

### OUR OPERATING ENVIRONMENT

The Hong Kong economy, for the first time in over a decade, dipped into recession in 2009 in the aftermath of the financial tsunami, with real GDP contracting by 2.7%. Nevertheless, the economy quickly bottomed out towards the end of the year as economic activity picked up amid signs of improvement in major developed economies. Nevertheless, considerable uncertainty has remained over the pace and impact of the withdrawal of unconventional rescue measures introduced by central banks worldwide at the height of the financial tsunami.

The banking sector of Hong Kong, which has demonstrated a strong resilience to the negative spillover of overseas financial woes, remained stable in 2009. The capital position of banks strengthened. Deterioration in loan quality was much milder than expected. Delinquency ratios remained at a low level compared with historical standards. Statistics released by the HKMA show the aggregate pre-tax operating profits of retail banks' Hong Kong offices rebounded by 14.9% in 2009. The post-tax return on average assets increased, to 0.98% in 2009 from 0.88% a year ago. The classified loan ratio increased mildly to 1.35% from 1.24% at the end of 2008, which was still at a relatively low level compared with historical figures. Retail banks generally remained liquid with the quarterly average liquidity ratio standing at 47.8% in the final quarter of 2009, well above the statutory minimum of 25%. The consolidated capital adequacy ratio of locally incorporated authorized institutions rose to 16.9% at the end of 2009 from 14.7% a year earlier. Tier-1 capital ratio increased to 12.9% in 2009 versus 11.0% in 2008.

On the back of the subsiding concern about the health of the banking sector, which has probably been helped by the availability of the full deposit guarantee provided by the Government, the Board could focus its efforts on strengthening the DPS as part of the financial safety net in Hong Kong. Significant progress was made by the Board on reviewing the DPS and initiating the enhancement process. Meanwhile, the Board continued to ensure the efficient and effective operation of the DPS under its existing framework.

### Profile of Scheme Members

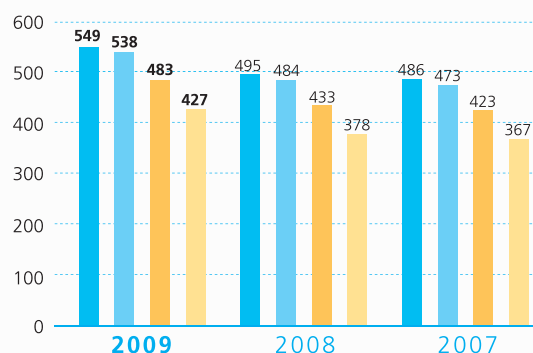
At the end of March 2010, there were 145 Scheme members, compared with 140 a year ago. During the year, seven new members joined, one of which was upgraded from a restricted licence bank to a licensed bank; two ceased to be members because of organisational restructuring and streamlining of operations. Of the 145 Scheme members, 23 are locally incorporated banks and 122 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 2009, the total amount of relevant deposits in the industry continued to grow, expanding to HK\$549 billion from HK\$495 billion a year earlier. On the back of strong inflows of funds into Hong Kong, the growth rate (at 11%) was much higher than the 2% increment recorded in 2008. As in previous years, the top 20 members by size of relevant deposits are all retail banks, accounting for more than 95% of the total relevant deposits in the industry.

Statistics show that large retail banks recorded a much higher growth of relevant deposits (at 12%) compared with their small to medium-sized counterparts (at 6%). Nevertheless, the split of relevant deposits among the retail banks remained stable: 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 Scheme members

(in HK\$ billion)



% of total	2009	2008	2007
Top 5	78%	76%	76%
Top 10	88%	87%	87%
Top 20	98%	98%	98%
Total	100%	100%	100%

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

(in HK\$ billion)	2009	2008	±%
Large retail banks	480.2	430.6	12%
Small to medium-sized retail banks	58.8	55.4	6%

## ADMINISTRATION OF THE DPS

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

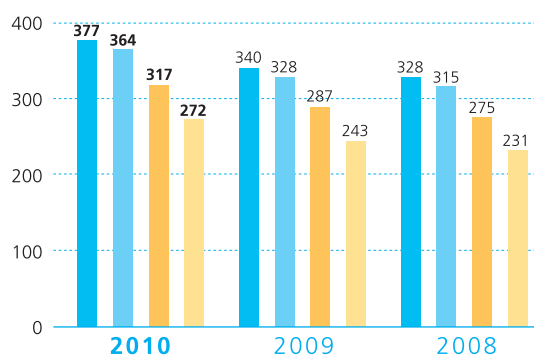
### Assessment and Collection of Contributions

The Board assessed and collected HK\$377 million in contributions from Scheme members in 2010, representing an increase of 11% from the HK\$340 million collected in 2009. Similar to the distribution of relevant deposits, over 95% of the total contributions were collected from the top 20 Scheme members. The distribution pattern has been stable since the DPS commenced operation. All contributions were paid by Scheme members on time in January 2010.

