

REPORT ON ACTIVITIES IN 2007-08

OUR OPERATING ENVIRONMENT

A key characteristic of the operating environment of the DPS is that the banking sector of Hong Kong is highly internationalised. Of the 141 Scheme members, 118 are foreign bank branches, many of which are top tier international banking institutions. These foreign incorporated banks are mainly providing wholesale or specialised banking services to corporations and premier customers. The retail segment of the banking sector is mainly served by 23 locally incorporated banks, including some that also belong to international banking groups or have a strong global presence. With the aim of improving banking stability, it is logical for the Board to prioritise its effort on the retail segment, as this accounts for the bulk of the deposits protected by the DPS and covers the majority of depositors. Nevertheless, the high level of foreign participation in the local banking system suggests the Board should also pay close attention to driving forces in the international marketplace.

Major developments in international financial markets

In 2007, international financial markets experienced significant turbulence triggered by the US sub-prime crisis, which began last August and led to a general tightening of global credit and liquidity that was felt in major financial centres. For example, in September a run on a major mortgage lender in the UK came amid reports of difficulties experienced by banks in borrowing from the interbank market. The crisis also contributed directly to substantial losses reported by major international banking institutions, many of which have a presence in Hong Kong. The pessimism generated by the crisis also affected other financial sectors, especially stock markets.

Local economic and banking environment

The Hong Kong economy remained strong in 2007 with real GDP growing by 6.4% on the back of 7.0% growth in 2006¹. This was mainly driven by strong domestic demand and service exports. Monetary conditions eased in line with successive US interest rate cuts that began in September 2007. Rising inflationary pressures were seen in the strong growth in domestic demand, increasing imported food prices and the weakening of the US dollar, to which the Hong Kong dollar is pegged. Significant gains were recorded by the stock market in the first three quarters of 2007 in parallel with an optimistic economic outlook and hopes of a near term expansion of the Mainland's Qualified Domestic Institutional Investor scheme. But fears of a contagion effect of the sub-prime crisis prompted major corrections in the stock market in the fourth quarter.

Supported by the buoyant economic conditions, the effective banking supervision exercised by the HKMA and the reportedly small sub-prime exposure of local banks, the Hong Kong banking sector was well able to withstand the turbulence. According to HKMA statistics, the banking sector had a solid year in 2007, with retail banks remaining highly profitable and local banks well capitalised. The aggregate pre-tax operating profits of retail banks' Hong Kong offices increased by 31.1% from a 10.2% increase in 2006 on the back of expanding assets, improving net interest margins and robust growth in fees and commission income associated with equity-related businesses. Consistent with the strong 7.5% growth in relevant deposits reported by Scheme members to the Board, retail

¹ According to figures published by the Hong Kong Census and Statistics Department

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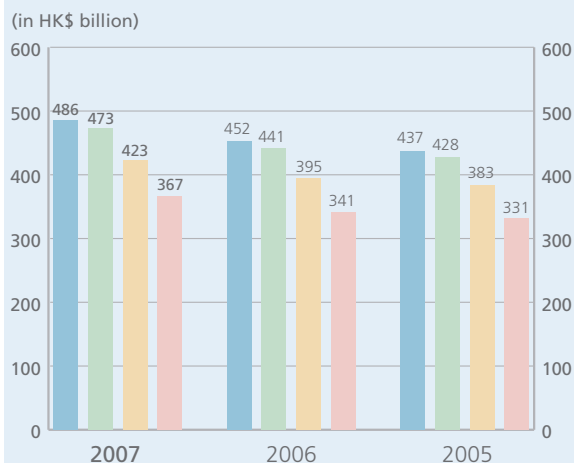
banks' customer deposits reported by the HKMA increased by 18.4%, compared with 15.6% in 2006. Retail banks also remained highly liquid as the growth in customer deposits outpaced loan growth. The asset quality of retail banks remained good, notwithstanding a worsening in the quality of investment in debt securities, mainly due to the sub-prime crisis. Despite a continued decline in the capital adequacy ratio observed for local banks, the capital position of the banking industry remained strong and well above the international minimum of 8%. The implementation of Basel II, a new capital adequacy framework for banks has further enhanced the resilience of the banking system in Hong Kong during the year.

