

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

**CONSULTATION PAPER**

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, to consult on proposals for a resolution regime for certain financial institutions operating in the banking, securities and futures and insurance sectors, as well as for certain financial market infrastructures, in Hong Kong.
2. After considering the submissions received in response to this consultation paper, the Government intends to refine its proposals, and expects to undertake a second stage consultation during 2014, with a view to introducing a bill into the Legislative Council in 2015.
3. A list of the questions raised in this consultation is set out for ease of reference in the Annex. 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.
4. Comments should be submitted in writing no later than 6 April 2014, by any one of the following means:-

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2 Tim Mei Avenue, Tamar, Hong Kong

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By email to: [resolution@fstb.gov.hk](mailto:resolution@fstb.gov.hk)

5. Any person submitting comments on behalf of any organisation is requested to provide details of the organisation they represent.
6. 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

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8. 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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## ABBREVIATIONS

AI	Authorized institution
AMV	Asset management vehicle
BIS	Bank for International Settlements
BO	Banking Ordinance (Cap. 155)
BoE	Bank of England
CCP	Central counterparty
CMG	Crisis management group
CO	Companies Ordinance (Cap. 32)
COAG	Institution-specific cross-border cooperation agreement
CPSS	Committee on Payment and Settlement Systems (of the Bank for International Settlements)
CSSO	Clearing and Settlement Systems Ordinance (Cap. 584)
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act
DPB	Hong Kong Deposit Protection Board
DPS	Deposit Protection Scheme
DPSO	Deposit Protection Scheme Ordinance (Cap. 581)
D-SIFI	Domestic systemically important financial institution
DTC	Deposit-taking company
EU	European Union
EU RRD	Recovery and Resolution Directive of the European Union
FDI Act	Federal Deposit Insurance Act
FDIC	Federal Deposit Insurance Corporation
FIs	Financial institutions (including financial market infrastructures unless the context otherwise requires)
FINMA	Financial Market Supervisory Authority (Switzerland)
FMI	Financial market infrastructures
FS	Financial Secretary
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSTB	Financial Services and the Treasury Bureau
G20	Group of Twenty
GLAC	Gone concern loss absorbing capacity
G-SIB	Global systemically important bank
G-SIFI	Global systemically important financial institution

G-SII	Global systemically important insurer
HKEx	Hong Kong Exchanges and Clearing Limited
HKMA	Hong Kong Monetary Authority
IA	Insurance Authority
IAIG	Internationally active insurance group
IAIS	International Association of Insurance Supervisors
ICF	Investor Compensation Fund
ICO	Insurance Companies Ordinance (Cap. 41)
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
LB	Licensed bank
LC	Licensed corporation
LegCo	Legislative Council
LRA	Lead resolution authority
MA	Monetary Authority
MAD	Market Abuse Directive (of the European Union)
MAS	Monetary Authority of Singapore
MOU	Memorandum of understanding
MPE	Multiple point of entry (resolution strategy)
NBNI G-SIFI	Non-bank non-insurance G-SIFI
NCWOL	No creditor worse off than in liquidation
OTC derivatives	Over-the-counter derivatives
PPF	Policyholders' Protection Fund
RI	Registered institution
RLB	Restricted licence bank
ROSC	Report on the Observance of Standards and Codes
SFC	Securities and Futures Commission
SFO	Securities and Futures Ordinance (Cap. 571)
SIFI	Systemically important financial institution
SPE	Single point of entry (resolution strategy)
SRR	Special Resolution Regime (UK)
TBTF	Too big to fail
TPO	Temporary public ownership
UK	United Kingdom
US	United States of America

## EXECUTIVE SUMMARY

### Overview

1. Following the recent global financial crisis, a series of international regulatory reform initiatives are being pursued to enhance the resilience and stability of the financial system. Some of these reforms – including the new international capital and liquidity standards for banks – are designed to improve the ability of financial institutions (FIs)<sup>1</sup> to withstand future shocks. At the same time, it is recognised that regulatory and supervisory measures cannot deliver a completely failure-free outcome.
2. For this reason, complementary reforms seek to contain the consequences should any FIs experience such a severe shock that their viability is undermined. The crisis highlighted that many of the most adversely affected jurisdictions lacked the powers necessary to protect the stability and effective working of the financial system in cases where a failing FI provides critical financial services and poses systemic risk. Such FIs may be described as being systemically important financial institutions (SIFIs) or “too-big-to-fail” (TBTF). In order to avert dire consequences for financial stability, the real economy and society in general, many of these jurisdictions intervened to rescue (or bail-out) failing FIs with unprecedented amounts of public funds.
3. The Financial Stability Board (FSB)<sup>2</sup> was tasked by G20 leaders<sup>3</sup> with developing robust alternatives to publicly-funded rescues, such that critical or systemic FIs might be allowed to fail safely. The FSB has concluded that each of its member jurisdictions needs to establish a “resolution regime” providing national authorities

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<sup>1</sup> For the purposes of this consultation paper, an FI is defined as “any entity the principal business of which is the provision of financial services or the conduct of financial activities, including, but not limited to, banks, insurers, securities or investment firms and financial market infrastructure firms” (this definition is drawn from the FSB (August 2013) “Consultative Document: Assessment Methodology for the Key Attributes of Effective Resolution Regimes for Financial Institutions”, [https://www.financialstabilityboard.org/publications/r\\_130828.pdf](https://www.financialstabilityboard.org/publications/r_130828.pdf))

<sup>2</sup> The FSB has been established to coordinate at the international level the work of national financial authorities and international standard setting bodies and to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies.

<sup>3</sup> The G20 brings together finance ministers and central bank governors from 19 countries plus the European Union to provide a forum for international cooperation on the most important issues on the global economic and financial agenda.

with administrative powers to rapidly bring about orderly resolution which stabilises and secures continuity for key parts of a failing FI's business. At the same time, these regimes should ensure that the costs of failure are borne by the shareholders and creditors of the failing FI, rather than through reliance on use of public funds. The essential features that each resolution regime should have to support these outcomes are set out in the "Key Attributes of Effective Resolution Regimes for Financial Institutions" (or "Key Attributes").<sup>4</sup> These new standards were published in November 2011 after being endorsed by G20 leaders at the Cannes Summit.

4. The FSB assesses that a majority of its member jurisdictions will need to undertake legislative reform in order to implement these new standards; something they are encouraged to do as a matter of priority and ahead of an end-2015 deadline.<sup>5</sup> Therefore the Financial Services and the Treasury Bureau (FSTB), together with the Monetary Authority (MA), the Securities and Futures Commission (SFC) and the Insurance Authority (IA), are considering what steps need to be taken in Hong Kong in this regard. The authorities assess, as summarised in this consultation paper, that the existing statutory framework does not provide for all of the powers that the FSB considers to be a necessary part of an effective resolution regime.
5. This consultation paper outlines the Government and the regulators' current thinking on the legislative changes that are needed to bring Hong Kong's existing arrangements into line with the standards set out in the Key Attributes such that, in the event that it becomes necessary to draw on them, the authorities will be better placed to carry out an orderly resolution of failing FIs in a manner that protects financial stability as well as public funds in Hong Kong.

