

**AN EFFECTIVE RESOLUTION REGIME FOR
FINANCIAL INSTITUTIONS IN HONG KONG**

**SECOND CONSULTATION PAPER
CONCLUSIONS FROM FIRST CONSULTATION AND
FURTHER POLICY DEVELOPMENT**

Jointly published by the Financial Services and the Treasury
Bureau, the Hong Kong Monetary Authority, the Securities and
Futures Commission and the Insurance Authority

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ABOUT THIS DOCUMENT

1. This consultation paper is published by the Financial Services and the Treasury Bureau of the Government of the Hong Kong Special Administrative Region, in conjunction with the Hong Kong Monetary Authority, the Securities and Futures Commission and the Insurance Authority.
2. It provides: (i) responses to submissions received in respect of certain of the proposals contained in the first consultation paper on establishing an effective resolution regime for financial institutions in Hong Kong, which was launched in early 2014; and (ii) further details on various issues (including those identified in the first consultation paper) central to the establishment of such a regime.
3. After considering the submissions received in response to this second consultation paper, and further expected developments at the international level, the Government intends to further refine its proposals, and considers that it may be necessary to undertake a shorter third stage consultation ahead of introducing a Bill into the Legislative Council by end-2015.
4. A list of the questions raised in this consultation is set out for ease of reference in Annex V. Interested parties are invited to submit comments on these and any relevant or related matters that may have a significant impact on the proposals in this consultation paper.
5. Comments should be submitted in writing no later than 20 April 2015, by any one of the following means:-

By mail to: Resolution Regime Consultation
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 Financial Services and the Treasury Bureau
 24/F, Central Government Offices
 2 Tim Mei Avenue, Tamar, Hong Kong

By fax to: +852 2856 0922

By email to: resolution@fstb.gov.hk

6. Any person submitting comments on behalf of any organisation is requested to provide details of the organisation they represent.
7. Submissions will be received on the basis that any of the Financial Services and the Treasury Bureau, the Hong Kong Monetary Authority, the Securities and Futures Commission and the Insurance Authority may freely reproduce and publish them, in whole or in part, in any form; and may use, adapt or develop any

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8. Please note that the names of respondents, their affiliation(s) and the contents of their submissions may be published or reproduced on the Financial Services and the Treasury Bureau's website (or the websites of the Hong Kong Monetary Authority, the Securities and Futures Commission or the Insurance Authority (i.e. the website of the Office of the Commissioner of Insurance)) and may be referred to in other documents published by the authorities. If you do not wish your name, affiliation(s) and/or submissions to be disclosed, please state this clearly when making your submissions.
9. Any personal data submitted will only be used for purposes which are directly related to this consultation. Such data may be transferred to other Government departments/agencies for the same purposes. For access to or correction of personal data contained in your submissions please contact:

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10. Terms adopted in this consultation paper are used in a generic sense to reflect the concepts underpinning the proposals in question, unless the context otherwise provides. When the relevant proposals are implemented in the form of legislation, it is possible that these terms may be modified or replaced in order to better reflect the precise policy intent of the proposals in the law or to aid or address issues relating to the legal interpretation of such terms when used in the law.

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ABBREVIATIONS

AI	Authorized institution
AMV	Asset management vehicle
AOE	Affiliated operational entity
BAU	Business as usual
BCBS	Basel Committee on Banking Supervision
BO	Banking Ordinance (Cap. 155)
BoE	Bank of England
BRRD	Bank Recovery and Resolution Directive (of the European Union)
BRT	Banking Review Tribunal
CCP	Central counterparty
CEO	Chief Executive Officer
CO	Companies Ordinance (Cap. 622)
COAG	Institution-specific cross-border cooperation agreement
CP1, CP2, CP3	First stage, second stage and third stage consultation papers
CSSO	Clearing and Settlement Systems Ordinance (Cap. 584)
CWUMPO	Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32)
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act
DPS	Deposit Protection Scheme (of Hong Kong)
D-SIFI	Domestic systemically important financial institution
DTC	Deposit-taking company
EU	European Union
FIs	Financial institutions (including financial market infrastructures unless the context otherwise requires)
FMI	Financial market infrastructures
FS	Financial Secretary
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSHC	Financial services holding company
FSTB	Financial Services and the Treasury Bureau
G-SIB	Global systemically important bank
G-SIFI	Global systemically important financial institution
G-SII	Global systemically important insurer
HC	Holding company
HKMA	Hong Kong Monetary Authority
IA	Insurance Authority
IAIG	Internationally active insurance group

IAIS	International Association of Insurance Supervisors
IAT	Insurance Appeals Tribunal
ICF	Investor Compensation Fund
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
KAAM	(Draft) Key Attributes Assessment Methodology
LB	Licensed bank
LC	Licensed corporation
LegCo	Legislative Council
LIFSHC	Locally incorporated financial services holding company
LIHC	Locally incorporated holding company
LoLR	Lender of last resort
LRA	Lead resolution authority
MA	Monetary Authority
MAHC	Mixed activity holding company
MOU	Memorandum of understanding
MPE	Multiple point of entry (resolution strategy)
NBNI FI	Non-bank non-insurer financial institution
NBNI G-SIFI	Non-bank non-insurer G-SIFI
NCWOL	No creditor worse off than in liquidation
OLF	Orderly Liquidation Fund
OTC derivatives	Over-the-counter derivatives
PPF	Policyholders' Protection Fund
RCT	Resolution Compensation Tribunal
RI	Registered institution
RLB	Restricted licence bank
SFAT	Securities and Futures Appeals Tribunal
SFC	Securities and Futures Commission
SFO	Securities and Futures Ordinance (Cap. 571)
SIFI	Systemically important financial institution
SPE	Single point of entry (resolution strategy)
SPM	Supervisory Policy Manual
SRR	Special Resolution Regime of the United Kingdom
TLAC	Total loss absorbing capacity
TPO	Temporary public ownership
UK	United Kingdom
US	United States of America

INTRODUCTION

1. On 7 January 2014 the Financial Services and the Treasury Bureau of the Government (“FSTB”), in conjunction with the Hong Kong Monetary Authority (“HKMA”), the Securities and Futures Commission (“SFC”) and the Insurance Authority (“IA”) (together “the authorities”), launched a first stage consultation paper (“CP1”) setting out proposals for legislative reform to implement an effective resolution regime for financial institutions (“FIs”) in Hong Kong.¹ This reform is needed to strengthen the options available to the authorities for dealing with a crisis situation in which a systemically important FI fails, posing a threat to the continuity of critical financial services and financial stability.
2. The severity of the recent global financial crisis has helped to forge broad international consensus on the essential features that effective resolution regimes for FIs should have. As explained in CP1, this consensus led to new international standards being set by the Financial Stability Board (“FSB”) in its Key Attributes of Effective Resolution Regimes for Financial Institutions (“Key Attributes”).² CP1 outlined the legislative changes that would be needed to bring Hong Kong’s existing arrangements in line with the standards set out in the Key Attributes. Since then, the International Monetary Fund (“IMF”) has also identified that there is a strong case for reform after undertaking its own assessment of Hong Kong’s crisis management arrangements as part of its Financial Sector Assessment Program (“FSAP”).³

¹ See FSTB, HKMA, SFC and the IA (January 2014), “An Effective Resolution Regime for Financial Institutions in Hong Kong”, http://www.fstb.gov.hk/fsb/ppr/consult/resolution_e.pdf

² See FSB (2011), Key Attributes of Effective Resolution Regimes for Financial Institutions, http://www.financialstabilityboard.org/publications/r_111104cc.pdf. In October 2014 the FSB reissued the Key Attributes to include four new Annexes including guidance on their application to non-bank FIs. See Footnote 4 for reference.

³ See IMF (2014), People’s Republic of China – Hong Kong Special Administrative Region: Financial Sector Assessment Program – Crisis Management and Bank Resolution Framework – Technical Note, <https://www.imf.org/external/pubs/ft/scr/2014/cr14209.pdf> and IMF (2014), People’s Republic of China – Hong Kong Special Administrative Region: Financial System Stability Assessment, <https://www.imf.org/external/pubs/ft/scr/2014/cr14130.pdf>

3. In the absence of an effective resolution regime, and as outlined in CP1, if a systemically important FI were to fail, the authorities would face a difficult choice between allowing it to enter into liquidation with the attendant widespread disruption this would cause, or deploying and risking considerable sums of public money to secure continuity of critical financial services and protect financial stability through bailing-out the FI (and its shareholders and creditors). An effective resolution regime would provide an alternative means of protecting the customers relying on the critical financial services provided by a failing FI as well as containing the potential for contagion to other parts of the financial system.
4. As outlined in CP1, it is proposed that the authorities responsible for operating the regime be required to ensure that a range of stakeholders (including customers and ordinary employees) of a failing FI resolved under the regime, obtain an outcome at least equal to that which they would have received had the FI instead entered liquidation. Under the regime, the costs of failure (and resolution) could be imposed more effectively on the owners – that is the shareholders – and some of the unsecured creditors of the failing FI. The regime would also better support a coordinated approach to resolution between the Hong Kong authorities and their counterparts overseas in the event that a failing FI operates in multiple jurisdictions.
5. Following a three-month consultation period, 33 submissions were received in response to CP1 from a range of stakeholders including FIs and their trade associations, as well as accountancy and legal practitioners (a list of respondents is set out in Annex I). The authorities note that an overwhelming majority of respondents to CP1 (“respondents”) indicated that reform was important both in the local and cross-border context. Much of the feedback received focused on the specific questions raised in CP1 on how to most effectively provide for a resolution regime which meets both local requirements and international standards. The responses received have been carefully reviewed and their content taken into consideration in the further refinement and development of the proposals for the local resolution regime as summarised in this second stage consultation paper (“CP2”).

6. The authorities are mindful of the need to progress the necessary legislative reform in a timely manner. The FSB has indicated that its member jurisdictions should seek to meet the standards set out in the Key Attributes by the end of 2015. The IMF also recommended in its FSAP report that the Government of the Hong Kong Special Administrative Region should “[c]ontinue efforts to develop a comprehensive resolution regime, in line with emerging international good practices” and indicated that this was a short-term priority (i.e. over an 18-month time horizon). As such, the authorities have decided to issue CP2 at this time notwithstanding that work continues at the FSB on certain aspects of resolution, particularly in a cross-border context. The authorities consider that there may therefore be a need for a third, shorter, consultation covering particular issues in light of the FSB’s ongoing work on certain aspects of resolution, the recently issued guidance in respect of the application of the Key Attributes to non-bank FIs,⁴ and, possibly, issues arising from submissions to this CP2. An indicative list of some of the issues the authorities would expect to address in a third consultation exercise is:

- further details on how the “bail-in” resolution option will work, potentially including local implementation of the FSB’s framework for total loss absorbing capacity (“TLAC”);
- mechanisms for the recognition of cross-border resolution actions and effective cross-border co-ordination;
- expanded proposals on how any costs of resolution should be funded;
- the protection of client assets⁵ in resolution.

⁴ In October 2014 the FSB reissued the Key Attributes, incorporating guidance on their application to non-bank FIs. While the Key Attributes issued by the FSB in 2011 (see Footnote 2 for reference) remain unchanged, they are now complemented by four new annexes: (i) Resolution of Financial Market Infrastructures (FMIs) and FMI Participants; (ii) Resolution of Insurers; (iii) Client Asset Protection in Resolution; and (iv) Information Sharing For Resolution Purposes. See FSB (2014), http://www.financialstabilityboard.org/wp-content/uploads/r_141015.pdf

⁵ As noted in CP1 “[u]nder the SFO, client assets are defined, broadly speaking, as securities, collateral and money that are entrusted to or received by an LC or AI on behalf of its client. The framework under which they are protected may be described as being a “trust regime” whereby “client securities”

CHAPTER 1 – SCOPE OF THE RESOLUTION REGIME

This chapter sets out the authorities' proposals regarding the scope of the resolution regime in Hong Kong. It covers:

- the provision of a common framework for resolution (i.e. a single regime for FIs in different sectors of the financial system);
- which FIs should be within the scope of the regime;
- the use of resolution powers in relation to the holding companies and 'affiliated operational entities' of FIs, where particular conditions are met.

Overview

7. A majority of respondents were supportive of the steps being taken to implement an effective resolution regime in Hong Kong. Most recognised the importance of strengthening current arrangements to protect local financial stability and public funds in the unlikely event that a systemically important FI were to fail. A number also stressed that it was important that, as a major international financial centre, Hong Kong implement a resolution regime meeting the standards set out in the Key Attributes to support resolution of systemically important FIs operating cross-border (as well as the resolution planning needed well in advance of any future failure). Since the publication of CP1, the IMF, having assessed Hong Kong's existing crisis management arrangements as part of the recent FSAP, also identified the implementation of a resolution regime as being a priority.⁶
8. The authorities have carefully reviewed the responses received to the questions raised in CP1 and have drawn on these in further refining and developing proposals for the resolution regime. The nature of those responses, including any key issues raised, are summarised in this CP2, which also sets out how the authorities intend to proceed in the relevant areas. In some cases, the authorities

and "client money" placed with an LC are held on trust for clients and are required to be held in segregated accounts. The framework differs slightly for those with client assets placed with an AI, as whilst AIs are required by the Securities and Futures (Client Securities) Rules to hold "client securities" on trust for clients, the Securities and Futures (Client Money) Rules do not apply to "client money" held by an AI.

⁶ See Footnote 3 for reference.

have determined a position on the optimal approach to be taken and made firm proposals. In other cases, the authorities have provided additional detail on particular aspects of implementation for further consultation (and as a result, this second CP includes further questions for consideration by stakeholders).

Single regime

9. A significant majority of respondents supported the proposal to establish a common framework for resolution through a single regime⁷ on the grounds that it would better support the orderly resolution of FIs which are part of wider financial services groups operating across multiple sectors of the financial system. A number of respondents stressed that the single regime would need to accommodate sector-specific requirements to reflect the different characteristics of the various types of FIs that would be within its scope. The authorities are mindful of the importance of this, and will further consider what sector-specific requirements are needed, including with reference to the reissued Key Attributes,⁸ to ensure that the local regime is consistent with these as well as any other international standards for FIs operating in the relevant sectors.
10. The authorities note that some respondents from the insurance sector questioned not only the extent to which insurers should be within the scope of a resolution regime, but also whether insurers could realistically be accommodated within a common framework. In support of this, various factors were cited including the differing business models of, and regulatory requirements for, insurers and the ways in which problem insurers are dealt with. Other respondents from the sector considered that a common framework would be acceptable as long as it made adequate provision for requirements specific to the sector. As explained in paragraphs 30 to 33 below, the authorities consider that implementation of the Key Attributes requires that any insurers that could be systemically significant or critical, in the unlikely event that they were to fail, are in scope of a resolution

⁷ As opposed to multiple sector-specific regimes.

⁸ As noted in Footnote 4, the reissued Key Attributes include new Annexes setting out guidance on the application of the Key Attributes to non-bank FIs.

regime. Additionally, after further consideration and in light of the common standards for resolution regimes set by the Key Attributes, the authorities continue to think that the insurance sector can be accommodated within a common framework.

Scope

Authorized institutions (licensed banks, restricted licence banks and deposit-taking companies)

11. A significant majority of respondents agreed with the proposal set out in CPI that all licensed banks (“LBs”) should be covered within the scope of the resolution regime. A minority of respondents questioned whether smaller LBs needed to be within scope on the grounds that: (i) LBs with relatively limited operations in Hong Kong are unlikely to be providers of critical financial services or generate systemic risk on failure; and (ii) being within the scope of the regime would create an unnecessary burden for these LBs.
12. In response to the concern identified in paragraph 11(i), and in line with the arguments set out in CPI, it remains the authorities’ view that the potential for an LB to be systemically significant or critical on failure is likely to be contingent (at least to some degree) on the state of the financial sector and the economy more generally and on prevailing market sentiment at the point of non-viability. In benign market conditions it might be expected that existing insolvency proceedings would be sufficient to effect the orderly wind-down of a non-viable small- or medium-sized LB providing few, if any, critical financial services without any discernible impact on financial stability. However, in a period of financial or economic stress, the non-viability of even a small LB has the potential to generate systemic risk if its failure were to seriously undermine confidence in other, apparently similar, LBs or in the banking sector more generally, prompting depositors and other creditors to withdraw funding from authorized institutions (“AIs”) or otherwise reduce or curtail their dealings with them. Such contagion is much more likely in times of stress.

13. In respect of paragraph 11(ii), the authorities understand that concern over any additional regulatory burden was focused on additional regulatory requirements for resolution planning, as outlined in Key Attribute 11.⁹ The authorities note that experience in other jurisdictions indicates that small- and medium-sized FIs are inherently more readily resolvable and as such could expect to find it easier to meet any regulatory requirements associated with the regime (as compared with larger more complex FIs). Consistent with this, and to mitigate the effect of such additional requirements, the authorities intend to pursue a proportionate approach to (recovery and) resolution planning. For example, the HKMA has already begun to roll out its recovery planning requirements for local AIs and has clearly set-out in its guidance the expectation that recovery plans should be proportionate to the nature, scale and complexity of an AI's operations.¹⁰ It is therefore envisaged that the recovery plan of a small AI with a basic retail business will be much simpler and shorter than that of a large and complex bank. A similarly proportionate approach will be taken when local resolution planning requirements are rolled out for AIs.

14. Respondents' views were somewhat more mixed in respect of the proposal to extend the regime's scope to all restricted licence banks ("RLBs") and deposit-taking companies ("DTCs") given they are considered less likely to pose a material threat to financial stability on failure when compared with LBs. The authorities consider, however, that similar arguments to those presented above in respect of extending the regime's scope to all LBs apply equally to RLBs and DTCs. That is, there will be heightened potential for their failure to pose a systemic threat through direct or indirect contagion in stressed market conditions. Additionally, and as outlined in CP1, there may be cases where the orderly resolution of an LB may rely on any resolution extending to RLBs and/or DTCs in its wider group.

⁹ Key Attribute 11 sets out a number of standards for home and host authorities to meet in establishing effective recovery and resolution planning frameworks. See Footnote 4 for reference.

¹⁰ For the full Supervisory Policy Manual module on Recovery Planning (RE-1) see: <http://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/supervisory-policy-manual/RE-1.pdf>

15. Furthermore, as re-iterated throughout CP1, a resolution authority’s decision to initiate resolution would not be automatic at the point of an AI’s, or indeed any other FI’s, non-viability but would be dependent on the resolution authority’s assessment of whether both of the two conjunctive conditions for resolution, namely the “non-viability condition” and the “financial stability condition”, had been met.¹¹ This approach affords the resolution authority a necessary degree of flexibility to determine whether (or not) to resolve a non-viable AI, taking into account the relevant AI-specific and wider market factors prevailing at the time in assessing risks posed to financial stability.
16. Having carefully considered respondents’ views, the authorities consider that the scope of the regime should extend to all AIs, i.e. all LBs, RLBs and DTCs. In combination with the conditions set for use of the regime, this approach strikes an appropriate balance between ensuring that all relevant AIs are within the regime’s scope but that resolution only occurs where appropriate to secure continuity of critical financial services and to contain the risks posed to financial stability by an AI’s failure.

Financial Market Infrastructures

17. It was proposed in CP1 that all Financial Market Infrastructures (“FMIs”) which are designated to be overseen by the Monetary Authority (“MA”) under the Clearing and Settlement Systems Ordinance (Cap. 584) (“CSSO”) (other than those which are owned or operated by the MA) and those that are recognized as clearing houses under the Securities and Futures Ordinance (Cap. 571) (“SFO”) be brought within scope of the resolution regime. Overall, respondents were supportive of the proposal recognising that these FMIs play a critical role in supporting payments, clearing and settlement in Hong Kong.
18. In the case of recognized clearing houses in particular, a few respondents stressed the need for the resolution regime to be able to take into account the specific requirements of the sector (and in particular the loss allocation rules of central

¹¹ See paragraph 59 for the detail of the two resolution conditions.

counterparties (“CCPs”). As noted in paragraph 9, in further developing the resolution regime, the authorities, will take into consideration the guidance on resolution of FMIs provided by the FSB in the new Annex to the Key Attributes on “Resolution of Financial Market Infrastructures (FMIs) and FMI participants” (“Annex on FMI resolution”) and any associated international developments to ensure that the regime in Hong Kong is consistent with applicable international standards.

19. The authorities note in particular that the Annex on FMI resolution provides some guidance in relation to the implementation of loss allocation rules and procedures prior to entry into resolution. The Annex on FMI resolution states that “where the FMI has rules and procedures for loss mutualisation or allocation, those rules and procedures should generally be exhausted prior to the entry into resolution of the FMI unless it is necessary or appropriate for achieving the resolution objectives ... to initiate resolution before those rules and procedures have been exhausted. Where any such rules and procedures have not been exhausted prior to entry into resolution, the resolution authority should have the power to enforce implementation of those rules and procedures.”
20. Given the rationale behind, and respondents’ support for, the proposal in CP1, the authorities intend to set the scope of the regime in relation to FMIs as originally proposed; namely to extend scope to those designated to be overseen by the MA under the CSSO (other than those which are wholly¹² owned and operated by the MA) and those that are recognized as clearing houses under the SFO. (It is noted that as for other FIs, even if an FMI were to become non-viable, the resolution authority would need to be satisfied that the two conjunctive resolution conditions are met before resolution can be initiated).

¹² CP1 referred to FMIs “owned and operated by the MA”. The addition of the word “wholly” is with a view to clarifying that scope would not need to extend to those FMIs over which the MA has a sufficient degree of control by virtue of being the sole owner.

Licensed corporations

21. It was proposed in CP1 to set the scope of the regime to extend to some licensed corporations (“LCs”) performing certain regulated activities and further narrow that scope through the use of a minimum size threshold, making reference to the work being undertaken by the FSB and the International Organization of Securities Commissions (“IOSCO”) to identify non-bank non-insurer (“NBNI”) global systemically important financial institutions (“G-SIFIs”).¹³ The majority of respondents agreed with the proposal to capture some LCs within the scope of the resolution regime.
22. Most respondents were supportive of narrowing the scope as it extends to LCs to those licensed to perform the types of regulated activities identified in CP1¹⁴ but a few respondents from the asset management industry were of the view that asset management firms should be excluded. Respondents’ views were mixed on the additional minimum size threshold proposed in CP1 to further refine the population of LCs subject to the regime. A number of respondents suggested that size should be only one of a number of quantitative and qualitative criteria used to determine an LC’s inclusion within the regime’s scope.
23. As concerns asset management firms, the authorities consider that it would be premature to conclude that asset managers, as a class of FIs, should be excluded from the scope of the regime since their systemic relevance is still under consideration by the FSB/IOSCO following their joint Consultative Document on Assessment Methodologies for Identifying NBNI G-SIFIs (“NBNI G-SIFI consultation”). Indeed, one focus of the initial NBNI G-SIFI consultation was to consider the appropriateness of assessing the systemic importance of asset

¹³ See FSB/IOSCO (2014), Consultative Document: Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institution. http://www.financialstabilityboard.org/wp-content/uploads/r_140108.pdf. This document was published on 8 January 2014, subsequent to the launch of CP1 on 7 January 2014.

¹⁴ In CP1 the authorities identified that the most relevant regulated activities regulated under section 116 of the SFO may be: (i) dealing in securities or futures contracts; (ii) asset management; and (iii) dealing in OTC derivatives or acting as a clearing agent for OTC derivatives.

management entities on different levels of focus, for example: “asset managers on a stand-alone entity basis”, or “asset managers and their funds collectively”.

24. More generally, the NBNI G-SIFI consultation proposed that a materiality threshold of USD 100 billion in “balance sheet total assets” be set to determine those market intermediaries to be subject to the NBNI G-SIFI assessment process. At present the asset sizes of the largest LCs are far below this threshold. Furthermore, the authorities note that based on the experience from failures of LCs over the last two decades, there is no evidence of significant disruption to the wider financial system and economic activity as a result.
25. The NBNI G-SIFI consultation sets out a proposed process for assessing the global systemic importance of NBNI FIs. Under this process, the primary national authority (home authority) would conduct an in-depth assessment of the global systemic importance of the FIs that meet the materiality threshold based on the applicable sectoral methodologies. The sectoral methodologies require the home authorities to conduct both qualitative and quantitative analyses using the proposed NBNI G-SIFI indicators, i.e. size, interconnectedness, substitutability, complexity and cross-jurisdictional presence, including, where appropriate, cross-border supervisory information sharing and by application of supervisory judgment to determine whether the financial distress or failure of the NBNI FI concerned would pose a threat to global financial stability. An international oversight group will be established to help ensure, through joint review, an internationally consistent application of methodologies and consensus on potential designation. The FSB and national authorities, drawing on relevant qualitative and quantitative indicators, together will determine the final list of NBNI G-SIFIs.¹⁵ As such, it would be appropriate for the authorities to adopt the FSB & IOSCO assessment process and proposed criteria, and to capture those LCs which are themselves designated as NBNI G-SIFIs within the scope of the local regime. The authorities do not see the need to introduce additional criteria other than those the FSB and IOSCO are considering. This is especially the case for

¹⁵ See paragraph 3.3 of the NBNI G-SIFI consultation, see Footnote 13 for reference.

market intermediaries (securities broker-dealers), where the methodology is likely to be finalised along the lines of the approach proposed in the NBNI G-SIFI consultation.

26. It was also proposed in CP1 to set the scope of the regime to extend to those LCs that are branches or subsidiaries of G-SIFIs and the authorities sought respondents' views on whether there is a need for the scope to extend to LCs which are part of wider financial services groups, other than G-SIFIs, whether those operate only locally or cross-border.
27. Overall, the majority of respondents supported the proposal to include LCs that are branches or subsidiaries of G-SIFI groups within the regime's scope, while some preferred a narrower scope. Those preferring a narrower scope suggested that such branches or subsidiaries should be covered only where the local operations of the G-SIFIs are systemically important locally. Respondents exhibited even less support for the regime to extend to LCs that are branches or subsidiaries of non-G-SIFI groups, unless they pose a financial stability risk to Hong Kong or are part of a group subject to similar resolution regimes overseas.
28. The authorities maintain the view that as a key host authority, Hong Kong should be able to support the orderly resolution of G-SIFIs, and therefore the scope of the local regime should extend to those LCs that are branches or subsidiaries of groups identified as being (or containing) G-SIFIs as proposed. However, the authorities consider that it is unnecessary to include all LCs of wider financial groups that are not classified as being (or containing) G-SIFIs within the regime's scope. Taking into account the historical and current profile of the LC population, the authorities are of the view that this approach captures appropriate LCs under the regime. As mentioned in paragraph 142 of CP1, the likelihood that any individual LC's failure would pose systemic risk in Hong Kong is low as compared with that in the banking sector. No LC currently appears to have sufficient market share to be considered a provider of critical financial services or sufficiently significant connections to other FIs to cause contagion.
29. Having carefully considered respondents' views, the authorities intend to continue to pursue the general approach set out in CP1 of identifying subsets of LCs for inclusion within scope of the regime. However, in view of the NBNI G-SIFI

consultation, which has identified the types of NBNI FIs undertaking activities with systemic relevance, it is proposed that instead of setting the scope on LCs by reference to regulated activities and minimum size threshold, the proposal be revised to capture the following LCs within the scope of the regime:

- (a) LCs which are themselves designated as NBNI G-SIFIs;¹⁶
- (b) LCs which are subsidiaries or branches of groups which are identified as being (or containing) G-SIFIs;¹⁷

The authorities do not intend to extend the scope to LCs that are part of wider financial services groups other than those that are branches or subsidiaries of groups which are identified as being (or containing) G-SIFIs.

Question 1

Do you agree with the revised scope of the regime in respect of LCs as set out in paragraph 29?

Insurers

30. CP1 proposed setting the scope of the regime in relation to insurers to cover: (i) the local operations of any global systemically important insurers (“G-SIIs”) and internationally active insurance groups (“IAIGs”) with a presence in Hong Kong; and additionally (ii) any other insurer which it is assessed could be systemically significant or critical locally on failure. The authorities note that there was considerable support for the resolution regime to cover the local operations of insurers designated as G-SIIs. A number of respondents also expressed support for the proposal to extend the regime’s scope to IAIGs as well as those insurers which it is assessed could be systemically important or critical locally on failure. Those respondents who had opposing views cited that: (i) insurers are unlikely to

¹⁶ The criteria for designating NBNI G-SIFIs will be set out in FSB/IOSCO’s consultation conclusion for identifying NBNI G-SIFIs.