The contribution payable by a Scheme member each year is assessed by the Board based on an annual return submitted by the member. In order to ensure the accuracy of the figures reported by Scheme members in their returns, the Board continued to review auditors' reports submitted by Scheme members for certifying the correctness of their returns, as required by a policy introduced by the Board in 2007. In 2009, 34 Scheme members were required to submit an auditor's report. The results of the review were satisfactory and no reporting error having a material impact on the total amount of contributions was noted. After the completion of the review, more than 90 Scheme members, accounting for about 95% of relevant deposits in the industry, have had the accuracy of their returns verified by an auditor. This has provided a strong 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	2010	2009	2008
Top 5	72%	72%	70%
Top 10	84%	84%	84%
Top 20	97%	97%	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 clear guidelines on the risk assessment and control measures, and the segregation of duties required for the investment activities.

As US dollar interest rates continued to stay above their Hong Kong dollar counterparts during the year, the Board switched most of the assets of the DPS Fund into US Treasury papers and US dollar deposits to take full advantage of the yield enhancement offered by US dollar assets. This brought the share of US dollar assets in the DPS Fund up to 90% at the end of March 2010. In terms of investment mix, cash and investment

securities accounted for about 40% and 60% of the DPS Fund respectively, compared with 20% and 80% a year ago. The investment return of the DPS Fund edged lower with the easing in global interest rates. The DPS Fund achieved an investment return of 0.6% for the year (0.8% in 2008-09).

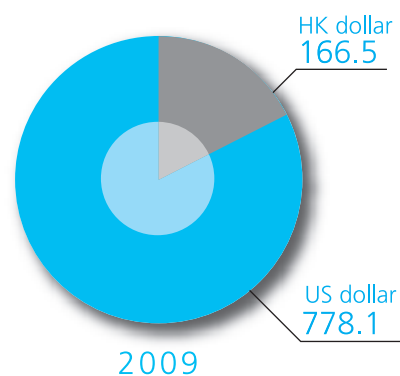
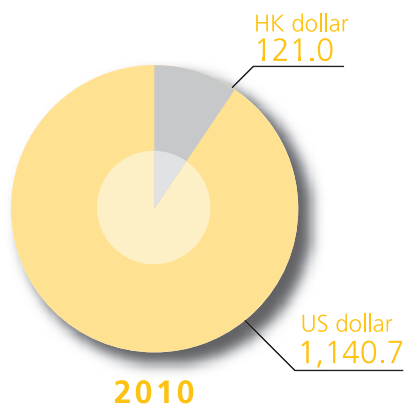
### Mix of cash and investments of the DPS Fund (as at 31 March)

(in HK\$ million)	2010	2009
Cash and deposit balance*	<b>479.1</b>	168.9
Investment securities	<b>782.6</b>	775.7
Total	<b>1,261.7</b>	944.6

\* Net of securities commitment payable

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

(in HK\$ million)



### ENSURING ADEQUACY OF THE DPS COVERAGE

#### Enhancement of the DPS

The Board completed the review of the DPS that commenced in the fourth quarter of 2008 and the consultation on the findings of the review in two phases. After completing the review in each phase, the Board published a consultation paper on the findings and the recommendations from the review. The consultation papers for the first and second phases of the review were issued in April and August 2009, respectively. After collecting and analysing the comments received from the public and various stakeholder groups, the Board published a consultation report to conclude each phase of the review. The consultation reports for the two phases of the review were issued in August and November 2009, respectively.

The review concluded that the existing design features of the DPS in Hong Kong were already in substantial compliance with international best practice. Nevertheless, a number of enhancements to the DPS were identified to address the latest developments in international and local financial markets, especially to meet heightened public expectation for better deposit protection. Enhancements concluded in the first phase of the review focused on improving deposit protection and mitigating the cost of providing better protection. Enhancements in the second phase, on the other hand, focused on expediting the payout process and enhancing transparency of the DPS coverage.