### **Structure of this Consultation Paper**

6. Chapter 1 outlines why there is now consensus that relevant authorities should be given the administrative powers needed to secure the orderly resolution of FIs whose failure could pose a threat to financial stability, including because of the

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<sup>4</sup> See FSB (October 2011) "Key Attributes of Effective Resolution Regimes for Financial Institutions", [http://www.financialstabilityboard.org/publications/r\\_111104cc.pdf](http://www.financialstabilityboard.org/publications/r_111104cc.pdf)

<sup>5</sup> See FSB (September 2013) "Progress and Next Steps Towards Ending "Too-Big-To-Fail" (TBTF): Report of the Financial Stability Board to the G-20", [http://www.financialstabilityboard.org/publications/r\\_130902.pdf](http://www.financialstabilityboard.org/publications/r_130902.pdf)



critical financial services they provide. To illustrate this, the chapter considers the consequences that could arise if such FIs were instead to enter insolvency proceedings.

7. The administrative powers, alongside other essential features, which the Key Attributes say are necessary for resolution regimes to be effective, are introduced in Chapter 2. It is outlined that regimes should provide for a menu of resolution options designed to ensure that, across a range of FIs and circumstances, some or all of a failing FI's business can be continued within a viable (and adequately capitalised) entity. Chapter 2 also provides a summary of the reforms undertaken elsewhere, showing that a series of key jurisdictions have already acted to strengthen their statutory frameworks in recent years and are currently pursuing further reform to better comply with the Key Attributes.
8. The existing powers available to the regulatory authorities – the MA, SFC and IA – to support interventions in relation to distressed FIs are outlined in Chapter 3 and consideration is given to how far these might be used to support resolution. The chapter finds that the existing powers are insufficient to achieve all of the outcomes required by the Key Attributes.
9. Chapter 4 considers which FIs from the banking, securities and futures and insurance sectors, as well as which financial market infrastructures (FMIs)<sup>6</sup> should be subject to the resolution regime proposed for Hong Kong. As the Key Attributes set common standards, and in light of the need to be able to support resolution of groups which operate across multiple sectors, a single cross-sectoral resolution regime is proposed. Based on an assessment of the risks that could be posed locally on the failure of FIs in each sector in turn, it is proposed that the regime should cover: all authorized institutions (AIs); certain financial market infrastructures (FMIs) designated under the Clearing and Settlement Systems Ordinance (Cap. 584) (CSSO) or recognized as clearing houses under the

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<sup>6</sup> For the purposes of this consultation paper, an FMI is defined as a “multilateral system among participating institutions, including the operator of the system, used for the purposes of clearing, settling or recording payments, securities, derivatives, or other financial transactions”. This definition is drawn from the Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organization of Securities Commissions (IOSCO) “Principles for Financial Market Infrastructures” published in April 2012 (see <http://www.bis.org/publ/cpss101a.pdf>). There are five major types of FMIs: payment systems, central securities depositories (CSDs), securities settlement systems (SSSs), central counterparties (CCPs) and trade repositories (TRs).

Securities and Futures Ordinance (Cap. 571) (SFO); and certain licensed corporations (LCs) and insurers. It is also proposed that the regime should allow for resolution powers to be used in relation to locally-incorporated holding companies of FIs, and potentially also affiliated operational entities, where certain conditions are met.

10. The conditions which would need to be met in Hong Kong before the regime could be used as well as the objectives which any resolution should seek to fulfil are outlined in Chapter 5. It is proposed that the resolution regime would be used where it is assessed that an FI is no longer viable and that the FI's failure poses a threat to financial stability. Any resolution should seek to secure continuity for critical financial services, including payment, clearing and settlement functions, and to protect financial stability. It should also seek to provide a measure of protection to depositors, investors and insurance policyholders covered under protection schemes and, subject to delivering on these objectives, to contain the costs associated with resolution and protect public funds. It is proposed that each of the sectoral regulators would act as resolution authorities for FIs under their respective purviews. If this proposal is adopted, arrangements to ensure an appropriate degree of coordination between these resolution authorities will be given further consideration.
11. Chapter 6 considers the menu of resolution options, including allowing for a compulsory transfer of business to another FI, or as a temporary arrangement to a bridge institution. To ensure that the resolution of large and complex FIs is possible, it is proposed that the regime should support resolution by means of an officially mandated creditor-financed recapitalisation (commonly known as bail-in). The case for including a temporary public ownership (TPO) option, for use as a last resort if other options will not protect financial stability adequately, is also made.
12. The safeguards which are an inherent part of any resolution regime, and which it is proposed would be available in Hong Kong, are outlined in Chapter 7. These are designed to limit the adverse effect that the exercise of the resolution powers could have on particular parties, including through the provision of a "no creditor worse off than in liquidation" (NCWOL) compensation mechanism. The chapter also

sets out options for funding resolution actions, including any compensation due to affected parties, in a manner that also adequately protects public funds.

13. Given that the resolution of cross-border FIs will likely depend on there being effective cooperation between home and host authorities,<sup>7</sup> Chapter 8 considers how the local resolution regime could support this whilst also protecting financial stability and affected parties locally. The chapter also outlines proposals designed to ensure that information-sharing necessary to support resolution can take place between local and foreign authorities.
14. This consultation paper presents initial thinking and some proposals for implementing an effective resolution regime for FIs in Hong Kong. As noted throughout the text, certain policy issues will require further development following this consultation and additional details on these will be set out in the second stage consultation during 2014. While the pertinent issues will depend in part upon the outcome of this first stage consultation, these are likely to include (without limitation):
  - the structure and functioning of certain resolution options, such as statutory bail-in powers (see paragraphs 229 - 237) and TPO (see paragraphs 238 - 243);
  - how certain rights of creditors might be temporarily suspended during the initial stages of resolution (see paragraphs 249 - 254; and 262 - 264);
  - the interface between existing corporate insolvency proceedings and the proposed regime (see paragraphs 261- 269);
  - the calculation of compensation for creditors adversely affected by resolution and their right to appeal the valuation (see paragraphs 278 - 284);
  - the interaction of the proposed regime with existing laws in Hong Kong, as well as how to strike an appropriate balance between the need for the resolution authority to act quickly and existing legal remedies and judicial action (see paragraphs 301 - 303);

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<sup>7</sup> A home jurisdiction is 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.

- how the securities regulations, such as listed company disclosure laws and takeover and listing rules will operate in resolution (see paragraphs 304 - 309);  
and
- how the costs of resolution should be funded (see paragraphs 310 - 317).

### **Next Steps**

15. The Government recognises that the reforms discussed in this consultation paper need careful consideration and welcomes responses during the three-month consultation period ending on 6 April 2014.
16. After considering submissions in response to this consultation, the Government intends to further develop its proposals, and to undertake the aforementioned second stage consultation during 2014, with a view to introducing a bill into the Legislative Council (LegCo) in 2015.

## CHAPTER 1 – INTRODUCTION

This chapter considers how the lessons learned during the recent global financial crisis have generated broad international consensus on the importance of establishing effective resolution regimes for FIs. It covers:

- the difficult choices faced by public authorities in a number of jurisdictions in dealing with failing FIs during the crisis;
- the subsequent development by the FSB of the Key Attributes;
- why it is considered important that the new international standards outlined in the Key Attributes are implemented in Hong Kong.