¹⁷ G-SIFIs include G-SIBs, G-SIIs and NBNI G-SIFIs.

pose systemic risk upon failure (either locally or more generally) and (ii) there is no reliable means of assessing the systemic risk posed by insurers.

31. The authorities note that there is now an internationally agreed assessment methodology for identifying insurers whose distress or disorderly failure may pose systemic risk globally.¹⁸ The methodology is applied on an annual basis, by the International Association of Insurance Supervisors (“IAIS”) as part of the wider FSB initiative to identify G-SIFIs.¹⁹ In turn, the new Annex to the Key Attributes on the Resolution of Insurers (“Annex on insurer resolution”) clearly requires that “any insurer that could be systemically significant or critical if it fails and, in particular, all insurers designated as...G-SIIs, should be subject to a resolution regime consistent with the Key Attributes”.²⁰ It is noted that there is no requirement to extend the regime to IAIGs and after further consideration the authorities do not consider that it would be appropriate to seek to automatically capture within scope any local entities that are identified as IAIGs, or that are a local branch or subsidiary of a cross-border entity identified as an IAIG.²¹
32. The authorities consider that in order to identify any insurers that may pose risk in a local context, reference can be made to the IAIS G-SII assessment methodology and the guidance on identification of critical functions and critical shared services to be finalised by the FSB²² as well as the experience of overseas jurisdictions, while taking into account local circumstances. The insurance-specific factors for

¹⁸ See IAIS (2013), “Global Systemically Important Insurers: Initial Assessment Methodology”, <http://www.iaisweb.org/index.cfm?event=getPage&nodeId=25233#>

¹⁹ The latest list of G-SIIs was issued in November 2014. See: http://www.financialstabilityboard.org/wp-content/uploads/r_141106a.pdf.

²⁰ See Footnote 4 for reference.

²¹ Including because there is unlikely to be an exact mapping between insurers identified as being IAIGs and those posing systemic risk locally or more generally. See IAIS (2014), updated version of “Frequently Asked Questions for The IAIS Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame)”, <http://www.iaisweb.org/index.cfm?event=getPage&nodeId=25229#>).

²² See FSB (2014), Recovery and Resolution Planning for Systemically Important Insurers: Guidance on Identification of Critical Functions and Critical Shared Services - Consultative Document, http://www.financialstabilityboard.org/publications/c_141016.pdf

considering local systemic importance may include, among others, size, interconnectedness, market share/concentration, substitutability and any other factors that the IA deems appropriate.

33. Having considered respondents' views and noting the relevant FSB guidance, the authorities propose to proceed on the basis that the scope of the resolution regime will extend to: (i) insurers which are subsidiaries or branches of G-SIIs operating in Hong Kong; and (ii) any insurer which it is assessed could be systemically significant or critical locally on failure.

Question 2

Do you have any views on the factors that should be taken into account when assessing the local systemic importance of insurers?

34. The proposals on which AIs, FMIs, LCs and insurers should be within the scope of the resolution regime, are tailored to reflect the risks which the authorities currently perceive the failure of each type of FI could pose to continuity of critical financial services and wider financial stability. In an endeavour to accommodate future developments in the risks potentially posed by these different types of FIs, the authorities are inclined to consider that the regime should provide the Financial Secretary ("FS") with a power to designate FIs (not initially covered by the regime) as being within scope where it is considered that systemic disruption could result were they to become non-viable.

Question 3

With a view to ensuring that all FIs which could be critical or systemic on failure are within scope of the regime, and recognising that the risks posed by any given types of FI may change over time, do you agree that providing the FS with a power to designate additional FIs as being within scope is appropriate?

Branches of overseas incorporated entities

35. It was proposed in CP1 that the scope of the resolution regime should extend to branches of overseas FIs ("branches") operating in Hong Kong in line with the

way in which the scope of the regime is set for each sector. This is important because Hong Kong, as a major international financial centre, plays host to a large number of FIs, particularly in the banking and insurance sectors, which operate as branches (including some whose failure could pose a threat to local financial stability). Extending the regime's scope to branches is considered necessary to enable the local resolution authority to facilitate resolution being undertaken by a home authority. However, CPI also recognised that there may be cases where a coordinated approach to resolution is not possible - perhaps because a home authority lacks the necessary mandates, powers or incentives - and where the Hong Kong regime would need to be deployed to undertake resolution of a branch independently in order to secure continuity of critical financial services and protect financial stability locally.

36. Respondents were largely supportive of the proposal for the regime to extend to branches in order to facilitate cross-border resolution in cooperation with a home resolution authority. And some (although fewer) respondents acknowledged the rationale behind extending the scope of the regime to branches to enable the local resolution authority to initiate independent resolution as a contingency. These respondents emphasised that the local resolution authority should, in the first instance, always seek to achieve a cooperative approach to cross-border resolution given the significant challenges associated with independent resolution action for a branch which is, legally, part of an overseas incorporated entity and therefore likely financially and operationally dependent on that entity to a significant degree. One respondent suggested that the independent exercise of resolution powers over a branch should be subject to additional conditions. The authorities note this point, but consider the setting of such conditions to be unnecessary as independent action in respect of branches may deliver suboptimal outcomes for Hong Kong as compared with coordinated approaches. As such, delivery on the objectives proposed for resolution combined with the proposal set out in paragraph 65 for the resolution authority in Hong Kong to duly consider the potential impact of its actions on financial stability in other jurisdictions ought to materially reduce the likelihood of the independent resolution of a branch.

37. Some respondents also identified additional practical challenges around resolving branches independently of the legal entity of which they are part. These included: (i) conflict of laws issues; and (ii) challenges in identifying branch assets that are separate from those of the overseas entity. These concerns are acknowledged as issues which may complicate the taking of effective independent resolution action in respect of a branch, in Hong Kong as well as in other jurisdictions, even in cases where such action is being pursued to secure the continuity of critical financial services and protect financial stability locally (for the sorts of reasons set out in paragraph 35). It is not clear that there are any ready solutions, but in undertaking local resolution planning and assessing resolvability,²³ the resolution authority will give consideration to any steps which could be taken to alleviate such challenges, including with regards to information that branches of cross-border FIs would be asked to submit.
38. Some respondents noted that they would not favour an outcome where the authorities required branches to convert to locally incorporated subsidiaries to facilitate resolution. The implementation of the regime is not expected in and of itself to impact existing policies under which FIs may operate as branches in Hong Kong, as long as their doing so is consistent with the objectives set for the regulatory authorities.²⁴ It may be determined through FI-specific resolution planning, however, that in some individual cases use of a branch structure serves as a material barrier to resolvability (for example where a home authority and the FI in question are unable to provide sufficient assurances as to the proposed treatment of local branches during resolution). In such cases, it is intended that under the regime it would be possible to require that the FI in question convert some, or all, of its local branch operations into a subsidiary. Further details on

²³ Local resolution planning and resolvability assessment requirements for AIs are expected to be rolled out by end-2015.

²⁴ For background on this matter in relation to the banking sector, for example, see paragraph 16, “Universal Banking – Hong Kong’s perspective”, speech by Norman T.L. Chan, 2011, <http://www.hkma.gov.hk/eng/key-information/speech-speakers/ntlchan/20110407-1.shtml>

how barriers to resolvability might be addressed are set out in paragraphs 129 to 135 of Chapter 3.²⁵

39. On balance, having carefully considered respondents' views, the authorities intend to pursue an approach whereby the local resolution regime will extend to the branches of overseas FIs operating in Hong Kong in line with the way in which the scope of the regime is set for each sector. While the primary objective of this approach is to facilitate orderly, coordinated cross-border resolution, the resolution authority will, subject to the local conditions for resolution being met, be able to resolve a branch independently of its wider group where the home resolution authority's action, or inaction, requires the local resolution authority to take independent action to deliver on the local resolution objectives.

Locally incorporated holding companies and affiliated operational entities

40. It was proposed in CP1 that the local regime should empower the resolution authority to initiate resolution at the level of a locally incorporated holding company ("HC") of one or more FIs in scope of the regime, with a view to delivering orderly resolution of the FIs themselves. Overall, respondents were broadly supportive of the proposal, although two main issues were identified.
41. The first was that a 'blanket' requirement for FIs to establish a locally incorporated HC structure in Hong Kong should not be created. The authorities acknowledge this point and confirm that there is no intention to require that all FIs within scope of the regime restructure in this manner. At the same time, there may be individual cases where it is determined by the resolution authority (in the course of resolution planning and assessing resolvability) that the absence of a locally incorporated HC represents a material barrier to orderly resolution. In such cases the resolution authority may, following discussion with the FI in question (and with the home resolution authority in the case of a cross-border FI with operations in Hong Kong) use the powers to be provided under the regime to

²⁵ CP1 noted that powers to improve the resolvability of FIs would be required under the regime and that further consideration would be given to how to provide for such powers for inclusion in CP2.

require the FI to establish a locally incorporated HC to remove that barrier and thus improve its resolvability. Such an assessment would be made on a case-by-case basis, and under the framework set out in paragraphs 129 to 135 of Chapter 3.

42. The second issue identified, was the potential for the exercise of resolution powers to affect other group companies under a locally incorporated HC where those companies are not FIs and operate outside of the financial sector. The authorities agree that in general it would be neither desirable nor necessary for the resolution authority to use resolution powers in relation to companies, within a mixed-activity group, operating outside of the financial sector. At the same time, there may be some cases where absent an ability to act in relation to certain group companies, given the way a group is structured and operates, orderly resolution of one or more FIs within scope of the regime may be precluded.
43. To respond to the concerns raised, the authorities propose that the regime will include a safeguard making it unambiguously clear that where a failing FI is part of a wider mixed-activity group and it is assessed that resolution of that FI can only be achieved by taking resolution action at the level of a HC, the presumption is that resolution would be undertaken at the level of a locally incorporated financial services holding company (“FSHC”).²⁶ A condition would be set that resolution action could only be taken at the level of a locally incorporated mixed activity holding company (“MAHC”)²⁷ in exceptional circumstances where the way in which a mixed-activity group has chosen to structure and operate necessitates such action to bring about orderly resolution.
44. On a related matter, CP1 also asked whether respondents had views on how best to ensure continuity of essential services in resolution (“operational continuity”) where those are provided by an affiliated operational entity (“AOE”) of an FI. The authorities propose to define an AOE as a locally incorporated entity that is,

²⁶ A FSHC is a holding company whose subsidiaries’ business is predominantly in the provision of financial services.

²⁷ A MAHC is a holding company with at least one subsidiary operating in the financial sector but which owns other subsidiaries whose business is not in or related to the provision of financial services.

or but for the exercise of a resolution power would be, in the same group as an FI (or FIs) and which provides a service (or a series of services) to that FI (or FIs). CP1 outlined two possible approaches whereby: (i) resolution powers (such as those allowing for transfer of assets) available under the regime can be used in relation to AOE directly (to support the resolution of one or more FIs within scope of the regime); and/or (ii) the regime provides for specific powers under which AOE could be directed to continue to provide essential services to an affiliated FI (or FIs) being resolved for a time (for reasonable consideration).

45. Some respondents expressed a preference for the approach outlined in (ii) by noting that it could be sufficient to rely on powers to impose continuity obligations and/or resolution planning (e.g. creating “resolution-proof” contracts with the relevant AOE, which might themselves need to be “bankruptcy-remote”). However, other respondents noted that in some cases securing operational continuity might depend on the resolution authority being able to exercise resolution powers, such as transfer powers, in relation to AOE (i.e. approach (i) also had merit).
46. The authorities consider that effective resolution planning and powers to impose continuity obligations (as proposed in paragraphs 153 to 157) could provide sufficient means for the resolution authority to secure operational continuity from AOE in relation to certain groups. However, it also appears, including from responses to CP1, that in other cases, the resolution authority may need to be able to exercise a wider set of resolution powers in relation to AOE to ensure the continuity of essential services they provide to an FI in resolution in light of the way a group has chosen to structure itself to deliver operational continuity.
47. After further consideration, therefore, and in light of developments observed in the approach taken by other jurisdictions and the requirements of the Key Attributes,²⁸ the authorities propose that, in addition to the continuity provisions

²⁸ Key Attribute 1.1 requires that scope of the regime extend to “non-regulated operational entities within a financial group or conglomerate that are significant to the business of the group or conglomerate” and Key Attribute 3.2(vi) requires powers to “ensure continuity of essential services and functions by requiring other companies in the same group to continue to provide essential services”.

outlined in paragraphs 153 to 157 of Chapter 3, it should be possible to use resolution powers available under the regime in relation to an AOE (or AOE(s)), but only where: (i) one or more FIs in the same group are to be resolved; and (ii) using powers in relation to the AOE(s) is justified to secure operational continuity and achieve the orderly resolution of the affiliated FI (or FIs). This proposed approach is similar to that taken in the United Kingdom (“UK”) where the Special Resolution Regime (“SRR”) extends to banking group companies, which could be a parent or subsidiary of the bank in resolution or a group subsidiary,²⁹ subject to certain exclusions.³⁰ The authorities will further consider whether it is desirable to more precisely define what constitutes an AOE to reduce any potential impact of resolution powers on entities not engaged in activities supporting an FI’s provision of critical financial services.

48. The authorities note that some respondents were concerned about the potential regulatory impact on AOE(s). However, it should be emphasised that the proposal would not in and of itself make AOE(s) subject to the same regulatory requirements applicable to FIs operating under the respective purviews of the HKMA, the SFC and the IA. The objective is solely to ensure that the resolution authority could exercise powers available under the regime in relation to AOE(s) with a view to securing provision of essential services, where this cannot otherwise be achieved and where doing so is justified to secure an orderly resolution of one or more FIs within scope of the regime in a manner that fulfils the objectives set for resolution.
49. The authorities note that the ability of AOE(s), which may be ordinary companies subject to companies law, to continue to provide essential services could be

²⁹ The Banking Act 2009 (Banking Group Companies) Order 2014, http://www.legislation.gov.uk/ukxi/2014/1831/pdfs/ukxi_20141831_en.pdf, defines a group subsidiary as “a subsidiary of a parent of the bank which is not a parent or subsidiary of the bank”.

³⁰ The Banking Act 2009 (Banking Group Companies) Order 2014, see reference in Footnote 29, provides for exclusions in cases where the bank in resolution is a subsidiary of a mixed activity holding company (“MAHC”) and of a financial holding company which is also a subsidiary of the MAHC. In this case: (i) the MAHC is not a parent of the bank; (ii) a group subsidiary which is a subsidiary of the MAHC is not a group subsidiary unless it is (a) a financial institution; (b) a subsidiary of a financial institution which is also a subsidiary of the MAHC. The Order also makes further exclusions in respect of covered bond vehicles, securitisation companies and warehouse companies.

undermined if the AOE were itself to enter liquidation or, other restructuring and insolvency arrangements e.g. the proposed corporate rescue (“CR”) regime.³¹ Further consideration will be given to this potential interaction between restructuring and insolvency arrangements and the resolution regime.

Question 4

Do you agree that in cases where one or more FIs within scope of the regime are part of mixed activity groups, the presumption should be that resolution will be undertaken at the level of a locally incorporated FSHC? And that resolution at the level of a locally incorporated MAHC would be undertaken only in exceptional circumstances where orderly resolution cannot otherwise be achieved?

Question 5

Do you agree with the proposed definition of, and approach to, setting the regime’s scope in respect of, AOE’s?

Question 6

Do you have views on how AOE’s might be more precisely defined, without restricting the resolution authority’s ability to achieve orderly resolution of an affiliated FI?

Exchanges

50. The Key Attributes do not require that exchanges (which are not covered by the definition of FMIs in Key Attribute 1.2) be subject to resolution regimes and thus, the authorities did not propose in CP1 to capture exchanges within the scope of the resolution regime.

³¹ Preliminary legislative proposals on CR are included in the discussion paper for the meeting of the LegCo Panel on Financial Affairs held on 7 July 2014. Please see <http://www.legco.gov.hk/yr13-14/english/panels/fa/papers/facb1-1536-1-e.pdf>. The current thinking is that certain regulated FIs are to be scoped out of the CR regime.

51. While it is noted that exchanges, as trading platforms, do not face financial and default risks similar to those associated with CCPs, the price discovery and risk transfer functions which they perform are critical to the efficient and orderly functioning of the financial market. As such, the failure of an exchange may affect the effective functioning of the financial markets.
52. Depending on market structure, the failure of an exchange could have a significant impact on the orderly functioning of financial markets and may thus be of systemic importance. The authorities therefore believe that it is necessary to evaluate, taking into account the local market structure, whether existing powers would allow the authorities to respond effectively to the failure of, or a major disruption at, an exchange to prevent significant disruption to the domestic and global financial systems or whether additional measures are required.

Recognized Exchange Companies

53. The SFC is responsible for supervising exchange companies recognized under the SFO. As in the case of recognized clearing houses,³² the SFO provides the SFC with a range of powers for use in relation to recognized exchange companies. These powers are similar to those that apply to recognized clearing houses and include the power to impose conditions, amend, revoke or add new conditions on recognized exchange companies, withdraw the recognition of an exchange company or direct it to cease providing services or operating such facilities, issue a “restriction notice” requiring an exchange company to take (or desist from taking) particular actions or a “suspension order” to suspend the functions of the board of directors or the governing body or a committee or a director or the chief executive officer of a recognized exchange company. The SFO requires the SFC to consult with the FS prior to the exercise of any of these powers. In addition to the above, the SFC may direct a recognized exchange company to cease to provide services or operate such facilities for not more than 5 business days in emergency situations if the SFC is of the opinion that the orderly transaction of

³² See paragraph 107 of CP1. See Footnote 1 for reference.

business on a stock market or futures market is being, or is likely to be, impeded. The SFC may extend this emergency measure for another 10 business days, if necessary.

54. As explained in CP1, these existing powers available to the SFC are not primarily intended for resolution and would not enable the SFC to execute any of the resolution options set out in CP1 and Chapter 3 of this CP2, such as to effect the compulsory transfer of the critical financial services provided by an exchange to another viable entity or to a bridge institution, or to sell its shares, or to take the exchange into temporary public ownership.
55. Currently, there is only one recognized exchange company that operates a stock market (i.e. The Stock Exchange of Hong Kong) and one other recognized exchange company that operates a futures market (i.e. Hong Kong Futures Exchange) in Hong Kong. In view of the current market structure, the authorities believe that there would be severe disruptions to the Hong Kong financial system and damage to Hong Kong's role as an international financial centre if one or both of these exchanges were to fail. Therefore, in the unlikely event that an exchange were to fail, the authorities assess that it would be prudent to have resolution powers to facilitate its orderly resolution. The authorities therefore see the need to consider including exchanges in the scope of the resolution regime.
56. The authorities however note that if there are multiple exchanges that operate in the same market, the impact of the failure of an exchange may be less disruptive and may be less likely to have a systemic impact. This is because the existence of multiple exchanges may provide an alternative to market participants and minimise the impact of the failure of one exchange. Under such circumstances, it is arguable whether it is necessary to extend the resolution regime to all exchanges.
57. As articulated in CP1, in deciding whether an FI should be subject to a resolution regime, the key consideration is whether its failure *could* be systemically significant or critical. To address the issue of whether a particular exchange should be covered by the resolution regime, the authorities thus propose that only those exchanges considered to be systemically important to the effective

functioning of the financial markets in Hong Kong will be covered by the regime and to this end, there will be an assessment and designation process based on objective criteria to identify such systemically important exchanges.

58. The authorities therefore propose that the SFC, as the regulator of recognized exchange companies, will be responsible for the designation of systemically important recognized exchange companies. In determining whether a recognized exchange company is, or is likely to become, systemically important, it is proposed that the SFC will take into consideration the following:

- (i) The role and importance of the recognized exchange company in the Hong Kong financial market, such as the importance and continued availability to the financial market of the financial products traded on the exchange;
- (ii) The availability of any alternative recognized exchange companies to assume the functions of the failed recognized exchange company;
- (iii) The relationship, interdependencies, or other interactions of the recognized exchange company with FMIs in Hong Kong;
- (iv) The potential impact of the failure of or a disruption to the services provided by the recognized exchange company on the financial market in Hong Kong; and
- (v) Any other factors that the SFC deems appropriate.

Question 7

Do you agree that it would be appropriate to extend the scope of the proposed resolution regime to recognized exchange companies that are considered systemically important to the effective functioning of the Hong Kong financial market?

Question 8

Do you agree with the factors to be taken into consideration in designation of systemically important recognized exchange companies set out above? Do you have suggestions as to what other factors should also be taken into consideration?

CHAPTER 2 – GOVERNANCE ARRANGEMENTS

This chapter builds on the proposals set out in CP1 regarding the governance arrangements for the resolution regime. It covers:

- the conditions which would need to be met before an FI could be resolved under the regime;
- the objectives which resolution should seek to advance;
- the designation of public authorities to act as resolution authorities;
- the arrangements to support effective coordination, including through designation of a lead resolution authority and consultation with a “higher authority”.

Conditions for initiating resolution

59. To reflect the intention that a high threshold should be set for the initiation of resolution, it was proposed in CP1 that an FI would have to meet two conjunctive conditions, to be assessed by the resolution authority of the FI in distress, before the resolution authority could intervene. Those conditions are:

- a) the first non-viability condition, which is met where it is assessed that an FI is, or is expected to become, no longer viable; where this implies that:
 - (a) the FI is, or is expected to become, unable to meet one or more of the conditions set for its continued authorisation or licence to carry out regulated business or activities; or in the case of a recognized clearing house it is, or is expected to become, unable to meet one or more conditions for recognition or to discharge one or more of the duties set out under the SFO, such that removal of its permission to carry out those regulated activities or the withdrawal of its recognition would be warranted; and
 - (b) it is assessed that there is no reasonable prospect that private sector or supervisory action, outside of resolution, will result in the FI once again satisfying the relevant conditions or the recognized clearing house satisfying the relevant recognition conditions or discharging the duties under the SFO, over a reasonable timeframe; and
- b) the second financial stability condition which is met where it is assessed that resolution will serve to contain risks posed by non-viability to: (a) the continuity of critical financial services, including payment, clearing and

settlement functions; and (b) the general stability and effective working of the financial system.

A majority of respondents agreed that these two conditions were generally appropriate for initiating resolution.

60. Notwithstanding the examples provided in Box E of CP1, which is set out again in Annex II to this CP2, a number of respondents requested greater clarity on the factors that would be considered by the resolution authority when making an assessment of whether the first non-viability condition had been met. As explained in CP1, it is difficult to identify each and every situation in which an assessment of an FI's non-viability could be made, since the circumstances may be unique in each case and, as such, judgment will need to be applied on a case-by-case basis. Given the wording of the resolution conditions, whereby the non-viability condition is explicitly linked to the conditions for authorization (for an AI and insurer); licence to carry out regulated activities (for an LC); or the conditions for recognition or the duties set out under the SFO (for a recognized clearing house), it is the authorities' view that (as is currently the case) counterparties with investments in and/or exposures to FIs should continue to monitor the risk of those FIs by reference to these conditions, which the resolution authorities would take into account when assessing an FI's non-viability.

61. Two respondents felt that, in addition to the conjunctive non-viability and financial stability conditions proposed, the authorities should give consideration to adopting broader conditions for triggering resolution, such as it being in the "public interest". Clearly, there could be some merit in this approach from the perspective of retaining flexibility for the resolution authority to address a range of unforeseen and unpredictable circumstances. However, it is noted that the financial stability condition effectively incorporates a public interest element, by requiring that resolution can only be initiated where doing so will serve to contain the risks posed by an FI's failure to the continuity of critical financial services and the general stability of the financial system, which is clearly in the public interest. In any case, the resolution authority will need to observe administrative law principles in making sure that its assessment of the resolution conditions is not unreasonable, and is rational and proportionate.

62. A couple of respondents queried whether the drafting of the financial stability condition, in particular the use of the wording that resolution “will serve” to contain the systemic risks posed by an FI’s non-viability, might be interpreted as setting too low a threshold for initiating resolution. The authorities would reiterate that, as discussed in paragraph 59, the two conjunctive resolution conditions are designed to set a high threshold for resolution to be initiated. The wording “will serve” in the financial stability condition is not intended to indicate a view that resolution would make a marginal difference as compared with any alternative proceedings to deal with an FI’s failure. Rather it reflects the authorities’ intention that, absent initiating resolution, it is assessed that the result of alternative proceedings being initiated against a non-viable FI would pose an unacceptable threat to the continuity of critical financial services and financial stability. While the precise terminology to be adopted in the legislation is yet to be decided, the policy intention, as set out above, is to ensure a sufficiently high threshold for the exercise of resolution powers.

Resolution objectives

63. Three resolution objectives that would guide the resolution authority’s decision-making process in undertaking resolution were proposed in CP1, namely that in exercising its powers the resolution authority should: (i) promote and seek to maintain the general stability and effective working of the financial system in Hong Kong, including by securing continued provision of critical financial services, including payment, clearing and settlement functions; (ii) seek an appropriate degree of protection for depositors, investors and policyholders; and (iii) subject to pursuing resolution objectives (i) and (ii), seek to contain the costs of resolution and, in so doing, to protect public funds. These were modelled largely on the resolution objectives set out under Key Attribute 2.3. Respondents broadly supported the intention of the three objectives proposed, with comments focusing on the precise drafting and hierarchy of the objectives, in addition to identifying additional objectives that respondents felt should be added.

64. In respect of the hierarchy of the three resolution objectives, some respondents raised concerns about the primacy of resolution objectives (i) and (ii) over

resolution objective (iii). In general, the authorities are clear that the intention of the resolution regime is to protect financial stability while minimising the risk that use of public funds will be required to achieve the orderly resolution of a non-viable FI. However, the authorities do not see an equally ranking objective to the effect that the resolution authorities should seek to contain the costs of resolution as desirable because it could effectively prevent or deter the resolution authority from taking action it deems appropriate to achieve the overarching objective of protecting financial stability. The authorities see the approach set out in CP1 as being in line with Key Attribute 2.3(iii), which states that the resolution authority should “seek to minimise the overall costs of resolution in home and host jurisdictions and losses to creditors, where that is consistent with the other statutory objectives” (emphasis added), and which, in the view of the authorities, implies a level of subordination to the other resolution objectives. The authorities therefore propose to retain the hierarchy between objectives (i) and (ii) and objective (iii).

65. In respect of additional objectives proposed by respondents, some noted that, in line with Key Attribute 2.3(iv), a fourth objective should be added requiring the resolution authority to duly consider the impact of its actions on financial stability in other jurisdictions. Significant attention was given in CP1 to the importance of cross-border resolution given the nature of the financial sector in Hong Kong and CP1 also highlighted that the authorities would give consideration to “how to ensure that the resolution authority in Hong Kong may take into account any other relevant factors, such as the impact of its actions on financial stability in other jurisdictions, which may be relevant in the resolution of cross-border FIs”. The authorities, however, have concerns that a formal objective for the resolution authority to duly consider the impact of its actions on financial stability in overseas jurisdictions may conflict with other resolution objectives (e.g. the objective to protect financial stability locally) as well as with the conditions proposed for supporting cross-border resolution actions³³ since it could restrict

³³ It was proposed in CP1 that “the local resolution authority should be able to use the local resolution regime in cases where: (a) a home resolution authority is initiating resolution in relation to a

the local resolution authority's ability to take independent action in respect of an 'in scope' FI in Hong Kong, even where the resolution strategy proposed by an overseas authority did not meet the local conditions for supporting cross-border resolution action. Hence, rather than establish an additional formal resolution objective, the authorities propose to require the resolution authority to duly consider the potential impact of its actions on financial stability in other jurisdictions in the context of deciding how to apply their powers in respect of a cross-border resolution.

66. As noted in paragraph 63, resolution objective (ii) states that the resolution authority should "seek an appropriate degree of protection for depositors, investors and policyholders". CP1 explained that the drafting of resolution objective (ii) was intended to require the resolution authority to ensure outcomes in resolution that were no worse than would have been the case in liquidation for those depositors, investors and policyholders protected by the Deposit Protection Scheme ("DPS"), the Investor Compensation Fund ("ICF"), the Insolvency Fund (which is administered by the Motor Insurers' Bureau of Hong Kong), the Employees Compensation Insurer Insolvency Scheme (which is administered by the Employees Compensation Insurer Insolvency Bureau) and the proposed Policyholders' Protection Fund ("PPF") respectively as well as having regard to other relevant protections in liquidation.³⁴ Notwithstanding this, some respondents expressed a preference for including an additional resolution objective specifically requiring the protection of client assets.³⁵ The authorities

cross-border group whose Hong Kong operations are within the scope of the local regime; and (b) it is assessed, by the resolution authority in Hong Kong, that the approach to resolution which the home authority proposes to adopt will deliver outcomes that are consistent with the objectives for resolution and will not disadvantage local creditors relative to foreign creditors". Cross-border resolution is considered further in Chapter 5 of this CP2.

