK$800,000, at which the target size of the DPS Fund will remain at 0.25% of total protected deposits?

2. Do you agree with the proposal to keep the levy rates unchanged while broadening the circumstances under which the build-up levy becomes chargeable again to cover the situation where the protection limit is raised regardless of whether the target fund size as a percentage of protected deposits is changed or not?

3. Do you support the proposal to introduce enhanced arrangements for depositor protection for a limited period of time in the event of a bank merger? If so, do you agree with the proposed key features of the enhanced arrangements?

4. Do you support the proposal to require Scheme members to display the DPS membership sign on their digital channels in addition to their physical branches? If so, do you agree with the specific proposed arrangements?

5. Do you support the proposal to treat PB customers in the same way as institutional customers in terms of the negative disclosure requirements?

The views expressed in this submission paper are not necessarily summaries of the views taken from the industry but may have undergone more independent and critical analysis and consideration by the IFPHK as a professional body. As a result, not all the views collected by the IFPHK are recorded in this submission paper and neither have all the views expressed in this submission paper been directly endorsed by those industry representatives or members consulted.

IFPHK's Submission

Consistent with our previous submissions, this submission will be focused on the following three aims of the establishment of a Deposit Protection Scheme ("DPS") in Hong Kong, namely:

(a) to protect smaller depositors;
(b) to discourage reckless behaviour by both consumers and financial institutions; and
(c) to ensure costs to the industry are not prohibitive.

Generally, IFPHK's submission is based on the following principles:

Aligning with international best practices

The primary objective of a Deposit Protection Scheme (DPS) is to provide depositors with a level of assurance that their deposits will be reimbursed up to a certain limit if a bank fails. This helps maintain financial stability by preventing bank runs and systemic disruptions caused by depositors. As such, DPS forms an integral part of the entire resolution regime in most jurisdictions.

The International Association of Deposit Insurers (IADI) is primarily responsible for promoting best practices for deposit protection schemes. IADI is a multinational organization that works to improve the effectiveness and stability of deposit insurance systems all around the world. IADI's Core Principles for Effective Deposit Insurance Systems ("Core Principles") offer direction and best practices for Deposit Protection Schemes (DPS), notwithstanding the fact that they do not specify a particular model for DPS. The IADI Core Principles act as a standard against which jurisdictions can evaluate and improve their deposit insurance systems.

The DPB reviews the DPS regularly to make sure that it is still effective and efficient in achieving its goals for public policy and is in line with global best practices. Additionally, the Core Principles were modified in 2014. These Core Principles provide best practices from around the world for the major aspects of deposit insurance schemes, including governance, deposit coverage, funding arrangements, and speed of recovery. The financial and banking landscape has seen considerable changes both locally and worldwide since the last two rounds of major enhancements to the DPS. To guarantee that the Scheme complies with worldwide standards, the DPB once more launched a complete evaluation of the DPS in 2021.

Enhancing consumer protection

As financial products get more complex and sophisticated, it is of utmost importance that investors/consumers are provided with proper and adequate protection under a sound and effective regulatory system. The IFPHK supports a regulatory system that would facilitate delivering better financial products and services to the benefit of members of the public, as well as protecting them. Hence, the effectiveness of consumer protection and a healthy balance of robust regulations and market development are the IFPHK's areas of focus.

As Consumer protection is a fundamental principle of any deposit protection scheme, the primary objective is to safeguard the interests of depositors and provide them with confidence in the banking system. Enhancing consumer protection involves ensuring adequate coverage and timely reimbursement of deposits in the event of a bank failure. It also includes promoting transparency, educating depositors about their rights and responsibilities, and establishing effective communication channels to address their concerns.

Balancing cost and benefit

Enhancing a deposit protection scheme requires striking a balance between costs and benefits. While the scheme should provide robust protection to depositors, it should also be financially sustainable and minimize the burden on the banking industry and taxpayers. The design and implementation of the scheme should consider the costs associated with funding the scheme, managing risks, and administering reimbursement processes. It should also evaluate any potential advantages, such as preserving economic development, boosting public trust, and preserving financial stability.

Protection Limit

The guiding principles as stipulated in the Consultation Paper are that the protection limit should be adequate in protecting depositors and hence contributing to banking stability. Additional costs should be reasonable and the risk of moral hazard manageable. Three indicators are commonly used the coverage ratio by depositor, the real value of the protection limit, adjusted for inflation and the protection limit as a percentage of per capita GDP

The IADI cited guidance of at least 90% of depositors as a reference for assessing whether a deposit insurance scheme can cover the large majority of depositors. Another important consideration is whether the value of protection offered to depositors can keep up with inflation over time. Policymakers should take into account inflation when reviewing the protection limit.