### **Crisis Experience**

17. The recent global financial crisis served as a stark reminder that the viability of FIs may be undermined by external or domestic shocks despite regulatory and supervisory frameworks designed to promote their resilience. In a number of jurisdictions, some banks, as well as securities firms and insurers, suffered both severe liquidity shortages and losses sufficient to substantially erode their capital base. Whilst some FIs were able to take the necessary steps to restore their viability, others swiftly reached a point at which they could not continue to operate (without public support).
18. One factor which seems to have contributed to these recent failures was that owners and creditors expected that governments would have no option but to rescue their FIs if they got into difficulties. This was particularly the case where FIs were so large and interconnected that their failure had the potential to cause significant disruption to the financial system, thus undermining the effective functioning of the economy (i.e. where FIs were SIFIs or TBTF).
19. With few exceptions, expectations of rescue were fulfilled and public funds were used on an unprecedented scale.<sup>8</sup> This may have protected financial stability in the

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<sup>8</sup> For example, the cash outlay for the UK government in bailing out its banking sector peaked at £133 billion, according to the Parliamentary Commission on Banking Standards, <http://www.parliament.uk/documents/banking-commission/Banking-final-report-volume-i.pdf>

short term, but it also put public finances under considerable strain (particularly in countries with large financial systems). Rescues also served to shield the owners and creditors of failed FIs from the losses they would have faced in insolvency; reinforcing the view that some FIs carry an implicit government guarantee. The resulting “moral hazard” has the potential to further weaken market discipline, making future crises more likely.

20. Where publicly-funded bail-outs occurred, it was on an assessment that the costs, in terms of the wider impact on society, would have been greater still had certain FIs been allowed to fail. Such costs arise because of the reliance that individuals and companies have on the financial services provided by FIs, in going about their daily lives and activities (see Box A for examples of financial services provided by FIs). When certain FIs fail and enter insolvency proceedings, individuals and companies may suffer considerable hardship because access to the various financial services they rely on suddenly ends (so that the process of realising and distributing assets to creditors can begin).<sup>9</sup> Where the affected parties run into the hundreds of thousands or millions, there may be a severe effect on consumption, investment and the real economy and such FIs could be considered to be providers of “critical financial services”.<sup>10</sup>

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<sup>9</sup> This would tend to be the case even where corporate insolvency proceedings provide for restructuring options because the stay which generally comes into effect on entry into such a proceeding, to allow for a restructuring plan to be identified and agreed, would likely result in provision of financial services being suspended.

<sup>10</sup> The FSB uses the term “critical functions” as opposed to “critical financial services”. Guidance recently issued by the FSB explains how to assess whether any individual FI is a provider of critical financial services. See (July 2013) “Recovery and Resolution Planning for Systemically Important Financial Institutions: Guidance on Identification of Critical Functions and Critical Shared Services”, [http://www.financialstabilityboard.org/publications/r\\_130716a.pdf](http://www.financialstabilityboard.org/publications/r_130716a.pdf)

**Box A: Examples of financial services<sup>11</sup>**

Services	Allow...	Sectors providing:
Deposit-taking and associated payment services	Individuals and companies to make and receive payments (e.g. to receive salaries and to pay for living expenses in the case of individuals, and to pay salaries and to purchase or receive payment for goods and services in the case of companies).	e.g. banking
Saving and borrowing	Individuals and companies to save (and invest savings) and borrow from FIs, and companies to raise funding in capital markets, to finance consumption, investment, trade etc.	e.g. banking, securities and futures, insurance
Risk management	Individuals, companies and FIs to manage a variety of risks, including through the taking out of insurance.	e.g. banking, securities and futures, insurance
Payment, clearing and settlement	Individuals, companies and FIs to clear and settle trades in securities and make and receive payments, including for financial assets, in a manner that helps to reduce the associated risks.	e.g. banking, securities and futures, FMIs

21. In addition to the effect that a sudden withdrawal of critical financial services may have, the failure of an FI has the potential to cause general financial instability because it creates a risk of contagion to other parts of the financial system. For example, the failure of one FI has the potential to bring down others in a “domino effect”, as it could result in the liquidity and capital positions of other FIs coming under pressure, due to a number of direct or indirect channels of contagion.
22. A broad international consensus has developed on the need for frameworks under which FIs can be allowed to fail safely, without threatening financial stability or public funds. To achieve this aim, it is now considered to be necessary to establish “effective resolution regimes”, offering alternatives to public rescue or disorderly insolvency, by providing public authorities with the powers necessary to rapidly bring about orderly resolution which stabilises, and secures continuity for, key parts of a failing FI’s business. As indicated in Box B below, where an orderly resolution can be achieved, it has the potential to deliver better outcomes to a range of affected parties as compared with insolvency.

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<sup>11</sup> This table is not exhaustive. It draws on the guidance issued by the FSB which identifies critical financial services provided by banks. See Footnote 10 for reference.

**Box B: Resolution compared with insolvency**

	<b>Resolution</b>	<b>Insolvency</b>
<b>Outcome</b>	FI fails; but key parts of its business are stabilised to secure continuity for critical financial services, including payment, clearing and settlement functions, and to protect financial stability.	FI fails; liquidator appointed to wind up business; on-going business ceases and FI's assets are gathered in and disposed of to meet the claims of creditors. In some cases, a restructuring may be attempted but restructuring techniques e.g. creditor standstill agreements and broad based moratoria are ill-suited to FIs (including due to numerous depositors, investors and policyholders).
<b>Approach</b>	Resolution takes place very quickly (i.e. in a matter of days) so that there is (close to) no interruption to the activities of the FI and so that creditors may have certainty, quickly, on the outcomes they will experience.	Winding-up, or any restructuring, may take some months or even years to complete. The activities of the FI will terminate, or be suspended, and customers and creditors will have to wait to find out what outcomes they will experience.
<b>Customers</b>	Could expect close to uninterrupted access to critical financial services (e.g. if retail deposit accounts (and credit balances) are transferred to a sound FI over a weekend, depositors could access them as normal on Monday). Continued access to other financial services might be achieved in some cases.	Provision of all financial services would terminate, or be suspended, and customers with claims (e.g. depositors with balances in excess of the limit set for cover under a protection scheme) would have to wait to see whether these would be repaid in full or in part.
<b>Employees</b>	Continuity of employment for some or all employees (those whose contracts are terminated will enjoy the same rights and protections and will not be worse off than in liquidation).	Employment contracts terminated for the majority of employees (with a measure of statutory protection being offered in relation to their claims on the failed FI).
<b>Owners and creditors</b>	Owners and some unsecured creditors could expect to bear losses, but as resolution may better preserve value these losses may be lower than in insolvency.	Owners and some unsecured creditors could expect to bear losses on a gone concern basis.

**New international standards for effective resolution regimes**

23. Determining what should be the essential features of resolution regimes has been an important aspect of the FSB's work to address the TBTF problem. The resulting Key Attributes were endorsed by the G20 leaders at the Cannes Summit in November 2011. The Hong Kong Monetary Authority (HKMA) is a member of the FSB and, as an FSB member jurisdiction, it is incumbent upon Hong Kong to meet the new standards in the Key Attributes.
24. The detailed requirements of the Key Attributes are considered further in Chapter 2. In summary, they require that designated public authorities should be made responsible for the orderly resolution of FIs whose failure could be critical and



pose systemic risk. Furthermore, these authorities should have a set of resolution options, and supporting powers, capable of containing the risks posed by such failures by securing continuity for any critical financial services. More specifically, the Key Attributes require that resolution authorities be empowered to: undertake a compulsory transfer of an entire FI, or of some or all of its business, to a third party acquirer or temporary bridge institution that is able to continue the transferred business; and to restore the viability of an FI by means of bail-in. As securing orderly resolution requires that action be taken quickly and decisively, resolution regimes should empower resolution authorities to act without needing to seek the consent of affected parties.