Keen responses and wide public support were registered during the consultation on the review's findings and recommendations. As a result, the Board decided to proceed with the implementation of the recommendations. The Board assisted the Department of Justice (DoJ) in completing the drafting of an amendment bill, the Deposit Protection Scheme (Amendment) Bill 2010 (the Bill), for amending the DPS Ordinance to give effect to the recommendations on improving deposit protection, mitigating the cost of providing the additional protection and improving payout efficiency. The Bill was introduced into the LegCo in April 2010. The Board also assisted the DoJ in drafting legislative amendments to implement the remaining recommendations concluded in the review, mainly those for enhancing transparency of the DPS coverage concluded in the second phase of the review. These amendments will be promulgated in the form of subsidiary legislation and will be submitted to LegCo for negative vetting after the Bill is passed. Subject to the completion of the relevant legislative processes, all the enhancements are expected to take effect on 1 January 2011, immediately after the expiry of the Government's full deposit guarantee at the end of 2010.

## Enhancement of the DPS – Summary of recommendations

### 1. Providing better deposit protection

- Raising the DPS protection limit from HK\$100,000 to HK\$500,000
- Expanding DPS coverage to protect secured deposits

### 2. Eliminating the potential for cost transfer

- Reducing the rates for charging annual contributions on Scheme members and the total amount of contributions relative to the total amount of protected deposit in the industry, that is, the target size of the DPS Fund
- Allowing Scheme members to report protected deposits on a net basis for contribution assessment purposes
- Aligning priority claims for depositors in bank liquidations to protection under the Scheme to ensure the Scheme can continue to fully recover the compensation it pays to depositors

### 3. Facilitating the Board to make fast payment

- Empowering the Board to make reasonable estimate of values relevant for compensation determination but are uncertain at the time of a payout
- Empowering the Board to make different amounts of interim payment to different depositors to expedite the payout process
- Allowing the Board's businesses to be conducted by electronic means to ensure that time-critical decisions in a payout can be dealt with promptly

### 4. Improving transparency of the DPS coverage

- Revising existing disclosure rules and making additional ones to enhance the DPS representation regime, including rules to improve negative disclosures, introduce positive disclosures and impose requirements on the prominence of disclosures and restrictions on the description of deposit products

## Popularity of structured deposits

In addition to enhancing the coverage of the DPS through the DPS review, the Board continued to pay close attention to market developments that may have an impact on the adequacy of its coverage. The Board conducted a survey in December 2009 to monitor the popularity of structured deposits and assess whether it is necessary to bring them under the protection of

the DPS, with reference to the existing protection limit of HK\$100,000 as well as the new limit of HK\$500,000. The findings were similar to those of the 2007 survey, concluding that structured deposits were not popular among small depositors and the percentage of depositors holding various structured deposits remained well below the quantitative benchmarks set for reviewing the protection status of such products.

### ENSURING READINESS OF THE DPS TO PAYOUT

As part of a continuous programme to improve the Board's capacity to make accurate and fast compensation payments, a number of tasks were

undertaken during the year to enhance – (a) its payout processes and technology resources; (b) its co-ordination with other financial safety net players; (c) the knowledge and abilities of its payout agents; and (d) the reliability of the data to be obtained from a failed Scheme member.

#### Background on 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. The Board regularly undertakes activities to ensure the elements as described in the following Payout Process diagram are sufficiently developed and can operate effectively.

#### Payout Process

Compensation is triggered when (i) the Court issues a winding-up order to a Scheme member, or (ii) the MA, after consultation with the Financial Secretary, instructs the Board to pay compensation

The Board sets up an operation team in an offsite location and calls on the external service providers (payout agents) to help handle the payout

The Board obtains depositor information from the failed Scheme member and activates the Payout System for calculation of deposit compensation payment

The Board makes payment to depositors by cheque or funds made available through other Scheme members. Interim payment will be made where appropriate

The Board makes use of a virtual organisation of external service providers (collectively referred to as payout agents) to assist in the calculation and payment of compensation to depositors in the event of a payout, so it ensures 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 high 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 and amended in 2009, which provides directions to Scheme members on how data in 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 the Board will rely on those records obtained in making its determinations of entitlement to compensation payments.

