

OPERATIONS OF THE DEPOSIT PROTECTION SCHEME

Launch of the Deposit Protection Scheme

After two years of intensive preparation, the Deposit Protection Scheme began providing deposit protection and collecting contributions from Scheme members on 25 September 2006. By protecting deposits, the Scheme helps strengthen public confidence in the banking system and contributes to the maintenance of financial stability. The following chapters detail the Board's key accomplishments both prior to and following the launch of the Scheme.



Members of the Board celebrating the launch of the DPS with official guests



Financial Secretary, Mr Henry Tang, and Chief Executive of the Hong Kong Monetary Authority, Mr Joseph Yam at the DPS launching ceremony



Chairman of the Board, Professor Andrew Chan (left), and Chief Executive Officer, Mr Raymond Li (right) announcing the launch of the DPS

Structured and Secured Deposits

In the course of preparing for the launch of the DPS, the Board observed that some Scheme members were unclear about the protection status of structured deposits, such as equity-linked deposits, currency-linked deposits, credit-linked deposits, index-linked deposits, inverse floaters and range accruals. In order to remove this ambiguity, the Board introduced legislative amendments to Schedule 1 of the DPS Ordinance to clarify that structured deposits were not protected by the Scheme. The related amendment notice came into force on the same day as the launch of the Scheme. The Board has established a set of quantitative benchmarks based on the popularity of structured deposits for triggering a review of the protection of such products. In the unlikely event the exclusion of structured deposits materially impinges upon the effectiveness of the DPS, the Board will consider introducing appropriate amendments to the Ordinance to reverse the exclusion.

The Board also noted that some Scheme members provide secured credit facilities as part of their integrated banking services to their depositors. As deposits pledged as security for credit facilities are not protected under the Scheme because they do not constitute a deposit within the meaning of section 2 of the DPS Ordinance, the Board considered there was a need to assess the popularity of secured credit facilities under integrated banking services and whether they would alter the effectiveness of the DPS. A survey is being designed to assess the implications of the popularity of integrated banking services with secured credit facilities and structured deposits for the coverage of the Scheme.

Compliance with 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 they can make decisions on selecting suitable products. The Representation Rules were issued by the Board in the form of subsidiary legislation in May 2006 and became effective on the launch date of the Scheme on 25 September 2006.



Member banks displaying the official DPS sign

In order to ensure representations made by Scheme members to general depositors complied with the requirements of the Representation Rules, the Board conducted a focus review in the fourth quarter of 2006 of 24 Scheme members with relatively large retail customer bases. The scope of the review covered the major requirements of the Representation Rules which included:

- Display of membership signs at relevant places of business
- Display of membership signs on the website
- Membership representation in advertisements
- Disclosure of financial products offered before commencement of the Representation Rules
- Disclosure of financial products offered on or after commencement of the Representation Rules
- Disclosure when deposits were no longer protected by the DPS.

The results indicated the selected Scheme members generally achieved full compliance with the Representation Rules.

Co-operation with the Hong Kong Monetary Authority

Both the Board and the HKMA are financial safety net players in Hong Kong. They share a common objective, which is to promote the stability of the banking system. To ensure this important objective is accomplished, the Board and the HKMA have agreed on how the two organisations should co-operate with each other in the performance of their respective functions. In addition, as the Board is required by the DPS Ordinance to perform functions through the HKMA, the Board has agreed on the extent of support provided by the HKMA. The Board has also secured a standby facility from the Exchange Fund to provide the necessary liquidity required for payment of compensation in the event of a bank failure. The detailed arrangements on how the two organisations should co-operate have been set out in a Memorandum of Understanding.

Plans for 2007-08

Monitoring the coverage of the DPS

In the coming year, the Board will continue to monitor the implications of key market developments for the coverage of the DPS. A survey to assess the implication of the popularity of structured deposits and integrated banking services with secured credit facilities for the coverage of the DPS is now being designed and will be issued for completion by Scheme members in the second half of 2007.

Compliance with Representation Rules by Scheme members

To ensure members of the public are properly informed of the protection status of their deposits, the Board will continue to monitor the compliance of Scheme members with the disclosure requirements in the Representation Rules. Taking into account the experience of the focus review on selected Scheme members in 2006, another review on compliance will be held in 2007-08.