³⁴ It was stated in CP1 that "depositors, investors and insurance policyholders are already offered a measure of protection through modifications made to corporate insolvency procedures (e.g. being preferred creditors at least in relation to certain claims up to specified limits) as well as through statutory protection schemes" and it is therefore important "that where an FI is resolved... resolution should take a form that seeks to secure a degree of protection for the relevant depositors, investors and policyholders, at least equal to that which they would have received in liquidation proceedings."

³⁵ See Footnote 5 for definition.

will give further consideration to such an additional objective and set out the proposed approach in CP3. In line with the Key Attributes' Annex on Client Asset Protection in Resolution ("Client Asset Annex"),³⁶ it is intended that the local regime should cover those client assets which are subject to protection under the applicable laws or regulations in Hong Kong.

Question 9

Do you have any views on whether it is necessary to introduce an additional resolution objective in respect of the protection of client assets considering the policy intention behind the drafting of resolution objective (ii) in paragraph 63?

Resolution authority

67. CP1 set out two alternative models for designating a resolution authority responsible for exercising the resolution powers under the regime. The first would see each of the sectoral regulators, namely the HKMA, the SFC and the IA, designated as the resolution authority for FIs, within scope of the regime, under their respective purviews (the "sectoral model"). The second would see the establishment of a new single, standalone cross-sector resolution authority. Having considered the pros and cons of each approach, the authorities proposed in CP1 that the sectoral model be adopted.

68. A majority of respondents agreed with this proposed approach, citing that: (i) the sectoral model is consistent with the regulators' existing mandates; and (ii) the regulators are already well-placed to identify when resolution should be initiated for the FIs operating under their respective purviews.

69. The minority of respondents expressing a preference for the establishment of a single resolution authority considered that this alternative model would: (i) concentrate cross-sector resolution-specific expertise in a single entity; (ii) promote consistency and coordination in decision-making and reduce the potential

³⁶ See paragraph 3.1 of the Client Asset Annex. See Footnote 4 for reference.

for inter-institution conflict; and (iii) reduce the potential for perceived, and real, conflict of interest between supervisory and resolution functions.

70. Overall, the pros and cons of the two approaches identified by respondents were consistent with those identified in CP1. After carefully considering this matter further the authorities propose to proceed with the approach under which each of the HKMA, the SFC and the IA will be designated as the resolution authority for ‘in scope’ FIs operating under their respective purviews (i.e. the sectoral model). Each resolution authority will be responsible for ensuring that the issues raised by respondents, including the potential for a perceived, or real, conflict of interest (if any) between resolution and supervision functions within a single regulatory body, are effectively addressed.
71. As recognised in CP1, Key Attribute 2.2 requires that, under such a sectoral model, “the resolution regime of that jurisdiction should identify a lead authority that coordinates the resolution of the legal entities within that jurisdiction”. A number of respondents also emphasised the importance of designating such a lead authority in Hong Kong under a sectoral model and ensuring that this arrangement was effective. Further consideration has been given to the designation of such a lead resolution authority (“LRA”) and its role, which is described in greater detail below.

Lead resolution authority

72. As explained in CP1, and noted in paragraph 71 above, adopting the sectoral model for designating resolution authorities creates the need for an LRA that can coordinate the resolution of different FIs operating within a cross-sector group. Whilst no specific question was asked on this issue in CP1 (as no definitive position on the approach to designating resolution authorities had then been reached), respondents nevertheless offered views which the authorities have considered in determining how an LRA should be appointed.
73. Some respondents indicated that the role of the LRA should be performed by a single authority, with one respondent suggesting that the FSTB might fulfil this role. However, the authorities are of the view that the resolution authority should be, and should be seen to be, operationally independent (as specified in the Key

Attributes). Hence, it is considered that the Government should not have an active role, beyond that of a party to be consulted in line with the proposal in paragraphs 78 and 79 below, in the resolution authority's decision-making processes.

74. The authorities therefore propose that the FS should designate, in advance, an LRA for each cross-sector financial group containing 'in scope' FIs, once the legislation establishing the regime has passed, based on an assessment of the relative systemic importance, including the nature of the business undertaken, of the 'in scope' FIs within that cross-sector group. The authorities will work together to determine the relevant factors to be used to objectively assess the relative systemic importance of the individual FIs within a cross-sector group.
75. In considering the relevant factors the authorities will, *inter alia*, make reference to the HKMA's recent consultation on the Supervisory Policy Manual ("SPM") module on "Systemically Important Banks", which sets out factors which the HKMA proposes should form the basis of an assessment of the systemic importance of AIs in Hong Kong.³⁷ Those factors are: size, interconnectedness, substitutability and complexity. The authorities will also consider the Basel Committee on Banking Supervision ("BCBS") methodology for assessing global ("G-") and its principles for assessing domestic ("D-") systemically important banks ("SIBs").³⁸ The authorities will consider the extent to which these factors are also appropriate for determining the systemic importance of the individual FIs within a cross-sector group for resolution purposes, as well as whether any additional factors should be taken into account.
76. Once an LRA has been designated by the FS, following the authorities' assessment of the 'in scope' FIs' systemic importance, its primary role will be to lead any

³⁷ See HKMA (2014), Systemically Important Banks, <http://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/supervisory-policy-manual/C-A-B-2.pdf>

³⁸ See BCBS (2013), Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement, <http://www.bis.org/publ/bcbs255.pdf> and BCBS (2012), A framework for dealing with domestic systemically important banks, <http://www.bis.org/publ/bcbs233.pdf>

local resolution planning for the relevant cross-sector financial group and, in the unlikely event that resolution is initiated, it will consult with and coordinate the other sectoral resolution authorities to achieve an orderly resolution of the group. Where a local cross-sector group is part of a wider cross-border group, the LRA may provide a single local point of contact with the relevant overseas authorities on matters pertaining to the resolution of the group and coordinate the actions of the local resolution authorities as appropriate.

77. In circumstances where consensus cannot be reached amongst the sectoral resolution authorities on resolution planning and/or on the exercise of resolution powers in respect of a cross-sector group, the LRA would assume an ultimate decision-making role. This is particularly important in respect of initiating and executing resolution since such action needs to be swift and decisive, given the objective to minimise the risks posed by non-viability to the continuity of critical financial services and financial stability. In leading the resolution and in its role as ultimate decision-maker the LRA would also have the responsibility to consult with the FS, in line with the proposal set out in paragraphs 78 to 79, ahead of initiating and carrying out the resolution of a cross-sector group.

Question 10

Do you agree that an LRA should be designated for each cross-sector financial group containing “in scope” FIs by the FS once the legislation establishing the regime has passed?

Question 11

Do you agree that the designation of the LRA should be based upon the resolution authorities’ assessment of the relative systemic importance of the individual ‘in scope’ FIs within a cross-sector financial group and that the resolution authority of the FI assessed to pose the greatest systemic risk be designated as the LRA for that group?

Question 12

Do you agree that the role of the LRA should be one of coordination and, when required, ultimate decision-maker?

Coordination: Consultation with a “higher authority”

78. CP1 highlighted the need for the resolution authority to coordinate effectively with the Government in light of the Government’s overarching responsibilities in relation to the financial system and wider economy as well as for managing the public finances. It was proposed that a requirement for the resolution authority to consult a “higher authority” ahead of initiating and carrying out resolution could achieve this objective. It would, however, be vital that any consultation requirement did not compromise the ability of the resolution authority to act independently to initiate and carry out resolution quickly and decisively.
79. The authorities have determined that the FS would be the most appropriate “higher authority” for the purposes under consideration. In keeping with the requirement of Key Attribute 2.5 that the resolution authority should have operational independence, it is proposed that the FS be consulted, in line with similar existing requirements under the ordinances governing the respective regulators, before resolution could be initiated and carried out.³⁹ For example, both the MA and SFC may currently only exercise certain powers under their respective ordinances after consultation with the FS.⁴⁰

³⁹ Key Attribute 2.5 states that: “[t]he resolution authority should have operational independence consistent with its statutory responsibilities, transparent processes, sound governance and adequate resources and be subject to rigorous evaluation and accountability mechanisms to assess the effectiveness of any resolution measures...”.

⁴⁰ In respect of the MA, those powers include the supervisory intervention powers available to him under section 52 of the Banking Ordinance (Cap. 155). In respect of the SFC, those relevant powers under the SFO include: (i) recognizing a company as an exchange company (section 19(2)); (ii) recognizing a company as a clearing house (section 37); (iii) making a suspension order relating to a recognized exchange company, recognized clearing house, etc. (section 93(1)); (iv) making rules requiring LCs to maintain certain financial resources (section 145); and (v) intervening in proceedings (section 385(1)).

CHAPTER 3 – RESOLUTION POWERS

This chapter sets out proposals regarding the resolution powers to be made available under the resolution regime in Hong Kong. It covers:

- expanded proposals for resolution options and powers initially described in CP1; and
- proposals for additional resolution powers recommended by the Key Attributes but not covered in detail in CP1.

Overview

80. As explained in CP1 the following menu of resolution options is considered necessary for the local regime in order to secure orderly resolution of failing FIs which are systemic or critical:

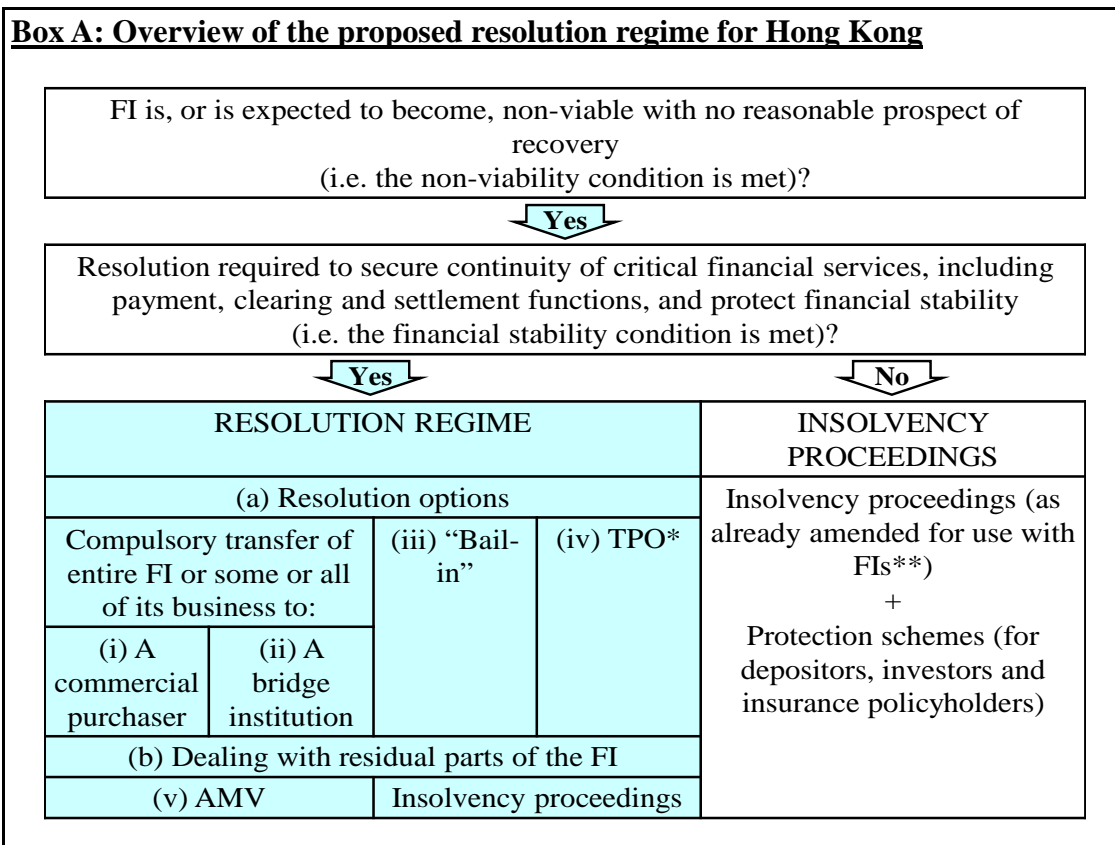
- (i) Transfer of a failing FI, or some or all of its business, to a commercial purchaser;⁴¹
- (ii) Transfer of some or all of a failing FI’s business to a bridge institution;
- (iii) Transfer of a failing FI’s assets and liabilities to an asset management vehicle (“AMV”);
- (iv) Statutory bail-in of liabilities to absorb losses and recapitalise a failing FI; and
- (v) Taking a failing FI into temporary public ownership (“TPO”).

81. CP1 outlined how the resolution authority would be responsible for determining which resolution option or options are most appropriate for a particular FI. Where resolution planning has been completed, a “preferred” strategy setting out the likely options for resolution should have been identified in advance. However, the resolution authority would retain discretion to take a different approach if it judges that the circumstances prevailing at the time are such that the

⁴¹ Whilst CP1 referred to transfer to “another FI” the term “commercial purchaser” may be more appropriate as described in paragraph 84 below.

preferred strategy no longer represents the optimal course of action in terms of delivering on the objectives set for resolution. Box A, reproduced from CP1, provides an overview of the proposed resolution regime for Hong Kong as well as illustrating the intention that the regime will sit alongside existing insolvency arrangements.

82. In order to execute the resolution options, the resolution regime obviously needs to provide for any specific powers integral to these options (including, for example, powers to transfer shares, assets, rights and liabilities without the consent of shareholders or creditors). Other general powers are, however, also needed to facilitate rapid execution of resolution (e.g. to require improvements to resolvability, see paragraphs 129 to 135). CP1 set out initial proposals for most of the key resolution options and powers with the details relating to certain of these (principally statutory bail-in, TPO, stay on early termination rights and powers to require improvements to resolvability) deferred to this CP2. This was to allow the authorities time to further develop proposals for local implementation including in the light of ongoing international developments in these areas as well as comments received in the initial consultation exercise.



** Not required by the Key Attributes, but standards set which should be met if available.*

*** Modifications to corporate insolvency procedures have already been made under the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap.32) (“CWUMPO”) and relevant sectoral ordinances as they apply to AIs, insurers and LCs in particular.*

Compulsory transfer to a commercial purchaser

83. This option would allow the resolution authority to carry out a compulsory transfer of an entire FI, or all or part of an FI’s business, to one or more commercial purchasers. An illustration of how such transfer powers have been used elsewhere in relation to an FI in resolution to transfer selected assets and liabilities (through a “partial transfer”) is shown in Box C below. If suitable (and willing) buyers can be found and it is feasible to safely complete the necessary transfer in the time available, then this option may be advantageous as it keeps the business in the private sector (as noted in CP1 however this option cannot be used in each and every case⁴²). The consent of shareholders and other affected stakeholders would not be needed ahead of any transfer, but safeguards would offer a degree of protection, including those for certain financial arrangements and the ‘no creditor worse off than liquidation’ (“NCWOL”) compensation mechanism (more detail is set out in Chapter 4).

84. In responding to CP1, the majority of submissions considered the option of compulsory transfer to a commercial purchaser to be a necessary part of the regime and were broadly content with the way in which it was described in CP1. Although no specific comments were received on this point, after further consideration the authorities propose that in describing the “transferee” it may be more appropriate to use the term “commercial purchaser” as opposed to “another

⁴² This is particularly so for large and complex FIs where it may be difficult to find an acquirer willing and able to complete the necessary due diligence and absorb all of a failing FI’s business; and given the operational challenges associated with completing partial transfers for all but the most simple FIs.

FI” with a view to avoid unintentionally precluding other potentially suitable types of commercial purchaser from acquiring an FI.⁴³

85. Some respondents helpfully identified issues that would need to be taken into account if using this power. These included: licensing and authorisation requirements, change of control approvals and the importance of assessing the suitability of the acquirer. The authorities recognise the issues raised by respondents as important factors, and are considering what may be needed under the regime as well as the steps that could be taken to plan for its use, including when developing resolution strategies and plans for individual FIs. Respondents also noted the need for a mechanism in the resolution regime to override contractual rights in the transfer of assets and liabilities. As outlined in CP1, the authorities agree that the resolution legislation will need to ensure that transfers carried out by the resolution authority take effect despite, and by overriding, any restrictions that would otherwise arise by virtue of legislation or contract. It is noted that for this option, as well as the others provided for under the regime, the formal commencement of resolution proceedings in relation to an FI would be accompanied by issuance of a public notice. Additionally, some respondents raised the need to consider tax treatments and the authorities are considering this matter and will set out proposals in CP3.

86. Some respondents questioned the suitability of an option to effect a compulsory transfer of business in the context of insurers. The authorities note that the resolution regime would only be used in cases where it is assessed that allowing a non-viable FI to enter existing restructuring or insolvency arrangements could pose a threat to financial stability and continuity of critical financial services. In other words, the proposed regime will sit alongside existing arrangements and would be used only in cases where it is assessed that commonly used procedures, which in the case of insurers include portfolio transfer and run-off,⁴⁴ would not

⁴³ Any transferee will need to meet statutory requirements set for owners of, and substantial shareholders in, regulated entities.

⁴⁴ An insurer enters “run-off” when it discontinues the writing of new policies while continuing to administer existing contractual policy obligations for in force business.

adequately contain the risks posed. The authorities note that the Key Attributes require that a full menu of resolution options should be available for all FIs within the scope of the regime, including insurers, and that paragraph 4.6 of the Annex on insurer resolution requires, inter alia, that “the resolution authorities should have the power to transfer contracts of insurance and reinsurance”.⁴⁵ The authorities therefore continue to consider that the compulsory transfer resolution option should be available for use in relation to the insurers in scope of the regime.

Temporary increase in DPS cover

87. CP1 noted that there may be a case for a temporary increase in the cover provided under the Hong Kong Deposit Protection Scheme (“DPS”) where a transfer of business includes a transfer of protected deposits. This would allow time for depositors to reallocate any balances over the cover limit if they hold deposits at both the failing and acquiring banks. In turn this reduces incentives to move such balances immediately on completion of the transfer (given that could result in a degree of liquidity stress at the acquiring bank). It is noted that other jurisdictions (including the US, Canada, Singapore and Malaysia) make provision in this regard; and proposals for the local regime are outlined below.

(i) Scope of application

88. The authorities consider that the resolution objective set in relation to protection of depositors would generally preclude use of the regime in a manner that results in protected deposits being transferred to any institution which is not a DPS member.⁴⁶ The temporary additional cover will be applicable, therefore, only to the transfer of deposits both from one DPS member to another.

⁴⁵ See Footnote 4 for reference.

⁴⁶ RLBs and DTCs are not members of the DPS (neither are a couple of overseas-incorporated banks which are covered by similar schemes in their country of incorporation).

(ii) Extent and duration of additional cover

89. After taking overseas practice into account, the authorities propose that a deposit transfer should not affect the amount of DPS protection available in respect of any existing deposits at the acquiring bank. Such deposits would be separately insured up to the maximum level of protection under the DPS (currently HKD 500,000). With respect to the deposits transferred from the failed bank, temporary additional cover will be capped at the amount of deposits transferred, plus any interest accrued to the end of the period specified below, up to the maximum limit of HKD 500,000 (see Box B for a worked example).
90. It is proposed that the temporary additional DPS cover for the transferred deposits should apply for a maximum of six months from the date of transfer or, in the case of term deposits maturing after the end of the six-month period, until the next maturity date. Where a term deposit matures within the six-month period and is renewed with the acquiring bank, the additional temporary protection under the DPS will continue to apply to the end of the original six-month period.⁴⁷ These deposits will be covered (up to the end of the six-month period) even if they are renewed under different terms.

Box B: Illustration of the temporary increase in DPS cover

If a depositor has HKD 200,000 at the failed bank and HKD 400,000 at the acquiring bank, his maximum DPS protection following the transfer will be HKD 700,000 (i.e. the HKD 200,000 transferred from the failed bank plus the original protection cap of HKD 500,000 at the acquiring bank). The new HKD 700,000 protection limit will remain in place for six months irrespective of any change in the depositor's total deposit balance during that period. Six months after the transfer, the maximum protection available at the acquiring bank will revert to HKD 500,000.

⁴⁷ The authorities will give consideration to a mechanism to ensure that the acquiring bank is required to disclose to depositors seeking to roll their deposits beyond the six-month period the point at which the temporary additional DPS cover will fall away.

(iii) Levies on additional cover

91. Given it is proposed that the additional cover will only be temporary (lasting six months) and the annual DPS levy contributions are collected at the beginning of each year, it is not proposed that a levy will be imposed on the transferred deposits for the duration of the additional cover.⁴⁸ This avoids a sudden increase in the levy due from the acquiring bank in respect of the deposits it takes on.

Question 13

Do you agree that the proposals for providing temporary DPS cover should reduce the incentives for transferred depositors to withdraw excess balances immediately on completion of a business transfer in resolution?

Compulsory transfer to a bridge institution

92. The primary purpose of this option would be to allow the resolution authority to temporarily transfer all or part of an FI's business to a bridge institution in circumstances where the resolution authority assesses that a commercial purchaser might ultimately be found for the business of a failing FI, but where this cannot be arranged immediately.⁴⁹ Again, and as explained in CP1, whilst this option has been deployed successfully in this way in other jurisdictions for small- and medium-sized FIs, it may not be suitable for large and complex FIs.⁵⁰ Powers to create a bridge institution may also be deployed to support other resolution options, including bail-in, which necessitates a degree of flexibility over some aspects of its design. Box C provides an illustration of how bridge institution powers have been used previously in other jurisdictions.

⁴⁸ It is noted that, as a quid pro quo, the levies paid by the failed bank at the start of the year in which it failed would not be refunded.

⁴⁹ As noted in CP1, there may be cases where it ultimately proves impossible to find an acquirer for some or all of the business transferred to a bridge institution, and it may then be necessary to wind-up the transferred business instead.

⁵⁰ As outlined in CP1, use of a bridge institution would not be advisable if the resolution authority assessed that the prospects for returning the transferred business to the private sector at a later date were poor or if there were substantive operational obstacles to transferring assets and liabilities on a selective basis.

93. Most respondents recognised the need to provide the resolution authority with powers to establish a bridge institution as well as to allow for the transfer to it of selected assets and liabilities (without needing the consent of affected stakeholders (e.g. shareholders and creditors)). CP1 outlined how this option might be structured, including the control of the bridge institution by the resolution authority to support the carrying out of the preferred approach to resolution, and respondents were broadly content with this approach. After further consideration, it is expected that the bridge institution would initially be owned by the Government and incorporated under the Companies Ordinance (Cap. 622) (“CO”). The authorities consider that some variant of the model adopted by the UK might be appropriate for Hong Kong, where a specific bridge institution could be created for a given resolution by incorporating a company (most likely a company limited by shares) under the CO, with the Government as the initial shareholder and staff of the resolution authority as directors. Such an approach would allow the bridge institution itself to be transferred to a third party commercial purchaser or, if appropriate, to bailed-in creditors.
94. As for the case of a transfer to a commercial purchaser, some respondents questioned whether transfer to a bridge institution was applicable in the context of the insurance sector. The authorities continue to consider that there may be circumstances where use of this option could secure continuity of critical financial services provided by a failing insurer (and thereby protect financial stability) with a view to returning the related insurance business to the private sector once circumstances permit. The Key Attributes’ Annex on insurer resolution requires that this option be available for use with insurers within the scope of the regime, clarifying that this is with a view to ensuring that the bridge can: “(i) continue to fulfil in whole or in part existing obligations under contracts of insurance; (ii) permit the exercise of options under existing contracts of insurance, including the surrender or withdrawal of contract cash value and the payment of further premiums provided for under the existing contracts; and (iii) buy reinsurance (or retrocession) coverage”.
95. Some respondents helpfully identified additional issues that would need to be taken into account if using a bridge institution power. These included the

approach to capitalising and funding the bridge institution to a level compliant with authorisation requirements; obtaining change of control approvals and the relevant regulatory status; managing the bridge institution and ensuring availability of people with the necessary skills and experience to operate it; considering what might be done with the residual FI;⁵¹ and the use of powers in cooperation with the home authority where a bridge institution is used in relation to a failing FI that is part of a cross-border group.

96. With respect to capitalising and funding the bridge institution, it is noted that the objectives set for resolution are such that the resolution authority will seek to ensure, insofar as is possible, that assets transferred to the bridge exceed liabilities transferred to it by a sufficient margin to ensure the adequate solvency of the bridge institution (as is the case in the illustration provided in Box C below). Establishing the bridge institution in this way will help to maximise the likelihood of securing any additional funding needed from market sources (as well as reducing risks posed to any public funds which may need to be deployed as a temporary measure). With regards to the other issues raised, the authorities are considering what (if any) provision is needed under the regime as well as the steps that could be taken in preparing for its use, including in developing resolution strategies and plans for individual FIs. As outlined in CP1, the authorities intend to issue guidance on how resolution options, including the bridge institution option, available under the resolution regime will be used.

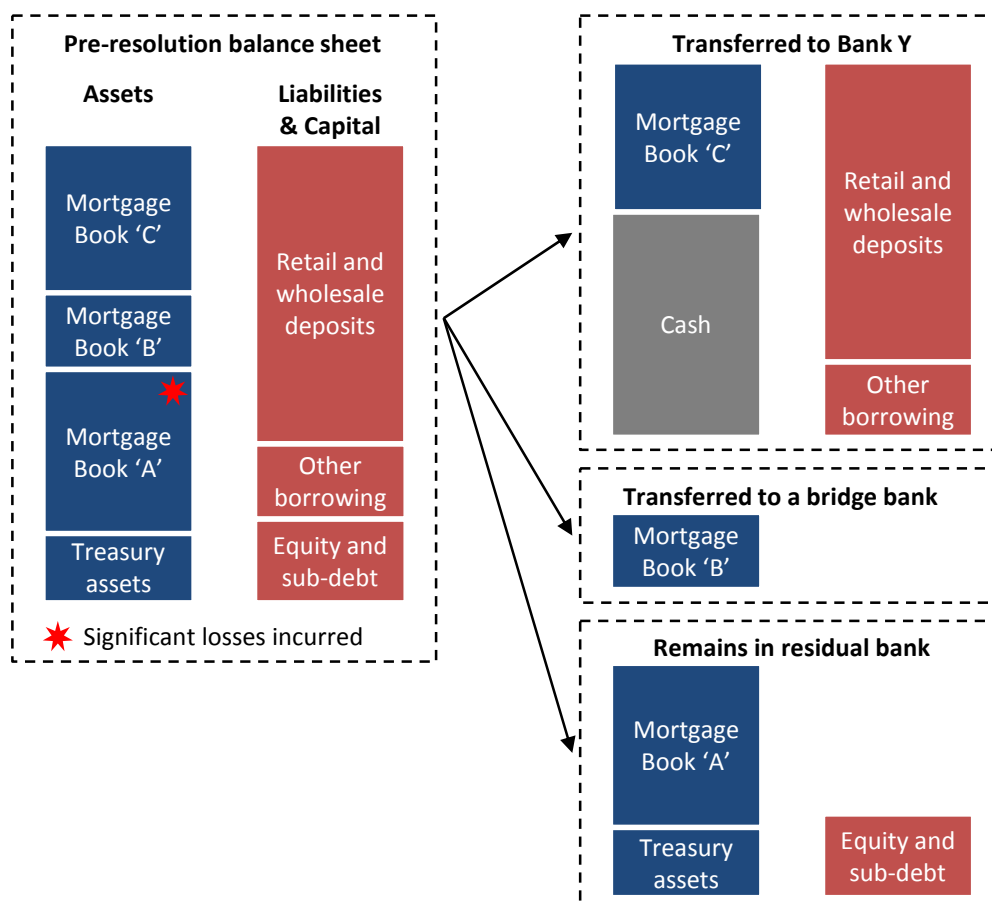
Box C: Illustration of how transfer powers have been used in other jurisdictions

The following illustration draws on case studies from other jurisdictions to provide a simplified hypothetical example of how proposed transfer powers might be used to resolve a non-viable FI.

