

OUR OPERATING ENVIRONMENT

The financial turmoil triggered by the US sub-prime mortgage crisis eventually precipitated into a systemic crisis on a global scale in 2008. The collapse of the US investment bank Lehman Brothers and the failure of a number of large financial institutions in major markets resulted in a severe global credit crunch in the fourth quarter of 2008, triggering widespread concern over a possible meltdown of the global financial system. The crisis also spilled over to the real sectors and dragged major economies into recession. Unprecedented measures were taken by many countries to restore confidence in their financial systems and to stimulate their economies. These included steep and rapid rate cuts, injections of liquidity, tremendous packages to rescue troubled financial institutions and stimulate economies, and measures to protect depositors. While there have been signs these measures are beginning to restore stability and confidence, it remains unclear whether the crisis will end soon.

Being a highly open economy, Hong Kong is not immune from the contagion of the financial and economic downturn of its major trading partners. A brief and small-scale run occurred on a local bank in late September 2008 on unfounded rumours amid the deteriorating market sentiment after the collapse of Lehman Brothers. The tightness of liquidity in the global market also spread to the local market. In response, the authorities introduced a series of pre-emptive measures to reinforce confidence and promote stability. In addition to measures for easing market liquidity, a blanket deposit guarantee was introduced in mid-October 2008 covering all deposits in Hong Kong. The guarantee protects fully the deposits held with all authorized institutions in Hong Kong, in excess of the portion covered by the DPS, until the end of 2010.



Mr John Tsang (centre), Financial Secretary, together with Mr Joseph Yam (left), Chief Executive of the HKMA, and Mr Raymond Li (right), CEO of the Board at the press conference in mid-October 2008 announcing the blanket deposit guarantee by the Government

As a result of these measures, the operation of the local banking system gradually returned to normal towards the end of the year. Indeed, banks in Hong Kong generally remained liquid and well capitalised despite the sector's profitability being noticeably affected by the crisis and the conspicuous slow-down in domestic economic growth, from 6.4% in 2007 to 2.4% in 2008.

Statistics released by the HKMA show the aggregate pre-tax operating profits of retail banks' Hong Kong offices fell by 35.7% in 2008 compared with 2007. The post-tax return on average assets declined to 0.85% in 2008 from 1.48% a year earlier. The deterioration in profitability mainly resulted from narrower interest margins and a sharp decline in non-interest income. An increase in provisions for asset devaluation and impairments also eroded operating income. The asset quality of retail banks, however, remained good by historical standards, but a few indicators showed signs of deterioration. The classified loan ratio increased to 1.24% in 2008 from 0.85% in 2007 and sub-standard debt securities represented about 0.06% of retail banks' total assets in 2008, compared with 0.04% in 2007. Retail banks generally remained liquid with the quarterly average liquidity ratio standing at 45% in the final quarter of 2008, compared with the statutory minimum of 25%. Despite the difficult operating environment, the consolidated capital adequacy ratio of all locally incorporated authorized institutions rose to 14.8% at the end of 2008 from 13.4% a year earlier. Tier-1 capital ratio also increased to 11.2% at the end of 2008 from 10.4% in 2007. Overall, Hong Kong's banking sector has managed to withstand the external shocks reasonably well.

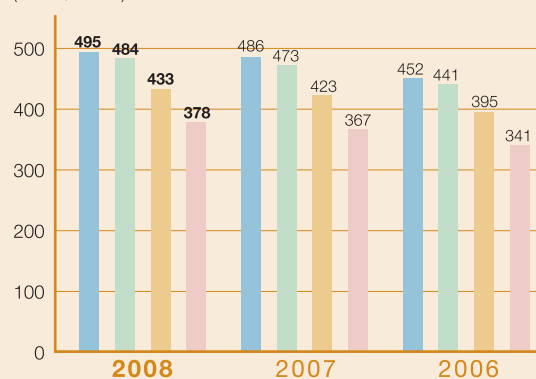
Profile of Scheme members

At the end of March 2009, there were 140 Scheme members, compared with 141 a year earlier. During the year, three new members joined, two of which were upgraded from restricted licence banks to licensed banks; four ceased to be members because of mergers and acquisitions, and downsizing. Of the 140 Scheme members, 23 are locally incorporated banks and 117 are foreign bank branches. This is roughly in line with the number of retail banks and wholesale banks in Hong Kong respectively.