DEPOSIT PROTECTION SCHEME FUND

Contributions from Scheme Members

Each Scheme member is required to make an annual contribution to the DPS Fund in the manner prescribed by the *DPS (Payment of Contributions, Late Payment Fees and Rebates) Rules* (Contribution Rules) issued by the Board in May 2006. In accordance with Schedule 4 of the DPS Ordinance, the Board assessed and collected HK\$90 million in contributions from Scheme members in 2006. This covered the amount for the period from the launch date of the DPS (25 September 2006) to 31 December 2006. All contributions were paid on time in October by Scheme members in the manner prescribed in the Contribution Rules.

Based on the amount of relevant deposits held by each Scheme member and their respective supervisory ratings on 20 October 2006, the annual contributions for the year 2007 amounted to HK\$300 million. The Board collected the contributions from Scheme members in January 2007, with all payments made on schedule. Assuming that relevant deposits will grow at a similar pace as in 2006 and the supervisory ratings remain relatively stable, the contribution to be collected in 2008 is estimated to be around HK\$310 million.

Investments of DPS Fund

The DPS Ordinance

In keeping with the need for capital preservation and liquidity, section 21 of the DPS Ordinance provides that the Board may invest money of the Fund that is not immediately required for the performance of its function in the following types of financial instruments:

- (a) deposits with the MA for the account of the Exchange Fund;
- (b) Exchange Fund Bills;
- (c) US Treasury Bills;
- (d) exchange rate contracts or interest rate contracts including derivative products entered for hedging purpose; and
- (e) any other investment approved by the Financial Secretary.

Investment Objectives

An investment policy governing the investments of the DPS Fund was endorsed by the Board's Investment Committee in August 2006. The policy aims at specifying how the Fund's investments are to be managed. The policy objectives are:

- (a) to preserve capital;
- (b) to ensure that sufficient liquidity will be available to meet the Board's financial obligations;
- (c) subject to (a) and (b), to obtain the maximum investment return on the assets of the DPS Fund.

The Investment Process

The Board's management team is responsible for the day-to-day investment management of the DPS Fund and reports to the Investment Committee on the Fund's performance. In discharging its responsibilities, the management team operates in accordance with the relevant provisions of the DPS Ordinance and the investment policy of the DPS Fund endorsed by the Investment Committee.

Risk Management and Controls

An investment control policy was developed in November 2006 setting out the risk management and internal controls of the DPS Fund. This policy details the risk assessment consideration and the related control measures governing the investment activities of the Fund, the segregation of duties between the trading functions and the back-office functions of the Board, and the respective responsibilities of each staff member of the Board responsible for investments. Under the investment control policy, investment reports are to be submitted to the Board and the Investment Committee for regular monitoring.

Performance of the DPS Fund

The contributions collected from Scheme members since the launch of the DPS have been invested according to the provisions of the DPS Ordinance and the investment policy of the DPS Fund. By law, the Fund's investments are limited to deposits with the Exchange Fund, Exchange Fund Bills and US Treasury Bills with an original maturity of not more than 12 months. At the end of March 2007, the DPS Fund amounted to HK\$374 million. Between 25 September 2006 and 31 March 2007, the Fund earned gross income of HK\$3.3 million, representing an annualised return of 4.06%. The audited statement of accounts are set out in pages 45 to 68.

Improving the System for Assessing Contributions

Since assessment and collection of contributions are an on-going activity, the Board believes improving the contribution collection system will be beneficial to its long-term operations. The user requirements for the contribution database system have been defined and the development is now substantially completed. Testing is being conducted to ensure the system can deliver the desirable features.

Plans for 2007-08

Based on the returns of relevant deposits to be submitted by Scheme members in relation to their positions on 20 October 2007 and the supervisory ratings of individual Scheme members to be supplied by the HKMA, the Board will assess and collect the contributions payable for 2008 in January 2008. The Board will continue to invest the DPS Fund in line with the DPS Ordinance and the investment policy. The improved system for assessing contributions is progressing on schedule and is expected to be completed by the end of 2007.