Profile of Scheme members

At 31 March 2008, there were 141 Scheme members, compared with 135 a year earlier. During the year, eight new members joined and two ceased to be members because of mergers and acquisitions. Of the 141 members, 23 are locally incorporated banks and 118 are foreign bank branches, which are roughly in line with the number of retail banks and wholesale banks respectively.

Based on the returns of relevant deposits submitted by Scheme members in 2007, the top 20 members by size of relevant deposits are all retail banks and they accounted for more than 95% of total relevant deposits in the industry.

Relevant deposits held with Scheme members



% of total	2007	2006	2005
Top 5	76%	75%	76%
Top 10	87%	87%	88%
Top 20	98%	98%	98%
Total	100%	100%	100%

An analysis of the changes in the amount of relevant deposits held with Scheme members in the retail segment from 2006 to 2007 shows that the growth recorded by small to medium-sized retail banks was generally higher than that recorded by large retail banks. On average, the deposits held with the smaller banks recorded a 10% year-on-year increase while the average increase recorded by the larger banks was 7%. In general, higher growth rates were recorded by those members who pursued a relatively more aggressive marketing strategy. This demonstrates that the DPS has contributed to fostering a more competitive banking environment.

Relevant deposits held with large retail banks and small to medium-sized retail banks

(in HK\$ billion)	2007	2006	± %
Large retail banks	420	393	7%
Small to medium retail banks	55	50	10%

Responses to trends and changes in the operating environment

As a deposit insurer, the Board must stay alert to changes or emerging trends in its operating environment to identify challenges and, where necessary, take appropriate actions to address any potential risks.

While Hong Kong's banking sector remains sound and robust, and has been little affected by the sub-prime crisis, valuable lessons have been learnt by the Board, including the measures taken and planned by overseas authorities to tackle the crisis or reinforce the resilience of their systems. Following the UK bank run in September, the Board conducted a review of the incident and any implications it might have for the DPS in Hong Kong. The review identified notable differences between the design features of Hong Kong's DPS and the scheme for protecting depositors in the UK. Given that there were so many factors at play, it is difficult to conclude whether the bank run incident could have been avoided had there been better deposit protection in the UK. The review, however, highlighted a few key factors for the success of the DPS, including the need to regularly assess and ensure the adequacy of the coverage of the Scheme, securing a readiness to make compensation in a reasonably expeditious manner and maintaining a high level of public awareness and understanding of the DPS.

The Board has also been keeping abreast of reforms to financial regulatory and deposit insurance regimes on the international scene in the aftermath of the sub-prime crisis. For example, in January 2008, the UK authorities issued, for public consultation, a package of recommendations for reforming the UK financial regulatory and deposit insurance arrangements. The US Treasury released in March a blueprint for modernising the US financial regulatory structure. In response to the turmoil on global markets, the Financial Stability Forum, a prominent international forum of national financial regulators, central banks and international financial institutions also issued, in April, recommendations to improve financial market and institutional resilience. In addition, the Board noted the HKMA had completed a review of its work on banking stability, which may have a bearing on the various financial safety net arrangements in Hong Kong, including the DPS. The Board will carefully review the recommendations of these reports and proposals, and monitor the progress of their implementation by the relevant authorities to see whether they may be appropriate to the DPS in Hong Kong.

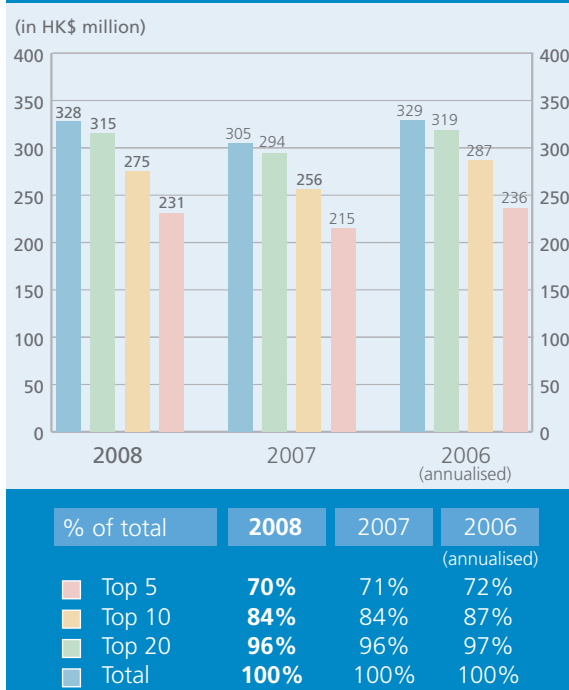
ADMINISTRATION OF THE DPS

Since the DPS commenced operation in 2006, one of the main operational objectives of the Board has been to maintain and improve the efficiency and effectiveness of the administration of the DPS. Notable achievements were made last year in the assessment and collection of contributions, investment of the DPS Fund and ensuring compliance with the DPS (Representation on Scheme Membership and Protection of Financial Products under Scheme) Rules. (Representation Rules).