25. The Key Attributes also outline a series of other essential features for a resolution regime in relation to: the scope of the regime; the arrangements governing the initiation and the carrying out of resolution; safeguards to ensure an adequate degree of protection for the parties who might otherwise be adversely affected by resolution; and the options for providing any necessary funding to support resolution. Certain features are designed to encourage and support effective coordination and cooperation between home and host resolution authorities in the resolution of FIs operating cross-border.
26. The FSB recognises that in order to implement the Key Attributes, most member jurisdictions will need to undertake legislative reform. The FSB has said that the necessary changes should be pursued as a matter of priority, ahead of an end-2015 deadline, and that it will monitor and report on the progress made.<sup>12</sup> Indeed, the Thematic Review on Resolution Regimes: Peer Review Report published by the FSB in April 2013 included an assessment of how far existing statutory frameworks across all FSB member jurisdictions already met the newly agreed standards.<sup>13</sup> (The aspects of the FSB report pertaining to Hong Kong are considered further in Chapter 3.) Each member jurisdiction will be assessed against the Key Attributes within the FSB framework for implementation monitoring as well as in the context of the joint work of the International Monetary

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<sup>12</sup> See Footnote 5 for reference.

<sup>13</sup> See FSB (April 2013) “Thematic Review on Resolution Regimes: Peer Review Report”, [https://www.financialstabilityboard.org/publications/r\\_130411a.pdf](https://www.financialstabilityboard.org/publications/r_130411a.pdf)

Fund (IMF) and the World Bank in the Financial Sector Assessment Program (FSAP) and the Reports on the Observance of Standards and Codes (ROSC).

### **Why an effective resolution regime is needed in Hong Kong**

27. The Government considers that securing an effective resolution regime that meets the standards set out in the Key Attributes will further strengthen the resilience of the financial system in Hong Kong to any future shocks or stress events.
28. Through both regulatory and supervisory means, the authorities in Hong Kong will continue to require that FIs operating locally meet standards designed to ensure that they are well-placed to withstand future shocks and stress events. However, in any competitive market economy, despite such prudential regulation and supervision, FIs may fail, including as a result of inadequate internal risk management or as a result of external stress factors. Even if it will be used only infrequently, it follows that an effective resolution regime is necessary to deal with any failures posing systemic risk. Although Hong Kong was not as adversely affected by the recent financial crisis as some other jurisdictions, there have been past cases where it was assessed that the failure of FIs posed systemic risk locally and they were rescued using public funds (see Box C below).
29. There are regulatory and supervisory intervention powers currently available to the regulatory authorities in Hong Kong for dealing with distressed FIs, as described in Chapter 3. However, not all of the powers that the FSB says are necessary to resolve failing FIs are included. The FSB noted this in its recent high-level assessment of Hong Kong's local arrangements undertaken in the course of producing the Thematic Review on Resolution Regimes referred to in paragraph 26 above. Hong Kong is not alone in this, as before the recent crisis, very few FSB member jurisdictions had resolution regimes in place which come close to complying with the Key Attributes.

#### **Box C: Past failures posing systemic risk**

Hong Kong experienced a banking crisis from 1983-1986, when following various adverse economic and financial sector developments, seven local banks got into difficulties including the then third largest local bank, Overseas Trust Bank. It was assessed that the failure of these FIs, given the circumstances prevailing at the time, posed a systemic threat

and so the banks were rescued. The Government took over three banks following the passing of acquisition ordinances,<sup>14</sup> and gave financial assistance (e.g. in the form of guarantee of assets, liquidity support etc.) to facilitate the takeover of the other four banks by private sector entities.<sup>15</sup>

In 1987, following the global stock market crash in that year, both the stock market and the futures market in Hong Kong were temporarily closed. Due to very substantial defaults by futures brokers, the futures market and the clearing house for the futures market had to be rescued using funds drawn from both private and public sources.<sup>16</sup>

30. Now that there is greater international consensus on the need for effective resolution regimes, as well as on their key characteristics, the Government considers that it must begin legislating for the necessary powers in Hong Kong. Acting to strengthen the resilience of the domestic financial system in this way should help to ensure that, if any systemically significant or critical FI becomes non-viable, acceptable alternatives to disorderly failure or a costly public rescue will be available. More generally, it should help to improve the incentives of the owners and creditors of these FIs to ensure that risks to their viability are managed effectively; which should in turn help to further reduce the likelihood of any future failure.
31. It is particularly important that Hong Kong as a relatively small open economy, and as an international financial centre hosting many global and regional FIs, should take action in this regard. Absent an effective resolution regime, the contingent risk may be significant given both the potential for shocks originating elsewhere in the world to be transmitted swiftly to Hong Kong's financial system and the size of the local financial system, and of some individual FIs, relative to Hong Kong's economy. By seeking to further contain the risks, including the moral hazard of reliance on public rescue of FIs, an effective resolution regime

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<sup>14</sup> See the Overseas Trust Bank (Acquisition) Ordinance (Cap. 379) and Hang Lung Bank (Acquisition) Ordinance (Cap. 345).

<sup>15</sup> See Li, R. (August 1999) "Banking problems: Hong Kong's experience in the 1980s", Bank for International Settlements (BIS), <http://www.bis.org/publ/plcy06.pdf>

<sup>16</sup> 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>

will complement other mechanisms adopted to bolster the resilience of the local financial system.<sup>17</sup>

32. Furthermore, the contingent risks associated with the failure of the largest cross-border FIs are faced, and shared, by multiple jurisdictions. The Key Attributes reflect a new international consensus that these risks can be better managed if all of the home and key host authorities of cross-border FIs, and of global systemically important financial institutions (G-SIFIs) in particular,<sup>18</sup> establish resolution regimes which meet common standards and reach agreement in advance on how they would seek to deploy these in a coordinated and cooperative manner in respect of individual G-SIFIs. The FSB expects all major host jurisdictions of G-SIFIs, including Hong Kong,<sup>19</sup> to establish resolution regimes to support work being undertaken to plan for the resolution of each FI identified as a G-SIFI.
33. Absent progress in this regard, there is a clear risk that some home, or indeed other host, jurisdictions will become so concerned that coordinated and cooperative efforts to resolve G-SIFIs will not succeed that they will resort to measures to protect their own local taxpayers. This could take the form of on-going supervisory requirements designed to ensure that additional liquidity and capital (or assets) are maintained within each jurisdiction in which an FI operates. Such requirements would raise the cost of operating cross-border, and may have the effect that G-SIFIs scale back cross-border activities, with consequences for economic growth and development across regions, including Asia, and jurisdictions, including Hong Kong. As outlined in Chapter 8, if a cross-border FI gets into difficulties and the prospects of achieving a coordinated and cooperative

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<sup>17</sup> Such as implementation of the Basel III framework, for example. Basel III is a comprehensive set of reform measures developed by the Basel Committee on Banking Supervision, to strengthen the regulation, supervision and risk management of the banking sector, see <http://www.bis.org/bcbs/basel3.htm>

<sup>18</sup> The FSB is coordinating work, along with sectoral standard setters (and in particular the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors (IAIS) and IOSCO) to identify G-SIFIs. A list of global systemically important banks has been identified (this list is updated each year). For the 2013 list, see FSB (November 2013) “2013 update of groups of global systemically important banks (G-SIBs)”, see [http://www.financialstabilityboard.org/publications/r\\_131111.pdf](http://www.financialstabilityboard.org/publications/r_131111.pdf). A list of global systemically important insurers has also been identified recently; see FSB (July 2013) “Global systemically important insurers (G-SIIs) and the policy measures that will apply to them”, [http://www.financialstabilityboard.org/publications/r\\_130718.pdf](http://www.financialstabilityboard.org/publications/r_130718.pdf). Work is underway to identify global systemically important non-bank non-insurance FIs.