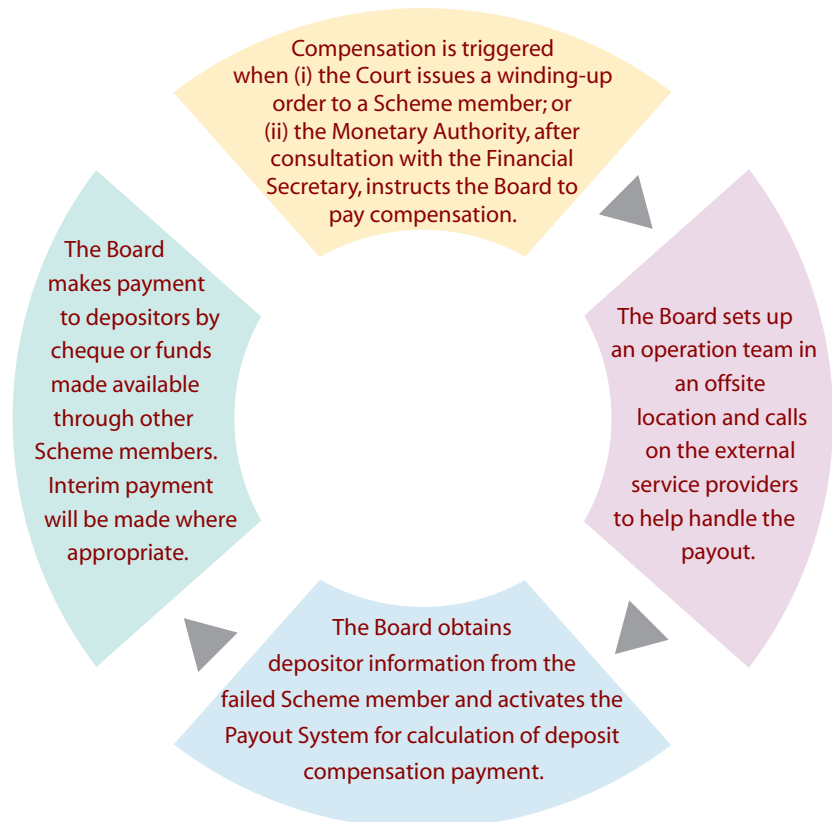
PAYOUT READINESS

Development of the Payout System and Procedures

To facilitate payment of compensation to depositors (a process referred to as payout), the Board developed a Payout System and conducted several rounds of user acceptance testing (UAT). The final round of the UAT made use of “live” data from a Scheme member to assess the Payout System’s capabilities in handling real banking data. During the process, appropriate measures were taken to mask and safeguard any personal data involved. The results of the UAT were satisfactory, and the Board formally accepted the Payout System from its information technology vendor in February 2007.

Although the Board is satisfied with this tool for facilitating compensation payments, it continually reviews the system’s capabilities to assess whether improvements are required based on the results of its simulation tests, payout rehearsals and any changes in the banking sector that may have an impact on the Board’s procedures for making compensation payments.

Payout Process

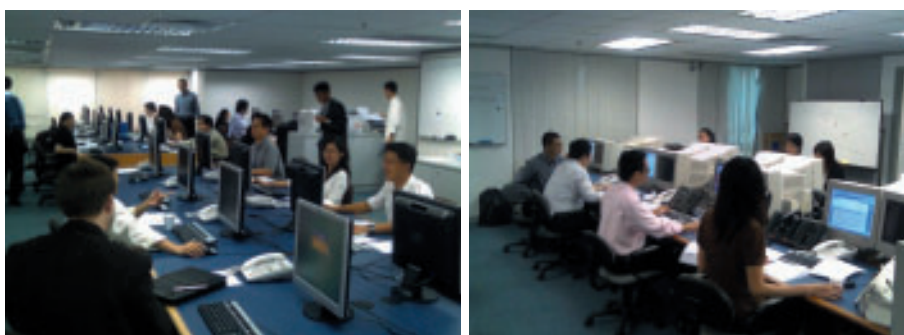


Simulation Tests

During the year, the Board commenced a programme of simulation tests in which it obtained data from Scheme members, processed the data on the Board's Payout System and applied payout processes and procedures to maintain the knowledge and readiness to perform a payout involving Board personnel and its network of service providers. The Board also worked with Scheme members during the simulation tests to assist them in complying with the Board's *Guideline on Information Required for Determining and Paying Compensation (ISG)* before the Board would commence a compliance review programme based on the ISG. The first simulation test was conducted in conjunction with the final round of the UAT of the Payout System and a second simulation test began in March 2007.