Based on the returns of relevant deposits submitted by Scheme members in 2008, the total amount of relevant deposits in the industry continued to grow, albeit at a slower pace. They expanded by about 2% to HK\$495 billion from HK\$486 billion a year earlier. The growth was more benign than the 7% recorded in 2007, possibly due to the economic slow-down during the year. As in previous years, the top 20 members by size of relevant deposits are all retail banks, accounting for more than 95% of total relevant deposits in the industry.

Relevant deposits held with Scheme members

(in HK\$ billion)



% of total	2008	2007	2006
Top 5	76%	76%	75%
Top 10	87%	87%	87%
Top 20	98%	98%	98%
Total	100%	100%	100%

Statistics on the growth of relevant deposits recorded by small to medium-sized retail banks and large retail banks show that the rates are largely comparable, at 1% and 2% respectively. As a result, the split of relevant deposits among the retail banks remained stable over the year: large retail banks accounted for 87% of the total relevant deposits of the industry, and small to medium-sized retail banks held 11%.

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

(in HK\$ billion)	2008	2007	±%
Large retail banks	430.6	420.5	2%
Small to medium-sized retail banks	55.4	54.8	1%

ADMINISTRATION OF THE DPS

The Board completed the key tasks in different operational areas of the DPS smoothly in accordance with the applicable requirements, based on past experience and under the guidance of well established policies and procedures.

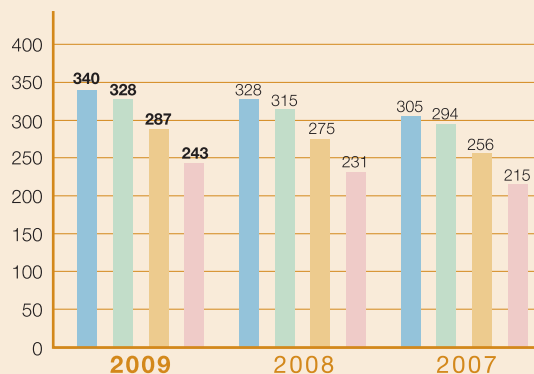
Assessment and collection of contributions

All Scheme members are required to make an annual contribution to the DPS Fund in the manner specified in a set of statutory rules (Contribution Rules). Under Schedule 4 of the DPS Ordinance, the Board assessed and collected HK\$340 million in contributions from Scheme members for 2009 – a 4% increase on the HK\$328 million collected in 2008. Similar to the distribution of relevant deposits, over 95% of the total contributions were paid by the top 20 Scheme members. This distribution pattern has been much the same since the commencement of the DPS. All contributions were paid by Scheme members on time in January 2009 in the manner prescribed in the Contribution Rules.

The contribution payable by a Scheme member each year is assessed by the Board based on an annual return submitted by the member. To ensure the accuracy of the amount of relevant deposits reported by Scheme members in the returns, the Board introduced a policy in 2007 to require Scheme members to submit an auditor's report to certify the correctness of their returns. A second review under the policy was conducted in early 2009. In the review, 27 Scheme members were required to submit an auditor's report. The results were satisfactory and no reporting error with a significant impact on the total contributions was noted. After the completion of the second review, 60 Scheme members, accounting for more than 90% of the relevant deposits, have had the accuracy of their returns verified by an auditor. This has provided a reasonable assurance over the correctness of the total amount of contributions payable by the industry.

Contribution paid by Scheme members by relevant deposits held

(in HK\$ million)



% of total	2009	2008	2007
Top 5	72%	70%	71%
Top 10	84%	84%	84%
Top 20	97%	96%	96%
Total	100%	100%	100%

Investment of the DPS Fund

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

As US dollar interest rates generally stayed above their Hong Kong dollar counterparts during the year, the Board switched most of the DPS Fund assets into US Treasury papers to fully capture the yield advantage offered by the US dollar assets. At the end of March 2009, cash and investment securities accounted for about 18% and 82% of the investment assets of the DPS Fund respectively, compared with 52% and 48%

a year ago. In terms of currency mix, the proportion of US dollar assets increased from 48% to 82% during the same period. However, the investment return of the DPS Fund fell along with the rapidly easing global interest rates. Nevertheless, the DPS Fund was able to achieve a positive return of 0.8% for the year (3.8% in 2007-08) despite the highly volatile market environment.