<sup>19</sup> Hong Kong may be considered to be a major host jurisdiction because whilst it is not the home authority for any G-SIFIs, it hosts 28 out of the 29 global systemically important banks and 8 out of 9 of the global systemically important insurers identified.

solution are seen as low, a destabilising value-destructive run on the group may ensue as national resolution authorities ring-fence local assets.

## CHAPTER 2 – INTERNATIONAL REQUIREMENTS AND IMPLEMENTATION

This chapter considers the FSB’s Key Attributes in outline. It covers:

- the essential features which the Key Attributes require of a resolution regime;
- developments in other FSB member jurisdictions in implementing the Key Attributes.

### Introduction to the Key Attributes

34. The new standards outline the essential features, grouped under twelve Key Attributes, which all resolution regimes should have so that public authorities may act to resolve failing FIs in a manner that protects financial stability as well as public funds. These features are outlined below, focussing particularly on those whose implementation will require legislative reform.
35. The FSB is also finalising guidance in a number of key areas including on how: (i) to implement the Key Attributes in relation to non-bank FIs, specifically FMIs, FIs holding client assets<sup>20</sup> and insurers;<sup>21</sup> (ii) to meet the standards set in relation to information sharing;<sup>22</sup> and (iii) the compliance of FSB member jurisdictions with the new standards will be assessed in future.<sup>23</sup>

#### *Scope*

36. Under Key Attribute 1, all FIs, including any banks, securities firms, insurers or FMIs, whose failure *could* result in a cessation in the provision of critical financial services or otherwise pose systemic risk, should be within the scope of an effective resolution regime. The scope of the regime should extend to “branches of foreign

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<sup>20</sup> “Client assets” are assets of an investor that are entrusted to, or received by, an FI on behalf of a client. See paragraph 286 for further detail.

<sup>21</sup> The FSB issued a draft annex to the Key Attributes covering implementation of the new standards in relation to non-bank FIs for public consultation in August 2013. See FSB (August 2013) “Application of the Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions, Consultative Document”, [https://www.financialstabilityboard.org/publications/r\\_130812a.pdf](https://www.financialstabilityboard.org/publications/r_130812a.pdf)

<sup>22</sup> The FSB issued a draft annex to the Key Attributes covering information sharing for resolution purposes for public consultation in August 2013. See FSB (August 2013) “Information sharing for resolution purposes: Consultative Document”, [https://www.financialstabilityboard.org/publications/r\\_130812b.pdf](https://www.financialstabilityboard.org/publications/r_130812b.pdf)

<sup>23</sup> Assessment will be conducted under FSB peer reviews, as well as the joint work of the IMF and World Bank assessments in the context of FSAPs and ROSCs. See Footnote 1 for reference.

firms” as well as to those FIs which are locally-incorporated. The Key Attributes also say that it should be possible to use the regime in relation to other group entities, particularly holding companies and affiliated operational entities, to support the resolution of one (or more) FIs.

37. Proposals on how to set the scope for the resolution regime in Hong Kong are outlined in Chapter 4.

#### *Governance arrangements*

38. Under Key Attribute 2, one or more public authorities should exercise the resolution regime powers and should be designated as “resolution authorities”. To act as a resolution authority, the authority must be operationally independent in this role and be adequately resourced. Where there will be more than one resolution authority within a jurisdiction, the Key Attributes say that “their respective mandates, roles and responsibilities should be clearly defined and coordinated”. Additionally, a lead resolution authority should be identified to coordinate the resolution of entities within a wider financial services group which operates across sectors of a local financial system.

39. Under Key Attribute 3, it should be possible to resolve an FI if it “is no longer viable or likely to be no longer viable, and has no reasonable prospect of becoming so”. A decision on whether and how to resolve an FI should be based on appropriately set objectives and functions. The Key Attributes say that these should require consideration of: how to contain the risks posed to financial stability locally; how to secure an appropriate degree of protection for particular parties covered under protection schemes; how to contain the overall costs of resolution and protect public funds; and, where appropriate, the potential impact of resolution actions on financial stability in other jurisdictions after coordinating with the relevant foreign resolution authorities.

40. Proposals on the governance arrangements for the resolution regime in Hong Kong are discussed in Chapter 5.

#### *Resolution powers*

41. Key Attribute 3 outlines a menu of resolution options which should be available under every resolution regime. These are designed to support the stabilisation, alongside the restructuring, of an entire FI, or of some or all of its business, so that

continuity of critical financial services can be secured and the wider effects of failure on financial stability can be contained. The Key Attributes recognise that in cases where the risks posed to financial stability are more limited, it may remain appropriate for failing FIs to be closed and wound-up under corporate insolvency proceedings.

42. The menu of resolution options, and supporting powers, which the Key Attributes say each regime should have are summarised below.

*(i) Compulsory transfer of business to another FI*

43. The Key Attributes say that it should be possible for the resolution authority to transfer a failing FI, or some or all of its business, to another FI. The idea is that the acquirer could then continue the provision of critical financial services so that customers would have close to uninterrupted access to the services that they rely on in going about their day-to-day activities. In practice, for example, this could imply that over the course of a weekend, deposit accounts and their credit balances would be transferred to a sound FI, and that depositors could continue to access them as normal. The acquiring FI would then take on the responsibility for honouring in full the claims of the customers, counterparties and creditors transferred. Where achievable, resolution by this means is an attractive option because responsibility for continuing the business transferred will remain in the private sector.

44. In light of these potential benefits, the Key Attributes require that resolution authorities should be able to intervene to sell, and transfer, the entire FI, or the relevant parts of its business, without needing the consent of any affected parties associated with the failing FI, including its shareholders. As such, this transfer would be “compulsory” from the perspective of the failing FI. Clearly the acquiring institution would need to be willing to enter into the transaction.

*(ii) Transfer to a bridge institution*

45. The Key Attributes recognise that in some cases it will not be possible to find a willing acquirer sufficiently quickly, and require that resolution authorities should be able to stabilize and restructure a failing FI through use of a “bridge institution”. It is intended that the resolution authority should be able to first establish an entity for this purpose, over which it would need to exercise a sufficient degree of control,



and to undertake a compulsory transfer of some or all of a failing FI's business to it. The bridge institution would then continue the transferred activities, providing continuity for some or all of the customers of the failed FI, until a more permanent solution can be found and the activities returned to the private sector or, where that is not possible, wound-down over time. The Key Attributes also recognise that bridge institutions might be used alongside, or to support, bail-in.

