IFPHK's Response to the Financial Services and the Treasury Bureau and Hong Kong Monetary Authority's Consultation Paper on Enhancement to the Deposit Protection Scheme

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Institute of Financial Planners of Hong Kong (IFPHK) Profile

Background

IFPHK was established in June 2000 as a non-profit organization for the fast-growing financial industry. It aims to be recognized in the region as the premier professional body representing those financial planners that uphold the highest standards for the benefit of the public.

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

It represents more than 6,800 financial planning practitioners in Hong Kong from such diverse professional backgrounds as banking, insurance, independent financial advisory, stockbroking, accounting, and legal services.

Currently there are more than 147,000 CFP certificants in 25 countries/regions; the majority of these professionals are in the U.S., Canada, China, Australia and Japan, with more than 4,800 CFP certificants in Hong Kong.

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IFPHK's interest in this consultation

During the financial crisis, the absence of an orderly resolution regime forced some countries to provide extraordinary support to a number of systemically important financial institutions ("SIFIs") that were considered "too big to fail". Although Hong Kong is not the host jurisdiction to any of the failed financial institutions, the collapse of Lehman Brothers and the accompanying Minibond Saga created negative market sentiment, and greatly affected consumer confidence. In June 2009, the IFPHK submitted its response to the consultation paper of enhancing deposit protection under the Deposit Protection Scheme ("DPS"). 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 light of the above, the IFPHK has a vested interest in the Consultation Paper and wishes to express its views on the proposed changes.

IFPHK's representation

The IFPHK was founded by 30 members (the "Founding Members") in order to raise the standards of financial planners and highlight the importance of sound financial planning advice.

The IFPHK currently has 47 Corporate Members including banks, independent financial advisors, insurance companies, and securities brokerages. With our Corporate Members providing a full spectrum of the client services and products, the IFPHK is well positioned to understand the needs, concerns and aspirations of the financial planning community.

Executive Summary

Following the collapse of BCCI in July 1991, the Hong Kong government began the legislative process to establish a Deposit Protection Scheme (“DPS”). The DPS is established under the Deposit Protection Scheme Ordinance (“DPSO”), and it commenced operation in 2006.

The global financial crisis demonstrated the urgent need to improve resolution regimes so as to enable authorities to resolve failing financial institutions (FIs) quickly without destabilizing the financial system or exposing taxpayers to loss from solvency support. The Financial Stability Board (“FSB”) published the *Key Attributes of Effective Resolution Regimes* (“Key Attributes”) demonstrating the core elements of effective resolution should any financial institution deemed to be systemically significant or critical fail. Deposit insurance is an essential part of a resolution regime. A review of the DPS was conducted in 2009 after the financial crisis. As a result of the review, the protection limit was raised to HK$500,000 which now provides full coverage to 90% of depositors. The IFPHK submitted its response to the Consultation Paper issued in 2009. Consistent with our previous submissions, this submission will be focused on the following three aims of the establishment of a deposit protection scheme in Hong Kong, namely:

- to protect smaller depositors;
- to discourage reckless behaviour by both consumers and financial institutions; and
- to ensure costs to the industry are not prohibitive***.***

Based on the above assumptions, the IFPHK agrees on the following proposed changes in the Consultation Paper:

- the adoption of the gross payout method to determine DPS compensation, whereby the depositors will be compensated an amount up to the DPS protection limit without the need to go through any netting process of their liabilities to the same bank;

- the enhancement of the payment process by providing more certainty for the determination of the “Quantification Date” (“QD”) in the Deposit Protection Scheme Ordinance (“DPSO”) to facilitate deposit compensation determination; and

- the enablement of the use of electronic communication channels by the Hong Kong Deposit Protection Board (“HKDPB”), in addition to the traditional paper communication, to notify affected depositors of the compensation and related arrangements in case the DPS is triggered.

Notwithstanding our general support to the proposal, the IFPHK urges the Government to ensure that the proposed changes will align with the proposed financial resolution regime. Also, proper internal controls and contingency planning should be in place to ensure the proposed changes can be executed smoothly and effectively. As for the use of electronic communication, the IFPHK would like to remind the HKDPB and the Government to take reference to CAP 553 Electronic Transactions Ordinance and to consider whether electronic communications and records are subject to the ordinance.

The FSTB and HKMA Consultation

To achieve a faster and more effective payout for depositors in case the Deposit Protection Scheme ("DPS") is triggered during a bank failure or crisis, the Financial Services and the Treasury Bureau ("FSTB") and the Hong Kong Monetary Authority ("HKMA") published a consultation paper in September seeking industry comments on proposals for enhancing the operation of the DPS (the "Consultation Paper"). The three-month consultation period ended on 12 December 2014.