Mix of cash and investment of the DPS Fund (as at 31 March 2009)

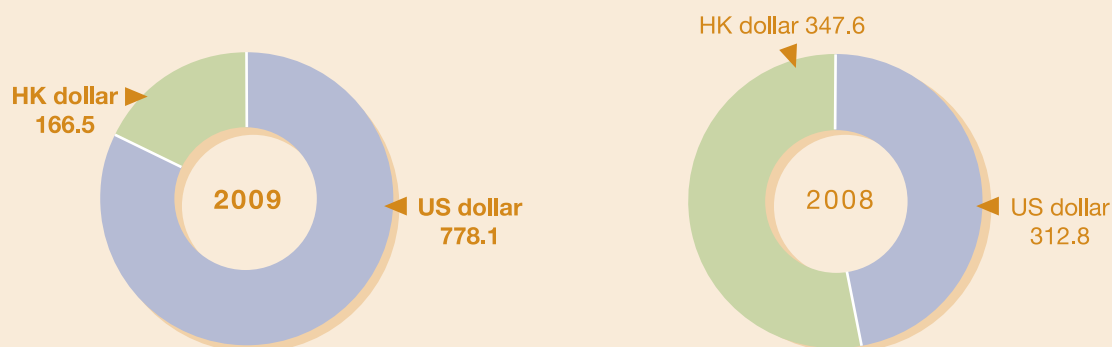
(in HK\$ million)	2009	2008
Cash and deposit balance*	168.9	347.6
Investment securities	775.7	312.8
Total	944.6	660.4

* Net of securities commitment payable

To improve the return on the DPS Fund, the Board sought the FS's approval to lengthen the investment horizon of the DPS Fund to include Exchange Fund Notes and US Treasury Notes of a tenor up to two years. Expansion of the investment scope was approved by the FS in December 2008. However, as the yield advantage of 2-year papers over the shorter term papers diminished with the easing in global interest rates during the year, no switching was made to the longer term papers. The Board also reviewed its investment policies and control procedures to accommodate the expansion in the investment scope of the DPS Fund.

Currency mix of cash and investments of the DPS Fund (as at 31 March 2009)

(in HK\$ million)



ENSURING ADEQUACY OF THE DPS COVERAGE

In response to changes and emerging trends in the operating environment, the Board initiated a review of the DPS to maintain and improve its effectiveness in protecting depositors and promoting banking stability. The first phase of the review, which focused on enhancing the coverage of the DPS, identified a number of improvements.

Enhancing deposit protection under the DPS

Since the onset of the US sub-prime mortgage crisis in August 2007, a number of countries have proposed reforms to their financial regulatory and deposit insurance regimes. In March 2008, the US Treasury released a blueprint for modernising its financial regulatory structure. In the UK, following a run on the Northern Rock bank in September 2007, the authorities commenced consultation on measures to reform the UK financial regulatory and deposit insurance arrangements in January 2008. The Financial Stability Forum, a prominent international forum of national financial regulators, central banks and international financial institutions, issued recommendations in April 2008 to enhance financial market and institutional resilience. This led to the development and consultation of a set of recommended core principles for effective deposit insurance systems by the Basel Committee on Banking Supervision of the Bank for International Settlements in March 2009. The European Parliament adopted a series of amendments to its directive governing deposit insurance schemes in the European Union in December 2008. Extraordinary measures, such as capital injections to banks and blanket deposit guarantees, were introduced by many countries in the second half of 2008 to combat the deepening crisis in global financial markets.

In Hong Kong, the HKMA published a consultancy report on its work on banking stability in July 2008. The report carries a number of recommendations in respect of the DPS. Towards the end of 2008, public attention to the security of their deposits at banks heightened amid the deepening global financial crisis. The unlimited protection offered by the blanket deposit guarantee introduced by the authorities and misunderstandings about the circumstances under which a deposit would fall outside the scope of the DPS protection triggered concerns in early 2009 about the coverage of the DPS.