Appointment of Payout Agents

The Board continued to build its virtual organisation of external service providers that might be called on to assist with the calculation and payment of compensation to depositors should a payout be required. Contractual arrangements were made with an information technology consultancy firm, a business recovery service provider, a cheque printing company, and a call centre operator to provide services that would support the Board at the time of a payout. To ensure these payout agents are capable of delivering the services if and when required, the Board conducted technical drills to test their operational capabilities. For instance, a technical drill was organised in September 2006 with the Board's business recovery service provider to test the facilities and infrastructure of the Payout Operation Centre and its readiness for the Board's needs.



Technical drills at the Board's Payout Operation Centre – primary and secondary sites

The Board also worked with a selected number of Scheme members to confirm the technical requirements for providing information to them so they could efficiently disburse the compensation payments to depositors in a payout. In addition, the Board continued to work with accounting firms selected to co-ordinate the activities of other service providers, confirming their understanding of their role and responsibilities during a payout.

Rehearsal Exercise and Planning

To ensure the Board's virtual organisation can operate in an efficient and co-ordinated manner during a payout, the Board will conduct regular rehearsals with its network of external service providers. Planning has already started on the first rehearsal scheduled to be conducted in the second half of 2007-08.

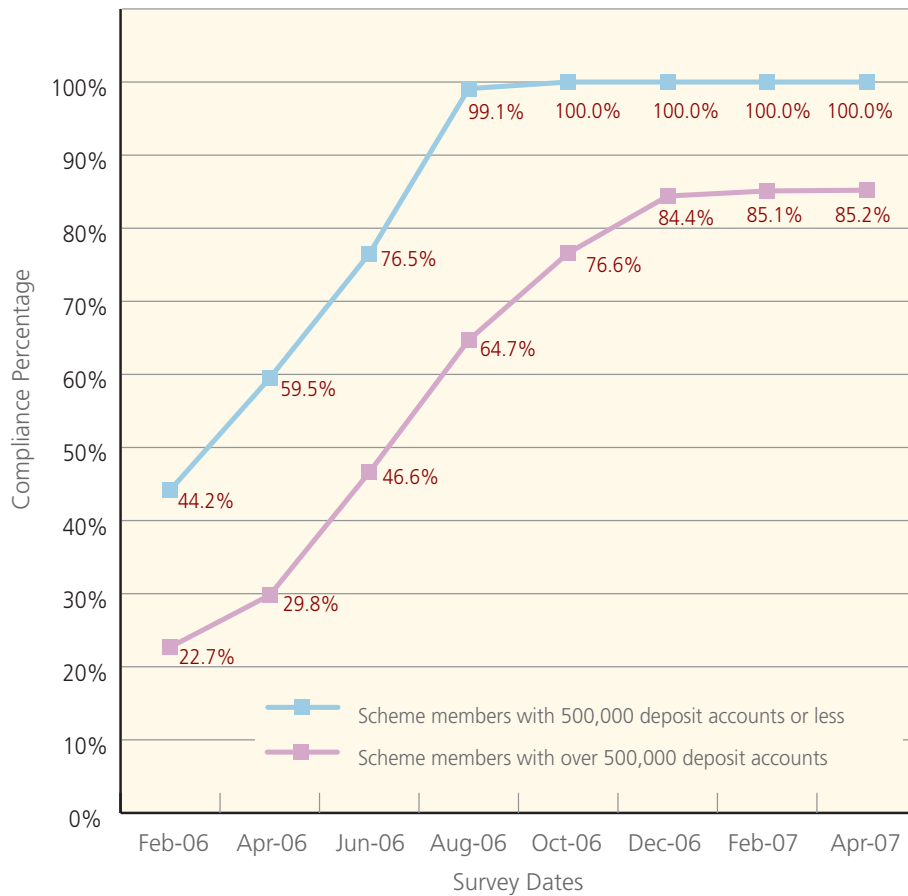
These rehearsals include familiarising the payout agents with the Board's payout policies, procedures and systems through pre-rehearsal training, applying management control and reporting processes to strengthen co-ordination between service providers, and developing scenarios and challenges that test the capabilities of the service providers to perform their functions. For all payout agents to benefit from these rehearsals, different agents will be included on a rotating basis.