At present, the DPS provides protection of up to HK$500,000 on a per depositor per bank basis. This limit has not been changed since 2011. As of March 2023, Hong Kong's consumer price index has increased by 39% since 2011. This means that the real value of the current HK$500,000 protection limit, adjusted for inflation, has effectively declined by 39% over the years.

Given the above the DPB proposes to raise the protection limit of the DPS to HK$800,000, as this level (representing an increase of 60% from the existing protection limit of HK$500,000) would suitably enhance protection to depositors while keeping additional costs and the risk of moral hazard at manageable levels, that

(i) the percentage of depositors fully covered will be restored to 92.2%, which is in line with the international guidance with a reasonable buffer;

(ii) the real value of the protection limit will increase by 21%, providing a reasonable enhancement in protection to depositors;

(iii) the protection limit as a percentage of per capita GDP will be comparable to many other major jurisdictions;

(iv) the 38% increase in potential loss to the DPS is kept at a manageable level, so there is no need to raise the existing target fund size of 0.25% of total protected deposits, and hence the increase in the annual contributions payable by Scheme members can be contained at about 26%; and

(v) the increase in moral hazard should be manageable since the percentage of fully protected depositors is within the IADI's recommended range.

Question 1:

Do you agree with the proposal to increase the protection limit of the DPS from the current HK$500,000 to HK$800,000, at which the target size of the DPS Fund will remain at 0.25% of total protected deposits?

IFPHK Response:

Increasing the protection limit from HK$500,000 to HK$800,000 means that depositors would have additional coverage for their funds in the event of a bank failure. Increasing the protection limit can provide depositors with a higher level of financial security. It may help to build trust and confidence in the banking system, potentially encouraging individuals and businesses to keep their funds in Hong Kong banks. This can also contribute to the stability and competitiveness of the financial sector. Hence, IFPHK supports the proposal to raise the protection limit of the DPS.

Maintaining the target size of the DPS Fund at 0.25% of total protected deposits suggests that the fund's resources would need to be adjusted to accommodate the higher protection limit. To make sure the fund can fulfill its duties, one can entail raising member banks' contributions to the fund or looking into additional funding options. When considering such proposals, it is important to assess the potential impact on the financial stability of the banking system and the overall economy. Increasing the protection limit could provide greater confidence to depositors, but it may also increase the burden on the banking sector and potentially affect the cost of banking services. After reviewing the proposal, IFPHK considers cost and benefits of raising the protection limit have been reasonably balanced, please refer to our comments on the questions below.

<u>Levy System</u>

The DPS adopts a differential levy system, whereby the annual contribution payable by each Scheme member is determined with reference to the supervisory rating assigned to it by the HKMA. This differential levy system is designed to limit moral hazard by providing incentives for banks to better manage their risks. The levy rates fall under two categories: (i) the build-up levy, which is the levy paid by Scheme members before the target fund size is reached; and (ii) the expected loss levy, which is the levy paid by Scheme members after the target fund size is reached.

Since the launch of the DPS in 2006, Scheme members have been paying the build-up levy as the target fund size has yet to be reached. As of March 2023, the net asset size of the DPS Fund stood at HK$6.2 billion. The target fund size, which is equivalent to 0.25% of total protected deposits, was reached this year. The DPSO stipulates that once the target fund size is reached, Scheme members will contribute the expected loss levy instead starting from the first quarter of the following year (i.e. 2024).

Under the existing DPSO, the build-up levy can be charged again if the target fund size as a percentage of protected deposits is amended. If the protection limit is to be raised to HK$800,000 as recommended in this consultation paper, the existing target fund size as a percentage of total protected deposits (currently at 0.25%) is expected to be sufficient to cover the potential loss to the DPS. If Scheme members' contributions remain based on the expected loss levy rates, which amount to only around 40% of the build-up levy rates, the DPS Fund is likely to take more than 10 years to reach the new target size, as opposed to around three years under the build-up levy approach.

To ensure the new target fund size can be reached within a reasonable timeframe, the DPB proposes a technical amendment to the existing legislation such that the circumstances under which the build-up levy can be charged again be broadened to cover the situation where the protection limit is raised regardless of whether the target fund size as a percentage of protected deposits is changed or not.