Assessment and collection of contributions

Each Scheme member is required to make an annual contribution to the DPS Fund in the manner specified in the DPS (Payment of Contributions, Late Payment Fees and Rebates) Rules (Contribution Rules) issued by the Board. Under Schedule 4 to the DPS Ordinance, the Board assessed and collected HK\$328 million in contributions from Scheme members in 2008. This represented a 7.5% increment from the HK\$305 million collected in 2007. From the amount of relevant deposits held, over 95% of the total contributions were paid by the top 20 Scheme members. The distribution pattern was similar to those observed for the past two years. All contributions were paid by Scheme members on time in January 2008 in the manner prescribed in the Contribution Rules.

Contributions paid by Scheme members by relevant deposits held



The amount of contribution payable by a Scheme member for a year is assessed by the Board based on an annual return submitted by the member on the amount of relevant deposits held with it on 20 October of the previous year. To ensure the accuracy of the returns, the Board introduced a policy to require members to submit an auditor's report to certify the correctness of their returns on a rotational basis. In early 2008, 34 Scheme members submitted an auditor's report on their returns for 2007. The results were satisfactory and no reporting errors with a significant impact on the total contributions were noted. As the amount of relevant deposits held with the 34 members accounted for over 90% of the relevant deposits of all Scheme members, the exercise was successful in assuring the correctness of the aggregate amount of those deposits and, therefore, the aggregate amount of the industry's contributions.

Investment of the DPS Fund

During the year, the Board invested the DPS Fund in accordance with the DPS Ordinance and the Board's investment policy, which sets out strict guidelines on the risk assessment and control measures, and the segregation of duties required for the investment activities.

To take advantage of the relatively higher US dollar interest rates, the Board increased the weight of US Treasury Bills in its investment portfolio. At the end of March 2008, cash and investment securities accounted for about 52% and 48% of the investment assets of the DPS Fund respectively, compared with 91% and 9% a year ago. In terms of currency mix, the proportion of US dollar assets increased to 48% from 9% during the same period. Despite the significant easing of Hong Kong dollar and US dollar interest rates last year, the Board was able to achieve an investment return of 3.8% on the DPS Fund in 2007-08, compared with 4.1% the previous year.

Mix of cash and investment securities of the DPS Fund (as at 31 March)

(in HK\$ million)	2008	2007
Cash and deposit balances	347.6	329.7
Investment securities	321.8	31.0
Total	660.4	360.7

Note: Scheme members started making contribution to the DPS Fund in 2007

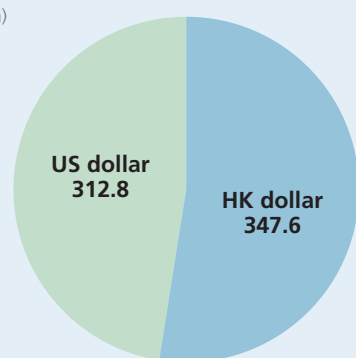
Compliance of Scheme members with the Representation Rules

To assist the public in distinguishing between financial products protected and not protected by the DPS, the Board issued the Representation Rules in June 2006. The Representation Rules govern the representations made by Scheme members regarding their member status and the protection status of their financial products.

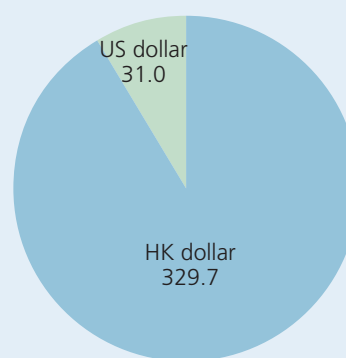
In 2007, the Board introduced a self-assessment framework to assess the level of compliance of Scheme members with the Representation Rules. The framework took into account the experience of a focus review on selected Scheme members in 2006. The first self-assessment covered the period from 25 September 2006 (the DPS commencement date) to 30 September 2007. According to the assessment reports received by the Board, the overall compliance level of all Scheme members was satisfactory.