Compliance with the Guideline on Information Required for Determining and Paying Compensation

When compensation under the DPS is triggered in respect of a Scheme member, the Board will determine whether a depositor is entitled to compensation under the DPS and, if so, the amount of the entitlement. In accomplishing this task, the Board will rely on the records obtained from the failed Scheme member. To enable the Board to make compensation payments efficiently, an ISG was issued in the form of a statutory guideline in June 2006 under section 8(1) of the DPS Ordinance. This guideline sets out the requirements on information systems and customer records to be followed by Scheme members.

While members were expected to achieve compliance with the guideline shortly after it was issued, flexibility to achieve full compliance by the end of 2007 was given to Scheme members with more than 500,000 deposit accounts, or a member belonging to the same group of companies.

Average Compliance of Scheme Members with ISG



The Board has been monitoring Scheme members' compliance with the ISG using bi-monthly surveys in which the members self-report their level of compliance. The results to date are encouraging as those Scheme members with 500,000 deposit accounts or less reported 100% compliance by October 2006, while those with over 500,000 deposit accounts reported 85% compliance by April 2007 with 8 months still remaining before they must be in full compliance.

Plans for 2007-08

The Board will continue its series of simulation tests, completing the one commenced in March 2007 and conducting two more tests that will focus on different aspects of the payout procedures and processes. The Board will also conduct its first payout rehearsal in the second half of 2007-08, bringing together its key payout agents to run through payout processes and co-ordination activities, as well as perform payout procedures in a scenario designed to test their effectiveness in working as a team to deliver the expected results of a payout operation.

The Board has recently recruited two new employees, a Senior Manager (IT Compliance) and a Manager (IT Compliance), whose duties are to develop and execute a compliance review programme for verifying the level of compliance with the ISG reported by Scheme members. The review will begin with Scheme members with 500,000 deposit accounts or less, and continue with members having more than 500,000 deposit accounts once this group has reported 100% compliance with the ISG.

Using the results of the simulation tests, the Board will continue to work with members to advance their understanding and application of the ISG. Where appropriate, the Board will issue clarifications and make amendments to the ISG to increase its transparency and comprehension for Scheme members. Consultations will be held with the Consultative Committee on Deposit Protection Scheme to provide effective implementation by Scheme members.

Based on the knowledge gained from conducting simulation tests and rehearsal exercises, the Board will continue to improve its payout policies and procedures to ensure they embrace all the challenges that may be encountered in a deposit payout.

PUBLIC AWARENESS AND EDUCATION



Student ambassadors of the Board at one of the roving exhibitions for promoting the Scheme

The Importance of Public Awareness

A key objective in establishing the DPS is to contribute to the stability of Hong Kong's financial system. In the event of a banking crisis or amid rumours of a crisis, the protection provided by the DPS will help allay public fears and maintain confidence in the banking system. For the DPS to be effective in achieving this objective, however, it is essential the public is well informed of the availability of the DPS and its benefits. Considering that Hong Kong has no prior experience with deposit protection, raising public awareness of the Scheme is a major challenge to the Board and strengthening public understanding of its features is a long term task that requires persistent effort of the Board.

With the assistance of a professional public relations consultant firm, the Board formulated a publicity plan for promoting the DPS. Under the plan, a series of promotional and educational activities were held during and after the launch of the DPS.



Chairman of the Board, Professor Andrew Chan (right) and Chief Executive Officer, Mr Raymond Li (left) promoting the DPS at the press conference