1. Consider ‘Bank X’ that experiences a significant loss in one of its mortgage portfolios – mortgage book ‘A’ – a loss of such severity that the resolution

⁵¹ The residual FI is the part of the FI which remains after a partial transfer of an FI’s assets and liabilities is made to a commercial purchaser and /or bridge institution.

authority determines that the conditions for initiating resolution are met and that Bank X needs to be resolved.



2. As illustrated in the diagram above, over the resolution weekend:
- The resolution authority negotiates the sale of mortgage book 'C', the bank's retail and wholesale deposits and other borrowing (consisting mainly of loans from other banks) to another FI – 'Bank Y'. These are transferred to Bank Y together with a balancing payment of cash.⁵²
 - The resolution authority assesses that any losses within mortgage book 'B' are likely to be negligible however, it cannot be reliably valued in the time available, and therefore, could not be sold for a reasonable consideration. To provide time to complete thorough due diligence and to ensure continued

⁵² Paragraphs 222 to 230 of Chapter 4 further consider the funding of resolution. In the example provided here, it is expected that the injection of cash would first be recouped from the liquidation of the residual entity and onward sale of mortgage book 'B' as far as possible.

servicing of these loans, mortgage book 'B' is transferred to a bridge bank.

(c) The remaining assets and liabilities are left in the residual FI.⁵³

3. Mortgage book 'B' is managed within the bridge bank for a period of time. During this period the residual FI continues to provide essential services, such as technology and the use of premises, that were not transferred to Bank Y or to the bridge bank, to ensure continuity of the business that has been transferred.
4. Following a due diligence process, mortgage book 'B' is sold through competitive tender to another third party purchaser – 'Bank Z'.
5. Following the transfer of mortgage book 'B' from the bridge bank to Bank Z, there is a transitional period in which the residual bank continues to provide services to Bank Z that are required for the continuity of the transferred business. Once the necessary services have been fully transitioned from the residual bank to Bank Z, the residual bank is no longer required and the creditors petition to take it into liquidation.
6. To ensure that the resolution of Bank X has not left creditors worse off than they would have been had it been left to go into liquidation, a NCWOL calculation is conducted.⁵⁴

Transfer to an AMV

97. CP1 proposed the inclusion in the resolution regime of an option to transfer some of an FI's business to an AMV for management for a period of time ahead of that business being sold on or wound-up. As described in CP1, use of an AMV as an alternative to liquidation, could be appropriate where there is a risk that immediately commencing a winding-up of the relevant portfolios or business could undermine delivery on the objectives set for resolution. Liquidation of a substantial portfolio of assets could have a materially adverse effect on one or more financial markets in some cases, for example.

⁵³ See paragraphs 139 to 142 regarding proposals as to how the residual FI may support the transferred business.

⁵⁴ Please refer to paragraphs 168 to 179 for more detail on the NCWOL safeguard.

98. The authorities confirm that this power is likely to be used in conjunction with one or more of the other resolution options. For example, following a transfer of good quality assets to a commercial purchaser or bridge institution, other assets, which could not be safely wound-up immediately, could be transferred to an AMV (and dealt with over a more appropriate timeframe).
99. Respondents were broadly supportive of this option, recognising its role in ensuring that the sale or winding-up of parts of a failing FI's business can be effected in an orderly manner (which may, in some circumstances, better protect financial stability and also maximise value for creditors). Given the broad support for this power, the authorities intend to include it within the regime, as outlined in CP1.

Statutory bail-in

100. There is now broad consensus that it may not be possible to carry out an orderly resolution of the largest and most complex FIs using the compulsory transfer powers outlined above. It was proposed in CP1 that, in line with the requirements of the Key Attributes, the local regime should include an option for resolution by means of a bail-in of liabilities.
101. Statutory bail-in seeks to ensure that shareholders and certain creditors of the failed FI, rather than public funds, absorb any losses incurred and meet the costs of recapitalisation so that the FI can continue to provide critical financial services to its customers. Following a recapitalisation through bail-in, restructuring measures can then be implemented to address the cause of the failure. In turn, this should help to limit disruption to the FI's customers and maintain public confidence in the financial system.
102. Under a bail-in option, the resolution authority would be able to write down shareholders of a failing FI and thereafter to write down and/or convert the claims of creditors to the extent needed to absorb losses and recapitalise the FI to a level

capable of restoring market confidence.⁵⁵ Exposing shareholders and creditors to the costs of failure in this way should sharpen their incentives to curb excessive risk-taking in the normal course of business. Respondents were broadly supportive of including a bail-in option within the local resolution regime and some offered views on how to structure and use it.

103. With a view to ensuring that local implementation is consistent with that in other major financial centres, as well as with work underway within the FSB particularly with regards to articulating requirements for TLAC⁵⁶ and to support cross-border resolution⁵⁷, no firm proposals on a bail-in option for Hong Kong were included within CP1. Substantive progress has been made in certain jurisdictions and internationally over the past year, which has brought greater clarity around how best to structure and use this option. The European Union (“EU”) Bank Recovery and Resolution Directive (“BRRD”), for example, makes provision for a bail-in option.⁵⁸ In light of this, some initial proposals for local implementation are set out below. As certain aspects of how best to provide for a bail-in option are still under development internationally, including with regards to ensuring this option is effective for use with insurers, FMIs and NBNI FIs, the authorities intend to provide further details on local implementation in CP3.

⁵⁵ As outlined in CP1, a bail-in of liabilities may occur directly in relation to an FI – either at holding or operating company level – or through transfer of the assets and some of the liabilities of a holding company to a bridge institution.

⁵⁶ The FSB published a consultation document on loss-absorbing capacity of G-SIBs in November. See FSB (2014), “Adequacy of loss-absorbing capacity of G-SIBs in resolution”, <http://www.financialstabilityboard.org/2014/11/adequacy-of-loss-absorbing-capacity-of-global-systemically-important-banks-in-resolution/>

⁵⁷ The FSB published a consultation document on cross-border recognition of resolution actions in September. See FSB (2014) “Cross-border recognition of resolution actions”, http://www.financialstabilityboard.org/wp-content/uploads/c_140929.pdf

⁵⁸ See Articles 43 to 55 of “Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms”, <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN>

Execution of a bail-in

104. Given the need to move quickly to commence resolution, the authorities propose that the resolution authority should be able to carry out a preliminary valuation upon entry of the FI into resolution with a view to identifying those liabilities that may be subject to write-down and/or conversion (the resolution authority could then make an initial announcement identifying the liabilities likely to be subject to bail-in). The preliminary valuation will, by necessity, need to be based on prudent assumptions as to the level of loss incurred and hence the value of equity and debt that needs to be written-down and converted. An announcement on the final terms of the bail-in could follow only once further detailed valuation work had been completed.

105. The authorities are further considering how to execute a bail-in and note the Bank of England (“BoE”) has set out some detail on its intended approach.⁵⁹ The BoE has indicated that it may issue certificates of entitlement to those shareholders and creditors potentially within scope of the bail-in. This is because it may be necessary to suspend trading in the relevant instruments, with shares being held on trust for example, whilst a definitive valuation is completed. The shares could be distributed to former bondholders or other creditors, once the final terms of the bail-in are announced. The issuing of certificates of entitlement would provide creditors with continued access to their claims during the detailed valuation process when it may be necessary to block trading in the underlying liabilities subject to the bail-in.

106. Additionally, the authorities will further consider what provision is needed under the regime, and in guidance, with respect to a valuation process designed to support use of the bail-in option (as well as other resolution options). It is noted that a valuation designed to support the carrying out of resolution is likely to differ somewhat from that which is described in paragraph 176 in respect of the NCWOL compensation mechanism.

⁵⁹ See BoE (2014), “The Bank of England’s Approach to Resolution”, <http://www.bankofengland.co.uk/financialstability/Documents/resolution/apr231014.pdf>

Question 14

Do you have any views on the steps and processes, outlined in paragraphs 104 to 106, with a view to making the bail-in process operational?

Scope of write-down and conversion

107. To the extent that the regime allows for bail-in of a relatively broad set of liabilities, it may help to ensure that resolution by this means is effective. At the same time, there are clearly liabilities which it would be inappropriate or otherwise undesirable to write-down and/or convert into equity claims in all cases. Following the recent global financial crisis, there is a greater degree of consensus that certain types of liabilities should always be excluded from the scope of any bail-in. The authorities agree with this approach and consider it appropriate to identify certain liabilities which would be excluded from any bail-in on the grounds that:

- (i) the liabilities would not be exposed to losses in insolvency (through being secured, collateralized or otherwise guaranteed or preferred in insolvency and/or covered by a recognised protection scheme); and/or;
- (ii) subjecting the liabilities to bail-in would be likely to undermine efforts to deliver on the objectives set for resolution, and in particular to secure continuity of critical financial services and/or the general stability and effective working of the financial system.

108. The following list represents the authorities' initial thinking on exclusions from bail-in, drawing on suggestions received in response to CP1. Following this consultation exercise, the list will be further refined, including to ensure it is comprehensive in respect of non-banks within the scope of the regime. The types of liabilities which it is proposed should be excluded are:

- (i) Liabilities which are deposits protected by the DPS (as well as liabilities of a failing bank to the DPS in respect of any levies due);
- (ii) Liabilities which relate to policyholder claims to the extent that the relevant policies are protected by the Insolvency Fund, the Employees

Compensation Insurer Insolvency Scheme or the proposed PPF (as well as liabilities of a failing insurer to these Funds and Scheme);⁶⁰

- (iii) Liabilities which are secured, collateralized or otherwise guaranteed (including covered bonds);
- (iv) Client assets⁶¹ protected under applicable domestic laws and regulations;
- (v) Liabilities to current or former employees of the FI in respect of fixed salary and pension benefits (but excluding variable remuneration);
- (vi) Liabilities which relate to commercial claims for goods and services critical to the FI's daily functioning;
- (vii) Unsecured short-term inter-bank liabilities with an original maturity of less than 7 days except for those which are intragroup;
- (viii) Liabilities arising from participation in payments, clearing and securities settlement systems and owed to such systems, or operators of or participants in such systems;
- (ix) Liabilities which are statutory debts due to the Government provided that those liabilities are preferred under CWUMPO; and
- (x) Any liability that arises by virtue of a fiduciary relationship between the FI in resolution (as fiduciary) and another person (as beneficiary) provided that such a beneficiary is protected under the insolvency framework.

109. It is clearly important to carry out resolution, including by means of bail-in, in a manner that ensures losses are imposed in a way that broadly respects the hierarchy of claims in liquidation. Therefore, shareholders should be completely written down before subordinated creditors are exposed to loss. Senior creditors should only experience losses where subordinated debt (including all regulatory

⁶⁰ The Insolvency Fund is administered by the Motor Insurers' Bureau of Hong Kong and the Employees Compensation Insurer Insolvency Scheme is administered by the Employees Compensation Insurer Insolvency Bureau.

⁶¹ See Footnote 5 for definition.

capital) has been exhausted. And creditors in the same class should experience the same level of loss (i.e. *pari passu* treatment) as far as possible.

110. It was also proposed in CP1, consistent with K.A. 5.1,⁶² to set as a guiding principle for use of the local regime that the statutory creditor hierarchy should be respected and that any departures from equal treatment of creditors in the same class should only be limited to cases where they can be justified against the objectives set for resolution. A number of respondents recognised that such flexibility might be particularly important in carrying out a bail-in, where additionally there may be cases where there are practical obstacles to bailing-in certain liabilities in a reasonable timeframe or where this might be unnecessarily value destructive.⁶³ The authorities consider it would be appropriate to set criteria which must be met if liabilities in addition to the excluded liabilities listed in paragraph 108 are to be wholly or partially excluded from bail-in. It is proposed that these criteria would, broadly speaking, be that the exclusion is justified on the grounds that bailing-in particular liabilities:

- (i) is not possible within a reasonable timeframe despite the good faith efforts of the resolution authority;
- (ii) could undermine efforts to secure continuity of critical financial services and the general stability and effective working of the financial system;
- (iii) would be value destructive such that losses borne by other creditors would be higher than if those liabilities had not been bailed-in.

⁶² Key Attribute 5.1 states that: “[r]esolution powers should be exercised in a way that respects the hierarchy of claims while providing flexibility to depart from the general principle of equal (*pari passu*) treatment of creditors of the same class, with transparency about the reasons for such departures, if necessary to contain the potential systemic impact of a firm’s failure or to maximise the value for the benefit of all creditors as a whole. In particular, equity should absorb losses first, and no loss should be imposed on senior debt holders until subordinated debt (including all regulatory capital instruments) has been written-off entirely (whether or not that loss-absorption through write-down is accompanied by conversion to equity).”

⁶³ In respect of this latter point, the resolution authority will need to consider the scale of potential NCWOL compensation claims which could arise in relation to the treatment of particular liabilities in bail-in as a result of those liabilities being either (i) excluded from bail-in or (ii) subject to bail-in but resulting in value destruction.

111. Several respondents highlighted the issues that may arise in seeking to bail-in derivatives.⁶⁴ The authorities are of the view that liabilities arising from derivatives transactions should generally remain within the scope of the bail-in powers, whilst noting that some may be excluded by virtue of one or more of the exclusions outlined in paragraph 108 above. Furthermore, the resolution authority would need to consider, on a case-by-case basis, whether to subject other derivatives liabilities (i.e. those not covered by one of the exemptions in paragraph 108) to bail-in taking into account the criteria outlined in paragraph 110 above and the need to adhere to the safeguards protecting certain financial arrangements (outlined in paragraphs 191 to 201 of Chapter 4).

Question 15

Do you have views on the scope of the bail-in power within the resolution regime and specifically on (i) the list of liabilities identified in paragraph 108 which would always be excluded from bail-in and (ii) the grounds for excluding further liabilities from any bail-in on a case-by-case basis as identified in paragraph 110?

Question 16

Do you have views on how the list of excluded liabilities in paragraph 108 should be expanded to ensure that the bail-in option is suitable for use with FIs other than banks, and specifically in relation to insurers, FMIs and NBNI FIs?

Question 17

Do you have views on the proposed approach to bail-in of liabilities arising from derivatives as outlined in paragraph 111?

Loss absorbing capacity

112. Ultimately, the successful implementation of bail-in will be dependent upon the availability, on an FI's balance sheet, of a sufficient amount of eligible liabilities

⁶⁴ To effect a bail-in, the resolution authority would first need to terminate and close-out the relevant derivatives transactions.

that can feasibly and credibly absorb losses at the point of entry into resolution. As noted in paragraph 103, work is underway at the level of the FSB to enhance the loss absorbing capacity of G-SIBs in resolution in particular through the setting of TLAC requirements (a brief overview of the FSB’s proposals in this regard is set out in Box D below). Further consideration will be given to how best to implement the resulting TLAC framework locally; noting that some key jurisdictions are already considering whether and how requirements set in relation to loss absorbing capacity should extend more broadly with a view to supporting orderly resolution by means of bail-in.

Box D: Overview of FSB’s TLAC proposals

The FSB is seeking to ensure that adequate TLAC is available in resolution by setting a new requirement for G-SIBs to have in issue a common minimum amount of outstanding instruments satisfying certain eligibility criteria. This requirement is designed to ensure loss absorbency and capacity to support recapitalisation at the point of resolution and recognises both Basel 3 compliant capital instruments (subject to constraints on the amount of equity as opposed to liabilities included) as well as other instruments satisfying the TLAC eligibility criteria. It is also proposed that home and host authorities coordinate in setting a specifically tailored and additional TLAC requirement for their given G-SIBs, which would take into account a series of factors relevant to the risks that the failure of the individual G-SIB may pose. The FSB has outlined a term sheet identifying the criteria that liabilities eligible as TLAC must meet.

A key objective of the new TLAC standard is to provide both home and host authorities with confidence that G-SIBs can be resolved in an orderly manner. So the FSB proposals also seek to ensure that sufficient amounts of loss absorbing capacity will be available at the right locations within a G-SIB group. This means that the TLAC proposals cover both “external” TLAC – i.e. instruments held by third parties – and “internal” TLAC or intragroup arrangements designed to upstream losses within the group to the entities that, under the group’s resolution plan, will be subject to the exercise of resolution powers. In setting requirements, authorities will therefore need to take into account the preferred resolution strategies

for each G-SIB, and the entity (or entities) within a group to which resolution powers will be applied, as well as their wider resolution groups.⁶⁵

Cross-border considerations

113. The authorities recognise the importance of seeking to ensure that bail-in will be effective in a cross-border context and note that at least in relation to G-SIBs, preferred resolution strategies tend to be based on a bail-in carried out by the home resolution authority. Chapter 5 outlines early thinking on how the local regime could allow for the resolution authority to recognise and/or support resolution actions being taken by a foreign resolution authority.⁶⁶ As explained there, in addition to providing for the necessary statutory powers, FSB member jurisdictions are expected to promote the widespread adoption of contractual clauses to recognise the exercise of bail-in powers by a foreign resolution authority. The FSB considers that contractual clauses of this type could help to ensure that bail-in would be effective even in relation to instruments governed by the law of a jurisdiction other than that of the issuing entity.

Temporary public ownership

114. CP1 explained the rationale for providing for, as a last resort, a TPO resolution option under the regime. Respondents were broadly supportive of this but highlighted the need for clarity on the conditions for its use. Some respondents also identified the importance of including a mechanism to recoup any net costs incurred in, and asked whether a limit would be set on the duration of, a TPO resolution.

115. Since TPO is viewed as a last resort, to be deployed where none of the other resolution options are sufficient to enable the resolution authority to deliver on the

⁶⁵ The resolution entity and any direct and indirect subsidiaries of the resolution entity which are not themselves resolution entities form the resolution group.

⁶⁶ As outlined in Chapter 5, this would be contingent on an assessment that any such actions were consistent with the resolution objectives in Hong Kong and would not disadvantage local creditors relative to foreign creditors.

resolution objectives, the authorities propose that an additional condition be set for its use. Such a condition would require that before TPO could be initiated, in addition to an FI having met the first non-viability and second financial stability conditions for initiating resolution, it would also have to be assessed that an orderly resolution, which delivers on the objectives set, cannot be achieved through use of any of the other resolution options available to the resolution authority under the resolution regime (at that time).

116. As the name temporary public ownership suggests, the intention would always be to return the business of the FI to the private sector. It is, however, difficult, if not impossible, to predict how long it would take to find a suitable acquirer, which may very much depend on financial and economic conditions prevailing when TPO is carried out. Further, it may not prove possible to dispose of all of the business taken into TPO and, after parts of it have been returned to the private sector, there may be a residual FI that would need to be wound down. The authorities do not, therefore, intend to limit the permitted duration of public ownership as this could vary significantly case-by-case and to do so could actually hinder the resolution authority's ability to fulfil the resolution objectives. It is, however, proposed that the resolution authority should be required to monitor and contain the duration of TPO to what is reasonably required to fulfil the resolution objectives. Initial proposals for funding resolution with a view to ensuring that any net costs incurred in using the regime could be recouped, across all of the resolution options including TPO, are set out in paragraphs 222 to 230 of Chapter 4.

Question 18

Do you agree that an additional condition is required for TPO? Is the additional condition, proposed in paragraph 115, appropriate?

Temporary stay on early termination rights in financial contracts

117. As outlined in CP1, and in keeping with the Key Attributes, a mechanism is needed within the local resolution regime to ensure that entry of an FI into resolution and the exercise of resolution powers does not trigger contractual acceleration, early termination or other close-out rights (collectively known as

“early termination rights”). At least in relation to large and complex FIs, it is conceivable that the termination of large volumes of financial contracts could otherwise lead to a disorderly “race for the exit”, resulting in broader market instability as well as undermining the prospects for an orderly resolution of the failing FI itself. It was therefore proposed that the regime would include provision such that entry into resolution and the exercise of resolution powers would not, in itself, constitute an ‘event of default’ under which those rights may be exercised (as long as substantive obligations under the contracts continue to be performed).⁶⁷ Respondents were broadly in agreement with this proposal, with one noting that whilst resolution does not currently constitute an event of default, this was likely to change in light of widespread adoption (of Key Attribute-compliant) regimes.

118. In relation to cases where such rights would be nevertheless exercisable, most respondents were supportive of the proposal, designed to provide the resolution authority with a short window to determine what form resolution should take, for a temporary stay of early termination rights on entry of an FI into resolution. Some questioned whether such a stay, given it would by necessity be limited to a very short period of time, would be useful. Others stressed that in order to contain the potential for knock-on consequences for a failing FI’s counterparties, it was important that the stay was underpinned by the sorts of safeguards identified in paragraph 252 of CP1.⁶⁸ The authorities continue to consider that the power to temporarily stay early termination rights is an important one, and note its inclusion in regimes in key jurisdictions (not least the EU BRRD). Clearly any such power would need to be structured appropriately and so this section builds upon CP1 to outline proposals with respect to: (i) the scope of the contracts to be covered by the stay; (ii) timing considerations; (iii) conditions for the stay; and (iv) cross border recognition.

⁶⁷ This provision would not be limited to contracts entered into by the non-viable FI but would also extend to cover contracts entered into by its subsidiaries, or any related entities, the obligations of which are guaranteed or otherwise supported by the FI, with a view to covering cross-default provisions.

⁶⁸ See Footnote 1 for reference.

Scope of the temporary stay

119. It is proposed that the resolution authority should have the power to stay early termination rights of counterparties to financial contracts with an FI in resolution, or related group companies, provided the conditions set out in paragraph 121 are met.⁶⁹ “Financial contracts” would include the following broad types of contracts and agreements (with further detail provided in Annex III): (i) securities contracts; (ii) commodities contracts; (iii) futures and forwards contracts; (iv) swap agreements (v) inter-bank borrowing agreements where the term of the borrowing is three months or less; (vi) master agreements for any of the contracts or agreements referred to in points (a) to (e) of Annex III. Some other jurisdictions appear to have made provision such that a temporary stay may also apply to non-financial contracts and the authorities are further considering whether this would be appropriate for the local regime (noting that it is possible that other contracts relating to matters important to operational continuity may reference “event of default” type events).⁷⁰

Timing and duration of the temporary stay

120. The authorities propose that the public notice issued on commencement of resolution proceedings, mentioned in paragraph 85 above, would specify that a temporary stay had come into effect. Some respondents expressed a view that thereafter, the stay should be limited in time and not exceed two business days. It is proposed, therefore, that the stay should be effective from the publication of the notice until, at the latest, midnight in Hong Kong on the business day following that publication. The term “business day” for this purpose would mean any day other than Saturday, Sunday, or any official Hong Kong public holiday.

⁶⁹ It is intended that the scope of this stay as it relates to FIs within scope of the regime, and related entities, would be as described in Footnote 67 above.

⁷⁰ Article 71 of the EU BRRD, for example, requires that member states provide resolution authorities with “the power to suspend the termination rights of any party to a contract with an institution under resolution”.

Conditions for a temporary stay

121. Taking into account the requirements set out in the Key Attributes, and responses to CP1, the authorities propose that the temporary stay on early termination rights should be subject to the following conditions:

- (i) The stay is limited in time (as set out in paragraph 120 above);
- (ii) The stay only applies to early termination rights that arise for reasons of entry into resolution or in connection with the use of resolution powers (this implies that the substantive obligations under a contract must continue to be performed);
- (iii) The early termination rights of the counterparty are preserved against the FI in resolution in the case of any default occurring before, during or after the period of the stay that is not related to entry into resolution or the exercise of a resolution power (for example, a failure to make a payment or to deliver or return collateral, in either case, on a due date occurring during the period of the stay);
- (iv) The counterparty can exercise the right to close out: (i) immediately on expiry of the stay (if the conditions for contractual termination exist);⁷¹ or (ii) before expiry of the stay if the counterparty receives notice from the resolution authority that the rights and liabilities covered by the relevant financial contracts will not be transferred to another entity;
- (v) Where resolution involves the transfer of assets and liabilities, the resolution authority is permitted to transfer either all or none of the eligible financial contracts (together with any related collateral) with a particular counterparty to a new entity.⁷² In other words, the resolution authority would not be permitted to selectively transfer individual

⁷¹ If the substantive obligations under the contracts continue to be performed, there should be no further cause to close out.

⁷² Noting this is provided for under the safeguard for certain financial transactions as outlined in paragraphs 191 to 200.

financial contracts with a particular counterparty subject to a netting agreement;

- (vi) For financial contracts that are transferred to a third party or bridge institution, the acquiring entity would assume all the rights and obligations of the FI from which the financial contracts were transferred;
- (vii) Following a transfer of financial contracts the early termination rights of the counterparty are preserved against the acquiring entity in the case of any subsequent independent default by the acquiring entity;
- (viii) After the period of the stay, early termination rights could be exercised for those financial contracts that are not transferred to a sound third party (e.g. commercial purchaser or bridge institution).

122. One respondent proposed that any transferee should be a financially sound entity with whom the counterparty would prudently be able to contract in the normal course of its business and that the transferee should be subject to the same or a substantially similar legal and tax regime so that the economic and tax position of the counterparty is not materially affected by the transfer. This suggestion is reflected, in part, in condition (viii), and the authorities additionally propose to identify these as factors for the resolution authority to consider when assessing the suitability of a commercial purchaser.

Question 19

Do you agree with the scope, timing and conditions proposed for temporary stays on early termination rights in financial contracts?

Question 20

Do you have views on whether a temporary stay on early termination rights should apply solely to financial contracts or whether broader provision should be made?

Question 21

Do you have views on whether there are other issues which need to be considered in relation to staying early termination rights in resolution?

Recognition of temporary stays under the laws of foreign jurisdictions

123. As noted by some respondents, FIs enter into large volumes of financial contracts with counterparties in different jurisdictions and those contracts are often governed under foreign law. The authorities recognise that full implementation of the Key Attributes may imply ensuring that a temporary stay of early termination rights can be enforced in respect of contracts governed under Hong Kong law in support of an overseas-led resolution of a cross-border FI. Chapter 5 outlines more generally how, under the local regime, the resolution authority might recognise and/or support resolution actions being taken by a foreign resolution authority, subject to certain conditions being met.⁷³ In addition to considering what is needed under the local regime in this regard, the authorities are also considering the merits, as well as the most effective means, of promoting the adoption of contractual clauses in financial contracts governed by Hong Kong law.

Temporary stays on early termination rights in resolution of FMIs

124. The Annex on FMI resolution provides that the entry into resolution of, or the exercise of any resolution power in relation to, an FMI should not trigger a right to acceleration or early termination by any participant in, or any other counterparty of, an FMI. However, such rights should remain exercisable where the FMI fails to meet payment or delivery obligations, including collateral transfers, in accordance with its rules, subject to any application of loss allocation to margin or collateral under the rules of the FMI. Where such early termination rights nevertheless arise, the resolution authority should have the power to temporarily stay such rights. In considering whether to impose a temporary stay on the exercise by FMI participants and other relevant counterparties of their early termination rights, the resolution authority should take into account the impact on

⁷³ See Footnote 66 for reference in relation to those conditions.

the financial markets and the impact on the safe and orderly operations of the FMI and any linked FMI.⁷⁴

125. A stay on early termination rights may be particularly important in resolution of CCPs. Absent the ability to impose such a stay, a large number of participants could exercise their early termination rights, placing further strain on the CCP's operations and financial resources and undermining efforts to secure, through resolution, continuity of critical clearing services. Early termination by participants may also result in the CCP no longer having a "matched book" and hence increase the CCP's exposure to market risk. This might impede the resolution authority's efforts in trying to achieve an outcome that preserves financial stability.⁷⁵

126. While this consultation paper recognises the importance of providing the resolution authority with the power to temporarily stay the exercise of early termination rights on resolution of an FMI, it does not provide detailed proposals specifically relating to the sector for consideration. As the Annex on FMI resolution was issued relatively recently by the FSB,⁷⁶ the authorities believe that further time is required to consider whether the general power described in paragraphs 117 to 123 above is appropriate or would need to be adapted somewhat. Further, given the interconnections between global financial markets, the authorities consider it desirable that the approach developed locally for the

⁷⁴ Safe and orderly operation of the FMI includes ensuring the settlement of payments and transfers both to and from the FMI.

⁷⁵ The importance of a stay on early termination rights in resolution of CCPs is noted in Explanatory Note ("EN") 4.1(g) of the FSB's "Consultative Document: Assessment Methodology for the Key Attributes of Effective Resolution Regimes", http://www.financialstabilityboard.org/wp-content/uploads/r_130828.pdf. The draft Assessment Methodology is to facilitate the assessment of a jurisdiction's compliance with, and to guide jurisdictions in implementation of, the Key Attributes. The methodology proposes a set of essential criteria ("EC") for each Key Attribute that should be used to assess compliance with the relevant Key Attributes. The authorities recognize that the Assessment Methodology is yet to be finalised by the FSB and will monitor any relevant changes in the final version, that impact on policy development for Hong Kong.