Currency mix of cash and investments of the DPS Fund (as at 31 March)

(in HK\$ million)



2008



2007

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MONITORING COVERAGE OF THE DPS

To be effective in maintaining stability of the banking system, the DPS must be able to provide full protection to the majority of depositors. The Board continued to monitor the coverage of the DPS through statistics collected in regular simulation tests with Scheme members. The statistics collected from the tests completed in 2007-08 suggested the percentage of depositors fully protected should remain above 80%.

In addition to analysing these statistics, the Board has been paying attention to market developments that may have an impact on the coverage of the DPS. In 2007, the Board conducted a survey on the popularity of structured deposits and integrated banking service packages with a secured credit facility. The findings concluded that structured deposits were not popular among small depositors. The percentage of those holding such deposits remained well below the quantitative benchmarks set for reviewing their protection status when they were removed from the protection of the DPS in July 2006. Similarly, it was concluded that the popularity of integrated banking service packages with a secured credit facility had not reached the stage that warrants immediate action by the Board to bring the deposits pledged under such packages under the protection of the DPS.

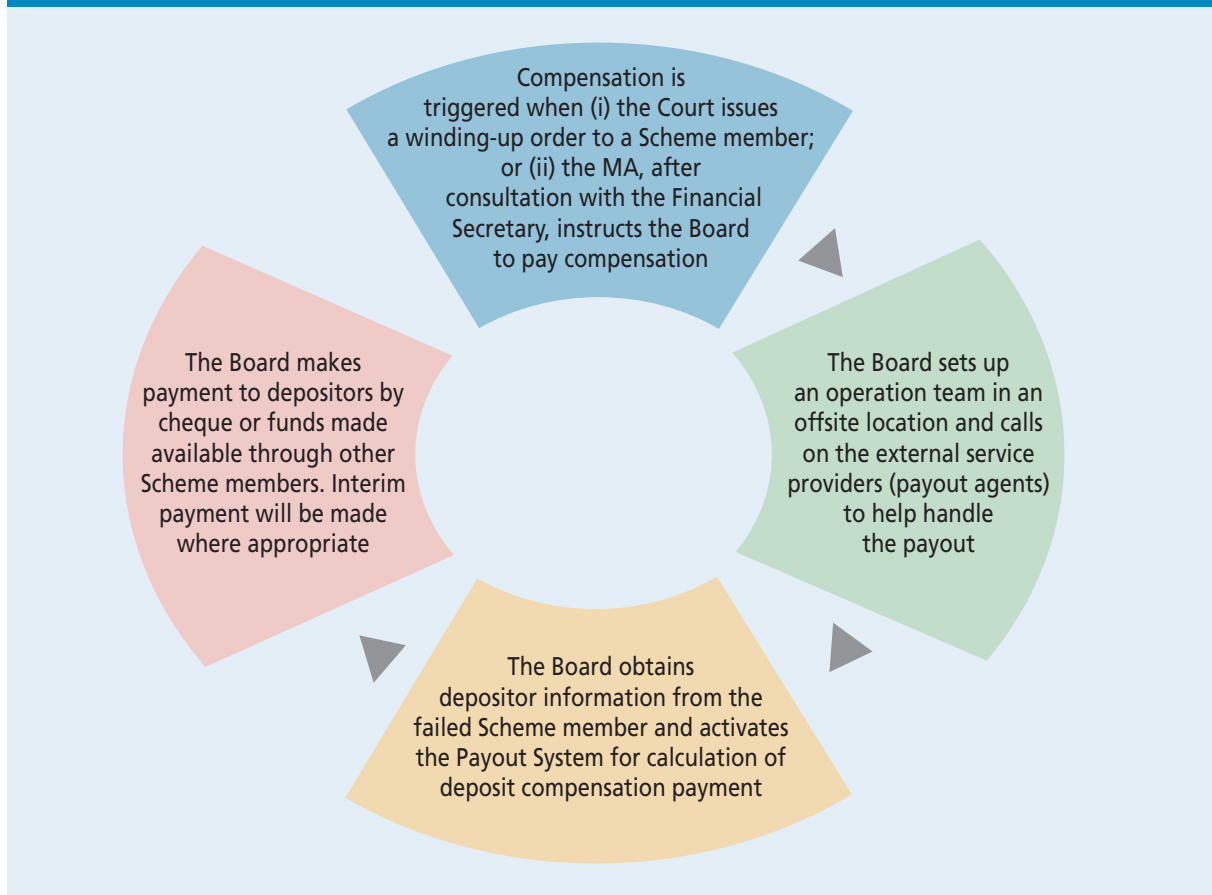
READINESS OF THE DPS TO PAYOUT

“Payout readiness” refers to the Board’s ability to deliver on its mandate of making compensation payments to affected depositors in the event of a bank failure (a process that is commonly referred to as a payout). This generally relates to having the appropriate people, processes and systems in place to be brought into action on short notice if payment of compensation from the DPS Fund is triggered. As suggested by the diagram on the following page, a number of elements need to be already in place for the Board to promptly begin and expeditiously complete a payout.

Since the Board makes use of a virtual organisation of external service providers (collectively referred to as payout agents) to assist with the calculation and payment of compensation to depositors in the event of a payout, this readiness extends to ensuring these payout agents are able to work in a co-ordinated and efficient manner and that they are familiar with the Board’s payout processes and systems.

The Management Team and these payout agents (the Payout Team) rely on a comprehensive set of procedures, documented in the Board’s Payout Procedure Manual as well as other reference materials, to guide them in performing the activities required to complete a payout. These procedures relate not only to manual processes performed during a payout, but also to the operation of the Board’s Payout System that was developed to handle the volumes of data and complex processing necessary to arrive at determinations of depositors’ balances on which compensation payments are based.

Payout process



The Board has also implemented a Guideline on Information Required for Determining and Paying Compensation (ISG), which provides direction to Scheme members on how data from their information systems should be made available or retrievable by the Board in the event of a payout. The ISG is necessary to ensure the Board can quickly use data from a failed Scheme member in its payout processing, as it will rely on those records obtained in making its determinations of entitlement to compensation payments.