Promotional and Educational Activities Undertaken by the Board

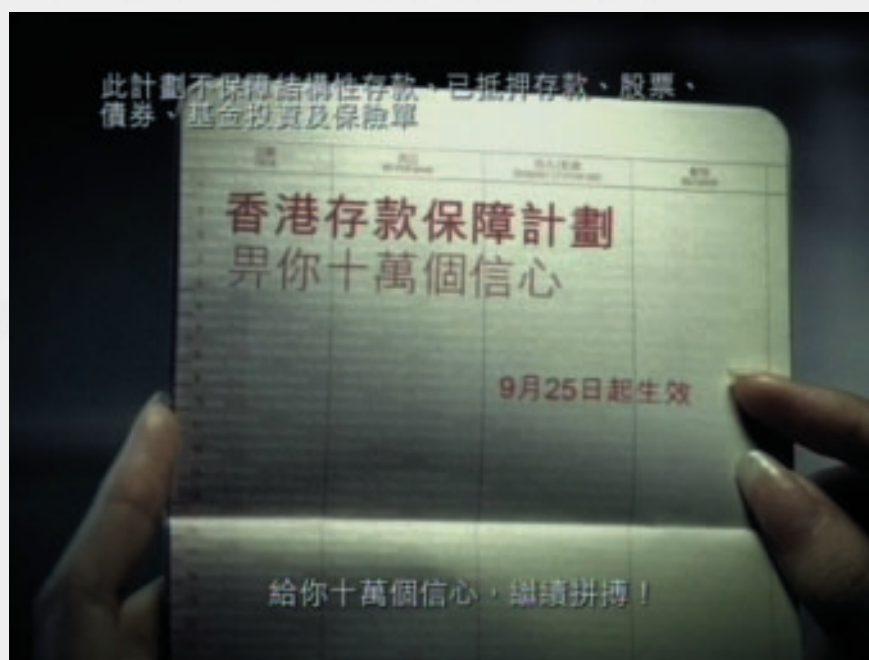
A press conference was held on 19 September to announce the launch of the Deposit Protection Scheme, which was followed by a reception on the launch date. Both events were covered extensively in the media and were successful in attracting widespread public attention. Media interviews by Board representatives during the launch period were also helpful in promoting public awareness.

An important element in the Board's publicity plan has been the use of various forms of advertising in the mass media to quickly build up public awareness and promote the DPS.

Promotion of the DPS Through the Mass Media

Deposit protection is a new concept to most people in Hong Kong, yet, it is relevant to almost everybody. The major challenge facing the Board in formulating its publicity strategy was how to introduce this new concept to millions of people with vastly different social and economic backgrounds.

On the advice of the public relations and advertising consultants, the Board used the mass media to promote the DPS. In the first wave of promotional activities during the launch period, TV and radio commercials were used extensively to quickly build up a general public awareness of the Scheme. To improve the reach of the messages, especially to the low-income group that the DPS aims to protect, the Board also used other mass media outlets, including commuter bus TV services, newspapers and the Internet. A lively and light-hearted approach was adopted to highlight the Board's messages in the advertisements to make them easily understood and conducive to engendering public recognition.



Slogan of the publicity campaign



TV and Radio Commercials

People in different walks of life and work occupations were featured in the TV commercial, signifying that the fruits (savings) of their labour were being well guarded by the DPS. By associating the benefits of the Scheme with people's day-to-day lives, the commercial was designed to help them appreciate the merits of the DPS and how it was relevant to them. The message was reinforced by the campaign's slogan – "Save with Confidence".

In line with the theme of the TV commercial, the radio commercials also emphasised the relevance of the Scheme to people from all walks of life, albeit in a more explicit and vivid manner to attract the attention of listeners.

“就連我



Catchy newspaper advertisements

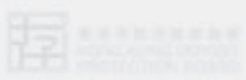


Educational cartoons emphasise the message

Newspaper Advertisements

The print media, with its capacity to allow greater detail for explaining key features, was employed to broaden the reach of the Board’s message and to improve public understanding of the DPS. In the first and second quarter of 2007, the Board launched an advertising campaign in a number of large circulation newspapers and all free newspapers.

In April 2007, the Board launched a series of educational cartoons in a lively and interesting setting to educate readers on the main features of the DPS.



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REPORT ON ACTIVITIES



Taking the campaign to the Internet

On-line Advertisements

According to the findings of an opinion survey conducted by the Board in December 2006, young people were generally less exposed to conventional advertising, such as TV, radio and newspapers. With this group generally more involved in using the Internet, the Board launched an on-line advertising campaign, also in April 2007, to expand the reach of the Board's messages. Advertisements were uploaded to mass-appeal portals and to special-interest applications and sites that are popular among young people.



A familiar sight on public transport

Advertising on Public Transport

The Board explored the feasibility of utilising other advertising channels to promote the DPS, and in the second quarter of 2007 launched an advertising campaign on major public transportation systems. Advertisements were displayed on bus bodies and at MTR platforms and in MTR carriages.



Snapshots of advertisement at MTR platforms and MRT carriages



REPORT ON ACTIVITIES

Apart from utilising the mass media, the Board obtained support from Scheme members to promote the DPS. Information leaflets were made available at branches of all Scheme members, and over three million copies were sent out by 46 members for their customers as a statement insert in the fourth quarter of 2006. Some Scheme members also helped by displaying DPS posters and broadcasting the TV commercials in their branches.