⁷⁶ The Annex on FMI resolution was released on 15 October 2014, alongside three further annexes. See Footnote 4 for reference.

resolution of FMIs is consistent with that adopted in other jurisdictions and will therefore continue to observe how the Annex on FMI resolution is being implemented in other overseas jurisdictions, and will take those approaches into consideration when formulating further proposals.

Question 22

Do you have views on how best to implement a temporary stay of early termination rights such that it is effective in supporting resolution of FMIs in particular?

Stays in relation to contracts of insurance

127. In the event of resolution of an insurer, there is a risk that policyholders rush to terminate their policies and get back the surrender value of the policies or exercise contractual rights to a refund of premiums to secure their rights as far as possible if they think that the insurer in resolution may not be able to honour their insurance contract. This could exacerbate the operational and financial pressure faced by an insurer in resolution. To avoid this risk, and in keeping with requirements set out in the Annex on insurer resolution,⁷⁷ the authorities propose that the resolution authority should have powers to temporarily restrict or suspend the rights of policyholders to withdraw from their insurance contracts with an insurer. The authorities propose that issuance of the public notice that serves as the formal commencement of resolution proceedings, as mentioned in paragraph 85, should be the point at which the suspension would take effect. This would then run until, at the latest, midnight in Hong Kong on the business day following that publication. This is consistent with the proposals for temporary stays of early termination rights for financial contracts described in paragraph 120.

128. The Annex on insurer resolution also requires that the resolution authority be able to stay rights of reinsurers of an insurer or of another reinsurer in resolution to terminate or not reinstate coverage relating to periods after the commencement of resolution. By means of reinsurance/retrocession, the ceding insurer/reinsurer

⁷⁷ See Footnote 4 for reference.

is able to reduce its exposure to loss (gross exposure) by transferring part of the risk of loss to its reinsurers who will pay a share of the claims incurred by the ceding insurer/reinsurer. If reinsurers were to use resolution as a trigger to terminate or not reinstate coverage, this could leave the ceding insurer/reinsurer in resolution exposed to unacceptable risk. Similar to the temporary stay on early termination rights for financial contracts, it is necessary that this stay be subject to the following conditions:

- (i) The stay is limited in time as set out in paragraph 127 above;
- (ii) The stay only applies to early termination rights that arise for reasons of entry into resolution or in connection with the use of resolution powers;
- (iii) The early termination rights of the reinsurers are preserved against the ceding insurer/reinsurer in resolution in the case of any default occurring before, during or after the period of the stay that is not related to entry into resolution or the exercise of a resolution power;
- (iv) For reinsurance contracts that are transferred to a third party or bridge institution, the acquiring entity would assume all the rights and obligations of the ceding insurer/reinsurer from which the contracts were transferred;
- (v) Following a transfer of contracts, the early termination rights of the reinsurer are preserved against the acquiring entity in the case of any subsequent independent default by the acquiring entity; and
- (vi) After the period of stay, early termination rights could be exercised for those reinsurance contracts that are not transferred to a sound third-party.

Question 23

Do you have views on the proposals for the temporary suspension of insurance policyholders' surrender rights, including the proposed duration of the suspension?

Question 24

Do you have views on the proposals for a temporary stay on reinsurers of an insurer or of another reinsurer in resolution to terminate or not reinstate coverage relating to periods after the commencement of resolution?

Powers to require improvements to an FI's resolvability

129. CP1 identified that, even with the implementation of the full range of resolution options proposed for the regime in Hong Kong, some FIs are structured and/or operate in a manner that may frustrate efforts to carry out their orderly resolution (in other words, the FIs are not adequately resolvable). In keeping with Key Attribute 10.5, it was therefore proposed that the regime should enable the authorities to require FIs to adopt appropriate measures to remove identified barriers to effective resolution.⁷⁸ The MA and IA do have some existing powers to require FIs under their purview to take measures regarding their affairs, business or property as well as to provide information. Similarly, the SFC has powers to require a recognized clearing house to take certain actions with regards to the management, conduct or operation of its business and to provide information. Such powers are not, however, in full compliance with the requirements under Key Attribute 10.5, as confirmed by the outcomes of the FSB's Peer Review Report, which concluded that "a clear power to require changes explicitly for the purposes of improving resolvability is necessary" and that such a power was not yet available in Hong Kong.⁷⁹

130. Overall, respondents to CP1 recognised the need for this power although one suggested that actual barriers to resolution should be assessed before it can be considered what powers need to be provided to the resolution authority. Many

⁷⁸ Key Attribute 10.5 states that: "[t]o improve a firm's resolvability, supervisory authorities or resolution authorities should have powers to require, where necessary, the adoption of appropriate measures, such as changes to a firm's business practices, structure or organisation, to reduce the complexity and costliness of resolution, duly taking into account the effect on the soundness and stability of ongoing business. To enable the continued operations of systemically important functions, authorities should evaluate whether to require that these functions be segregated in legally and operationally independent entities that are shielded from group problems".

⁷⁹ See table 3, page 32 of the FSB's "Thematic Review on Resolution Regimes: Peer Review Report", http://www.financialstabilityboard.org/wp-content/uploads/r_130411a.pdf

respondents highlighted the importance of such powers only being used for FI-specific changes when an alternative solution cannot be agreed with the FI. It was suggested that changes be subject to rigorous analysis and justification in which costs and undesired outcomes are carefully considered, including the impact on other jurisdictions. Further, it was suggested that the FI be given time to consider changes proposed by the resolution authority and that there should be an appropriate appeals mechanism. These suggestions have been taken into account when developing the proposals set out below.

131. The authorities confirm that it is not intended that powers to improve resolvability would be used to require blanket structural or other reform across FIs in scope of the regime. Whilst certain practices and structures may generally tend to diminish resolvability, the extent to which such practices actually represent substantive barriers to the resolution of a given FI, which need to be addressed, would be assessed on a case-by-case basis.⁸⁰ The authorities also recognise the importance of engaging with the FI on the removal of barriers, and propose that use of the powers would be subject to a formal consultation process. This would commence with the resolution authority formally notifying the FI of any substantive barriers identified (as a result of resolution planning and a resolvability assessment). The FI, within a timeframe set by the resolution authority (for example, three months), would then have an opportunity to make representations to the resolution authority on how it proposed to address those barriers. The resolution authority would then only use its powers to direct FIs to take specific actions to improve its resolvability in the event that it is assessed that the FI's proposals would not to achieve the resolution authority's desired objective and no alternative measures can be agreed.

132. In assessing whether to exercise such powers, the resolution authority would be required to take into account the effect of any such changes on the soundness and stability of the FI's ongoing business. Additionally, and as explained in CP1, in determining how to exercise these powers the resolution authority will seek to

⁸⁰ Such a case-by-case assessment would likely be undertaken through resolution planning and resolvability assessments.

ensure their proportionate application. It therefore remains the case that, ahead of requiring that individual FIs take measures to improve resolvability, the resolution authority will be required to have regard to:

- (i) the extent to which it will otherwise be difficult to carry out resolution in a manner that fulfils the resolution objectives; and
- (ii) the likely impact on the FI, including in relation to its future viability and ability to continue to provide critical financial services and thereby support economy activity.

133. In respect of cross-border FIs with operations in Hong Kong, the authorities recognise that requiring FIs to make changes to enhance their resolvability should be undertaken in close consultation and cooperation with the FI's home resolution authority. The authorities emphasised throughout CP1 that they recognise the importance of effective cross-border co-operation and coordination in resolution of a cross-border FI. In keeping with that overall policy stance, the authorities would not expect to independently exercise powers to require that a foreign FI operating in Hong Kong enhance its resolvability, unless the resolution authority had not been provided with enough information on how the group-wide strategy might impact group entities in Hong Kong or had substantiated concerns that the strategy would not deliver on the resolution objectives locally.

134. In light of the range of FIs proposed to be within the scope of the resolution regime and the different business models they operate, it would be difficult (if not impossible) to identify in advance all of the powers which might potentially be needed by a resolution authority to require changes to improve their resolvability. It is intended, therefore, that the regime should include a non-exhaustive list of changes that the resolution authority could require of an in-scope FI, while also allowing for other changes as deemed appropriate by the resolution authority (see Box E for the proposed list).

Box E: Non-exhaustive list of measures to improve FIs' resolvability

The below sets out a non-exhaustive list of measures that, if required and consistent with the conditions for their use,⁸¹ the resolution authority could require FIs to implement to improve their resolvability:

Structural

- Make changes to legal or operational structures to reduce complexity and ensure that critical financial services can be legally and operationally separated from the group through use of the resolution powers;
- Establish an intermediate holding company to facilitate bail-in or to avoid there being a need to use resolution powers in relation to any parts of the FI's wider group which are not otherwise relevant to delivering on the objectives set for resolution;

Business

- Limit or cease specific existing or proposed activities or products;
- Divest specific assets;
- Restrict the development of new business lines or sale of new products, or impose structural or organisational requirements on the way such business lines or products are provided;

Financial

- Limit maximum individual and aggregate exposures;
- Issue additional loss absorbing capacity from particular parts of the group to support a specific resolution strategy;
- Meet enhanced reporting requirements;

Operational

- Improve management information systems such that key information necessary for

⁸¹ See paragraph 132 for those conditions.

executing the preferred resolution strategy can be produced on a timely basis;

- Improve arrangements for the continued provision of shared or third party services needed to maintain critical operations;
- Ensure effective segregation of client assets; and
- Implement effective processes for the management, identification and valuation of collateral.

Additionally the authorities propose that the resolution authority would be able to require that the FI take other measures as it deems appropriate, in accordance with proposed conditions and subject to the FI's right to appeal.

135. Given the potentially intrusive nature of such powers, and taking into account respondents' views, the authorities consider it appropriate that an FI should have the right to appeal against a resolution authority's decision to exercise these powers. As indicated in paragraphs 209 to 211 in Chapter 4, proposals on how an appropriate appeals mechanism might be provided for will be set out in CP3.

Question 25

Do you agree with the proposals set out above to provide the resolution authority with powers to require an FI to make changes to improve its resolvability?

Relationship with existing corporate insolvency proceedings

136. The resolution regime is intended for use only in cases where it is assessed that resolution of a non-viable FI is justified with a view to securing continuity of critical financial services and protecting financial stability more broadly. It is not intended that the regime would have any material effect on the use of existing corporate insolvency procedures, both compulsory and (where applicable) voluntary winding-up, in cases where the non-viability of an FI is assessed to pose little threat to financial stability. However, there are still circumstances where resolution proceedings and existing insolvency proceedings interact, and need to be accommodated under the regime, as described below.

Powers in relation to the filing of a winding-up petition

137. Paragraphs 261 and 262 of CP1 highlighted the risk that resolution proceedings could be pre-empted or frustrated by a person petitioning for the winding-up of an FI within the scope of the regime. As explained, this could have severe consequences for financial stability, other affected parties and the costs of resolution. It was therefore proposed that a mechanism be devised whereby the resolution authority is notified before any winding-up petition can be filed with the court. On receiving this notification, the resolution authority would be permitted a set period of time (“notice period”) to decide whether to initiate resolution instead. One respondent queried whether it is necessary to prohibit the filing of a winding-up petition, instead allowing winding-up proceedings to proceed but prevent a winding-up order from being determined by the court. The authorities are however, concerned that the presentation of a winding-up petition could itself initiate default and cross-default triggers in an FI’s financial contracts that may exacerbate financial instability and accelerate the deterioration of the FI’s condition.

138. Accordingly, the authorities propose to pursue an approach whereby the filing of a winding-up petition to the court would be prohibited, unless the relevant resolution authority has been notified and afforded the requisite notice period to assess whether resolution should be initiated. Under this approach the petition could not be filed until either (i) the resolution authority has determined whether (or not) to initiate resolution; or (ii) the notice period within which the resolution authority must make its decision has expired. It is proposed that the resolution authority should be permitted a maximum notice period of 14 days to make its determination.⁸²

Question 26

Do you agree with the proposal that the resolution authority should be notified of an intention to petition for an in-scope FI’s winding-up and be afforded a

⁸² This timing is consistent with the approach adopted in the UK, under s120(7) of the Banking Act 2009.

maximum 14 day notice period to determine whether or not to initiate resolution before that winding-up petition can be presented to the court?

Supporting the transferred business

139. Where resolution involves a partial transfer of business to a commercial acquirer, either directly or via a bridge institution, those assets and liabilities not transferred will remain in the residual FI. In some cases, the part of the business not transferred could include services and functions (people, systems and property, for example) essential to continuing the transferred business.⁸³ This implies, as recognised by Key Attribute 3.2(iv), that the resolution authority should have powers to secure continuity of essential services and functions by “ensuring that the residual entity in resolution can temporarily provide such services to a successor or an acquiring entity”.

140. Whilst the regime could empower a resolution authority to impose continuity requirements on a residual FI, using the power described in paragraphs 153 to 157 below in relation to regulated and non-regulated entities in an FI’s wider group, this could be ineffective were the residual FI to enter winding-up proceedings. Absent further provision under the regime there may be cases, therefore, where resolution by means of a transfer of business may be precluded on the grounds of feasibility (even if it would otherwise have delivered on the objectives set for resolution).

141. In implementing this aspect of the Key Attributes in a local context, it appears difficult to replicate the sort of approach adopted in, for example, the UK given that relies on modifications made to the corporate administration procedure.⁸⁴

⁸³ Such a situation could arise where commercial purchasers want to acquire some of the assets and liabilities, but not the underlying infrastructure, of the failed FI. Additionally, services which were shared by different parts of a failing FI (or group) could not be transferred to a single acquirer if resolution involves transferring the business of the FI (or group) to multiple commercial purchasers.

⁸⁴ As noted in CP1, in the UK, following a partial transfer, the residual part of a failed bank could be placed into a Bank Administration Procedure, under which the administrator is able and required to provide support for a period of time to a commercial purchaser or bridge institution taking on other parts of the business (by allowing for subsequent adjustments to the initial transfer as well as by

The authorities are currently considering two different approaches to securing the provision of the services and functions essential to continuity of the transferred business on a temporary basis and until alternative provision could be made. Those are:

- a) The appointment of a person to the residual FI to take control of, and manage, the residual FI, and who would be set a primary objective of securing the provision of the essential services and functions and may be granted powers similar to those provided for in relation to a Manager under Section 52 of the Banking Ordinance (Cap. 155) (“BO”). Under this approach, there would appear to be a need to defer any winding-up of the residual FI for an appropriate period of time;
- b) The establishment of a service company (“servco”) into which any assets and liabilities relevant to supporting the transferred business could be moved leaving other assets, and importantly liabilities, in the residual entity. At the same time, and under existing legislation, the residual FI could be allowed to enter a winding-up proceeding (such that the process of disposing of its assets to meet creditor claims could begin).

142. One potential disadvantage of the approach outlined in (b), relative to (a), is that it may not readily accommodate any adjustments to the assets and liabilities transferred in resolution (as described in paragraphs 196 and 197). The authorities would welcome respondents’ views on how one or both of these models might be developed so as to be effective in a local context.

Question 27

Do you have views on which of the approaches outlined in paragraph 141 above might best deliver continuity of services from a residual FI and which are essential to secure continuity of the business transferred to an acquirer?

continuing to supply any other services and functions necessary for the acquirer or bridge institution to operate effectively).

Other matters relating to insolvency

143. It is recognised that some of the provisions available to a liquidator under CWUMPO, such as to seek to avoid or adjust certain transactions which, but for the liquidation, would have remained binding on the FI, could be relevant where an FI enters resolution. These avoidance of dispositions provisions cover, amongst other transactions, any disposition of the FI's assets made after the commencement of the winding-up of the company.⁸⁵ The authorities will further consider whether to make similar provision under the regime to avoid or adjust certain transactions made in the run up to and/or following commencement of a resolution.

144. Respondents to CPI confirmed that they did not consider it a priority to pursue changes designed to better ensure that the claims of protected parties (such as insured depositors) can be transferred out of liquidation proceedings, alongside the reforms being pursued to establish an effective resolution regime. The Key Attributes say that liquidation procedures and protection schemes should secure an appropriate degree of protection for depositors, investors and insurance policyholders and that this implies not only that their claims are dealt with, or their client assets returned, sufficiently quickly, but also that where possible access to deposit and client asset accounts and so to related financial services, be protected by transferring them out of the liquidation to an acquiring FI.

145. The primary purpose of establishing the regime is to provide means of dealing with non-viable FIs which may be systemic or critical and only non-systemic FIs would be allowed to enter liquidation proceedings. Given this, and respondents' views, the authorities are not currently proposing to include provisions under the regime relating to the treatment of the claims of protected parties in cases where an entire FI is liquidated.

⁸⁵ See Section 182 of the CWUMPO.

Power to suspend certain obligations

146. Clearly, and as explained in CPI, a general moratorium coming into effect on entry of an FI into resolution would be inconsistent with delivering on the objective of securing continuity of critical financial services and protecting financial stability. The Key Attributes require, however, that some provision be made in relation to temporarily suspending certain payment and delivery obligations, as well as restricting the enforcement of security interests (with respect to attaching assets and collecting monies), in relation to contracts with an FI in resolution.⁸⁶

147. So whilst the authorities propose that the resolution authority should have such powers these would need to be subject to a set of exclusions. Taking into account the requirements set by the Key Attributes as well as practice elsewhere, it is proposed that exclusions in relation to suspending payment and delivery obligations be set in relation to: (i) eligible claims under any of the DPS, ICF, the Insolvency Fund, the Employees Compensation Insurer Insolvency Scheme and the proposed PPF; and (ii) payments and delivery obligations to an FMI. In relation to restricting enforcement of security interests, exclusions would include the security interests of FMIs over assets pledged or provided by way of margin or collateral by the FI under resolution. In using this power, it is proposed that the resolution authority would need to have regard to the impact it may have on the functioning of financial markets.

148. It is additionally noted, in relation to resolution of FMIs, that in its (draft) Key Attributes Assessment Methodology (“KAAM”), Explanatory Note (“EN”) 3.2(v) states that “the resolution authority should not impose a moratorium on payments due by the FMI to its participants or to any linked FMI if that would affect the ordinary flow of payments, settlements and deliveries being processed by the FMI

⁸⁶ Specifically, Key Attribute 3.2(xi) requires that resolution authorities have powers to “[i]mpose a moratorium with a suspension of payments to unsecured creditors and customers (except for payments and property transfers to central counterparties (CCPs) and those entered into the payment, clearing and settlements systems) and a stay on creditor actions to attach assets or otherwise collect money or property from the firm, while protecting the enforcement of eligible netting and collateral agreements”.

in the course of its core functions... and be inconsistent with the resolution objective of ensuring continuity of critical functions”.⁸⁷ However, for most FMIs, the ability to make payments, including within payment, clearing and settlement systems, is fundamental to the continuity of their critical financial services. The imposition of a moratorium on payments due by the FMI to its participants or any linked FMI that are associated with the performance of critical financial services would mean a full or partial interruption of the system, which would be likely to defeat the objective of continuity of critical financial services. Moreover, by preventing outgoing payments even for a short period, the imposition of a moratorium on payments by certain FMIs would carry the risk of continuing or amplifying systemic disruption, in particular by causing a build-up of exposures between market participants, placing liquidity strains on some market participants and causing or exacerbating market illiquidity. However, a resolution authority should not be prevented from imposing a moratorium on payments to general creditors, that is, creditors whose claims on the FMI (a) are not the result of the use of the FMI’s critical financial services or (b) do not arise from services necessary for the provision of those services.

149. Consistent with the approach for temporary stays on early termination rights for financial contracts⁸⁸ and similar to the approach adopted by the BRRD,⁸⁹ it is intended that the moratorium on payments to unsecured creditors and the stay on creditor actions would take effect from the point at which the public notice is issued announcing the formal commencement of resolution proceedings until, at the latest, midnight in Hong Kong on the business day following that publication.

Question 28

Do you agree that the regime should empower the resolution authority to impose a temporary moratorium on payments to unsecured creditors and to restrict the

⁸⁷ See Footnote 75 for reference.

⁸⁸ Please refer to paragraph 120.

⁸⁹ Please refer to Article 69(1) and Article 70(1) of the EU BRRD. See Footnote 58 for reference.

enforcement of security interests in line with proposals set out above? Do you have views as to the exclusions to which this power should be subject?

Powers to operate and resolve the FI

150. In keeping with Key Attribute 3.2(iii), the authorities propose that the regime should empower the resolution authority to temporarily operate an FI during resolution, including by providing powers to terminate contracts, continue or assign contracts, purchase or sell assets, write down debt and to take any other action to restructure or wind down the FI's operations. To illustrate the importance of these powers it is helpful to consider the example of an FI that has been recapitalised and stabilised through bail-in. In this situation, while the FI has been stabilised, the factors that have led to its resolution have not yet been addressed and the FI's resolution is incomplete. The FI will need to be restructured, with certain parts of the business being sold or wound down, and throughout this restructuring period it is essential that the resolution authority is able to ensure the continued operation of the FI. In the case of resolution of FMIs, it is further proposed that the regime should also include the power to continue the payment, clearing and settlement functions performed by an FMI in resolution. The authorities consider these powers important to facilitate an FI's resolution. As set out in paragraphs 151 and 152, it is intended that the resolution authority should be able to appoint a resolution manager in this regard.

Appointment of resolution managers

151. While the resolution authority would of course need to be able to exercise all of the resolution options and powers directly, there may be cases where it could be appropriate or necessary to appoint a person to act on its behalf. For instance, the resolution authority may need to appoint a person to take control of and manage an FI that is being stabilised through bail-in (as explained in paragraph 150). The authorities therefore propose that the regime should empower the resolution authority to appoint one or more people to assist them in the execution of their duties (a "resolution manager"). The resolution manager would have a responsibility to promote the resolution objectives in the course of carrying out their functions and duties. The resolution authority would be responsible for

ensuring that the resolution manager has the qualifications, ability and knowledge required to carry out his or her functions and duties. It is noted that such qualifications, ability and knowledge would need to be determined on a case-by-case basis, including consideration of the nature of the business of the FI in resolution.

152. The resolution manager's role and responsibilities would be set out by the resolution authority in the terms of his or her appointment. Examples of potential responsibilities for the resolution manager might include:

- (i) to prepare a business reorganisation plan setting out measures aiming to restore the long-term viability of the FI or entity or parts of its business within a reasonable timescale and based on realistic assumptions as to the economic and financial market conditions under which the institution or entity will operate;
- (ii) to report on the economic and financial situation of the FI and on the acts performed in the conduct of his or her duties, at regular intervals set by the resolution authority and at the beginning and the end of his or her mandate;
- (iii) to provide periodic budgets or forecasts to the resolution authority for review or approval;
- (iv) to notify or obtain the consent or approval of the resolution authority and / or relevant regulatory authority before taking or prohibiting certain major actions;⁹⁰ and
- (v) to co-operate with all relevant authorities, including regulatory authorities, to fulfil their mandates.

⁹⁰ These might including: the sale of major assets or parts of the business; placing of encumbrances on assets; hiring and dismissal of senior or key employees and managers; payment of bonuses to employees; pay-out to creditors, commencing litigation.

Question 29

Do you agree that the regime should empower the resolution authority to appoint a resolution manager in line with the proposals set out above?

Continuity of essential services

153. Paragraphs 139 to 142 discuss the need for the resolution authority to be able to secure continuity of essential services from a residual FI, where a compulsory transfer of part of an FI's business has been carried out. There may also be cases where the resolution authority needs to secure the continuity of essential services provided by other regulated and non-regulated entities in a group. As explained in paragraphs 44 to 49 of Chapter 2, it is proposed that AOE's be covered within the scope of the resolution regime. However, as explained in that section, it may not always be justified or desirable to take resolution action in respect of AOE's and providing for effective continuity provisions under the regime could reduce the need for such action.

154. CP1 set out the rationale for including powers within the regime to help secure the provision of services, which are required to maintain the critical financial services provided by an FI for at least a period of time. The consultative draft of the KAAM, Essential Criteria ("EC") 3.25, sets out that the resolution authority should have powers to require both regulated and non-regulated companies in the same group and within the same jurisdiction as an FI in resolution to continue to provide services to that FI or to any successor entity (including a bridge institution or commercial purchaser) that has acquired all or part of its business in order to secure the continuity of critical financial services.⁹¹

155. As outlined in Chapter 2, respondents highlighted some actions that can be taken in advance of resolution to help improve operational continuity in resolution such as resolution planning and reviewing contracts to ensure they are resilient to resolution actions. The authorities emphasise that providing for continuity provisions in the legislation establishing the regime would not be intended to

⁹¹ See Footnote 75 for reference.

negate or lessen the need for effective resolution planning, including enhancing operational continuity arrangements. The power would be intended to provide the resolution authority with an additional level of confidence that those essential services provided by another group entity and that are needed to secure continuity of an FI's critical financial services can reliably be made available in resolution. It is essential that stakeholders have confidence that the resolution actions being taken will be effective and the inclusion of this power should help to reinforce this in relation to operational continuity.

156. To help ensure continuity of essential services and functions, the authorities propose that the regime provide for the resolution authority to do any of the following:

- (i) Require that both regulated and non-regulated companies in the same group and within the same jurisdiction as an FI in resolution continue to provide services that are necessary to support operational continuity to the FI under resolution or to any bridge institution, third party purchaser or AMV at a reasonable consideration; and
- (ii) Procure such services from unaffiliated third parties at a commercial rate.

157. It is proposed that the requirement for temporary provision of services specified in (i) and (ii) above would stand until such time as the resolution authority determines that such services are no longer required in connection with the FI in resolution and any commercial purchaser, bridge institution or AMV.

Question 30

Do you agree that the regime should provide the resolution authority with the necessary powers to secure the continuity of essential services as set out in paragraph 156?

Powers to remove directors and remuneration claw-back

158. Key Attribute 3.2(i) provides that resolution authorities should have the power to “[r]emove and replace the senior management and directors and recover monies from responsible persons, including claw-back of variable remuneration”. The consultative draft of the KAAM (EC 3.2.1 and 3.2.2) elaborates that the power to

claw-back remuneration should constitute a power to “pursue claims against responsible persons with a view to recovering monies from such persons” and enable the resolution authority to “recover variable remuneration, both awarded and deferred, as appropriate from senior management and directors whose actions or omissions have caused or materially contributed to the failure of the firm, irrespective of whether those persons have been removed from their position.”.

159. In respect of the removal of directors and senior management, the HKMA, SFC and the IA have a variety of powers that may, in some instances, permit some or all of the following: the relevant authority removing certain officers of regulated FIs from their position;⁹² banning them from participating in providing regulated financial services; or banning them from participation in corporate management. However, the powers are not uniform across the authorities and are not specifically designed to be applicable in the event of a resolution of an FI.

160. In respect of remuneration claw-back, the HKMA’s Guideline on a Sound Remuneration System states that firms should operate a claw-back provision in respect of “unvested deferred remuneration in circumstances where it is later established that any performance measurement was based on data which is later proven to have been manifestly misstated, or it is later established that there has been fraud or other malfeasance on the part of the relevant employee, or violations by the employee of internal control policies”.⁹³ The SFC may, in certain circumstances, seek orders to recover unjust enrichment or losses from certain people who have contravened the SFO or participated in such a contravention or been involved in listed company fraud or misconduct and make compensatory payments to those who have suffered as a result, and may also seek orders to make contracts void or voidable.⁹⁴ The IA does not currently have an explicit power to

⁹² Under the Banking Ordinance (Cap. 155) the MA’s power to remove directors is confined to directors of authorized institutions incorporated in Hong Kong.

⁹³ See HKMA “Supervisory Policy Manual: Guideline on a Sound Remuneration System”, paragraph 2.4.3, <http://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/supervisory-policy-manual/C-G-5.pdf>

⁹⁴ See SFO, Sections 213 and 214, for reference.

claw-back remuneration paid, or payable, by authorized insurers. The powers relating to remuneration are not uniform among the authorities and are not designed to specifically apply to the situation of an FI entering into resolution or to permit recovery of remuneration when the acts or omissions of an FI's directors and senior management have contributed to the FI becoming non-viable and so entering into resolution.