*(iii) Bail-in*

46. The Key Attributes recognise that there may be cases where the size and complexity of a failing FI is such that it may be neither possible, nor desirable, for all of the activities which support provision of critical financial services to be taken on by other FIs either immediately or following use of a bridge institution. The size and complexity of an FI would also act as a barrier to a restructuring under which it is separated into several parts.
47. To avoid a situation where there is no option other than a public rescue or the taking of the FI into TPO, the Key Attributes require that resolution regimes should provide the powers necessary to impose bail-in. This would allow for the claims of shareholders and certain unsecured creditors to be written down, to absorb the losses, and for a debt-for-equity swap to be imposed on certain unsecured creditors to recapitalise the failing FI and to support continued provision of its critical financial services.
48. As outlined in Chapter 6, bail-in might take a number of forms resulting in recapitalisation of the failing FI itself, its holding company or a successor institution such as a bridge institution established to take on assets and liabilities from either the failing FI or its holding company.

*(iv) Temporary public ownership*

49. Establishing a regime which makes available all of the options outlined above will represent a major step towards ensuring that non-viable FIs can be resolved in a manner which will better protect financial stability and public funds. It remains the case, however, that some FIs are structured and operate in such a way that, at least initially, it may not be possible to deploy the resolution options made available under the regime. It follows that there remains a risk that if a large and

complex FI becomes non-viable, the authorities may continue to face the choice between disorderly failure and a publicly-funded rescue.

50. The Key Attributes recognise that some resolution regimes may make available an additional stabilisation option, which can be used in cases where resolution cannot readily be carried out by other means, under which a failing FI could be taken into TPO. The Key Attributes do not require that this option be available but say that, if it is, it should only be used as a “last resort and for the overarching purpose of maintaining financial stability”. This implies that this option should be called upon only in cases where it is assessed that it will not be practicable to resolve an FI, which is failing and whose failure poses a significant threat to financial stability, by deploying one of the other stabilisation options.

*(v) Transfer to an asset management vehicle*

51. To manage cases where it is assessed that some of the residual assets of a failing FI will need to be managed down over time, rather than being immediately liquidated, the Key Attributes say that it should be possible for the resolution authority to establish and make use of an asset management vehicle (AMV) to manage those parts of an FI pending their sale or liquidation.

*(vi) General powers*

52. In order to use these resolution options, the Key Attributes say that the resolution regime will need to make available a set of “general resolution powers”. These powers would, for example, permit the resolution authority to take control of the failing FI to operate and resolve it, including by supporting the transfer of the FI’s shares, assets and liabilities as well as legal rights and obligations, the writing-down of its shares and certain liabilities in issue and the subsequent conversion of certain liabilities into shares to support recapitalisation through bail-in.
53. It is also considered important that the resolution authority be able to stay the termination of large volumes of financial contracts, for a day or two, whilst the resolution is being carried out. Further, it is important that the regime ensures that resolution should not be a cause for termination for parties whose contracts are with the resolved entity, subject to the substantive obligations under those contracts continuing to be performed.

*(vii) Securing an adequate degree of resolvability*

54. Even where a resolution regime makes available a full menu of resolution options, it will not necessarily mean that it will be possible to use them successfully if an FI fails. To reduce the complexity and costliness of resolution, some FIs may need to take steps in advance to remove significant impediments or barriers to their orderly resolution arising from the way in which they are structured or operate. This might include, for example, concentrating activities supporting the provision of critical financial services into certain legal entities within a group so that they might be separated out and protected more readily in resolution.
55. To ensure that FIs take any necessary steps well in advance of getting into any difficulties, Key Attribute 10 requires that resolution regimes provide the authorities with any additional powers needed such that they may require individual FIs subject to the regime to take necessary measures to improve their resolvability.

*(viii) Exercise of resolution powers*

56. If there are significant doubts about the viability of an FI, the resolution authority will need an opportunity to consider whether resolution of the FI, rather than its closure and winding up under insolvency proceedings, is warranted in order to protect financial stability. The Key Attributes require that if the necessary conditions are met, the resolution authority should be able to initiate resolution without delay and that the potential for resolution to be delayed or reversed by legal actions taken by affected parties should be contained to some degree.

*(ix) Insolvency proceedings*

57. In cases where it is safe to close and wind up entire failing FIs using insolvency proceedings and protection schemes, the Key Attributes simply note that in addition to supporting the timely return of funds to insured depositors or of client assets to investors, these arrangements should also allow for their transfer out of liquidation to a third party able to provide continued access to both funds and accounts.<sup>24</sup>

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<sup>24</sup> The Key Attributes do not, otherwise, seek to set standards in relation to existing corporate insolvency arrangements.

58. Proposals to meet the standards in relation to resolution options as outlined under Key Attributes 3 and 10 are discussed further in [Chapter 6](#).

#### *Safeguards*

59. The Key Attributes contain a series of safeguards designed to protect various parties affected by resolution, including the shareholders, creditors (including customers and employees) and other counterparties of a failed FI. The underlying principle is that these parties should not experience outcomes in resolution which are worse than those they would have experienced if the FI had instead been liquidated. Under Key Attribute 5, this may be achieved by imposing losses in a way that broadly respects the creditor hierarchy as well as by establishing an appropriate compensation mechanism. It also implies a need to respect arrangements which would have been effective in limiting the risks faced by counterparties of a failing FI had it instead entered into liquidation (including in relation to collateralisation agreements, set-off rights and contractual netting) (Key Attribute 4).
60. There is also a need to safeguard public funds, and Key Attribute 6 states that any use of public funds should be temporary and that resolution regimes should be supported by adequate arrangements for the funding of resolution from the financial system. It is expected that any net costs should be recoverable from the firm itself, as well as its shareholders and creditors, and thereafter, and if necessary, from the wider financial system (including through use of resolution funds or levies).
61. Proposals on how the necessary safeguards could be put in place in Hong Kong, taking into account Key Attributes 4, 5 and 6, are outlined in [Chapter 7](#).

#### *Cross-border cooperation and information sharing*

62. Under Key Attribute 7, regimes should support coordinated and cooperative solutions between a foreign home and a local host resolution authority including: through the mandates set for resolution authorities which should “empower and strongly encourage” such solutions; and by enabling host resolution authorities to recognise and give effect in their jurisdiction to resolution measures taken by a home resolution authority.

63. Under Key Attributes 7 and 12, it is also considered important to remove any legal, regulatory or policy impediments that hinder domestic and cross-border information sharing between resolution authorities and other national authorities to support the planning for, and the carrying out of, recovery and resolution.
64. Proposals on how the local resolution regime should support cross-border cooperation and the necessary degree of information sharing are outlined in Chapter 8, drawing on Key Attributes 7 and 12.

#### *Resolution planning*

65. A number of the Key Attributes relate to resolution planning which resolution authorities are expected to undertake in advance, in relation to individual G-SIFIs at a minimum, to determine how their resolution could be carried out. The requirements include:
  - establishing and maintaining a crisis management group (CMG) for each G-SIFI to act as a forum for home and key host authorities to undertake recovery and resolution planning (Key Attribute 8);
  - putting in place “institution-specific cross-border cooperation agreements” (COAGs) for each G-SIFI setting out how the CMG will operate to support both the planning and execution of resolution (Key Attribute 9);
  - undertaking regular resolvability assessments for each G-SIFI, which determine the extent to which it would be possible to carry out its resolution in a manner that fulfils the resolution objectives (Key Attribute 10);
  - ensuring that any significant impediments (or barriers) to resolution identified in the course of these resolvability assessments are addressed in normal times, including by requiring FIs to make adjustments to the way in which they are structured and operate (Key Attribute 10);
  - establishing domestic arrangements for the carrying out of recovery and resolution planning which cover, at a minimum, any FIs whose failure could pose a risk to financial stability (Key Attribute 11).
66. In some cases, implementation of some of these recovery and resolution planning standards can be achieved under the existing supervisory framework through the development of appropriate policies and processes. To the extent that there is a

need for legislative reform, however, proposals are included in the relevant chapters of this consultation paper.