Creative poster appeals to the public



Information leaflet highlights features of the DPS

Collaboration with Scheme Members

Information leaflets available at member outlets





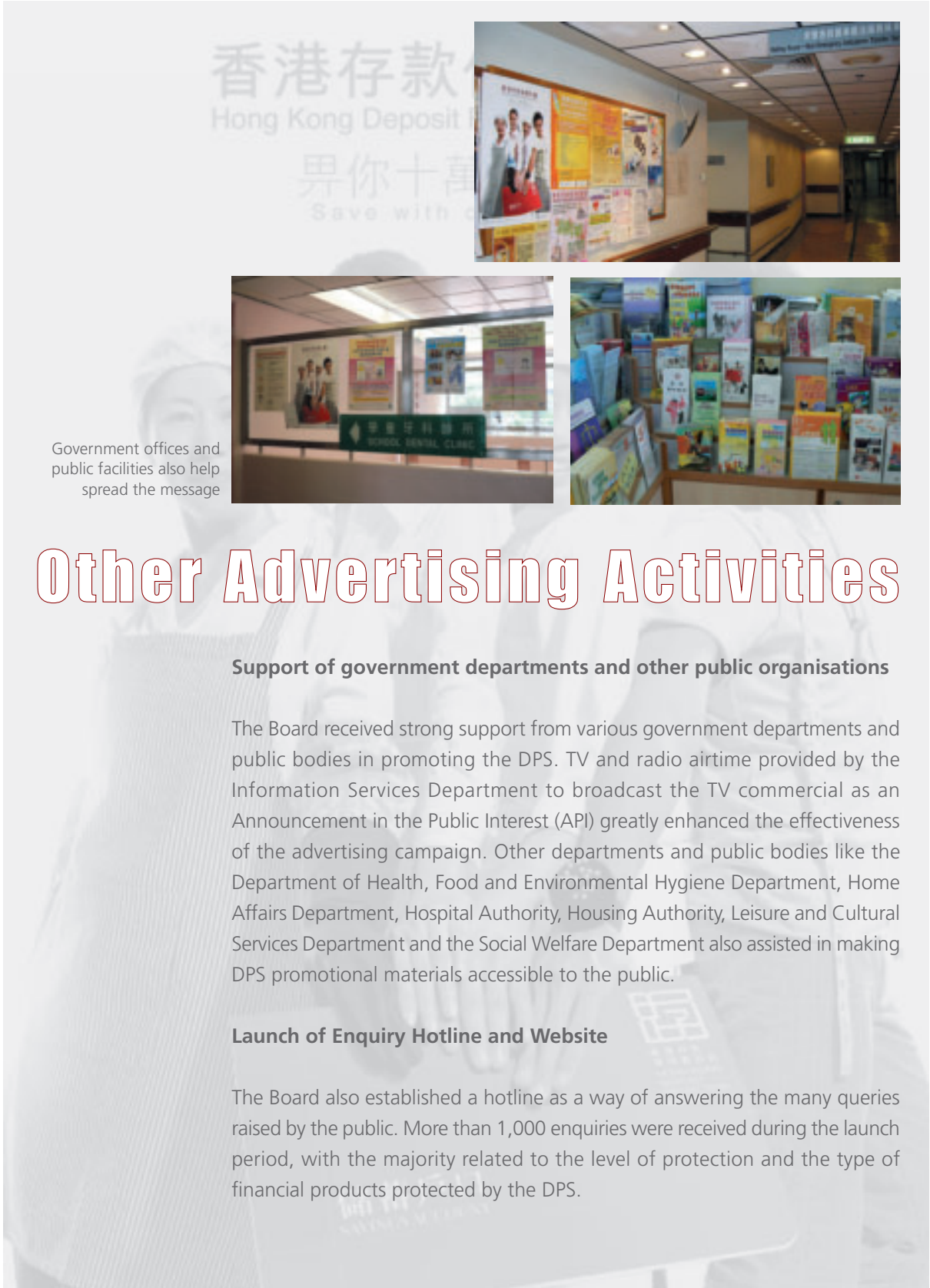
Roving exhibitions prove popular with the public

Roving Exhibitions

To provide an opportunity for the public to understand the DPS in an interactive setting, the Board launched a Hong Kong-wide roving exhibition in October 2006. Some 18 exhibitions were held between October and March 2007 at public housing estates, shopping malls and major MTR and KCRC stations. Student ambassadors of the Board were deployed at the exhibitions to introduce the DPS to the public and answer enquiries on the spot. Computer games and souvenirs were made available at the exhibitions to attract the public.