161. The regulators' existing powers for both director and senior management removal and remuneration claw-back are therefore considered not to fully meet the standards set by Key Attribute 3.2(i). The authorities propose to enact, as part of the resolution regime, uniform powers to enable the removal from office of directors and members of the senior management of FIs that enter into resolution. It is also proposed that it should be possible to claw-back remuneration from certain people whose acts or omissions have materially contributed to an FI becoming non-viable and so entering into resolution.

Director and senior management removal

162. It was noted in CP1 that a resolution authority should be empowered to remove and replace the senior management and directors, retaining flexibility to determine what is appropriate on a case-by-case basis whilst acknowledging that the resolution authority may not be able to secure continuity for some or all of the FI's business if all directors and senior management are dismissed.⁹⁵ On further reflection, the authorities are considering an approach whereby removal of all of a failed FI's directors, its Chief Executive Officer ("CEO") and Deputy Chief Executive Officer ("DCEO") (where relevant)⁹⁶ is automatic on the initiation of resolution, in order to ensure no conflict between directors' fiduciary duties and the objectives of resolution. The removal of other senior management could still be effected on a case-by-case basis.

⁹⁵ See paragraph 247 and the footnote thereto in CP1. See Footnote 1 for reference.

⁹⁶ By whatever name called.

163. When an FI enters resolution, the resolution authority will have to assume full management control over the FI very quickly in order to secure continuity for some or all of the FI's business. It may be desirable, therefore, that an FI's entry into resolution automatically, by operation of law, results in the removal of all of its existing directors and its CEO. Removal would apply without reference to wrongdoing. If directors and CEO are removed, rather than suspended, this will relieve them of their fiduciary duties which could otherwise be in conflict with the resolution objectives and impede resolution. Other members of senior management who are not directors may also exercise substantial management control over the FI and this may inhibit the resolution authority's managerial control or otherwise be undesirable. The authorities therefore also propose that the resolution authority should be able, at its discretion, to remove other members of senior management of an FI in resolution. This too would be without reference to wrongdoing and could be effected through the serving of a notice by the resolution authority. As the resolution authority may, however, need to retain the expertise and knowledge of some of the directors and senior management to best manage the FI in resolution, it is proposed that the resolution authority be able to appoint these persons to act as agents of the resolution authority to assist in the discharge of its functions.

164. As creditors of the FI, in respect of wages earned but unpaid at the point of resolution, those directors or members of senior management removed by operation of law at the initiation of resolution, or subsequently by the resolution authority, would have a right to seek compensation under the arrangements outlined in Chapter 4.⁹⁷ However, any monies recovered by the resolution authority as a result of a valid claw-back order (see paragraphs 165 to 167 below) could not be recovered under the proposed NCWOL compensation mechanism.

Remuneration claw-back

165. The authorities propose that the resolution authority be given the power to pursue claims in court for remuneration claw-back against relevant current or former

⁹⁷ See paragraphs 168 to 181.

directors, those involved in management and those identified and categorised as risk-takers⁹⁸ of an FI in resolution. Powers would extend to recovering remuneration in any form from any such people whose actions or omissions have caused or materially contributed to an FI becoming non-viable and so entering into resolution. Powers would apply irrespective of whether those people remained in their position before or after the FI enters resolution.

166. The authorities would welcome respondents' comments on whether remuneration claw-back should apply to both fixed and variable remuneration (both vested and unvested) or only to variable remuneration (both vested and unvested). While it could be argued that the variable (bonus) component has the greater potential to incentivise excessive risk-taking, the possible downside of including only the variable component of remuneration within a claw-back power is that it could encourage restructuring of pay packages towards fixed (and away from variable) pay. The authorities propose that the resolution authority would be required to demonstrate to the court that the individual, individually or collectively, materially contributed to the FI becoming non-viable, with the court then determining whether, and the extent to which, a claw-back order should be granted.⁹⁹ The court would be required to take into account how the individual, individually or collectively, contributed to the FI becoming non-viable, the loss or damage to the FI attributable to them (if quantifiable) and the extent to which they benefitted from their actions and their own financial condition. It is proposed that any clawed-back remuneration should contribute towards paying the costs of the relevant FI's resolution.

167. Some jurisdictions (for example the US and Singapore) have imposed a time limit on the number of years preceding initiation of resolution in relation to which remuneration can be subject to claw-back. In the US and Singapore, this limit is

⁹⁸ A "risk taker" might be defined as a person whose professional activities have, or have the potential to have, a material impact on the risk profile of an FI and who is held to be responsible because of their impact on an FI's risk profile regardless of whether they have any day-to-day decision-making capacity in the ongoing management of the FI.

⁹⁹ The authorities will give further consideration to providing guidance on those acts of wrongdoing which could give rise to a valid claw-back order in the drafting of the legislation.

either dis-applied or can be extended in certain cases, for example in the case of an officer who acted recklessly, fraudulently or dishonestly. The authorities consider that there may be a need to impose a similar limit in Hong Kong and will give further consideration to what would be appropriate in this regard.

Question 31

Do you agree that resolution should result in the automatic removal of all the directors, the CEO and Deputy Chief Executive Officer (“DCEO”) (where relevant) of an FI in resolution and that the resolution authority should have powers to remove other senior management at its discretion?

Question 32

Do you agree that the resolution authority should be able to apply to the court to seek remuneration claw-back from those parties identified in paragraph 165 whose actions or omissions have caused or materially contributed to an FI entering resolution?

Question 33

Do you have views on whether remuneration claw-back should apply to both fixed and variable remuneration (both vested and unvested) or only to variable remuneration (both vested and unvested)?

Question 34

In light of the practices adopted in other jurisdictions, do you have views on how far back in time a remuneration claw-back power should reach?

CHAPTER 4 – SAFEGUARDS AND FUNDING

This chapter considers the safeguards to be incorporated into the resolution regime, as well as how resolution should be funded. It covers:

- the structure of a NCWOL compensation mechanism;
- how other restrictions on the exercise of resolution powers could be structured most effectively;
- how any costs of resolution, including those arising because NCWOL compensation is due, might be met.

Providing for an NCWOL compensation mechanism

168. CP1 explained that creditors of a non-viable FI could be made worse off by a particular approach to resolution as compared with the treatment they would have received had the FI otherwise entered into liquidation. Recognising this, Key Attribute 5.2 states that “[c]reditors should have a right to compensation where they do not receive at a minimum [in resolution] what they would have received in a liquidation of the firm under the applicable insolvency regime”. CP1 outlined the importance of providing for such a compensation mechanism, and the authorities, having considered the matter further, including by drawing on respondents’ views, set out a proposal below.¹⁰⁰

169. Most respondents agreed that the regime should provide for an NCWOL compensation mechanism identifying that more detail would be welcome on: (i) who would undertake the necessary valuation to determine compensation due; (ii) what assumptions would form the basis of the valuation; (iii) how any

¹⁰⁰ While it should be expected that shareholders would generally receive little, if anything, by way of a “distribution” in resolution, it is noted that the Key Attributes state that resolution should be able to be initiated “before a firm is balance sheet insolvent and before all equity has been fully wiped out”. As such, there may be cases where an NCWOL valuation identifies residual value that would have remained for shareholders in a hypothetical liquidation and so compensation should be due if that hypothetical valuation is greater than the shareholders’ outcome in resolution. The authorities consider it appropriate, therefore, that the NCWOL safeguard apply to shareholders as well as creditors.

compensation due would be funded; and (iv) what channels would be available for affected parties to appeal. Each of these issues is addressed in more detail below.

Who should undertake an NCWOL valuation

170. Some respondents commented that it was important for an NCWOL valuation process to be transparent and fair, which the authorities agree would lend integrity and credibility to the mechanism. With this in mind it appears that a requirement should be set that the person undertaking the valuation (“NCWOL valuer”) must be independent and not conflicted in a way that may, or may be perceived to, influence their neutrality. Conflicts could arise, or be seen to arise, where the valuer has, or is seen to have, a current or recent direct relationship with any of the stakeholders in an FI’s resolution who have an interest in the outcome of the NCWOL valuation (such as the FI in resolution and its significant creditors and shareholders). Box F below sets out the authorities’ initial thinking on those criteria against which a potential NCWOL valuer could be assessed for independence during the appointment process. The list is intended to be indicative since the appointing party will need to exercise a degree of judgment as identifying each and every potential conflict of interest is likely to be infeasible in advance.

171. In addition to the proposed criterion of independence, an NCWOL valuer would also need to possess the necessary professional skills and experience to undertake the valuation, particularly in respect of large, complex FIs. Therefore, Box F also sets out further indicative criteria in this regard.

Box F: Indicative criteria for appointing an NCWOL valuer

The indicative criteria for establishing the independence of an NCWOL valuer are that he should:

- not have material interest in common or in conflict with the public authorities, the FI in resolution (including related group companies and all employees) or its significant creditors and shareholders;
- not be a public officer;
- be a separate legal entity with respect to both the resolution authority and the FI in

resolution and not part of the same group of companies as the FI in resolution.

The indicative criteria for establishing the expertise of an NCWOL valuer are that he should possess:

- ability, knowledge and expertise in relevant technical subjects, particularly accounting and finance, including in relation to the sector in which an FI in resolution operates, restructuring and insolvency; and an understanding of the resolution framework;
- experience in the valuation of complex companies;
- the standing and ability to carry out a high-profile public process;
- sufficient technical and human resources to carry out the valuation (including adequate and properly equipped premises and competent personnel), taking into account the nature, size and complexity of the FI to be valued.

172. In terms of appointing an NCWOL valuer, the authorities are considering whether an approach whereby the resolution authority makes the appointment, guided by the indicative criteria for independence and expertise set out in Box F, as well as any situation-specific factors at the time, would lend adequate credibility and independence to the process.

173. As concerns the timeframe for an NCWOL valuer's appointment, an NCWOL valuation cannot begin until resolution proceedings have formally commenced in order that the relevant reference date for the valuation can be determined.¹⁰¹ The authorities would, however, expect the process for appointment to commence as soon as practicable once formal resolution proceedings have been initiated (or in advance where possible).

Question 35

Do you agree that the indicative criteria to assess the independence and expertise

¹⁰¹ Paragraph 85 in Chapter 3 notes that the formal commencement of resolution proceedings will be marked by the issuance of a public notice by the resolution authority.

of an NCWOL valuer, as set out in Box F, are appropriate and that a degree of judgment will be inherent in assessing whether these, or any other, factors are relevant in individual cases?

Question 36

Do you agree that the resolution authority should appoint the NCWOL valuer, guided by the indicative criteria set out in Box F?

Grounds for removal of an NCWOL valuer

174. Although it would clearly be undesirable, situations might arise where there is a need to revoke the appointment of an NCWOL valuer. It is therefore proposed that the legislation establishing the local resolution regime should set out the grounds on which an application for removal of an NCWOL valuer can be made as well as by, and to, whom such an application can be made. This approach would appear to be consistent with the approach taken to the removal of persons from broadly similar offices, e.g. a liquidator may “on cause shown, be removed” from his office by the court (which would have made the original appointment) under Section 196 of the CWUMPO. The authorities therefore propose that similar provision should also apply to an NCWOL valuer and that the grounds for removal should be limited to: (i) death; (ii) incapacity; (iii) bias; (iv) serious misconduct; and/or (v) the valuer no longer meeting the appointment criteria.

175. Given the proposal set out in paragraph 172 that an NCWOL valuer would be appointed by the resolution authority it is proposed, for consistency, that the resolution authority should also have the power to revoke that appointment, subject to cause for doing so being presented to, and accepted by, it. In terms of who may apply to the resolution authority for the revocation of an NCWOL valuer’s appointment, the authorities propose to limit this to the shareholders and creditors of an FI in resolution given that these are the parties most directly concerned with an NCWOL valuer’s performance of his/her duties. Should the resolution authority determine that the grounds for removal of an NCWOL valuer proposed by the applicant are valid, then it would formally revoke his appointment and commence the process to appoint a replacement NCWOL valuer. The resolution authority would also be able to remove an NCWOL valuer from

office of its own volition, should it identify that one or more of the grounds for removal listed in paragraph 174 had been met. Should an NCWOL valuer be removed from office, the treatment of any work undertaken prior to the revocation of appointment would be a matter for the replacement valuer, and it would be expected that such treatment would be explained as part of the replacement NCWOL valuer's work.

Question 37

Do you agree with the proposed grounds for removal of a NCWOL valuer, as set out in paragraph 174? Do you agree that the proposed mechanism for seeking removal on those grounds is appropriate?

Question 38

Do you agree that the treatment of the outgoing valuer's work up to the point of removal is a matter for any incoming valuer, who should clearly explain that treatment in his/her final valuation?

Valuation Principles

176. One aspect of an NCWOL valuer's role is to determine the treatment that a non-viable FI's creditors and shareholders would have received had the FI instead entered into liquidation in its entirety.¹⁰² By its nature the NCWOL valuation is hypothetical and therefore needs to be based upon assumptions, some of which could depend upon firm-specific and market conditions at the time. However, in line with the approach taken in other jurisdictions, the authorities consider there to be three high-level valuation principles that should be applied in any NCWOL valuation, independent of firm-specific and market circumstances at the time, and which, therefore, should be included in the primary legislation to guide any NCWOL valuation:

- (i) Valuation reference date – A key assumption underpinning a determination of whether any NCWOL compensation is due to affected creditors and

¹⁰² The NCWOL valuer would then compare this hypothetical valuation against creditors' and shareholders' actual outcomes in resolution to determine whether NCWOL compensation is due.

shareholders of an FI in resolution is the date on which it should be assumed that a non-viable FI would have entered into liquidation (had it not been placed into resolution). The authorities' view is that this reference date should be that which marks the earliest point it could be assumed that the FI would otherwise have entered into liquidation (absent a resolution). While this will be further considered, one option is that the date on, and time at, which the resolution authority issues the public notice¹⁰³ announcing the formal commencement of resolution proceedings would be used.

(ii) Creditor hierarchy – An NCWOL valuer will also be required to adhere to the creditor hierarchy in a winding-up and thus assume that preferential debts will be paid in priority to other unsecured debts, which in turn will be paid in priority to deferred debts, and any surplus remaining after paying and discharging all the debts and liabilities of the FI will be paid to the shareholders of the FI. Although having no bearing on actual distributions, as the NCWOL valuation is hypothetical, respecting the creditor hierarchy is vital to ensuring that an NCWOL valuation can be relied upon as an accurate representation of the payments that would have been due to creditors and shareholders had the FI otherwise entered into liquidation. This valuation is then compared to those creditors' and shareholders' actual treatment in resolution in order to determine whether any NCWOL compensation is due.

(iii) Provision of financial assistance – An FI that is placed into resolution is likely to have experienced at least some distress in the preceding weeks and months. In response to this, the authorities may have provided some support, such as through the MA's role of Lender of Last Resort ("LoLR") under which short-term liquidity support can be provided to an AI if it meets certain conditions.¹⁰⁴ In such cases, it is proposed that an NCWOL valuer should disregard the actual or potential provision of any financial assistance

¹⁰³ See Footnote 101.

¹⁰⁴ HKMA (March 2009), Policy Statement on the Role of the Hong Kong Monetary Authority as Lender of Last Resort, <http://www.hkma.gov.hk/eng/key-functions/monetary-stability/liquidity-support-to-banks.shtml>

from the authorities to an FI in resolution, outside of the course of ‘business as usual’ (“BAU”) operations.¹⁰⁵ The key principle in disregarding such support is that the shareholders and creditors of the failed FI should not benefit from any extraordinary support provided by the authorities to an FI in order to protect financial stability in Hong Kong. Such support is provided to protect the public interest generally and not with the objective of protecting the individual shareholders and creditors of the recipient FI.

Question 39

Do you agree that the three overarching valuation principles identified in paragraphs 176 (i) to (iii) should be applied each time an NCWOL valuation is undertaken? Do you have views on other valuation principles that should underpin an NCWOL valuation?

Scope of right to seek NCWOL compensation

177. Under the proposed mechanism, a right to compensation would only be available to those who are creditors and shareholders of the FI in resolution as at the point resolution proceedings formally commence. In this way, only those stakeholders whose property rights have been affected by the exercise of resolution powers, and who have suffered a greater loss in resolution than it is assessed would have been the case in liquidation, would be entitled to NCWOL compensation.

Question 40

Do you agree that the right to receive NCWOL compensation (if due) should be restricted to those creditors and shareholders who held liabilities of a failed FI as at the point resolution proceedings formally commenced and who suffer an economic loss as a direct result of the resolution authority’s actions?

¹⁰⁵ An example of BAU liquidity provision is the HKMA’s discount window, which provides overnight liquidity to banks against eligible collateral to facilitate interbank settlement.

Timing of NCWOL compensation payments

178. Undertaking an NCWOL valuation, particularly in cases where the FI in question is large and complex, will naturally take some time and could result in (i) a final determination on whether NCWOL compensation is due and (ii) payments being made occurring materially in arrears of the resolution taking place. The authorities recognise that a significant time gap between the formal commencement of resolution proceedings and the determination and payment of any NCWOL compensation due is undesirable, given the uncertainty it creates for affected stakeholders. To address this concern, the authorities will give consideration to the practicality of including procedural mechanisms to expedite NCWOL compensation payments where it is possible to establish with a sufficient degree of certainty at least part of any NCWOL compensation due.

Question 41

Do you have views on how a mechanism might be provided for to expedite the payment of NCWOL compensation due where at least part of any valid NCWOL claims can reliably be identified?

Funding NCWOL compensation

179. In cases where an NCWOL valuation results in an assessment that compensation is due, then obviously the provision of that compensation will need to be funded. As outlined in paragraphs 222 to 230 in this Chapter, respondents recognised that NCWOL compensation is a resolution cost that, by necessity, would need to be met, ultimately, through recourse to the wider financial services industry. Recouping such costs in this way is also recognised by the BoE, which has stated that any compensation due to creditors and shareholders as a result of resolution action must be met by the industry.¹⁰⁶

¹⁰⁶ See paragraph 37 of “The Bank of England’s Approach to Resolution”. See Footnote 58 for reference.

Appealing an NCWOL compensation valuation

180. Some respondents expressed the view that parties affected by the exercise of resolution powers should have the right to appeal an NCWOL valuation. The authorities acknowledge that the NCWOL valuation process is so significant to the rights of affected stakeholders that a specific avenue of appeal should be established. It is therefore proposed that a Resolution Compensation Tribunal (“RCT”) be established under the regime to enable: (i) the shareholders and creditors of an FI in resolution who have suffered an economic loss as a direct result of resolution; and (ii) the resolution authority to appeal an NCWOL valuation.

181. Given the proposal that the RCT be established specifically to hear appeals against an NCWOL valuation, the relief available to successful applicants to the RCT will be limited to pecuniary compensation amounting to the difference between the valuer’s assessment of the NCWOL compensation payable and the RCT’s assessment of the NCWOL compensation payable.¹⁰⁷ Limiting the relief available to successful applicants to pecuniary compensation only is commensurate with the type of appeal being heard and is also in line with Key Attribute 5.5.¹⁰⁸

Question 42

Do you agree that the RCT should be established under the regime to hear appeals of: (i) the shareholders and creditors of an FI in resolution; and/or (ii) the resolution authority against a NCWOL valuation?

¹⁰⁷ Such amounts could be zero since the RCT may assess that an NCWOL valuation: (i) is accurate; or (ii) assumes a greater return for creditors and shareholders in liquidation than the RCT assesses would have been the case.

¹⁰⁸ Key Attribute 5.5 states that “[t]he legislation establishing resolution regimes should not provide for judicial actions that could constrain the implementation of, or result in a reversal of, measures taken by resolution authorities acting within their legal powers and in good faith. Instead, it should provide for redress by awarding compensation, if justified”.

Composition of the RCT

182. In line with existing tribunals established (or to be established) under the regulators' respective ordinances, it is proposed that the RCT should comprise three persons in total i.e. a Chair plus two Members.¹⁰⁹ Although it is expected that resolution would not be initiated frequently, and that the RCT would therefore not be expected to sit frequently, the authorities consider that it would still be appropriate to establish the RCT as a standing body and appoint the Chair and Members once the legislation providing for the regime has been passed.

183. The authorities propose that the Chair of the RCT be appointed for a five-year term. A long-list of suitably qualified persons who could sit as Members, should the RCT need to be convened, would also be appointed for a five-year term. This approach would establish, ahead of time, a broad pool of potential RCT Members who could be empanelled to the RCT as needed and so mitigate the risk for conflicts of interest crystallising (which would be more likely to occur if a more limited set of RCT Members were identified in advance).

184. To lend credibility to the NCWOL appeals process, the Chair and Members of the RCT would need to be, and be seen to be, independent of those parties concerned in the appeals which it hears (e.g. the FI in resolution,¹¹⁰ its creditors and shareholders and the resolution authority). Therefore, in line with the existing approach to appointing the Chair and Members of the Banking Review Tribunal ("BRT") and the Securities and Futures Appeals Tribunal ("SFAT"),¹¹¹ it is proposed that the Chief Executive of Hong Kong should appoint the Chair and long-list of Members of the RCT.

¹⁰⁹ See paragraph 184 for more detail on the tribunals established under the regulators' respective ordinances.

¹¹⁰ Reference to the FI in resolution in this context includes all former and current staff involved in the management of the firm and with an interest in the outcome of an NCWOL valuation.

¹¹¹ The Banking Ordinance (Cap.155) (under Part XVIIIA) and the Securities and Futures Ordinance (Cap. 571) (under Part XI) provide for the establishment of the BRT and the SFAT respectively, which provide channels through which parties aggrieved by certain decisions of the MA and SFC respectively can appeal those decisions. Similarly, it is expected that the Insurance Appeals Tribunal will be established once the Insurance Companies (Amendment) Bill 2014 has passed.

185. In order to guide the appointment process, the authorities propose that certain criteria must be met by the RCT's Chair and Members before they can be appointed. To provide the necessary judicial experience and neutrality the Chair of the RCT should: (i) be qualified for appointment as a judge of the High Court; and (ii) not be a public officer. While Members of the RCT would not be required to meet the criterion of being qualified for appointment as a judge of the High Court, they too should not be public officers. Additionally, the Members of the RCT should possess relevant expertise and practical experience in valuation as well as an understanding of the resolution framework. These criteria pertaining to expertise will be similar to those set out in Box F, against which a person being considered as an NCWOL valuer would also be assessed.

Powers of the RCT

186. To be able to effectively hear appeals submitted to it, the RCT would need to be vested with an extensive range of powers to regulate the conduct of the review proceedings in an appropriate manner. These might include powers to receive and consider evidence, require the production of documents and require persons to attend the review proceedings as a witness. In determining the exact set of powers to be conferred on the RCT, the authorities will have regard to the powers available to the BRT and the SFAT (as set out under section 219(1) of the SFO) as well as those proposed to be available to the Insurance Appeals Tribunal, ("IAT").

Appeals against determinations of the RCT

187. The authorities recognise that a party bringing an appeal to the RCT for review may be dissatisfied with the outcome. It is therefore proposed that provision be made under the regime so that decisions of the RCT can be taken to the Court of Appeal on a point of law. This approach is similar to that available to parties taking appeals to the BRT and SFAT.

Question 43

Do you agree with the proposed composition of, and process for appointment to, the RCT?

Question 44

Do you have any views on the powers that should be available to the RCT in addition to those identified in paragraph 186?

Question 45

Do you agree that applicants should have the right to appeal against a determination of the RCT on a point of law, as set out in paragraph 187?

Protecting client assets

188. CP1 asked whether any adjustments are needed to the existing framework for protecting client assets for the purposes of resolution. Respondents tended to agree with the position set out in CP1 that the resolution regime should provide for the prompt return of client assets to investors or for their transfer to another institution in order to secure continuity of access for the beneficial owners. All the same, only a minority of respondents felt that delivery of this desired outcome would be dependent on provisions made under the regime. Some did, however, identify certain issues that should be taken into account, including that: (i) client assets should be excluded from the scope of a bail-in resolution option; and (ii) the complexity of custody and sub-custody arrangements, particularly in a cross-border context, emphasises the importance of international cooperation.

189. In respect of 188(i), paragraphs 100 to 113 of Chapter 3 set out the proposed approach to structuring the local bail-in resolution option and it is explicitly stated in paragraph 108(iv) that client assets protected under the applicable domestic laws and regulations will be excluded from the scope of bail-in. In respect of paragraph 188(ii), Chapter 5 further considers how the local regime may be used in the context of, and with a view to supporting the carrying out, a cross-border resolution.

190. In light of the recently issued Client Asset Annex and keeping any other international developments in view, the authorities will continue to assess whether any further measures are required to enhance the protection of client assets under the existing framework, including in resolution.

Protecting other types of financial arrangement

191. CP1 identified that a safeguard may be needed to protect certain financial arrangements (as “protected arrangements”) in resolution and set out some initial thinking in this regard. Use of certain resolution options and powers, in particular those allowing for a partial transfer of business,¹¹² creates potential for the contractual rights and obligations, which collectively constitute financial arrangements, to be separated from one another or dealt with in a way that undermines their economic purpose. This is undesirable because market participants generally rely on these arrangements to limit their exposure to loss in the event that a counterparty, such as an FI, fails. As such, Key Attribute 4.1 says that “[t]he legal framework governing set-off rights, contractual netting and collateralisation agreements...should be clear, transparent and enforceable during a crisis or resolution of firms”.

192. Respondents generally agreed that certain financial arrangements should be protected and that the arrangements identified in paragraph 291 of CP1 were the relevant ones. Those “protected arrangements” are: (i) secured (or collateralised) arrangements; (ii) set-off and netting arrangements; (iii) title-transfer arrangements; (iv) structured finance arrangements; and (v) rules and arrangements with trading, clearing and settlement systems. One respondent noted that the safeguard should extend to repurchase agreements, stock borrowing and stock lending transactions and the authorities confirm that it is intended that these would be protected by virtue of being title-transfer arrangements. Other than this, respondents did not suggest additional arrangements which should, in their opinion, be routinely protected. Several respondents questioned whether structured finance arrangements should be safeguarded given that these might be used for risk taking. The authorities confirm that they consider that structured finance arrangements should be treated as protected arrangements given that if such arrangements were undermined by resolution, both the FI and its

¹¹² A partial transfer of business may occur in the course of a compulsory transfer to a commercial purchaser, bridge institution and AMV but also where use is made of onward, supplemental or reverse transfer powers.

counterparties may be significantly adversely affected with consequences for efforts to secure continuity as well as wider financial stability.

193. Several respondents asked for more details on the specific financial arrangements that would be protected, under the broad headings set out in CP1, and the authorities have sought to provide this in Annex IV. The authorities consider that it would be appropriate for the definition of secured arrangements to extend to include those secured by means of floating charges as well as fixed charges, except where those arrangements have been entered into in contravention of rules set by the relevant regulator with a view to limiting the scale of such charges.¹¹³

194. CP1 identified that deposits from, and loans to, individual retail customers should not be considered “protected arrangements”,¹¹⁴ such that in resolution those relating to an individual customer would need to be transferred together (or not) or otherwise set-off against one another. This is because were these assets and liabilities, and deposits protected under the DPS in particular, to be treated as “protected arrangements” it would pose a substantive barrier to resolutions involving transfers of retail deposits (for little obvious benefit). No respondents objected to this proposal.

195. Several respondents asked for further details on the way in which the relevant financial arrangements would be protected and the remedies proposed for cases where there was an inadvertent breach of the safeguard.¹¹⁵ As outlined in CP1, it is proposed that provision be made under the regime that use of resolution powers, particularly those to effect partial transfers, may neither: (i) separate the relevant assets and liabilities, legal rights and obligations, underpinning protected

¹¹³ It is noted, for example, that under section 106(1) of the BO, AIs are precluded, absent the approval of the MA, from creating an aggregate charge over their assets of 5% or more of the value of those assets.

¹¹⁴ Protections available to retail deposits under the regime are described elsewhere in this CP2, including in paragraph 66 on the objectives set for resolution.

¹¹⁵ It was noted in CP1 that “[f]aced with the need to undertake resolution action as swiftly as possible in order to protect public confidence and financial stability, it is possible that a resolution authority could inadvertently breach the safeguard restrictions and corrective action may be necessary”.

arrangements with either all being transferred (or not); nor (ii) terminate or modify the contracts underpinning the arrangements.