To ensure an appropriate level of payout readiness during the year, the Board focused its attention on a number of areas, which are described in more detail below.

Improving payout policies, procedures and processes

In continuing to update its payout procedures and improve the Payout System, the Board has undertaken simulation tests, rehearsals and periodic reviews of operational requirements. The Payout System's functionality was expanded for production of statements for depositors and for handling enquiries of depositors in a payout. Upgrades to the System's hardware were also undertaken to ensure the Board's ability to efficiently handle and process a range of volumes for the data used in making compensation determinations. A manual was also developed to provide assistance to the Board's information

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technology payout agents in handling unusual situations arising from Scheme member data processed by the Payout System.

Additional improvements also began later in the year to allow the Board to pursue different payout strategies depending on the particular circumstances of the failure of the Scheme member, and to transform Scheme member data that may be at variance with the Board's expectations as described in the ISG. In addition, the Board began revising its Payout Procedure Manual to include these changes; provide greater clarity for complex situations that may be encountered in a payout; and to streamline processes based on the experience gained from the payout rehearsal.

First payout rehearsal

The first payout rehearsal was conducted by the Board in November and December 2007. It involved Board members and personnel, and payout agents providing accounting, information technology consultancy, business recovery, security printing, and call centre services. The objectives of the rehearsal were to test the capacity of the Board's payout agents to perform payout processes while working in an efficient and co-ordinated manner as a team. In preparation for the rehearsal, the Board provided training to the agents on payout processes and the use of the Payout System to familiarise them with the relevant policies and tools before applying them in a payout scenario.

At the start of the rehearsal, a subset of the Payout Team, comprised mainly of accounting and information technology payout agents as well as Board personnel, assembled at the payout operation centre and quickly began making

determinations for compensation payments. The team applied procedures in the Payout Procedure Manual and processed data on the Payout System to verify the correctness and completeness of the "live" data provided to them from a Scheme member that was masked and safeguarded to protect any personal information. The team sorted through and grouped depositors' information into balances on which determinations of eligibility for compensation payments could be made, and prepared the payment files that would allow interim and final payments of compensation with explanatory payment statements to be produced. Call centre operators responded to simulated calls about the "payout", and the security printing company prepared cheques and statements using the payment files prepared by the other members of the Payout Team. Board members held event management meetings to keep informed of the progress of the "payout" and to make decisions at key junctures during the rehearsal. Sample statements were also drafted for release to the public in an actual payout, including updates to the Board's intervention website, designed to provide prompt communications updates on a payout.