## **Implementation of the Key Attributes**

### *Across FSB member jurisdictions*

67. Several FSB member jurisdictions had regimes in place for dealing with distressed FIs ahead of the crisis which displayed some of the features described in the new standards. A number of these jurisdictions found, however, that when put to the test their regimes did not deliver all of the powers necessary to contain the risks posed to financial stability and as a consequence, there was still a need to fall back on public rescues in some cases. This experience prompted reforms to address identified gaps; some of which pre-dated the publication of the Key Attributes. The FSB has concluded that substantive progress is being made in implementing the Key Attributes across a number of member jurisdictions, including Australia, Germany, France, Japan, Netherlands, Spain, Switzerland, the United Kingdom (UK) and the United States (US).<sup>25</sup> Even so, the FSB concluded in its Thematic Review on Resolution Regimes that many FSB member jurisdictions will need to undertake some further reform to ensure that their regimes are fully compliant with the Key Attributes.
68. The Thematic Review on Resolution Regimes identified that regimes, which broadly meet the new standards, are more commonly in place for banks, as compared with other types of FI. Furthermore the FSB observed that some, but not yet all, jurisdictions had extended the scope of their regimes to cover branches, financial holding companies and affiliated operational entities. The FSB reported that most jurisdictions felt that they could secure timely entry into resolution around the point of non-viability (and ahead of balance-sheet insolvency). In relation to resolution objectives, it was more commonly the case that these were set in relation to financial stability and protecting depositors, investors and policyholders, but that fewer jurisdictions had set objectives in relation to containing costs or cross-border impact. In jurisdictions with multiple resolution authorities, such that different resolution authorities may be responsible for resolving entities within the same group operating in different sectors of the local

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<sup>25</sup> See Footnote 5 for reference.

financial system, it was recommended that further action was needed to strengthen coordination arrangements, including by designating lead resolution authorities.

69. Resolution powers to carry out compulsory transfers to third parties, directly or via bridge institutions, or to AMVs were found by the Thematic Review on Resolution Regimes to be widely available amongst jurisdictions (at least in relation to the banking sector). The powers considered necessary to carry out bail-in had however only been made available in a small number of jurisdictions so far. Provision had been made in some, but not yet all, jurisdictions to ensure that resolution would not trigger set-off or constitute an event allowing contractual counterparties to exercise early termination rights. Many regimes did not yet provide for powers to require FIs to make the necessary changes in their structures or operations to improve their degree of resolvability.
70. The Thematic Review on Resolution Regimes further observed that regimes in some, but not all, jurisdictions provided for key safeguards including requiring that the insolvency hierarchy of claims be broadly respected in resolution and establishing an appropriate mechanism for compensation. A number of jurisdictions had put in place arrangements to fund resolution, although the FSB assessed that in some cases undue reliance continues to be placed on the use of public funds. A majority of the regimes assessed had not yet met the standards relating to encouraging and supporting effective cross-border cooperation on resolution. Further steps were also needed to remove obstacles to information sharing.
71. A significant majority of FSB member jurisdictions reported that reforms designed to meet the new standards in the Key Attributes were actively being considered or were already underway (with some being secured since publication of the Thematic Review on Resolution Regimes).

*In selected jurisdictions*

72. In considering and devising proposals for the resolution regime for Hong Kong, reference has been made to several jurisdictions selected because they have either recently undertaken reforms to establish or strengthen their resolution regimes, or are in the process of doing so (some fall into both categories). A number of these

jurisdictions were severely adversely affected by the recent crisis; but others were not. A high-level overview of the approach each has taken is provided below.

- US: A regime has long been in place in the US, under the Federal Deposit Insurance Act (FDI Act), to support the resolution of insured depository institutions with the Federal Deposit Insurance Corporation (FDIC) acting as resolution authority. This longstanding regime has been extensively used to carry out compulsory transfers of business from failed to sound banks, both directly and through use of bridge banks. The recent crisis highlighted limitations in resolving large complex financial groups, however, and so in mid-2010 the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) established a complementary regime whose scope extends to bank holding companies and non-bank FIs whose failure could have a seriously adverse effect on the stability of the US financial system.<sup>26</sup>
- UK: Limited arrangements were in place before the recent crisis, but a Special Resolution Regime (SRR) was swiftly established under the Banking Act 2009, with the Bank of England (BoE) acting as resolution authority. The SRR provided resolution powers for use by the BoE, initially in relation to banks only, where justified on systemic risk grounds including powers for the compulsory transfer of business to another bank both directly or via a bridge institution as well as for a TPO option. More recently, the scope of the SRR has been extended to cover a broad set of investment firms and central counterparties (CCPs) (as well as other entities within their groups, including holding companies). The UK authorities have also initiated reforms designed to implement the Recovery and Resolution Directive (EU RRD)<sup>27</sup> including to provide for bail-in powers.
- European Union (EU): The extent to which individual member states of the EU had regimes in place ahead of the crisis varied considerably; and some have acted to strengthen their arrangements subsequently (including France,

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<sup>26</sup> One key shortfall of the FDIC's pre Dodd-Frank Act powers was that, whilst the orderly resolution of some large banking groups would depend upon it being possible to undertake resolution at the level of their holding company because of the structure and complexity of the group, such holding companies were outside of the scope of the regime established under the FDI Act. Another was that powers were not available for non-bank financial services groups.

<sup>27</sup> A directive prepared at the EU level establishing a framework for the recovery and resolution of credit institutions and investment firms.



Germany, the Netherlands, Spain and the UK). Under a directive being finalised at the EU level, which establishes a framework for the recovery and resolution of credit institutions and investment firms (EU RRD), all member states will be required to make provision for domestic resolution regimes whose scope extends to a broad set of banks and investment firms.<sup>28</sup> An important feature of the EU RRD is that it includes powers designed to support bail-in, as well as mechanisms to improve cross-border cooperation both within the EU and with non-EU countries. The EU has indicated that it will consider extending the scope of the regime to other non-bank FIs, prioritising CCPs.<sup>29</sup>

- Switzerland: A regime was in place pre-crisis to deal with failing banks, under which the Financial Market Supervisory Authority (FINMA) acts as resolution authority. The crisis highlighted that the powers available were inadequate for use with large and complex FIs, and so reforms were pursued resulting in the Swiss Banking Act being amended in 2011 and 2012 to improve the options available in relation to such FIs. In addition to strengthening powers to transfer assets and liabilities from failing banks to entities able to continue them, these reforms also made available bail-in powers.
- Australia: Some powers were available pre-crisis in relation to banks and insurers, and these were strengthened by reforms in 2008 and 2010, resulting in the Australian Prudential Regulation Authority being able to carry out compulsory transfer of business to solvent FIs, bridge institutions or AMVs. Additional reforms consulted on in late 2012 included proposals on strengthening powers in relation to the branches as well as the holding