Question 2:

Do you agree with the proposal to keep the levy rates unchanged while broadening the circumstances under which the build-up levy becomes chargeable again to cover the situation where the protection limit is raised regardless of whether the target fund size as a percentage of protected deposits is changed or not?

IFPHK Response:

IFPHK concurs with the proposed changes. There are certain benefits of keeping the levy rates. Keeping the levy rates unchanged provides stability and predictability for member banks. They can plan their financial obligations accordingly, as they will not face immediate increases in their contribution rates to the DPS Fund. This can help maintain the financial stability of the banking sector. Broadening the circumstances under which the build-up levy becomes chargeable allows for a more flexible and adaptable funding mechanism for the DPS. If the protection limit is raised, the build-up levy would become chargeable to ensure that the DPS Fund can adequately cover the increased protection amount.

The proposal aims to strike a balance between providing enhanced depositor protection and minimizing any potential negative impact on member banks. Considerations have also be given to the potential impact on the cost of banking services, the competitiveness of the banking sector, and the overall economic implications. By broadening the circumstances for the build-up levy, the financial burden can be adjusted to reflect the increased protection limit. This can help prevent excessive strain on member banks' resources and potential disruptions to their operations.

<u>Deposit Protection Arrangements in the Event of a Bank Merger</u>

According to the IADI's updated Core Principles, in the event of, or prior to, a merger of separate banks that are members of the same deposit insurance system, depositors of the merged banks should enjoy separate coverage up to the protection limit for each of the banks for a limited and publicly stated period, as defined in law or regulation.

Some jurisdictions, including Canada, Malaysia, Singapore and the US, have put in place such arrangements, with the enhanced protection period (called “grace period”) varying from six months to two years. In Malaysia and Singapore, such arrangements also cover a scheme member’s acquisition of another scheme member’s deposit-taking business. Similar arrangements are in place in Hong Kong to cater for the case where deposits are transferred from a problem Scheme member to another Scheme member under a resolution strategy according to the Financial Institutions (Resolution) Ordinance (FIRO) (Cap. 628). Specifically, additional coverage of up to the protection limit will be provided to the deposits transferred from the problem Scheme member for six months after the transfer.

After reviewing the current arrangements, the Board proposes to establish enhanced arrangements for depositor protection in the event of a bank merger. To avoid overlapping with the relevant arrangements under FIRO, the enhanced arrangements in the context of DPSO are proposed to apply to cases where there is (a) a merger of two or more Scheme members, or (b) an acquisition of a Scheme member’s deposit-taking business by another Scheme member, both on a commercial basis, i.e. for reasons other than resolution which is already covered under FIRO.

For depositors who have deposits with more than one of the Scheme members involved before the merger or acquisition, each affected depositor will be entitled to compensation in respect of his/her protected deposits with each of the original Scheme members up to the DPS protection limit during the grace period, as if the merger or acquisition had not occurred. Some jurisdictions like Canada and Malaysia specify that the additional coverage will be reduced by subsequent withdrawals of deposits, while Singapore and FIRO arrangements allow it to remain in force irrespective of any subsequent changes in the deposit balance during the grace period.

As the enhanced arrangements are only temporary, the DPB considers it appropriate to keep the additional coverage unchanged throughout the grace period to avoid confusion to depositors and to minimize the administrative burden on the Scheme members concerned, thereby enabling a faster payout if needed. With reference to practices adopted by the US and the arrangements under FIRO, the DPB recommends the grace period of the separate coverage be set at six months from the date of merger or acquisition or, in the case of a time deposit maturing after the end of the six months, until its original maturity date.

Question 3:

Do you support the proposal to introduce enhanced arrangements for depositor protection for a limited period of time in the event of a bank merger? If so, do you agree with the proposed key features of the enhanced arrangements?

IFPHK Response:

Regarding the introduction of the enhanced measures for depositor protection in the event of a bank merger, IFPHK has no objection. For depositors who might be impacted by the consolidation of financial institutions, it offers additional protections. The enhanced arrangements are in line with international best practices and are intended to reduce any potential risks and uncertainties related to such mergers.