The rehearsal was completed successfully, with compensation payment being determined on an appropriate basis. The payout agents performed their work within the service standards set out in their agreements with the Board. The rehearsal proved to be an invaluable exercise to test the Board's payout processes and the payout agents' capabilities in a situation that was designed to be as close as possible to an actual payout. The payout agents made several suggestions on improvements to make the payout processes even more efficient for their own co-ordination as well as certain payout processes that could be streamlined.



Board members discussing rehearsal activities at the payout operation centre



Members of the Payout Team receiving instructions at the start of the rehearsal



Operators at the call centre responding to simulated enquiries



Board members caught up in the activities of the call centre

The Board will conduct regular rehearsals involving its virtual organisation, focusing on different objectives to test specific payout issues and to continue to familiarise the payout agents with the payout processes, using any feedback from the rehearsal to continually develop the Board's payout system and tools.

Engagement of payout agents

The Board completed the engagement of all the payout agents required for a payout by entering into contractual arrangements with a security printing company and two accounting firms, one of which was appointed to provide project management services in the payout rehearsal. As well, the Board engaged several Scheme members to provide compensation payment disbursement services so the Board could properly monitor the

cheques issued and to handle the logistical issues when dealing with large volumes of cheques for clearing and settling. To minimise the possibility of delays in disbursing compensation payments, sufficient cheque and statement stock has been pre-printed and securely stored.

The Board also worked with its existing payout agents to ensure they could properly deliver their services when called on to do so. For example, this included working with the call centre service provider in updating the set of frequently asked questions for payout, and providing training to the call operators on the use of the question and the Payout System so they could be more effective in responding to enquiries; and with the security printing company in developing a programme to allow more efficient processing of the payment file from the Payout System into cheques and statements to depositors.

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Payout funding secured

The Board has secured a credit facility from the Exchange Fund to pay compensation to depositors in the event of a bank failure. The size of the credit facility is sufficient to cope with the simultaneous failure of two medium-sized banks. This is consistent with international standards promulgated by the Financial Stability Forum. The Board has, so far, not had to draw on the credit facility from the Exchange Fund.

Compliance with the ISG

This statutory guideline, issued by the Board in June 2006, sets out the requirements on information systems and customer records to be followed by Scheme members. Having data available to, or retrievable by, the Board that conforms to particular requirements allows the Board to quickly begin its work in the event of a payout.

Compliance with the guideline was expected to be achieved by all Scheme members by the end of 2007. The Board has been monitoring progress of their compliance with the ISG using bi-monthly surveys in which the members self-report their level of compliance. In the December 2007 survey, all Scheme members reported compliance with the guideline. With this milestone achieved, the Board has moved to the next stage of checking the reported compliance through the development of a Compliance Review Programme. This verifies Scheme members' level of compliance and involves up to six compliance reviews being held each year. A risk-based approach will be adopted to identify Scheme members to be subject to a review. The selection of members will be made with reference to various factors such as the size and complexity

of their information systems in terms of data volume, variety and level of sophistication. The Programme is ready for implementation in 2008-09.

While developing the Programme, the Board has continued its simulation tests in which it obtains data from Scheme members; processes the data on the Payout System; and applies payout processes and procedures to assess specific payout issues that the Board may encounter, as well as to maintain the knowledge and readiness to perform a payout involving Board personnel and its network of payout agents. During the simulation tests, the Board also worked with Scheme members to assist them in complying with the ISG. Three simulation tests were completed during the year and a fourth was commenced in February 2008. A number of interpretation issues of the ISG were observed during the tests, which prompted the Board to issue an IT survey to Scheme members to understand the pervasiveness of these issues.

The results of the IT survey indicated a need for amendments to the ISG as well as an explanatory note for certain complex areas that will provide clarity on the issues and facilitate members' comprehension of the ISG. Consultations with the Consultative Committee on Deposit Protection Scheme will be held in the second quarter of 2008 to allow Scheme members to effectively implement the measures. The Board will take into consideration the impact of any changes to information systems or customer records that may be required of members when it conducts its compliance reviews.

PUBLIC AWARENESS AND EDUCATION

The Board fully recognises that the effectiveness of the DPS in maintaining banking stability relies heavily on a high level of public awareness and understanding of the Scheme. With the advice of a professional public relations consultant and an

advertising agency, together with the support of government departments, and private and public organisations, the Board continued to conduct a wide variety of promotional and educational activities to maintain and expand public awareness and understanding of the DPS.