### **Compliance with the ISG**

The Board continued its compliance review programme to verify Scheme members' compliance with the ISG. Six compliance reviews were conducted during the year. The scope of each review covered verification of the correctness of the format, and the completeness and accuracy in which the Scheme member made the required data available to the Board. The compliance levels of the Scheme members reviewed were generally satisfactory. Scheme members were required to provide remedial action plans on any variances from the ISG specifications identified in the review.

Amendments to the ISG and an explanatory note were issued in March 2009 to refine some of the requirements in the ISG to enhance payout efficiency, and to provide supplementary guidance to improve Scheme members' understanding of the ISG to promote compliance. The Board has been monitoring Scheme members' progress on achieving compliance

with the amended ISG by regular surveys. The progress has been satisfactory with most Scheme members having reported to have met the amended requirements. Full compliance is required by July 2010.

### **Payout Rehearsal and simulation tests**

Having satisfied itself during the previous rehearsals that its payout agents have sufficient knowledge of payout processes and can perform payout procedures as a well-organised team, the Board conducted its third payout rehearsal in November and December 2009 with a narrower focus. The rehearsal objectives concentrated on testing processes and procedures relevant to making an interim payment within 14 calendar days under realistic payout conditions. Included in these processes were several proposed protocols for co-ordination with the HKMA and the Manager appointed to take control of the failed Scheme member.

The results of the rehearsal were satisfactory and gave the Board confidence that an interim payment could be performed within 14 days in a real payout situation. Recommendations from the payout agents arising from the rehearsal have been applied to work plans for future enhancements to payout procedures and the Payout System, as well as to the protocols for discussion with the HKMA.

Information received from Scheme members on the ISG compliance review was also used for conducting simulation tests to maintain the readiness of Board personnel and payout agents to payout. The Board increased the number of simulation tests conducted during the year from three to six. The simulation tests increased the Board's confidence level that it can rely on, and promptly utilise, data provided by Scheme members for compensation determinations.

### **Updating payout policies, procedures and processes**

Building on its experience from previous simulations and rehearsals, and changes in the landscape arising from the global financial crisis, the Board reviewed its payout policies, procedures and processes. The Board continued to monitor key market developments to ensure its payout processes remained relevant in meeting the changing expectations of stakeholders. Based on this review and previous plans, changes were made to streamline payout procedures and workflows. Areas were also identified for improving operational efficiency, notably interest and principal valuations and differential treatment of depositors in making interim payments, resulting in proposed amendments to the DPS Ordinance in the review of the DPS.

The Board also progressed on the development of protocols with the HKMA on activities prior to, at the time of, and following the triggering of the making of a compensation payment, to give greater confidence that the various financial safety net players in the failure of a Scheme member will act in a co-ordinated and consistent manner.

## MAINTAINING AND ENHANCING PUBLIC AWARENESS AND UNDERSTANDING

### Promotion and public education

With advice of a professional public relations consultant and an advertising agency, together with the support of various government departments, private and public organisations, the Board conducted promotional and educational activities to maintain and enhance public

awareness and understanding of the deposit protection arrangement in Hong Kong, covering the DPS and the full deposit guarantee provided by the Government. The message was communicated through different channels, including conventional media such as TV and newspapers, and interactive approaches like drama performance, to ensure it could reach the intended recipients.



DPS educational comics published in newspapers



Community outreach programmes: roving exhibitions by student ambassadors and drama performances by professional artists

# REPORT ON ACTIVITIES IN 2009-2010

Apart from ongoing publicity activities to maintain general awareness and understanding, the Board rolled out targeted activities in the second and third quarters of 2009 to draw public attention to the consultation exercise on the results and recommendations of the first and second phases of the DPS review, respectively.

Multiple communication channels, involving TV, newspaper, internet, public transport and roving exhibitions, were employed to invite public participation in the consultation. Public comments were also collected through the DPS enquiry hotline.