The suggested six-month grace period from the date of the merger or acquisition, or until the time deposit's original maturity date, appears to be intended to give depositors more time to be protected throughout the transitional period. Even though the merged or acquiring bank might have a different deposit insurance limit or coverage system, this grace period enables depositors to preserve their separate coverage for a brief period of time. Setting a grace period of six months provides ample time but is not excessive for the deposit protection scheme to assess the new entity resulting from the merger or acquisition. Most importantly, the DPB implemented the enhanced arrangements while keeping the additional coverage unchanged which it will minimize the burden to the industry.

Representation Regime

Under the Deposit Protection Scheme (Representation on Scheme Membership and Protection of Financial Products under Scheme) Rules (Representation Rules) (Cap. 581A), scheme members are required to make representations regarding their DPS membership status and the protection status of their financial products. A Scheme member is also required to make a one-off positive disclosure as to which deposits qualify for protection under the DPS before opening an account for a customer. Section 3 of the Representation Rules requires Scheme members to display the DPS membership sign, in accordance with the format prescribed in the Representation Rules, at their relevant places of business where they conduct banking business and to which members of the public ordinarily have physical access for carrying out banking transactions. For non-protected deposits, a Scheme member is required to make a negative disclosure and obtain the customer’s acknowledgement before each transaction of non-protected deposits.

The DPB proposes that Scheme members be required to display the DPS membership sign on their digital channels, in addition to their physical branches. The proposed arrangement is expected to help enhance the public confidence in Scheme members, thus benefitting both depositors and the banking industry at large.

The DPB is of the view that the positive disclosure requirement remains appropriate, as similar requirements are observed in other major jurisdictions and the overall compliance of Scheme members with this requirement has been satisfactory generally. However, the Board considers that there is scope for enhancement to the display of the PS membership sign, and to the negative disclosure requirements.

The DPB proposes that a Scheme member should display the DPS membership sign prominently on the following pages of its digital channels in respect of its banking business in Hong Kong, with the accompanying hyperlink to the home page of the DPS website:

- the home pages of the Scheme member’s website and principal;
- Internet banking platform(s);
- the page that appears immediately after logging on to online banking or mobile banking for operating a bank account with the Scheme member.

Question 4:

Do you support the proposal to require Scheme members to display the DPS membership sign on their digital channels in addition to their physical branches? If so, do you agree with the specific proposed arrangements?

IFPHK Response

IFPHK considers that requiring Scheme members to display the DPS membership sign on their digital channels can have several benefits. With the increasing use of digital channels for banking transactions, displaying the DPS membership sign on these platforms ensures that depositors have easy access to information about depositor protection. It allows them to quickly identify which banks are members of the scheme and understand the level of protection available to them. It can maintain uniformity in the delivery of depositor protection information is made easier by requiring the display of the DPS membership sign on both physical branches and digital platforms. It promotes transparency and clarity by making sure depositors get the same information regardless of the channel they use.

<u>Negative disclosure requirement</u>

Section 6A(3) of the Representation Rules requires Scheme members to make a negative disclosure and to obtain an acknowledgement from the customer before completing each transaction of a non-protected financial product that has been described as a “deposit in any advertisement, promotional material or document. A streamlined process, however, is allowed under certain circumstances, whereby the negative disclosure and customer’ s acknowledgement can be made and obtained on a one-off basis rather than on a transactional basis. Among other circumstances, Scheme members may apply this streamlined treatment when they enter into non-protected deposit transactions with institutional customers, because institutional customers are generally in a better position than retail depositors to understand the risks of their investments, including bank deposits.

In recent years, some private banks have suggested streamlining the negative disclosure requirements for their private banking customers (PB customers) to bring them in line with the treatment for institutional customers. The Board has also reviewed the disclosure requirements of other major jurisdictions. The findings suggest that while many jurisdictions such as the UK and the US require negative disclosures on non-protected deposit products, they only require such disclosure to be made on a one-off basis when opening an account. Some other jurisdictions do not even require negative disclosure.

Question 5:

Do you support the proposal to treat PB customers in the same way as institutional customers in terms of the negative disclosure requirements?

IFPHK Response

IFPHK has no issues with the proposed changes because they aim to promote fairness and consistency in negative disclosures between institutional clients and private banking clients who are equally sophisticated in terms of knowledge and experience. The unique characteristics of PB customers, such as their higher net worth and potential differences in risk tolerance, which may warrant tailored disclosure requirements. Treating PB customers and institutional customers equally in terms of negative disclosure requirements can provide clarity for financial institutions and regulators. It establishes a consistent regulatory framework and eliminates potential confusion or ambiguity regarding the obligations of financial institutions in disclosing negative information to different customer segments.