During the year, the Board:

- hosted a media luncheon to mark the first anniversary of the launch of the DPS



Chairman Professor Andrew Chan reviewed the DPS operations at the media luncheon



The DPS publicity marking the first anniversary

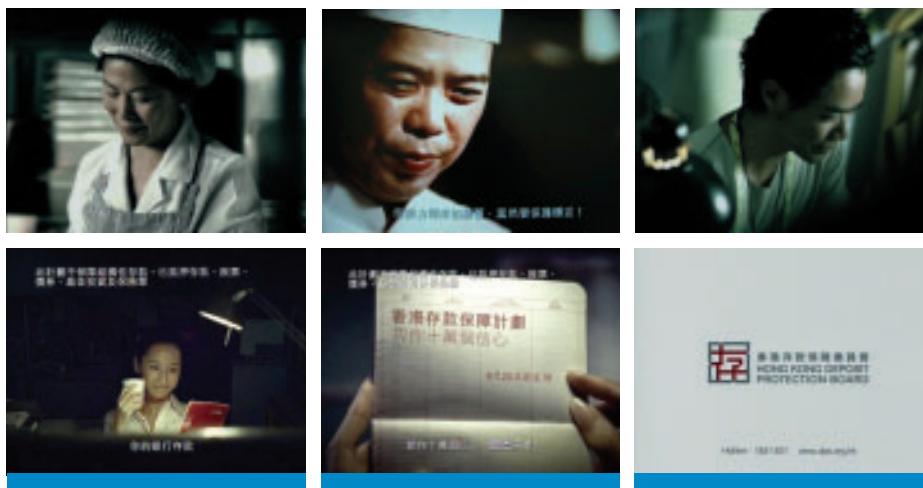
- launched five advertising campaigns in major transportation systems, including the MTR network and on buses



Keeping the public aware of the DPS on public transport

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- launched six advertising campaigns on TV and in newspapers



Scene from the DPS TV commercial



Catchy newspaper advertisements emphasise key features of the DPS

- collaborated with non-government organisations and labour unions on the promotion of the DPS



NGOs and labour unions help promote the DPS

- inaugurated two advertising campaigns on the internet, including on-line advertisements and advertisements in e-news letters



Advertising campaign in the internet

- held 48 "Know Your DPS Day" exhibitions in public housing estates



Roving exhibitions reinforce the DPS message in the community

A list of major public education and publicity activities is in Annex 2.