TV commercials encourage the public to express views and to announce the completion of the consultation



Full-page newspaper advertisements invite comments from the public



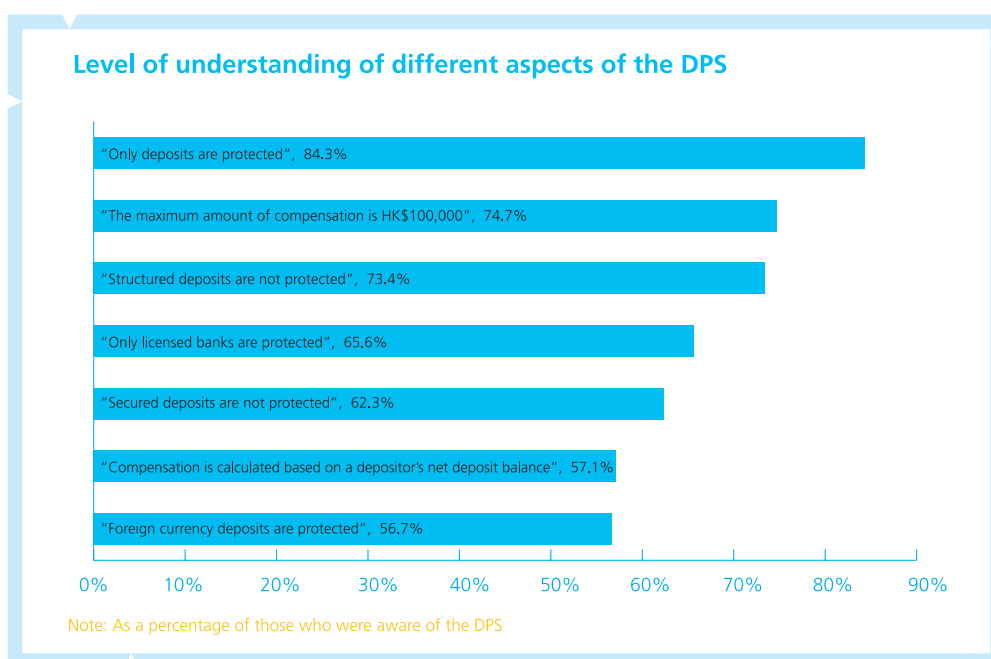
Weekly roving exhibitions inspire participation in the DPS review consultation process

A list of major promotional and educational activities is at Annex 2.

## Effectiveness of the publicity campaigns

Since the DPS commenced operation in 2006, the Board has engaged an independent research agency to conduct half-yearly opinion surveys to measure the level of public awareness and understanding of the DPS, and to assess the effectiveness of its publicity campaigns.

According to the findings of the survey in December 2009, general public awareness of the DPS continued to stand at a satisfactory level of about 70%. Improvements were seen in the understanding of certain key features of the DPS, for example, the fact that structured deposits and secured deposits are not protected by the DPS. The Board would continue to make use of the findings of the surveys to enhance its future communications and publicity strategies.



## DPS membership and product representations

Since the launch of the DPS, Scheme members have had to observe the requirements set out in a set of statutory rules on how to disclose their DPS membership status and the protection status of their financial products to the public. To monitor Scheme members' compliance with the relevant requirements, the Board started collecting and reviewing self-assessment reports from Scheme members in 2007. The review exercise conducted in 2009, covering the compliance status of Scheme members during the

period from 1 October 2008 to 30 September 2009, was completed in early 2010. The findings shared by the HKMA on its on-site examinations of authorized institutions' compliance with representation requirements on the full deposit guarantee has also helped the Board in monitoring Scheme members' compliance with the requirements applicable to the DPS. The results of the self-assessment exercise and the findings shared by the HKMA indicate that the overall compliance level of Scheme members was satisfactory.

### 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 full deposit guarantee provided by the Government.

#### 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 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 2009-2010, the Board's personnel took part in a number of international meetings including:

- the IADI 8th Annual Conference and Annual General Meeting in Basel, Switzerland;
- a seminar on claims management organised by Malaysia Deposit Insurance Corporation and IADI in Kuala Lumpur, Malaysia;



Manager Pierre Leung (fifth from right, third row) at the seminar in Kuala Lumpur, Malaysia

- the 8th Asia Regional Committee Annual Meeting and International Conference of IADI in Goa, India;

- a seminar on cross border banking resolution issues organised by Financial Stability Institute and IADI in Basel, Switzerland;
- the 5th Round Table meeting hosted by the Deposit Insurance Corporation of Japan in Tokyo, Japan; and



Former CEO Raymond Li is a guest speaker of the event

- a conference on strengthening deposit insurance system in crisis and post crisis situations organised by the Philippine Deposit Insurance Corporation and IADI in Cebu, Philippines.



Senior Manager Anita Chan (first from right, third row) at the conference in Cebu, Philippines