Shopping centres are a strategic outlet for promoting the Scheme



Government offices and public facilities also help spread the message

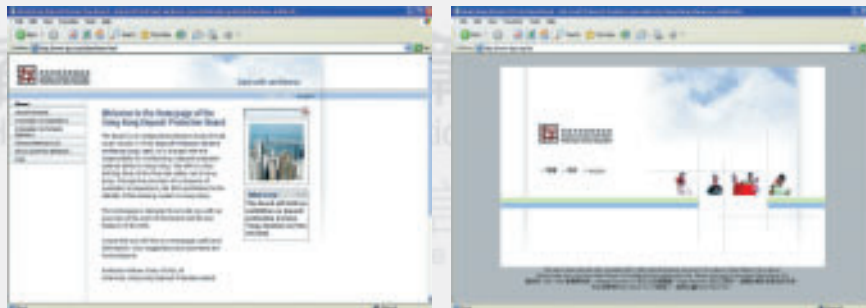
Other Advertising Activities

Support of government departments and other public organisations

The Board received strong support from various government departments and public bodies in promoting the DPS. TV and radio airtime provided by the Information Services Department to broadcast the TV commercial as an Announcement in the Public Interest (API) greatly enhanced the effectiveness of the advertising campaign. Other departments and public bodies like the Department of Health, Food and Environmental Hygiene Department, Home Affairs Department, Hospital Authority, Housing Authority, Leisure and Cultural Services Department and the Social Welfare Department also assisted in making DPS promotional materials accessible to the public.

Launch of Enquiry Hotline and Website

The Board also established a hotline as a way of answering the many queries raised by the public. More than 1,000 enquiries were received during the launch period, with the majority related to the level of protection and the type of financial products protected by the DPS.



The DPS website provides detailed information for Internet users

In addition, a website was launched to facilitate access to DPS information through the Internet. More than 20,000 visitors have viewed the website since its inception on 19 September 2006.

Review and Plans for 2007-08

Effectiveness of the Publicity Campaign

In December 2006, the Board commissioned an independent research agency to conduct an opinion survey on the DPS. The results of the survey indicated that the publicity activities undertaken during the launch period were effective in raising public awareness and understanding of the DPS. The survey also helped identify areas where further effort should be directed, for example, to increase public understanding of the Scheme's key features. The enhanced public awareness of the DPS achieved by the publicity campaign during the launch period will greatly facilitate the Board's work in these areas in the future.

Plans for 2007-08

Maintaining a high level of public awareness of the DPS and improving public understanding of the Scheme remain to be two important tasks of the Board in 2007-08. As such, the Board will explore the feasibility of utilising other means to extend the reach of the Board's messages to the public, especially to low-income groups that the DPS aims to protect. In the Board's promotional and educational activities in 2007-08, there will be more emphasis on strengthening the public's understanding of the Scheme.

INTERNATIONAL CO-OPERATION

As a member of the International Association of Deposit Insurers (IADI), the Board continued to participate in forums organised by both IADI and its member deposit insurers to exchange knowledge and ideas on issues relevant to deposit protection in an international context. During the year, Board personnel took part in a number of international meetings including:

- the Korean Deposit Insurance Corporation International Open House in Seoul
- the International Financial Stability: Cross-border Banking & National Regulation in Chicago
- the IADI 5th Annual Conference and 5th Annual General Meeting in Rio de Janeiro, Brazil
- the Japan Deposit Insurance Corporation 2nd Round Table in Tokyo
- the 5th Annual Asia Regional Committee Meeting of IADI and International Conference on Deposit Insurance in Hanoi, Vietnam

In March 2007, the Board hosted a study visit by a delegation from the Malaysian Deposit Insurance Corporation that focused on understanding the Board's payout processes, procedures and Payout System. The visit is part of a continuing programme to enable the establishment of closer ties with regional deposit protection organisations and for international counterparts to keep abreast of latest developments.