196. At the same time, CP1 identified that any inadvertent breaches of a protected financial arrangement might be addressed by restoring “the protected financial arrangement by carrying out a further transfer that reverses the original transfer” or “in relation to set-off and netting arrangements, ...to allow the affected counterparty to continue to set-off or net any amount it owes to the failed FI, under the protected financial arrangement in order to reduce the counterparty’s exposure.” Some respondents stressed the importance of ensuring legal certainty and, as far as possible, respecting private law contractual and property rights. Furthermore, and in relation to secured, set-off and netting arrangements in particular, it was suggested that the remedy for a breach should be “immediate and self-executing” rather than being purely “administrative”.¹¹⁶

197. The authorities consider that it may be appropriate to provide a remedy such that set-off and netting are enforceable notwithstanding a transfer of some but not all of the rights and obligations under a master netting agreement. Additionally, it appears a transfer which breaches protected arrangements in the form of rules and arrangements within trading, clearing and settlement systems) could be declared void.¹¹⁷ In other cases, however, it may be more appropriate for affected parties to notify the resolution authority of a potential breach so that the resolution authority could consider the nature of the arrangement, and its treatment in resolution, and make any adjustments assessed to be appropriate. This is because a general reliance on declaring transfers that *may* breach the safeguard void, might not, in fact, provide the market with a sufficient degree of certainty.

198. A number of respondents highlighted that the authorities should consider how this safeguard might work in a cross-border context, recognising that some of the

¹¹⁶ An administrative remedy would be one requiring application to an authority and may imply a period of time over which the authority would reach a determination and, if the application is granted, the payment of compensation or award of some other relief only at the end of that period.

¹¹⁷ This is the approach taken under Section 10 of the UK Banking Act 2009 (Restrictions on Partial Property Transfers) Order.

assets, rights and liabilities, which constitute a protected arrangement, may be located in another jurisdiction and/or governed under the law of another jurisdiction. The authorities consider that it is relatively likely, in particular in cases where an FI operates cross-border, that the financial arrangements it has in place will be cross-border in nature, at least in part. Securing orderly resolution in this context will likely require that the safeguard proposed for the local regime applies irrespective of whether the arrangements arise under, or are governed in whole or part by, the law of another jurisdiction and as such provision for this should be made under the regime.¹¹⁸

199. Finally some respondents suggested that the resolution authority would need to be able to identify, *inter alia*, the constituent parts of protected arrangements ahead of exercising resolution powers (given that doing so at the point of resolution would likely be extremely time-consuming and could therefore act as a barrier to orderly resolution). The authorities recognise this concern and may require that FIs, as part of the resolution planning they undertake, establish Management Information Systems (“MIS”) to monitor arrangements entered into which may constitute protected arrangements, and have the capability to deliver information on the relevant arrangements at short notice.

200. The authorities are considering including the enabling powers for this safeguard in the primary legislation for the regime, but leaving the technical details of which financial arrangements are protected (and any exclusions) and remedies for inadvertent breaches to be set out in secondary legislation. Given the complexity of this safeguard, and the need to ensure it can be adjusted to reflect any issues identified through resolution planning and execution, the authorities believe it is desirable to retain this flexibility.

201. The authorities are aware that a safeguard of this sort, in other words one which ensures that financial arrangements relied upon by market participants to manage counterparty risk are not undermined in resolution, is relevant in the context of

¹¹⁸ It will clearly also be important that other jurisdictions make similar provision under their own regimes.

bail-in also. The authorities are further considering whether to make the necessary provision by identifying those financial arrangements which must be protected in bail-in and will return to this issue in CP3.

Question 46

Do you have any further comments on the way in which it is proposed that the various types of protected financial arrangement would be safeguarded and remedies for inadvertent breaches executed?

Question 47

How could a similar safeguard be provided for to support use of the bail-in option?

Protection from civil liability

202. CP1 set out the case for providing: (a) officers, employees and agents of the resolution authority exercising resolution powers; and (b) directors and officers of FIs acting in compliance with the instructions of the resolution authority with protection from civil liability for anything done, or omitted to be done, where those parties acted in good faith. It was argued that absent such protections the timely execution of resolution actions could be prevented or impeded due to the potential legal liability that could otherwise be faced by those parties. The authorities also identified that the Key Attributes, namely Key Attributes 2.6 and 5.3, require an effective resolution regime to make provision for such protections.¹¹⁹ The majority of respondents supported the proposal, while providing further suggestions on how it might be further enhanced. These suggestions are explored below.

¹¹⁹ Key Attribute 2.6 states that “[t]he resolution authority and its staff should be protected against liability for actions taken and omissions made while discharging their duties in the exercise of resolution powers in good faith, including actions in support of foreign resolution proceedings”; and

Key Attribute 5.3 states that “[d]irectors and officers of the firm under resolution should be protected in law (for example, from law suits by shareholders or creditors) for actions taken when complying with decisions of the resolution authority”.

The resolution authority and its staff and agents

203. Few respondents commented specifically on the proposal that such protections should be afforded to the resolution authority and its officers, employees and agents for anything done, or, omitted to be done, by them in good faith in the exercise of their resolution functions. Those that did comment emphasised that, while appropriate, the scope of the protection should be limited to civil liability only and should not interfere with stakeholders' rights to appeal decisions of the resolution authority. As noted in CP1, the authorities reiterate that the protections proposed are to be strictly limited to civil liability and furthermore should not fetter stakeholders' right to seek to appeal the resolution authority's decisions through the relevant appeals mechanisms provided for under the regime, or existing legal remedies available in respect of the exercise of administrative powers. The authorities therefore intend to pursue the approach proposed in CP1 whereby the protections apply to the officers, employees and agents of the resolution authority.

Directors and officers of a failed FI

204. Similarly, respondents generally agreed that the directors and officers of a failed FI should also be afforded the same protections. Some respondents also felt that the proposed protections should extend to include *all* employees of an FI. The authorities agree with this view and therefore propose to extend the scope of the proposed protections to apply all employees of an FI in resolution (including directors and officers), as before limited to those cases where the relevant person's actions were taken in good faith to comply with the decisions or instructions of the resolution authority.

205. Some respondents felt that unlike in the case of the resolution authority, the protection from civil liability applicable to directors, officers and employees of an FI should not require that they act in 'good faith' when complying with the decisions or instructions of the resolution authority since they may have little

discretion in how to comply. EN 5.3(a) of the draft KAAM¹²⁰ further elaborates that it is considered appropriate that protections for directors and officers of an FI “extend to civil actions by shareholders or creditors relating to all actions taken in good faith when acting in accordance with or giving effect to decisions and instructions in connection with resolution measures of the relevant domestic authorities and of foreign authorities where such decisions and instructions have been recognised or given effect in the jurisdiction under review” (emphasis added). The authorities are therefore inclined to maintain that the directors, officers and employees of an FI should be required to act in good faith when taking actions (or not) in compliance with the instructions of the resolution authority in order to be covered by the proposed protection from civil liability.

206. One respondent suggested that the proposed protections “should be limited to the implementation of resolution and not cover failings pre-resolution”. The authorities confirm this is intended to be the case and the proposed protections will not apply to other actions taken by the directors, officers and employees absent decisions or instructions from the resolution authority. So other actions, which could include detrimental actions they may have taken (or not) that contributed to an FI’s entry into resolution, will not be covered. However, the protections will apply in cases where instructions have been issued by the resolution authority to the directors, officers and/or staff of an FI without formal resolution proceedings having been commenced, for example where an FI is instructed to make changes to its business practices, structure or operations in order to improve its resolvability.

207. In light of the above, the authorities intend to pursue the general approach proposed in CPI whilst taking into account respondents’ views and extending the proposed protections to directors, officers *and* employees of the FI in resolution (subject to their actions being taken (or not taken) in good faith on the decisions or instructions of the resolution authority).

¹²⁰ See Footnote 75 for reference.

208. The authorities also note that some respondents indicated that such protections should also apply in a cross-border context and therefore to: (i) directors, officers and employees of an FI in Hong Kong acting on the instructions of an overseas resolution authority (e.g. in an agreed group resolution strategy); and (ii) overseas staff (e.g. contracted by an overseas incorporated entity) acting on the instructions of the local resolution authority. The authorities are cognisant of the need for such protections to facilitate the smooth implementation of cross-border resolution and therefore intend to address this, along with other cross-border issues, in more detail in CP3, taking into account international developments on how best to provide for effective cross-border resolution mechanisms.

Question 48

Do you have any views on the factors the authorities should take into account in developing effective protections from civil liability for: (i) the resolution authority and its staff and agents; and (ii) the directors, officers and employees of an FI in resolution in a cross-border context?

Legal remedies and judicial action

209. CP1 stated that “it may be necessary for the regime to provide parties affected by resolution with a right to appeal against the decisions of the resolution authority and to be awarded compensation where appropriate”. It was also noted that any such appeals mechanism should neither “hinder the swift deployment of resolution powers” nor “impede, halt or reverse the carrying out of resolution (otherwise than because of illegality or bad faith), given that this would undermine efforts to secure continuity of critical financial services and protect financial stability”.

210. As explained earlier in this Chapter, recognising the importance of an NCWOL compensation valuation within the resolution process, the authorities propose to establish the RCT under the regime to hear appeals of: (i) the creditors and shareholders of an FI in resolution and; (ii) the resolution authority against a NCWOL valuation. The authorities also recognise that certain other decisions of the resolution authority, not directly relating to matters pertaining to compensation, should be appealable; in particular directions to an FI to make ex ante changes to its business practices, structure or operations to improve resolvability. The

authorities will further consider how best to provide for a suitable mechanism and set out proposals in CP3.

211. Importantly, none of the specific appeals mechanisms to be established under the regime will allow the initiation or carrying out of resolution to be halted (in line with Key Attribute 5.5).¹²¹ It is also emphasised that the appeals mechanisms being considered are not intended to interfere with existing legal remedies available to those stakeholders affected by administrative acts, which will remain available. Having considering the existing avenues of appeal available to stakeholders affected by the exercise of administrative powers, the authorities do not believe it necessary that all decisions that could be made by the resolution authority be appealable to a body established specifically under the regime since it is assessed that existing legal remedies are sufficient.

Safeguarding the integrity of financial markets - exemptions from and deferral of disclosure and other obligations of a listed FI or related listed entity

Deferral of disclosure requirements under the SFO

212. As discussed in CP1, a listed FI which is failing, or the listed affiliate of a failing FI, may become obligated to disclose that information under Part XIVA of the SFO (disclosure of inside information) and/or the Listing Rules. In addition Part XV of the SFO requires, among other things, the holders or acquirers of a 5% or greater voting interest in, and the directors and chief executives of, a listed corporation to disclose their interests or changes to such interests within three business days of the relevant transaction. It is envisaged that a failing FI or one of its affiliated entities or persons may be required to disclose certain information prior to the announcement of the initiation of resolution. To the extent that the exercise of resolution powers subjects a listed FI, or a listed affiliate, to one or more transactions that meet certain conditions specified in the Takeovers Code and/or Listing Rules, additional disclosure and other requirements may also arise. Any premature disclosure might prejudice orderly resolution by damaging public

¹²¹ See Footnote 108 for Key Attribute 5.5 in full.

confidence and, for example, triggering a run on the failing FI before the resolution authority has had an opportunity to take the necessary preparatory steps to resolve it.

213. In view of Key Attribute 5.6,¹²² the authorities propose that provision be made under the local resolution regime allowing the resolution authority, after consulting with the SFC, to grant a listed entity that is either itself an FI, or the affiliate of an FI, a deferral from compliance with the applicable disclosure requirements under Part XIVA of the SFO under certain circumstances (e.g. if, in the opinion of the RA, such disclosure might prejudice orderly resolution).

214. The same principles and conditions for a deferral of disclosure obligations should apply regardless of whether an FI's viability is undermined due to financial or non-financial causes. It is proposed that a listed entity or, in the case of Part XV of the SFO, shareholder of that listed entity who is or will become subject to a disclosure obligation as a result of actual or pending resolution (for example, due to a transaction imposed or ordered by the resolution authority) may apply for a deferral of disclosure requirements under the SFO provided that all of the following conditions are met:

- (i) It is reasonably likely that a listed FI (or an affiliate of that listed FI) will become subject to resolution and disclosure of the relevant information is reasonably likely to cause or contribute to non-viability and/or impede the ability of the resolution authority to achieve orderly resolution;
- (ii) The relevant information remains confidential and the confidentiality of that information can be maintained.

215. Any deferral of applicable disclosure requirements should continue only so long as the conditions for deferral continue to exist. The initial deferral and each

¹²² Key Attribute 5.6 states that: “[i]n order to preserve market confidence, jurisdictions should provide for flexibility to allow temporary exemptions from disclosure requirements or a postponement of disclosures required by the firm, for example, under market reporting, takeover provisions and listing rules, where the disclosure by the firm could affect the successful implementation of resolution measures.”

subsequent extension (if any) are proposed to be granted for a limited period. Prior to the expiry of each deferral period, the resolution authority shall, in consultation with the SFC, evaluate whether the conditions for deferral continue to exist (including whether the relevant information remains confidential) in order to determine whether the deferral should be extended.

216. The resolution regime will enable the resolution authority, after consultation with the SFC, to defer compliance with the applicable disclosure requirements under Part XIVA and Part XV of the SFO under the circumstances set out in paragraph 214. In addition, the authorities propose to amend the Listing Rules and the Takeovers Code so that any disclosure obligations arising thereunder as a result of the circumstances considered in paragraph 214 are automatically deferred upon any deferral of the foregoing disclosure requirements under the SFO.

Exemption from shareholders' approval requirements under the Listing Rules

217. Under the Listing Rules, a listed entity must seek prior approval from its shareholders in a general meeting if such entity (among other matters):

- (i) undertakes any transaction the relative size of which exceeds a certain percentage ratio prescribed in the Listing Rules;¹²³
- (ii) conducts any connected transactions (as defined in the Listing Rules); or
- (iii) allots and issues any shares in excess of any general mandate already approved by its shareholders.

218. The authorities propose to amend the Listing Rules to provide for an exemption for a listed entity that is a failing FI (or an affiliate) from compliance with the shareholders' approval requirements under the Listing Rules where the resolution authority has imposed or ordered the underlying transaction. Such power shall apply only to approval by shareholders of the firm in resolution (or its affiliated entity) and shall be exercised only after consultation with the SFC. In addition,

¹²³ The relevant percentage ratios can be found under paragraphs 14.07 and 14.08 of the Listing Rules. See Chapter 14 of the Listing Rules for reference, https://www.hkex.com.hk/eng/rulesreg/listrules/mbrules/documents/chapter_14.pdf

the exemption power will be conditioned upon it being reasonably likely that the listed entity (or its affiliate) will become subject to resolution and compliance with the relevant shareholders' approval requirement is reasonably likely to cause or contribute to non-viability and/or impede the ability of the resolution authority to implement orderly resolution.

Exemption from general offer obligation under the Takeovers Code

219. A change in control of an FI (or the affiliate of an FI) that is a public company, whether arising from an issue of new shares or a sale or transfer of existing shares, would trigger a general offer obligation under Rule 26 of the Takeovers Code by the new controlling shareholder(s).

220. Whilst the Takeovers Code already provides for a waiver power in respect of rescues of corporates which involve the issue of new securities, this waiver provision does not cover all possible forms of resolution or circumstances that may arise where an FI becomes subject to resolution.

221. It is recommended that the Takeovers Code be amended to provide a general power to the Takeovers Executive to waive or modify the requirements under the Takeovers Code in relation to resolution (including issues of new, or transfers of existing, shares or use of other resolution options which result in a change of control of a significant part of an FI's share capital as a result of, or in connection with, the exercise of a resolution power).

Question 49

Do you agree with the proposal to provide the relevant authorities the power to defer or exempt compliance with the following requirements, as discussed above: (i) the disclosure requirements under Part XIVA and Part XV of the SFO, the Listing Rules and the Takeovers Code; (ii) the shareholders' approval requirements under the Listing Rules; and (iii) the general offer obligation under the Takeovers Code?

Funding resolution

222. A resolution regime provides means, including through the proposed bail-in option, by which the costs of resolution can be imposed on the shareholders and creditors of a failing FI rather than on taxpayers. At the same time, it is recognised that in certain cases, the resolution authority may need temporary sources of funding to facilitate an FI's orderly resolution.¹²⁴ It is clearly important, and the Key Attributes require, that resolution funding arrangements be established to ensure that any costs incurred as a result of resolution action can be recovered from the wider financial system. The overarching features of such arrangements were considered in CP1 and whilst these are expanded upon below, more detailed proposals will follow in CP3.

223. As recognised by Key Attribute 6.3, funding arrangements could be structured as a “privately-financed deposit insurance or resolution fund”, implying that levies would be imposed on industry in advance of any resolution (i.e. *ex ante*) or as “a funding mechanism with *ex post* recovery from the industry of the costs of providing temporary financing to facilitate resolution”. As noted in CP1, in the US the Orderly Liquidation Fund (“OLF”) operates with an *ex post* funding model; whereas EU Member States are required to make *ex ante* provision (supplemented by powers to raise extraordinary *ex post* contributions).¹²⁵

224. The pros and cons of these funding models were outlined in CP1, although no firm proposal was made with regards to the preferred approach for the local regime. A majority of respondents favoured arrangements with *ex post* recovery, including one on the grounds that the scale of any *ex ante* fund could be so large as to be inefficient and that its very existence could be a source of moral hazard. In relation to this point, it is pertinent that whilst the costs associated with the

¹²⁴ Key Attribute 6.2 says that “[w]here temporary sources of funding to maintain essential functions are needed to accomplish orderly resolution, the resolution authority or authority extending the temporary funding should make provision to recover any losses incurred (i) from shareholders and unsecured creditors subject to the “no creditor worse off than in liquidation” safeguard...; or (ii) if necessary, from the financial system more widely.”

¹²⁵ See section 210(n) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) and Articles 100 to 105 of the BRRD.

failure and resolution of a large and complex FI may be substantial, the regime should help to ensure that these fall, to the greatest possible extent, on the shareholders and creditors of the failed FI itself rather than being mutualised across the industry.

225. After reflecting further, the authorities consider that it may be preferable for the regime to make provision for resolution funding arrangements such that recovery of the costs of resolution may occur once it is clear how much needs to be recouped (i.e. on an ex post basis). The arrangements would receive proceeds from resolution, as well as meeting certain costs arising and, ahead of raising levies on industry, access to temporary sources of funding to meet any shortfall arising would be needed.

226. Some respondents provided views on the sorts of resolution costs it would be appropriate to meet. It was generally accepted that recovery of administrative expenses and the meeting of NCWOL compensation claims was appropriate. It was suggested that the arrangements under the regime should not replace any LOLR which might, in certain circumstances, be provided to an AI.¹²⁶ Several respondents felt that resolution funding arrangements should not be used for recapitalisation (or at least not until an FI's shareholders and creditors had absorbed losses to an appropriate degree) although views were relatively mixed on this point. The authorities note it is not intended that the arrangements would supersede the existing LOLR mechanism, but it may be appropriate that in the event that LOLR is extended *and* losses incurred in the course of a resolution, that those costs could be recouped. The authorities do not consider it feasible to completely preclude provision of capital support, but it might be desirable to make it clear that this should be a last resort (only after an FI's shareholders and creditors had absorbed losses to an appropriate degree).

227. Several respondents suggested specifying the types of resolution costs which could be met under the arrangements. The authorities are mindful of the need to ensure that the resolution authority has an adequate degree of flexibility to

¹²⁶ For reference see Footnote 104.

structure resolutions appropriately in individual cases, and so consider that any list provided for in legislation would need to be non-exhaustive (and supplemented by guidance). An initial, and non-exhaustive, list of resolution costs to which resolution funding arrangements could contribute on a temporary basis, and as necessary, is set out in Box G below.

Box G: Potentially permitted uses of the resolution funding arrangements

- To meet the administrative expenses of resolution
- To pay NCWOL compensation due under the mechanism outlined in paragraphs 168 to 179 above
- To provide a guarantee of the assets (e.g. in relation to the quality of loans) of, or the liabilities issued by, the FI under resolution, its subsidiaries, a bridge institution or AMV
- To make loans to the FI under resolution, its subsidiaries, a bridge institution or AMV
- To purchase assets of the FI under resolution
- To, as a last resort, provide, or underwrite the provision of, capital to an FI under resolution, its subsidiaries, a bridge institution or AMV

228. A number of respondents asked for further details on how levies would be imposed, in relation to FIs operating in different sectors of the financial system. Some expressed a preference for sector-specific arrangements to avoid cross-subsidy, which could imply that FIs operating in one sector should not be called upon to meet the costs arising from the resolution of an FI in another sector. The authorities consider that it would be appropriate that the costs of each individual resolution be accounted for, and recovered, separately. It may be neither desirable nor feasible, however, to set up separate funding arrangements for each of the sectors covered by the regime given the interdependencies between different types of FIs. An FI in resolution may have operated across, directly or through its wider group, multiple sectors of the local financial system, for example. Additionally, it cannot be assumed that only those in the same sector as a failing FI will benefit from its orderly resolution. An obvious example would be

following failure of an FMI, where it would appear to be both necessary and reasonable to recover costs from a wider set of stakeholders than simply other FMIs.¹²⁷

229. The authorities are considering whether it may be preferable to empower the resolution authority to determine how best to raise any necessary levies taking into account the particular circumstances of each resolution. In this context, it may be appropriate to set some over-arching principles which the resolution authority would be required to take into account. Such principles might make reference to, amongst other things, the risks any FI would itself pose on failure (taking into account whether it would be likely to be systemic or critical as well as its degree of resolvability) as well as the benefit it could be considered to derive from the existence of the regime in general and in relation to a specific resolution.

230. As set out in CP1, it is not proposed that the existing DPS, the ICF and the proposed PPF would be called on to contribute to the costs of any resolution. Whilst some jurisdictions allow for such contributions, often capped at the amount a protection scheme would have been liable for had the FI instead entered insolvency proceedings, the authorities assess that existing local funds could not be called on to make a meaningful contribution to, and might be depleted by, the costs of resolving a large and complex FI.

Question 50

Are the costs identified in Box G those that might, most commonly, be met through resolution funding arrangements established under the regime? Do you agree that these should be set out only in a non-exhaustive list to allow for the structuring of resolutions appropriate to individual FIs?

¹²⁷ In this context a precedent exists locally, given that when, in 1987, the clearing house for the futures market had to be rescued, the costs were recouped, at least in part, through a transaction levy on the futures exchange and a special levy on the stock exchange. See Davison, I.H. et al. (May 1988) "The Operation and Regulation of the Hong Kong Securities Industry: Report of the Securities Review Committee", <http://www.fstb.gov.hk/fsb/ppr/report/davison.htm>

Question 51

Do you agree that it would be appropriate to set overarching principles which would guide the resolution authority in setting levies to recover costs incurred in any individual resolution? Do you have views on what those principles should be?

CHAPTER 5 – CROSS-BORDER RESOLUTION AND INFORMATION SHARING

This chapter considers how the resolution regime in Hong Kong could support resolution of FIs with cross-border operations. It covers:

- ways in which resolution actions can be coordinated cross-border;
- information sharing for the purposes of resolution.

Cross-border resolution

Statutory approaches to support cross-border resolution

231. CP1 described how, in a majority of cases, coordinated and cooperative approaches to the resolution of cross-border FIs are likely to deliver better outcomes for both home and host authorities. Such approaches could result in a significant share of a failing group’s activities being restored to a “going concern” which may better preserve critical financial services and financial stability across multiple jurisdictions and preserve, rather than destroy, value. In contrast, if home and host authorities were to take unilateral actions to protect their own domestic interests, including by ring-fencing local assets within each of their jurisdictions, this could precipitate the disorderly break-up of a group and amplify value destruction as significant parts of the business could become very much a “gone concern”.

232. The high-level standards set by the Key Attributes in relation to cross-border cooperation, and early thinking on how the resolution regime proposed for Hong Kong could meet those standards, were outlined in CP1. It was noted that local implementation needs to take into account work being undertaken by the FSB on ensuring the effectiveness of cross-border resolution measures. In September 2014, the FSB initiated a three-month consultation exercise on the “Cross border recognition of resolution action” (“FSB cross-border CP”) and is reviewing responses with a view to finalising guidance on this matter during 2015.¹²⁸ The authorities intend to provide further details on this aspect of the regime in due

¹²⁸ See Footnote 57 for reference.

course, but meanwhile outline below responses received to CP1 and how the authorities' early thinking maps to the FSB cross-border CP.

233. All respondents agreed that it was important that the local resolution regime supports, and is seen to support, cooperative and coordinated approaches to the resolution of cross-border groups, given Hong Kong's status as a major financial centre playing host to a significant number of global financial services groups. Recognising that orderly resolution of such groups would, in many cases, be led by a foreign resolution authority, many stressed the importance of ensuring that the regime provided for the resolution authority in Hong Kong to recognise and/or support resolution actions being taken by a home authority to resolve a group. Several respondents questioned whether it was appropriate for the local resolution authority to be able to act independently to resolve a branch, or even a subsidiary, of a cross-border FI, but others stressed that retaining such discretion was important. As outlined in CP1, the authorities continue to consider it important that the local resolution authority can act independently to resolve the local operations of an FI, whether the FI operates in Hong Kong as a branch or a subsidiary, in the event that it is assessed that action, or the absence of action, by foreign authorities will not adequately protect local creditors or financial stability. The Key Attributes clearly recognise this also.¹²⁹

234. The authorities note that the FSB cross-border CP stresses the importance of all member jurisdictions establishing resolution regimes which are compliant with the standards set out in the Key Attributes. As described in paragraphs 244 to 247 below, such statutory frameworks may be underpinned by contractual arrangements (designed to bind contractual counterparties into recognising and giving effect to resolution actions), which could also play an important role as an

¹²⁹ For example, in relation to branches, Key Attribute 7.3 states “[t]he resolution authority should have resolution powers over local branches of foreign firms and the capacity to use its powers either to support a resolution carried out by a foreign home authority (for example, by ordering a transfer of property located in its jurisdiction to a bridge institution established by the foreign home authority) or, in exceptional cases, to take measures on its own initiative where the home jurisdiction is not taking action or acts in a manner that does not take sufficient account of the need to preserve the local jurisdiction's financial stability”.

interim solution during the period in which home and key host authorities complete the legislative reform to provide for statutory powers. The FSB is clear, however, that contractual arrangements are not a substitute for a statutory framework.

235. The FSB cross-border CP describes three scenarios, taking into account different group structures, in which cross-border resolution measures may need to be taken and these are set out in Box H below. The scenarios identify the broad concerns a host authority, such as Hong Kong, might have, as well as the actions it might take, including where cross-border FIs operate locally as either branches and/or subsidiaries. In addition to these two scenarios, which were considered in CP1, the FSB identifies a third case where assets, liabilities or contracts of a foreign firm are located or booked in, or subject to the law of, Hong Kong (but where otherwise the firm has no physical presence locally). The authorities consider that the local regime will need to be effective in supporting cross-border resolution across each of these three scenarios.

Box H: Scenarios identified by FSB for cross-border resolution¹³⁰

1. **“a foreign bank undergoing resolution in its home jurisdiction operates a foreign branch.** Home resolution measures need to have effect throughout the whole legal entity, including the branches in host jurisdictions. In this scenario, the protection of the domestic creditors and local financial stability will generally be primary considerations for the host authorities;
2. **a foreign financial institution undergoing resolution in its home jurisdiction controls a subsidiary in another jurisdiction.** In order for home resolution measures to be effective, host jurisdictions may, in particular, need to provide a process to allow the transfer of shares in the subsidiary to another institution or to require local subsidiaries to continue to provide essential services to the parent company or other group entities. Particular concerns of host authorities may relate to local financial stability given the

¹³⁰ See pages 4-5 of the FSB cross-border CP. See Footnote 57 for reference.

potential spill-over between entities of the same group, and prudential matters (for example, ‘fit and proper’ test for the acquirer of the subsidiary); and

3. **assets, liabilities or contracts of a foreign firm in resolution are located or booked in, or subject to the law of, another jurisdiction in which the firm is not established.** In order for home resolution measures to be effective, the relevant jurisdiction would need to allow the implementation of the resolution measures adopted by a foreign authority.”