Against this backdrop, the Board decided in mid-2008 to review the DPS. The first phase of the review commenced in the fourth quarter of 2008 and was completed in the first quarter of 2009 as scheduled. With reference to the reform experience in other countries and emerging international principles for deposit insurance, the review concluded that the existing design features of Hong Kong's DPS already complied substantially with international best practices. Nevertheless, in the light of the latest developments in overseas and local markets, the review made a number of recommendations to enhance coverage of the DPS.

As part of the review, the Board conducted a survey of major retail banks on the percentage of their depositors fully covered by the DPS under different protection limits. The survey revealed that the percentage of depositors in the industry fully covered by the DPS under the current limit might have dropped below 80%, the threshold set by the Board for reviewing the protection limit. The review therefore recommended lifting the limit from HK\$100,000 to HK\$500,000, bringing the percentage of depositors fully covered to above 90%. This will also bring the level of protection for depositors in Hong Kong close to the higher end of international benchmarks and in line with the level in major countries.

The review also observed that the public concern about the coverage of the DPS in early 2009 was mainly caused by misunderstandings over the circumstances under which a deposit becomes pledged and falls outside the protection of the DPS. To eliminate any potential for misunderstanding, which can erode the effectiveness of the DPS, the review recommended extending the scope of the DPS to cover secured deposits.

The recommendations on raising the DPS protection limit and expanding its scope to cover secured deposits will increase the amount of deposits protected by the DPS, and hence, the contributions payable by Scheme members. However, the Board is mindful of the cost impact on Scheme members because of the recommendations, which, if substantial, can increase the likelihood of being passed on to depositors. The review, therefore, recommended introducing cost mitigating measures to neutralise any cost implications resulting from the enhancements to the Scheme. The measures include halving the premium rates and allowing Scheme members to report protected deposits on a net deposit basis for the purpose of assessing contributions.

The recommendations from the first phase of the review were published for public consultation in late April 2009 with the consultation period ending in late June. The Board has since commenced the second phase of the review and intends to introduce the enhancements identified in both phases simultaneously, preferably before the end of 2010, so the public can benefit from an enhanced DPS when the blanket deposit guarantee expires.

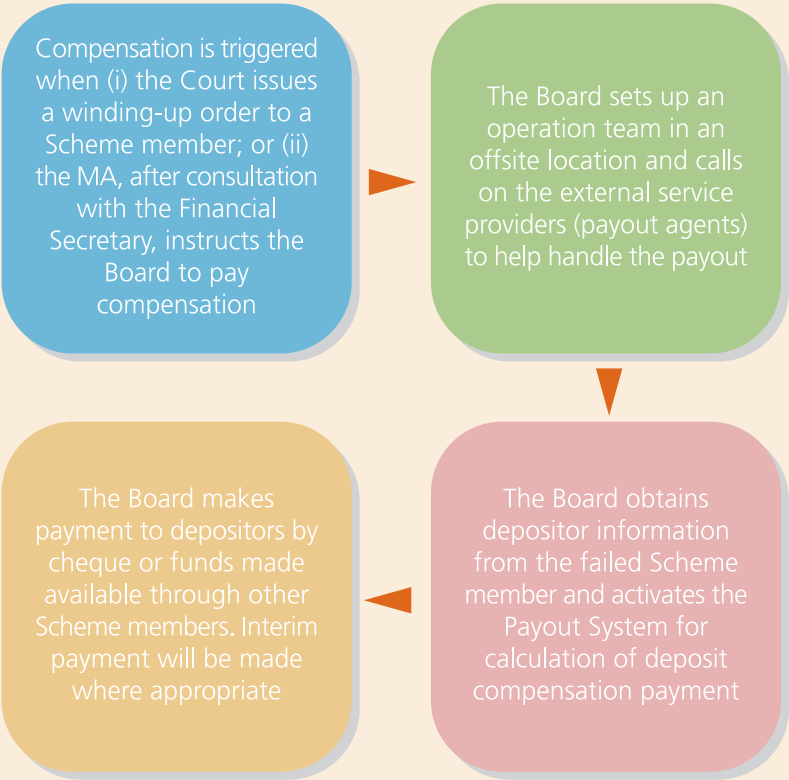
IMPROVING READINESS OF THE DPS TO PAYOUT

The Board continued to build on activities to enhance its payout readiness, concentrating its work on areas designed to allow the Board to better respond to the risks it may face if called upon to make compensation payments. These are described in more detail below.