The Consultation Paper mainly sets out proposals for increasing the speed of payout, including:

- the adoption of the gross payout method to determine the DPS compensation, whereby the depositors will be compensated an amount up to the DPS protection limit without the need to go through any netting process of their liabilities to the same bank;

- the enhancement of the payment process by providing more certainty for the determination of the "Quantification Date" ("QD") in the Deposit Protection Scheme Ordinance ("DPSO") to facilitate deposit compensation determination; and

- the enablement of the use of electronic communication channels by the Hong Kong Deposit Protection Board ("HKDPB"), in addition to the traditional paper communication, to notify affected depositors of the compensation and related arrangements in case the DPS is triggered.

The proposals do not entail any fundamental changes to the funding requirement or structure of the DPS Fund.

The Consultation Paper contains 3 questions in 6 parts. The Chapters of the Consultation Paper are as follows:

1 – Executive Summary

2 – Overview

3 – Gross Payout

4 – Quantification Date

5 – Electronic Notes

6 – Conclusion

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***.***

Gross Payment

Since its establishment in 2006, the DPS has not been triggered. Nevertheless, it is the objective of the DPS to payout depositors as soon as practicable. After the payout, the HKDPB will subrogate to the rights of depositors to preferential payment under the Companies (Winding Up and Miscellaneous Provisions) Ordinance ("CWUMPO") when claiming the compensation paid to depositors, from the liquidator of the failed bank.

At present, the DPS calculates the amount of the compensation payment to depositors on a net basis, which requires liabilities owed by a depositor to a failed bank to be set-off against protected deposits held or a corporate depositor with the failed bank. Despite the full netting payout approach being originally designed to mirror Hong Kong's insolvency regime, its application in determining compensation payments to each depositor is time-consuming and complicated due to the efforts required to identify and ascertain the value of all liabilities owed by a depositor to the bank. The existing full netting requirement presents challenges to the DPS in meeting depositors' expectations of an efficient and effective payout during a bank failure or crisis.

Under the current circumstances, interim payments would likely be made within 2 weeks and final payments would possibly take up to 6 weeks. The HKDPB estimates that the proposed gross payout approach will enable the DPS to make full compensation payments to depositors, ideally, within 7 days.

In addition to faster payouts, calculating compensation payments on a gross basis would provide more ready access to liquid funds up to the DPS protection limit for depositors whose deposits would have been partially or fully set-off by their liabilities under the current approach, and thus reduce the incentive for depositors to withdraw deposits from banks. In addition to depositors, Scheme members are expected to also benefit from the gross payout approach.

If the gross payout approach is adopted, the basis for both the compensation determination under the DPSO and the recovery of compensation paid by the DPS under the CWUMPO have to be aligned, to ensure the HKDPB's entitlement to claim for the equivalent sum as paid to affected depositors in the liquidation of the Scheme member. This is the approach taken by other deposit insurance systems that have adopted a gross payout approach (e.g. the UK and Singapore) or are in the course of doing so (e.g. the EU).

Nonetheless, the impact on the insolvency regime in Hong Kong is expected to be limited. The creditor hierarchy under the liquidation regime in the CWUMPO would remain unchanged. Also, it is proposed that the set-off be dis-applied up to the protection limit of the DPS. The depositor is still obliged to repay any outstanding balance of his debt to the failed bank after receiving deposit compensation from the DPS.

The proposal to adopt a gross basis for determining compensation is consistent with the trend in the reforms undertaken by other major overseas deposit insurers in order to speed up payouts. Currently, 13 major jurisdictions out of 24 FSB member jurisdictions are adopting a gross payout approach. No adjustment to the level of premium rates currently applicable to Scheme members is proposed.

In order to allow the implementation of the gross payout approach as proposed, the DPSO will need to be amended. The specific amendments, subject to further examination of the relevant legal implications, include the following:

- section 27 of the DPSO will need to be amended to remove all references to set-off and netting of liabilities for determining the entitlement to compensation of the depositor;
- the DPSO or the CWUMPO will need to be amended to provide that the mandatory insolvency set-off will be dis-applied up to the DPS protection limit in respect of the HKDPB's subrogation to the rights of a depositor's priority under section 265(1) of the CWUMPO; and
- the definition of "amount of relevant deposits" in Schedule 4 to the DPSO will need to be amended to enable the HKDPB to collect contributions from Scheme members on a gross basis.

Question 1:

Do you agree that it is appropriate to adopt the proposed gross payout approach to enable rapid compensation by the DPS? If not, what other approaches are recommended to reduce hurdles to DPS compensation determination arising from the set-off requirements so as to ensure a fast payout?