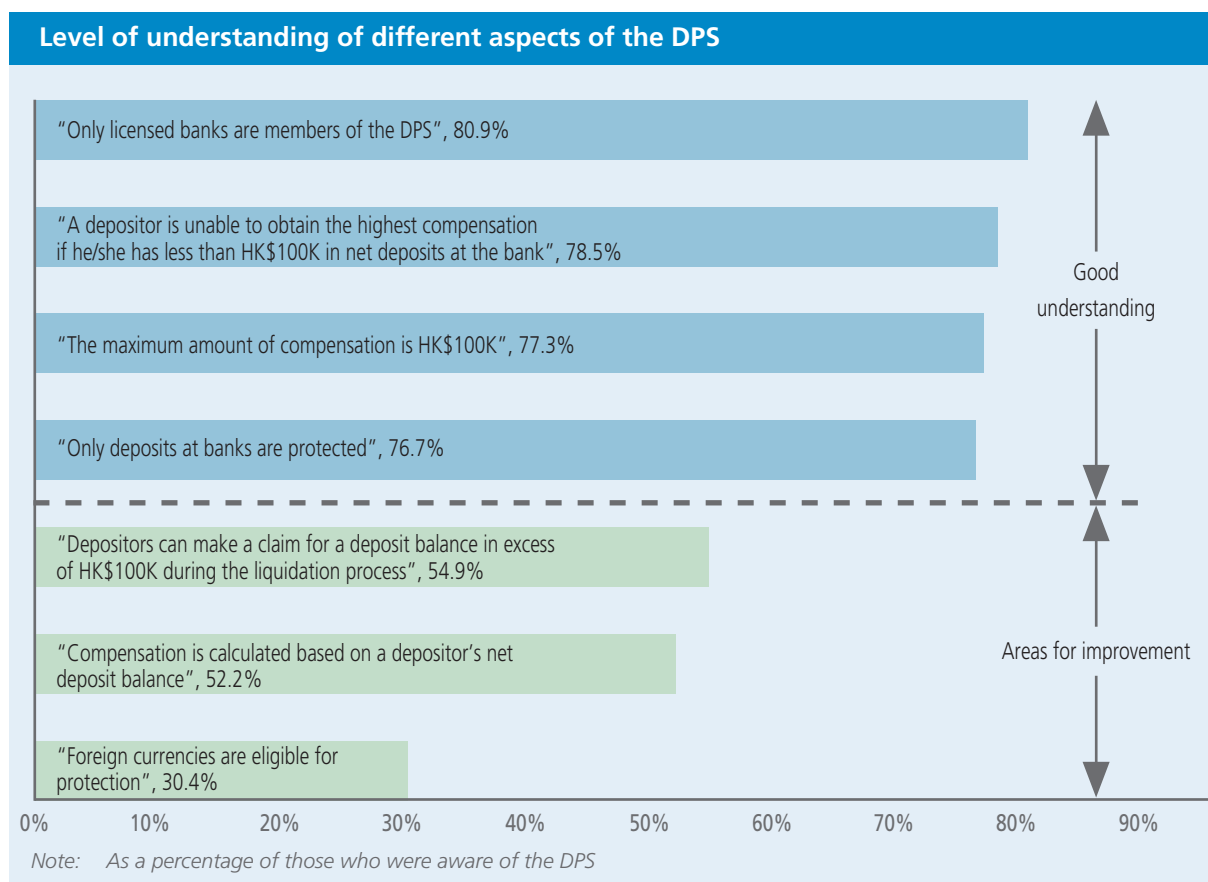
Effectiveness of the publicity campaign

The Board engaged an independent research agency to conduct two Hong Kong-wide opinion surveys on the DPS in 2007, one in June and the other in December, to monitor whether its communications objectives had been met and to identify improvements for the publicity plan.

The findings show that about 70% of Hong Kong people are aware of the DPS, indicating the Board met its objective for the year in fostering and maintaining a high level of public awareness. More importantly, the surveys found that public confidence in the banking system in general

has improved since the introduction of the DPS. Positive responses were seen in areas including the perceived level of security of deposits in banks, and increased confidence in small to medium-sized banks.

As expected, the findings of the surveys also indicated that people have not yet been able to understand fully some of the key features of the newly introduced Scheme. In addition, people on low-incomes, who generally fall into the category the DPS aims to protect, were relatively less aware of the Scheme. These two observations have provided useful information to the Board in formulating its future publicity strategy.



RELATIONSHIP WITH OTHER SAFETY NET PLAYERS

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 aim of promoting the stability of the banking system. To ensure this 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 MA, the Board and the HKMA have 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 (MoU). In the past year, the Board and the HKMA closely co-operated with each other under the terms of the MoU.

Relationship with the Securities and Futures Commission and the Investor Compensation Company

Under certain circumstances in the event of a bank failure, the funds of a depositor or a portion of those funds is simultaneously covered by the DPS and the Investor Compensation Fund (ICF) established under the Securities and Futures Ordinance for compensating securities or futures investors. To ensure that no person receives double compensation, the Board and the Securities and Futures Commission (SFC) agreed that a set of arrangements on co-ordination and exchange of information between the parties should be developed and documented in an MoU between the Board, the SFC and the Investor Compensation Company (ICC), the company recognised by the SFC for administering the ICF. During the year, the Board completed drafting the MoU with the SFC and ICC. Specifically, it recognises that the DPS will normally pay the depositors first in the event of a bank failure and, to avoid double compensation, the parties should inform each other when compensation is paid to a depositor that has lodged a claim with the ICF.

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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. In 2007-08, Board personnel took part in a number of international meetings including:

- the IADI 6th Annual Conference and Annual General Meeting in Kuala Lumpur, Malaysia;



- the Deposit Insurance Corporation of Japan 3rd Round Table in Tokyo, Japan; and



Manager Clarence Hui (third from left, back row) at the Deposit Insurance Corporation of Japan 3rd Round Table in Tokyo

- the 6th Asia Regional Committee Annual Meeting of IADI and International Conference of Deposit Insurance in Bali, Indonesia



Payout Consultant Gregory Zinmicki (sixth from left, second row), at the 6th Asia Regional Committee Annual Meeting of IADI in Bali