Payout readiness

“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 illustrated by the Payout process diagram below, a number of elements need to be already in place for the Board to promptly begin, and expeditiously complete, a payout.

Payout process



As the Board uses 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 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. The procedures relate not only to manual processes performed during a payout, but also to the operation of the Board's computer system (the Payout System) that was developed to handle the volume of data and complex processing necessary to arrive at determinations of depositors' balances on which compensation payments are based.

Integral to payout readiness is the Guideline on Information Required for Determining and Paying Compensation (ISG) issued by the Board in 2006, 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. This ISG is necessary to ensure the Board can quickly use data from a failed Scheme member in its payout processing, as the Board will rely on those records in making its determinations of entitlement to compensation payments.

Improving payout policies, procedures and processes

With the knowledge gained through conducting simulations and payout rehearsals, as well as analysing international developments in deposit protection spurred by the global financial crisis, the Board continued its programme of updating payout procedures and enhancing its Payout System. During the year, the Board completed and tested enhancements to the Payout System that allow the Board to better anticipate the outcomes of different payout strategies, and improve the efficiency of the payout process in terms of data transformation, payment generation and interest calculation. More information on the calculation and payment status has been made available in the Payout System for responding to depositors' enquiries.

Second payout rehearsal

Building on the results from its first payout rehearsal and previous simulations, the Board conducted a second payout rehearsal in November and December 2008. The rehearsal tested the capabilities of the Board's payout agents to efficiently perform payout processes as a cohesive team. The format and scope of work was similar to



Members of the Payout Team started the rehearsal activities at the payout operation centre



Operators at the call centre responding to simulated enquiries

the previous rehearsal, since the Board engaged its second accounting firm to act as the Project Manager for the exercise. In preparing for the rehearsal, the payout agents were provided with training on payout processes and the use of the Payout System. This was followed by a complete payout (from beginning to end) involving providers of accounting, information technology, business recovery, security printing and call centre services. Additional procedures were performed to test the capabilities of the Payout System to handle payment generation under the blanket deposit guarantee offered by the government to prepare the Board for providing assistance in making compensation payments under the guarantee.

The payout agents completed the rehearsal within the expected time frame, performed their work within the pre-specified service standards, and met the objectives of the rehearsal. The Payout System also satisfactorily performed the necessary payment processes for the blanket deposit guarantee. Recommendations from the payout agents have been incorporated in the Board's plans for future changes to payout processes and documentation, and for Payout System enhancements.

Compliance with the ISG

With Scheme members having self-reported compliance with the ISG by the end of 2007, the Board commenced a compliance review programme in 2008 to verify members' levels of compliance. As indicated to Scheme members in the programme, the Board conducted six compliance reviews during the year using a risk-based approach to select Scheme members. The scope of each review covered verification of the correctness of the format, and the completeness and the accuracy in which the Scheme member made the required data available to the Board. Based on the reviews conducted so far, the compliance level has been generally satisfactory. For the non-conformity issues identified, Scheme members were requested to take remedial action and the Board would monitor the progress until the measures were completed.

The Board also took the opportunity during the compliance reviews to conduct simulation tests in which data, from three of the Scheme members under review, were processed on the Payout System. Payout processes and procedures were applied to test for specific simulated scenarios, such as incomplete depositor details and the determination of compensation related to different capacities of trust and client accounts. The simulations also served as part of a knowledge management process to maintain the readiness of Board personnel and payout agents to perform payouts.

As reported last year, the Board observed a number of interpretation issues of the ISG during previous simulation tests, compliance reviews and results from a survey on the information systems of Scheme members. Following consultations with the Consultative Committee on the Deposit Protection Scheme and the Hong Kong Association of Banks, the Board issued an amendment to the ISG and an Explanatory Note in March 2009. The amendment refines some of the requirements in the ISG to enhance payout efficiency, and the Note provides supplementary guidance to improve Scheme members' understanding of the ISG to promote compliance. The Board will monitor Scheme members' progress in achieving compliance with the amended requirements in accordance with the specified time frames.