IFPHK Response:

It is a significant improvement if the target payment process can be shortened from 6 weeks to 7 days by adopting the gross payout approach. As such, the IFPHK agrees to adopt the gross payout approach to enable rapid compensation by the DPS with the assumption that there is no adjustment to the premium rates currently applicable to Scheme members. Also the proposed change needs to be able to align with the proposed resolution regime.

<u>Quantification Date ("QD")</u>

Currently, the amount of interest accrued on protected deposits and the conversion of foreign currency deposits into Hong Kong dollars are determined with reference to the QD. Interest will be accrued up to the QD and the exchange rate used to convert a foreign currency deposit is the market exchange rate on the QD. Under section 25 of the DPSO, the QD is the date of appointment of the provisional liquidator (PLD) in respect of the failed Scheme member unless the HKDPB specifies the QD as the DPS trigger date (TD) under certain conditions. The TD is the date on which the Monetary Authority serves a notice on the HKDPB to trigger the DPS. Owing to the administrative and legal processes for appointing the provisional liquidator, the appointment could take a week or two after the TD. This is an impediment to the target timeframe of making payments within 7 days.

To remove uncertainties on the reference date used for compensation payment determination so as to enable full payment to be made to depositors in an expeditious manner, it is proposed that the specific QD, in relation to a failed Scheme member, be defined to be the TD or the PLD, whichever is the earlier. This will provide the HKDPB with the necessary certainty to determine that the compensation could be made to the vast majority of depositors, ideally, in 7 days in most cases of bank failure after adoption of the gross payout approach. With the amendment of the QD as proposed, the existing provision for the HKDPB to make a specification of the QD under section 25 of the DPSO can be repealed. It can also remove the possible uncertainty arising from the discretion of the HKDPB to withdraw the specification of QD pursuant to section 25(3) of the DPSO, which can be confusing to depositors and may delay the compensation calculation process due to the re-calculation of entitlement of depositors.

The existing rights of entitlement of depositors will be unaffected. It is proposed to amend the definition of the QD in section 25 of the DPSO.

Question 2

Do you agree that we should remove the uncertainties in the reference date (i.e. the QD) for determination of compensation payment by amending the definition of the QD as the date of the TD and the PLD, whichever is earlier? If not, are there any other alternatives to the use of the TD and the PLD which may help address the same issue?

IFPHK Response:

The IFPHK has no objection on the proposal of amending the definition of the QD as the date of the TD and the PLD, whichever is earlier, if the change offers more certainty. Again, the IFPHK's endorsement is based on the assumption that there is no significant impact to the existing insolvency regime and the proposed financial resolution regime.

Electronic Notices

The HKDPB is required to inform depositors of the compensation entitlement as determined by the HKDPB and other relevant details as soon as practicable. This notification to depositors has to be made individually in writing under section 32(7) of the DPSO. To fulfill the legal requirement in respect of written notice, the HKDPB would send a written payment notice appended with a paper cheque for the amount of the depositor's entitled payment by post.

The key benefit of employing electronic channels would be to enable the delivery of compensation details and affect the payments to a vast number of depositors within a relatively short period of time when compared to the present paper-form notification. Thus, it is proposed to permit to notify a depositor on compensation decision by any electronic means it considers appropriate having regard to the circumstances of the depositor and satisfying itself that a notice sent by such electronic means will reasonably come to the attention of that depositor. The present channel for written notice will be retained to cater for the needs of the depositors who do not use electronic communication channels.

Upon implementation, the HKDPB will carefully assess the reliability and completeness of a depositor's record with the failed bank before deciding the suitability of issuing electronic notice to him. Security measures and technological safeguards will be put in place to protect the data privacy of depositors. After the disbursement of compensation payments, a written notice will continue to be sent to depositors receiving electronic notice in the first instance for better record keeping.

To grant the flexibility of using electronic notice to the HKDPB, the Government proposes that section 32 of the DPSO be amended to the effect that any notices required to be sent to a depositor by the HKDPB under section 32(7) of the DPSO may be sent by any electronic means the HKDPB considers appropriate.

Question 3

Do you agree that we should enable the HKDPB to have the flexibility of using electronic notice, in addition to paper notice, to handle the payout process more effectively? Do you have any other suggestions on the use of electronic notice to communicate with depositors?

IFPHK Response:

With the advancement of technology and the common use of electronic communication platforms and smart phones, electronic mail is undoubtedly the quickest and the cheapest way to disseminate information. For instance, listed companies use electronic communications to communicate with shareholders. Hence, the IFPHK agrees to allow the HKDPB to use electronic notice in addition to paper notice. However, the IFPHK reminds the HKDPB and the Government to take reference to CAP 553 Electronic Transactions Ordinance and to consider whether electronic communications and records are subject to the ordinance. Also, the HKDPB should ensure that proper information security policies and procedures and proper contingency planning are in place.