236. Some respondents agreed with the early thinking set out in CP1 that the resolution regime would need to provide for recognition procedures and/or the taking of supportive measures in Hong Kong. It was clear from responses, however, that ahead of the work being undertaken by the FSB, there remained some uncertainty on how to proceed with implementation, both locally and internationally, in this regard. The FSB cross-border CP includes a useful summary which provides further detail on what constitutes recognition as opposed to support measures, stating that:

- (i) “**Recognition** implies that, at the request of a foreign party, a jurisdiction would accept the commencement of a foreign resolution proceeding domestically and thereby empower the relevant domestic authority...to enforce the foreign resolution measure or grant other forms of domestic relief, such as a stay on domestic creditor proceedings” and that
- (ii) “**Supportive measures** involve the domestic resolution authority taking resolution measures, usually but not exclusively in the context of its own domestic resolution proceedings, that help implement and support resolution measures taken by the foreign resolution authority”.

237. The FSB also explains that “recognition and supportive measures complement each other and in some cases both may be required to achieve the desired outcome” and furthermore that it may be that “recognition procedures are more suitable for certain resolution actions or certain situations, while supportive measures may be the preferred approach for others”. Further details are provided in an Annex to the FSB cross-border CP on how different group structures (including whether foreign FIs have a presence as subsidiaries, branches or not at all) and approaches

to resolution (in terms of the resolution options used) may require use of either recognition or supportive measures (or indeed both). The authorities consider, therefore, that the local regime would need to allow for the recognition and the taking of measures in support of a resolution being carried out by a foreign resolution authority.

238. It was explained in CP1 that there may be cases where use of the Hong Kong regime to recognise and/or otherwise support foreign resolution measures is in the public interest, but where the conditions set for the resolution of any local FIs (as outlined in paragraph 59 in Chapter 2) which are part of the wider group, have not been met.¹³¹ The setting of, and preliminary wording for, “cross-border conditions” which would need to be met before the local regime could be used to recognise and/or support foreign resolution measures was considered in CP1. These appear to be consistent with the factors that the FSB cross-border CP identified as being most relevant to host jurisdictions in deciding whether to recognise and/or support foreign resolution measures.

239. The authorities confirm, in light of a question raised in relation to CP1, that there is no specific intent to limit use of the local regime to cases where a resolution is led by a “home” resolution authority¹³² and that it would be more appropriate to make reference, as in the FSB cross-border CP, to a “foreign” resolution authority.¹³³ Adjusted to reflect this specific point, the “cross-border conditions” for inclusion in the local regime could be that:

¹³¹ This may occur in cases where the local entities of the cross-border group appear viable and/or are assessed not to be systemically important or critical in Hong Kong.

¹³² CP1 defined a “home” jurisdiction as “being one where the operations of a financial firm or, in the case of a G-SIFI, its global operations, are supervised on a consolidated basis. A host jurisdiction is one where a cross-border FI has a presence either as a locally-incorporated subsidiary or as a branch”.

¹³³ Given in some, few, cases it could be, for example, that an agreed resolution strategy, particularly under a multiple point of entry approach, involves the Hong Kong resolution authority acting to recognise or support a resolution action being carried out by another host resolution authority in relation to a subsidiary of a global group which in turn owns other FIs located here in Hong Kong.

- (i) a foreign resolution authority is initiating resolution in relation to a cross-border group with operations in Hong Kong which are themselves within scope of the local regime;
- (ii) it is assessed, by the resolution authority in Hong Kong, that the approach which the foreign resolution authority proposes to adopt will deliver outcomes that are consistent with the objectives for resolution and will not disadvantage local creditors relative to foreign creditors.

240. The authorities consider it important to note that the resolution authority in Hong Kong should exercise discretion in assessing whether these cross-border conditions are met. This is clearly preferable to providing for any sort of automatic mechanism, which would not afford a sufficient degree of control locally. The FSB cross-border CP additionally notes that a basis for refusing to recognise or support a cross-border resolution could be an assessment that it “would have material fiscal implications (for example, by exposing local public authorities or taxpayers to loss)”. The authorities will consider whether to include such a requirement in the local regime, noting that by referencing the objectives set for resolution, as outlined in Chapter 2, the second cross-border condition in paragraph 239(ii) above already implies that any foreign resolution measures should be consistent with seeking to contain the costs of resolution, and implications for public funds.

241. Further consideration will also be given to whether and how to accommodate other scenarios, including where a cross-border group which is likely to be subject to foreign resolution measures has only: (i) operations in Hong Kong which are outside of the scope of the local resolution regime; or (ii) assets, liabilities or contracts located or booked in, or subject to the law of, Hong Kong but otherwise no physical presence here. It is noted in relation to (i) that the proposals set out in Chapter 1 would mean that all local branches and subsidiaries of groups identified as being or containing G-SIFIs would be covered by the local regime.

Question 52

Do you agree that it would be appropriate to set specific “cross-border conditions” which must be met before the local resolution regime may be used

to support foreign resolution measures?

Question 53

Are the conditions identified in paragraph 239 above appropriate? Do you consider that in addition to being satisfied that foreign resolution measures are consistent with the objectives set for resolution locally, a further requirement should be set with regard to considering the fiscal implications?

Question 54

Do you have any views on how to accommodate the scenarios outlined in Box H above?

242. More generally, the authorities are cognisant of the need to align the approach taken to design of the local regime, and in particular the key resolution options and powers, with the Key Attributes, with a view to minimising any differences with regimes in other major financial centres. Additional statutory provisions needed to support the recognition and taking of supportive measures in the context of cross-border resolutions will be considered and further detail outlined in CP3.

243. In the meantime, the authorities encourage interested stakeholders to review the FSB cross-border CP and would welcome any comments on the issues identified there, and in particular their application in the Hong Kong context.

Contractual approaches to support cross-border resolution

244. Statutory resolution regimes are likely to provide the preferred longer term solution to underpinning cross-border resolution, given the legal certainty they can provide, but the FSB cross-border CP identifies a number of cases where contractual solutions can play an important role.¹³⁴

¹³⁴ The FSB assesses that contractual solutions are helpful ahead of implementation of the Key Attributes across home and key host jurisdictions, but note that they have limitations – and specifically may not lead to a sufficient degree of legal certainty – and so should not be considered as substitutes for statutory regimes.

245. One such area is temporary stays on early termination rights (including as a result of cross-defaults) in financial contracts, in relation to which agreement was reached recently on a draft ISDA Protocol¹³⁵ designed to support the cross-border enforceability of stays on termination rights (arising from resolution). The authorities will consider the merits, as well as the most effective means, of requiring relevant FIs, and incentivising their counterparts, to adopt the necessary contractual language on stays in resolution.

246. The second area where contractual solutions may support resolution is in relation to bail-in and specifically the write-down, cancellation or conversion of debt instruments in resolution where the relevant instruments are governed by the laws of a jurisdiction other than that of the issuing entity. The authorities will give consideration to adopting measures, as well as the most effective means of, requiring relevant FIs to include contractual provisions of this nature in capital or debt instruments governed by foreign law (and perhaps additionally to demonstrate that any statutory bail-in of such instruments would be enforceable, e.g. through the provision of independent legal opinions, at or prior to the issue of the instrument).¹³⁶

247. The FSB has said that member jurisdictions should take official action to promote the widespread adoption of contractual clauses recognising stays on early termination rights and exercise of bail-in powers by the end of 2015.

¹³⁵ The draft Protocol is to the ISDA Master Agreement under which the majority of bilateral OTC derivatives are traded and, if adopted by market participants, would support the cross-border enforceability of a temporary stay in early termination rights with respect to OTC derivatives governed by the Master Agreement between such adopting parties upon specified resolution actions with respect to certain counterparties, relevant group companies or their credit support providers.

¹³⁶ In so doing, the authorities would be guided by any Key Principles set by the FSB in this regard noting that draft principles were set out in the FSB cross-border CP including those designed to ensure enforceability as a matter of contract law, by virtue of the debt holder having entered into a clear agreement to be bound by the terms of a bail-in under resolution and that statutory powers exercised in this regard would take precedent over other terms and conditions governing the debt instrument (see para 2.2.1).

Other measures to support cross-border resolution

248. A number of respondents stressed the importance of measures, including under regulatory frameworks and supervisory approaches, to support coordinated and cooperative approaches to the resolution of cross-border FIs. Several asked for more detail on the intended approach to coordinating with foreign counterparts on resolution planning and execution, including under the institution-specific Cross-border Cooperation Agreements (or “COAGs”) that home and key host authorities are required to prepare under the Key Attributes, as well as on measures to ensure effective information sharing (the latter is considered in more detail below).

249. The authorities consider that the proposals outlined for the local resolution regime will provide a firm basis for effective coordination with key counterparts overseas, as will steps taken to implement the statutory framework. Policy measures pursued now and in future, including for domestic recovery and resolution planning requirements will be of central importance. As will ongoing participation in the FSB-led initiative to undertake resolution planning for G-SIFIs, and G-SIBs in the first instance. As previously noted the HKMA is a member of the Crisis Management Groups for the ten G-SIBs whose Hong Kong operations are considered to be material to the group and as outlined by the FSB it is proposed that COAGs would, at a minimum, be signed for those groups setting out an agreed approach to the planning for, and execution of, recovery and resolution measures. More generally, it is recognised that the regime may have some implications for other aspects of the existing regulatory framework and supervisory approach which will need to be considered in due course.

Information sharing

250. CP1 outlined proposals designed to ensure that information sharing¹³⁷ between the authorities with a role to play in resolution will be effective. It was explained

¹³⁷ Noting that it is assumed that much of the relevant information to be shared will be non-public relating to individual FIs (and in some cases their customers) as well as the actions which might be taken by the FIs themselves or by the relevant authorities in resolution scenarios.

that the existing framework governing information sharing by the regulatory authorities in Hong Kong, and as provided for under their respective ordinances, is consistent with the approach outlined in Key Attribute 12.¹³⁸ As such it was proposed that a similar set of information sharing powers would be afforded to any public authority designated to act as a resolution authority in Hong Kong; and so to each of the MA, SFC and IA as resolution authorities under the proposals set out in paragraphs 67 to 71 of Chapter 2.

251. Respondents were broadly in agreement that the proposed approach struck an appropriate balance in terms of facilitating information sharing for resolution whilst also ensuring all reasonable steps are taken to preserve confidentiality. Some identified particular aspects of the framework which would need to be robust, including with a view to ensuring that information is shared only with relevant parties to the extent necessary for those parties to carry out functions relating to resolution as well as to ensure that adequate confidentiality safeguards are in place. The authorities recognise the importance of each of these aspects and consider that an approach modelled on the existing framework governing information sharing for the regulatory authorities, and designed to take into account the requirements and guidance outlined in the Key Attributes, will address such concerns.

252. One response suggested that information sharing on resolution should be limited to where an FI had become non-viable (or the period immediately prior to this). The authorities consider that a restriction of this sort would significantly hamper the ability of a resolution authority to undertake resolution planning effectively, both in normal times but also where risks to the viability of an individual FI start to emerge. It would also fall short of the standards set in the Key Attributes, given that Key Attribute 12.1 expressly requires information sharing to support resolution planning “should be possible in normal times and during a crisis”.

¹³⁸ As well as the additional guidance set out in Annex I: Information sharing for resolution purposes of the reissued Key Attributes (see Footnote 4 for reference).

253. Some respondents highlighted the importance of ensuring that powers enabling a resolution authority to require FIs to provide information for resolution purposes are proportionate. The authorities are mindful of these concerns but consider that an appropriate balance is already struck under the existing information gathering powers of the regulators. It is additionally noted that as outlined in paragraph 13 in Chapter 1, that the authorities intend to pursue a proportionate approach to resolution planning, including in terms of gathering information.

254. Some respondents offered views on other arrangements and processes needed to ensure that information sharing between relevant authorities will be effective. The authorities are cognisant of the importance of each resolution authority agreeing in advance an approach to information sharing with key domestic and cross-border counterparts. Related to this, it will be important for each resolution authority to consider whether Memorandums of Understanding (“MOUs”) adequately cover, inter alia, the sharing of information for resolution purposes and furthermore to meet FSB requirements in relation to COAGs.

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ANNEX I: List of respondents to CPI

- (1) AIA Group Limited
- (2) Allen & Overy
- (3) The Alternative Investment Management Association Limited
- (4) Chinese Academy of Governance (HK) Industrial and Commercial Professionals Alumni Association
- (5) Clifford Chance (together with Asia Securities Industry & Financial Markets Association and Global Financial Markets Association)
- (6) CLS Bank International
- (7) CompliancePlus Consulting Limited
- (8) The Consumer Council
- (9) Deutsche Bank
- (10) FWD Life Insurance Company (Bermuda) Limited
- (11) Hong Kong Association of Banks
- (12) Hong Kong Association of Restricted Licence Banks and Deposit-Taking Companies
- (13) Hong Kong Deposit Protection Board
- (14) The Hong Kong Federation of Insurers¹³⁹
- (15) Hong Kong Institute of Certified Public Accountants
- (16) Hong Kong Investment Funds Association
- (17) Hong Kong Retirement Schemes Association
- (18) Hong Kong Securities Association
- (19) Hong Kong Society of Financial Analysis
- (20) Hong Kong Trust Association
- (21) The Institute of Financial Planners of Hong Kong
- (22) International Swaps and Derivatives Association
- (23) Law Society of Hong Kong
- (24) Linklaters
- (25) Lloyd's
- (26) Manulife (International) Limited
- (27) MetLife Limited, Metropolitan Life Insurance Company of Hong Kong Limited
- (28) Slaughter & May
- (29) UBS

* *Four respondents asked not to be identified.*

¹³⁹ The submission from The Hong Kong Federation of Insurers comprised its own comments as well as comments from AXA China Region Insurance Company Limited, AXA General Insurance Hong Kong Limited, BOC Group Life Assurance Company Limited, Direct Asia Insurance (Hong Kong) Limited, Lloyd's, Manulife (International) Limited, Prudential Hong Kong Limited and Zurich Insurance Company Ltd, Hong Kong Branch.

ANNEX II: Factors relevant to assessing the first non-viability condition

Extract of Box E from CP1

For illustrative purposes, a non-exhaustive set of the factors which could indicate that the first non-viability condition for resolution has been met is outlined below *in relation to AIs*. Following further refinement (including adaptation for application to FIs in other sectors of the financial system), these factors might be elaborated in guidance on the use of the regime.

Factors relevant to assessing that an AI is, or is likely to become, unable to satisfy one of the conditions set for authorisation (condition (1)(a) in Box D above) would be those supporting an assessment that:

- (i) an AI's liquidity position is coming under severe pressure, including as a result of a loss of confidence by depositors or other funding providers, such that there is a real possibility it will breach the liquidity ratio as required under section 102 of the BO and/or might become unable to meet its liabilities as they fall due;
- (ii) an AI's capital position is inadequate, including as a result of actual or likely losses, such that the AI is, or is likely to become, unable to comply with the minimum requirements set by the MA in this regard, in the Banking (Capital) Rules (Cap. 155L) and under the BO, and may ultimately have insufficient assets to cover its liabilities;
- (iii) an AI is failing to satisfy other conditions set for continuing authorisation to such a material degree that withdrawal of its authorisation would be warranted.

Factors relevant to consideration of the prospects for addressing these issues (condition(1)(b) in Box D above) would include those supporting an assessment that it appears unlikely that:

- (iv) private sector action (including by means of a voluntary sale of the entire AI or of some or all of its business) or the deployment of supervisory intervention powers, outside of resolution, will restore viability, either at all or in a sufficiently timely manner taking into account relevant circumstances;
- (v) confidence in the AI can be re-established and its liquidity position returned to that necessary to continue its activities;
- (vi) the capital position of the AI can be restored including through new issuance, the write-down or conversion of contingent liabilities in issue (including those which trigger on an assessment of non-viability), or by managing down balance sheet risks;
- (vii) the AI is either willing or able to take necessary actions to address any material breach of other conditions for authorisation;
- (viii) failure could be averted other than through undue reliance being placed on the extraordinary provision of public funds.

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ANNEX III: Further detail on the temporary stay on early termination rights

It is proposed that financial contracts and agreements to be subject to the proposed temporary stay on early termination rights would be:

- a) securities contracts, including:
 - (i) contracts for the purchase, sale or loan of a security, a group or index of securities;
 - (ii) options on a security or group or index of securities;
 - (iii) repurchase or reverse repurchase transactions on any such security, group or index;
- b) commodities contracts, including:
 - (i) contracts for the purchase, sale or loan of a commodity or group or index of commodities for future delivery;
 - (ii) options on a commodity or group or index of commodities;
 - (iii) repurchase or reverse repurchase transactions on any such commodity, group or index;
- c) futures and forwards contracts, including contracts (other than a commodities contract) for the purchase, sale or transfer of a commodity or property of any other description, service, right or interest for a specified price at a future date;
- d) swap agreements, including:
 - (i) swaps and options relating to interest rates; spot or other foreign exchange agreements; currency; an equity index or equity; a debt index or debt; commodity indexes or commodities; weather; emissions or inflation;
 - (ii) total return, credit spread or credit swaps;
 - (iii) any agreements or transactions that are similar to an agreement referred to in point (i) or (ii) which are the subject of recurrent dealing in the swaps or derivatives markets;
- e) inter-bank borrowing agreements where the term of the borrowing is three months or less; and
- f) master agreements for any of the contracts or agreements referred to in points (a) to (e).

ANNEX IV: Further detail on protected arrangements

Type of arrangement	Definition	Protections	Remedy
Secured (or collateralised)	Arrangements under which one person acquires, by way of security, an actual or contingent interest in the property of another. Extends to arrangements where the liability is secured against all (or substantially all) of the property or rights of a person (i.e. floating charge); some of the property or rights of a person (i.e. fixed charge) as well as in cases where the property or rights acting as security are not owned by the party owing the liability	Resolution actions may not transfer the property or rights against which a liability, owed by one party to another, is secured, unless the liability and the benefit of the security are also transferred, nor terminate or modify the arrangement in other ways	Affected party to notify the resolution authority to potential breach, such that it might be corrected for (e.g. through supplemental, reverse transfer) as appropriate
Set-off	Arrangements under which two or more debts, claims or obligations can be set off against each other	Resolution actions may not transfer some but not all of the protected rights and liabilities between a third party and an FI under resolution covered by this type of arrangement, nor terminate or modify the arrangement in other ways	Set-off is enforceable
Netting	Arrangement under which a number of claims or obligations can be converted into a net claim or obligation. Includes “close-out” netting agreements under which actual or theoretical debts are calculated during the course of a contract for the purpose of enabling them to be set off against each other or to be converted into a net debt.	As above	Netting is enforceable

Title transfer arrangements (financial collateral)	Arrangements under which one person transfers assets to a second person on terms providing for the latter to transfer assets if specified obligations are discharged. Includes repurchase (and reverse repurchase), stock lending and borrowing.	As above	Affected party to notify the resolution authority to potential breach, such that it might be corrected for (e.g. through supplemental, reverse transfer) as appropriate
Structured finance (capital markets)	Arrangements under which an issuer creates a financial instrument whose value and/or performance is linked to, and/or secured on, financial assets. Includes asset-backed securities, securitisations, asset-backed commercial paper, residential and commercial mortgage backed-securities, collateralised debt obligations and covered bonds.	Resolution actions may not transfer some but not all of the property, rights and liabilities which are part of a capital market arrangement	Affected party to notify the resolution authority to potential breach, such that it might be corrected for (e.g. through supplemental, reverse transfer) as appropriate
Rules and arrangements within trading, clearing and settlement systems	Rules and arrangements pertaining to a participant's obligations in relation to participation in the trading, clearing and settlement systems. E.g. relating to settlement finality, payment and delivery obligations, transfer orders or processes to be observed on default of a participant.	Resolution may not transfer property, rights or liabilities or modify the operation of or render invalid securities cleared through an FMI, or the settlement or default rules of an FMI.	Actions taken to transfer property, rights or liabilities or modify or invalidate securities cleared through an FMI or the settlement or default rules of an FMI could be declared void

ANNEX V: Consultation questions

Question 1

Do you agree with the revised scope of the regime in respect of LCs as set out in paragraph 29?

Question 2

Do you have any views on the factors that should be taken into account when assessing the local systemic importance of insurers?

Question 3

With a view to ensuring that all FIs which could be critical or systemic on failure are within scope of the regime, and recognising that the risks posed by any given types of FI may change over time, do you agree that providing the FS with a power to designate additional FIs as being within scope is appropriate?

Question 4

Do you agree that in cases where one or more FIs within scope of the regime are part of mixed activity groups, the presumption should be that resolution will be undertaken at the level of a locally incorporated FSHC? And that resolution at the level of a locally incorporated MAHC would be undertaken only in exceptional circumstances where orderly resolution cannot otherwise be achieved?

Question 5

Do you agree with the proposed definition of, and approach to, setting the regime's scope in respect of, AOE's?

Question 6

Do you have views on how AOE's might be more precisely defined, without restricting the resolution authority's ability to achieve orderly resolution of an affiliated FI?

Question 7

Do you agree that it would be appropriate to extend the scope of the proposed resolution regime to recognized exchange companies that are considered systemically important to the effective functioning of the Hong Kong financial market?

Question 8

Do you agree with the factors to be taken into consideration in designation of systemically important recognized exchange companies set out above? Do you have suggestions as to what other factors should also be taken into consideration?

Question 9

Do you have any views on whether it is necessary to introduce an additional resolution objective in respect of the protection of client assets considering the policy intention behind the drafting of resolution objective (ii) in paragraph 63?

Question 10

Do you agree that an LRA should be designated for each cross-sector financial group containing "in scope" FIs by the FS once the legislation establishing the regime has passed?

Question 11

Do you agree that the designation of the LRA should be based upon the resolution authorities' assessment of the relative systemic importance of the individual 'in scope' FIs within a cross-sector financial group and that the resolution authority of the FI assessed to pose the greatest systemic risk be designated as the LRA for that group?

Question 12

Do you agree that the role of the LRA should be one of coordination and, when required, ultimate decision-maker?

Question 13

Do you agree that the proposals for providing temporary DPS cover should reduce the incentives for transferred depositors to withdraw excess balances immediately on completion of a business transfer in resolution?

Question 14

Do you have any views on the steps and processes, outlined in paragraphs 104 to 106, with a view to making the bail-in process operational?

Question 15

Do you have views on the scope of the bail-in power within the resolution regime and specifically on (i) the list of liabilities identified in paragraph 108 which would always be excluded from bail-in and (ii) the grounds for excluding further liabilities from any bail-in on a case-by-case basis as identified in paragraph 110?

Question 16

Do you have views on how the list of excluded liabilities in paragraph 108 should be expanded to ensure that the bail-in option is suitable for use with FIs other than banks, and specifically in relation to insurers, FMIs and NBNI FIs?

Question 17

Do you have views on the proposed approach to bail-in of liabilities arising from derivatives as outlined in paragraph 111?

Question 18

Do you agree that an additional condition is required for TPO? Is the additional condition, proposed in paragraph 115, appropriate?

Question 19

Do you agree with the scope, timing and conditions proposed for temporary stays on early termination rights in financial contracts?

Question 20

Do you have views on whether a temporary stay on early termination rights should apply solely to financial contracts or whether broader provision should be made?

Question 21

Do you have views on whether there are other issues which need to be considered in relation to staying early termination rights in resolution?

Question 22

Do you have views on how best to implement a temporary stay of early termination rights such that it is effective in supporting resolution of FMIs in particular?

Question 23

Do you have views on the proposals for the temporary suspension of insurance policyholders' surrender rights, including the proposed duration of the suspension?

Question 24

Do you have views on the proposals for a temporary stay on reinsurers of an insurer or of another reinsurer in resolution to terminate or not reinstate coverage relating to periods after the commencement of resolution?

Question 25

Do you agree with the proposals set out above to provide the resolution authority with powers to require an FI to make changes to improve its resolvability?

Question 26

Do you agree with the proposal that the resolution authority should be notified of an intention to petition for an in-scope FI's winding-up and be afforded a maximum 14 day notice period to determine whether or not to initiate resolution before that winding-up petition can be presented to the court?

Question 27

Do you have views on which of the approaches outlined in paragraph 141 above might best deliver continuity of services from a residual FI and which are essential to secure continuity of the business transferred to an acquirer?

Question 28

Do you agree that the regime should empower the resolution authority to impose a temporary moratorium on payments to unsecured creditors and to restrict the

enforcement of security interests in line with proposals set out above? Do you have views as to the exclusions to which this power should be subject?

Question 29

Do you agree that the regime should empower the resolution authority to appoint a resolution manager in line with the proposals set out above?

Question 30

Do you agree that the regime should provide the resolution authority with the necessary powers to secure the continuity of essential services as set out in paragraph 156?

Question 31

Do you agree that resolution should result in the automatic removal of all the directors, the CEO and Deputy Chief Executive Officer (“DCEO”) (where relevant) of an FI in resolution and that the resolution authority should have powers to remove other senior management at its discretion?

Question 32

Do you agree that the resolution authority should be able to apply to the court to seek remuneration claw-back from those parties identified in paragraph 165 whose actions or omissions have caused or materially contributed to an FI entering resolution?

Question 33

Do you have views on whether remuneration claw-back should apply to both fixed and variable remuneration (both vested and unvested) or only to variable remuneration (both vested and unvested)?

Question 34

In light of the practices adopted in other jurisdictions, do you have views on how far back in time a remuneration claw-back power should reach?

Question 35

Do you agree that the indicative criteria to assess the independence and expertise of an NCWOL valuer, as set out in Box F, are appropriate and that a degree of judgment will be inherent in assessing whether these, or any other, factors are relevant in individual cases?

Question 36

Do you agree that the resolution authority should appoint the NCWOL valuer, guided by the indicative criteria set out in Box F?

Question 37

Do you agree with the proposed grounds for removal of a NCWOL valuer, as set out in paragraph 174? Do you agree that the proposed mechanism for seeking removal on those grounds is appropriate?

Question 38

Do you agree that the treatment of the outgoing valuer's work up to the point of removal is a matter for any incoming valuer, who should clearly explain that treatment in his/her final valuation?

Question 39

Do you agree that the three overarching valuation principles identified in paragraphs 176 (i) to (iii) should be applied each time an NCWOL valuation is

undertaken? Do you have views on other valuation principles that should underpin an NCWOL valuation?

Question 40

Do you agree that the right to receive NCWOL compensation (if due) should be restricted to those creditors and shareholders who held liabilities of a failed FI as at the point resolution proceedings formally commenced and who suffer an economic loss as a direct result of the resolution authority's actions?

Question 41

Do you have views on how a mechanism might be provided for to expedite the payment of NCWOL compensation due where at least part of any valid NCWOL claims can reliably be identified?

Question 42

Do you agree that the RCT should be established under the regime to hear appeals of: (i) the shareholders and creditors of an FI in resolution; and/or (ii) the resolution authority against a NCWOL valuation?

Question 43

Do you agree with the proposed composition of, and process for appointment to, the RCT?

Question 44

Do you have any views on the powers that should be available to the RCT in addition to those identified in paragraph 186?

Question 45

Do you agree that applicants should have the right to appeal against a determination of the RCT on a point of law, as set out in paragraph 187?

Question 46

Do you have any further comments on the way in which it is proposed that the various types of protected financial arrangement would be safeguarded and remedies for inadvertent breaches executed?

Question 47

How could a similar safeguard be provided for to support use of the bail-in option?

Question 48

Do you have any views on the factors the authorities should take into account in developing effective protections from civil liability for: (i) the resolution authority and its staff and agents; and (ii) the directors, officers and employees of an FI in resolution in a cross-border context?

Question 49

Do you agree with the proposal to provide the relevant authorities the power to defer or exempt compliance with the following requirements, as discussed above: (i) the disclosure requirements under Part XIVA and Part XV of the SFO, the Listing Rules and the Takeovers Code; (ii) the shareholders' approval requirements under the Listing Rules; and (iii) the general offer obligation under the Takeovers Code?

Question 50

Are the costs identified in Box G those that might, most commonly, be met through resolution funding arrangements established under the regime? Do you agree that these should be set out only in a non-exhaustive list to allow for the structuring of resolutions appropriate to individual FIs?

Question 51

Do you agree that it would be appropriate to set overarching principles which would guide the resolution authority in setting levies to recover costs incurred in any individual resolution? Do you have views on what those principles should be?

Question 52

Do you agree that it would be appropriate to set specific “cross-border conditions” which must be met before the local resolution regime may be used to support foreign resolution measures?

Question 53

Are the conditions identified in paragraph 239 above appropriate? Do you consider that in addition to being satisfied that foreign resolution measures are consistent with the objectives set for resolution locally, a further requirement should be set with regard to considering the fiscal implications?

Question 54

Do you have any views on how to accommodate the scenarios outlined in Box H above?