MAINTAINING AND ENHANCING PUBLIC AWARENESS AND UNDERSTANDING

Promotion and public education

With advice from a professional public relations consultant and an advertising agency, the Board continued to conduct a wide variety of promotional and educational activities to maintain and enhance public awareness and understanding of the DPS. After successfully building up a satisfactory level of general awareness through the work in the past two years, the Board has shifted the focus of its publicity effort to enhancing public understanding of the Scheme's key features. In addition to utilising publicity material issued through traditional communications channels, the Board has explored new approaches to more effectively explain the relevant concepts of the DPS, for example, through seminars and drama performances.



Keeping the public awareness of the DPS on public transport



Table-mat advertising campaign promoting the DPS



The DPS message is spread through cyberspace



Community outreach programmes: seminars by the Board's personnel, drama performances and roving exhibitions to promote the DPS

In response to the deepening global financial crisis, the Board adjusted its publicity plan and stepped up its publicity effort since the third quarter of 2008 to address the growing concern of members of the public about the security of their bank deposits and to help reinforce confidence in the banking system.

Local sentiment in the financial market deteriorated notably after the collapse of US investment bank Lehman Brothers and a small-scale run on a local bank in September 2008. In mid-October, the authorities introduced a blanket deposit guarantee to help reinforce confidence and maintain banking stability. The guarantee fully protects deposits held with all authorized institutions in Hong Kong in excess of the portion covered by the DPS, until the end of 2010. Shortly afterwards, the Board launched a modified TV Announcement in the Public Interest (API) and an updated information leaflet to assist in enhancing the effectiveness of the measure and to explain the co-existence of the government guarantee and the DPS.



A new API is released on full deposit protection



Updated campaign message for educational purposes

In early 2009, a spate of concerns over the coverage of the DPS was observed. The concerns were probably triggered by the introduction of the guarantee, which offered unlimited protection in line with DPS principles, and worries about the security of bank deposits. In collaboration with the HKMA, the Board launched a focused publicity campaign highlighting and explaining the coverage of the DPS. The campaign included a new TV API, printed advertisements, media releases and a feature article by the CEO in newspapers. Arrangements were also made to distribute about eight million copies of an updated information leaflet to bank customers as an insert with their statements starting from March 2009.



Scenes from the new TV API



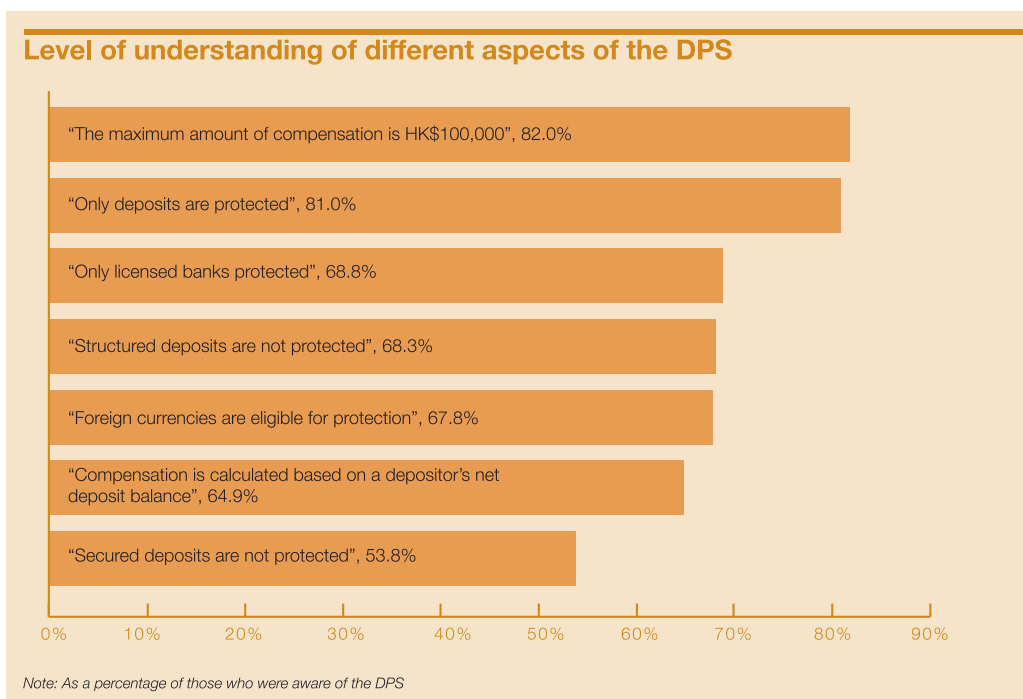
A full page newspaper advertisement explains coverage of the DPS

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

Effectiveness of the publicity campaign

To monitor whether the Board's communications objectives had been met and to identify improvements for the publicity plan, an independent research agency was engaged to conduct two Hong Kong-wide opinion surveys on the DPS in June and December 2008.

Based on the surveys' findings, the general level of public awareness of the DPS improved to over 75% in December 2008 from about 70% a year earlier. There were notable improvements in the level of public understanding of the DPS' key features, for example, the percentage of respondents knowing foreign currency deposits are protected jumped to 67.8% from 30.4% a year ago. This improvement might be partly explained by the heightened public interest in the DPS following the introduction of the blanket deposit guarantee and partly by the more focused publicity effort by the Board.



DPS membership and product representations

Since the DPS commenced operation in 2006, Scheme members must observe the requirements in a set of statutory rules (Representation Rules) on how they should disclose their DPS membership 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 second self-assessment review, covering the period from 1 October 2007 to 30 September 2008, was completed in early 2009. According to the self-assessment reports received by the Board, the overall compliance level of all Scheme members was satisfactory.

Following the introduction of the blanket deposit guarantee by the authorities, the Board shared its experience in developing and implementing the Representation Rules with the HKMA to facilitate the HKMA in formulating and promulgating a statutory guideline on the representation requirements for the guarantee. Under the statutory guideline issued by the HKMA, all authorized institutions are required to practise disclosures in respect of the guarantee similar to those applicable to the DPS. The application of these uniform disclosure standards has been helpful in enhancing clarity and confidence in the two deposit protection arrangements.

香港特別行政區政府外匯基金對存放在[認可機構名稱]超過存款保障計劃保障額的合資格存款提供償還擔保，直至2010年底。

The repayment of eligible deposits in excess of the amount protected under the Deposit Protection Scheme taken by [name of authorized institution] is guaranteed by the Hong Kong SAR Government's Exchange Fund, until the end of 2010.

The deposit guarantee sign displayed by Scheme members next to the DPS Membership sign

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 and 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, especially in areas common to the operation of the DPS and the blanket deposit guarantee introduced by the authorities.

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) have agreed on a set of arrangements on co-ordination and exchange of information between the parties. The detailed arrangements have been 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. Specifically, the MoU 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.

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, its member deposit insurers and other international organisations to exchange knowledge and ideas on issues relevant to deposit protection in an international context. In 2008-09, Board personnel took part in a number of international meetings including:

- the 2008 Financial Stability Institute and the Executives' Meeting of East Asia-Pacific Central Banks Seminar in Seoul, South Korea;
- the IADI 7th Annual Conference and Annual General Meeting in Washington, USA;



- the Deposit Insurance Corporation of Japan 4th Round Table in Tokyo, Japan;



Manager Eve Law (fifth from left, second row) at the Deposit Insurance Corporation of Japan 4th Round Table in Tokyo

- an audit and control workshop organised by the Malaysia Deposit Insurance Corporation in Kuala Lumpur, Malaysia;
- the 7th Asia Regional Committee Annual Meeting of IADI and International Conference in Almaty, Kazakhstan; and



Manager Teresa Lai (seventh from left, second row) at the 7th Asia Regional Committee Annual Meeting and International Conference of IADI in Almaty

- a course organised by the South East Asian Central Banks Research and Training Centre and the Malaysia Deposit Insurance Corporation in Kuala Lumpur, Malaysia



Payout Director Gregory Zimnicki (middle) is a guest speaker at the event

To share the Board's experience in conducting payout simulations and to promote international co-operation and knowledge sharing among deposit insurers, the Board received delegates from the Jamaica Deposit Insurance Corporation in March 2009.



Payout Director Gregory Zimnicki (middle) with representatives from the Jamaica Deposit Insurance Corporation