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<sup>28</sup> Each of the European Commission, European Parliament and European Council has issued a draft text for the EU RRD and political agreement on their reconciliation was reached in December 2013. The Directive is now subject to the approval of the European Council and European Parliament Plenary in early-2014 and member states will then be required to transcribe the Directive into national legislation by end-2014. References in this consultation paper to proposals made under the EU RRD, are to those set out in the 28 June 2013 version of the text (i.e. that of the European Council), <http://register.consilium.europa.eu/pdf/en/13/st11/st11148-re01.en13.pdf>

<sup>29</sup> The European Commission issued an initial consultation paper “Consultation on a possible recovery and resolution framework for financial institutions other than banks” in late 2012, see [http://ec.europa.eu/internal\\_market/consultations/2012/nonbanks/consultation-document\\_en.pdf](http://ec.europa.eu/internal_market/consultations/2012/nonbanks/consultation-document_en.pdf) (and published a summary of responses in early 2013, see [http://ec.europa.eu/internal\\_market/consultations/2012/nonbanks/summary-of-replies.pdf](http://ec.europa.eu/internal_market/consultations/2012/nonbanks/summary-of-replies.pdf)).

companies of FIs covered by the existing regime, and to provide for a resolution regime for FMIs.<sup>30</sup>

- Singapore: Some powers were available pre-crisis, but reforms undertaken in 2007 and 2011 provided for the Monetary Authority of Singapore (MAS), as resolution authority, to transfer assets and liabilities from failing banks and insurers to third party acquirers as well as to bridge institutions. More recently, and following consultation in late 2012, the scope of the regime available for use with banks has been extended to cover other non-bank FIs and FMIs as well as holding companies of those FIs subject to the regime.
73. In considering implementation of the Key Attributes in Hong Kong (in Chapters 4-8 of this consultation paper), reference is made to the approach taken in these “selected jurisdictions” for comparative purposes.

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<sup>30</sup> See The Treasury (September 2012) “Strengthening APRA’s Crisis Management Powers: Consultation Paper”, <http://www.treasury.gov.au/~media/Treasury/Consultations%20and%20Reviews/2012/APRA/Key%20Docs/PDF/Discussion%20Paper.ashx>

## CHAPTER 3 – EXISTING FRAMEWORK IN HONG KONG

This chapter considers the existing powers of the regulatory authorities in Hong Kong and the extent to which these could be drawn upon to support resolution. It covers:

- those powers already available to the MA, SFC and IA which are most relevant to the resolution of FIs;
- how far these powers can be relied upon to secure resolution by means of the various options that the Key Attributes say should be available.

74. In the context of Hong Kong, FIs are regulated by different regulatory authorities based on the types of activities they perform and their legal status. Each of these regulatory authorities can draw on a set of existing supervisory intervention powers should there be significant deterioration in the condition of any FI. Whilst the precise powers available to each regulator vary, generally speaking, they support supervisory intervention to secure remedial action or to adopt protective measures in cases where the viability of an FI is under threat. Ultimately, where the viability of an FI has been fundamentally undermined, the regulatory authorities are empowered to withdraw the authorisation and licences needed for the carrying out of regulated business and activities as well as to seek the initiation of liquidation proceedings.
75. The resolution options which the Key Attributes say should be available under a resolution regime, as outlined in Chapter 2, are designed for use in the very specific circumstances where an FI is no longer viable but where some of its activities must be continued in order to protect the provision of critical financial services and financial stability more generally. The focus of this chapter is on how far each of the regulatory authorities in Hong Kong could rely on their existing supervisory intervention powers to secure the resolution of FIs under their purview via the various options which the Key Attributes say should be available.

76. How far existing arrangements and powers would support the winding-up of non-systemic FIs in insolvency proceedings<sup>31</sup> in the manner envisaged by the Key Attributes is also briefly considered.
77. As the FSB’s Thematic Review on Resolution Regimes covers substantially similar ground, reference is made in this chapter to its findings in relation to Hong Kong where relevant.<sup>32</sup>

### Authorized Institutions

#### *(i) Nature of existing powers*

78. In line with the principal function of promoting the general stability and effective working of the banking system, the Banking Ordinance (Cap. 155) (BO) confers powers upon the MA which can be deployed where a threat to the viability of an AI has been identified.
79. The powers most directly relevant to potentially stabilising the activities of an AI are those available under section 52 of the BO allowing the MA, after consulting the Financial Secretary (FS), to give binding directions, or to appoint a Manager, to an AI.<sup>33</sup> Under a binding direction, an AI may be required to take any action or do anything whatsoever in relation to “its affairs, business and property”. Subject to the objectives set by the MA in making the appointment, a Manager is empowered to do anything “necessary for the management of the affairs, business and property of the institution”. Without limiting this power, an indicative list of the actions that a Manager may take can be found in the Ninth Schedule to the BO and includes the power to sell or dispose of an AI’s business or property and the power to enter into, assign, vary or rescind contracts.

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<sup>31</sup> It is noted that it is not proposed that the Corporate Rescue Procedure, upon which the Government consulted in 2009, will apply to FIs (see [http://www.fstb.gov.hk/fsb/ppr/consult/doc/review\\_crplp\\_e.pdf](http://www.fstb.gov.hk/fsb/ppr/consult/doc/review_crplp_e.pdf)).

<sup>32</sup> See Footnote 13 for reference.

<sup>33</sup> Under section 52(1) of the BO these powers become available if one of a series of conditions is met including: the MA being of the opinion that an AI: is “likely to become unable to meet its obligations”; is carrying on its business in a manner detrimental to the interests of its depositors or creditors; or is failing to comply with the provisions of the BO or any licensing condition; and where the FS considers that action is in the public interest.

(ii) *Adequacy of existing powers to carry out resolution*

80. Although the MA may seek to draw on the existing intervention powers under section 52 of the BO in the circumstances described in paragraph 75, they are subject to some relatively significant limitations which could effectively hinder efforts to resolve a failing AI by means of a majority of the resolution options mandated by the Key Attributes. The FSB reached a similar conclusion in its Thematic Review on Resolution Regimes, as summarised in Table 1 below.
81. Difficulties would arise in effecting a compulsory transfer of either a failing AI or its business to a willing third party directly or through the temporary use of a bridge institution. In cases where an acquirer is willing to take over the entire AI, neither the MA's power of direction nor the appointment of a Manager could be used to compel the sale of the shares in the AI or the passing of a shareholder's resolution to approve the transaction. Directions may be given to AIs but not to their shareholders and, whilst a Manager can sell the business or property of an AI, he is not empowered to sell the AI itself (i.e. the ownership of the shares in the AI). In the words of the Key Attributes, the MA is not able to "[o]verride rights of shareholders of the firm in resolution, including requirements for approval by shareholders of particular transactions, in order to permit a merger, acquisition, sale of substantial business operations". The FSB regarded this as a gap against the new standards (see first row in Table 1).

<b>Table 1: Selected powers for resolving banks<sup>34</sup></b>	<b>Available in Hong Kong*</b>	<b>Wider availability (out of 23)**</b>
Override shareholder rights	No	20
Transfer / sell assets and liabilities	Assets only	20
Establish, run a bridge institution	No	15
Establish, operate an asset management company	Yes	16
Write-down debt, convert to equity (“bail-in”)	No	3
Temporarily operate a firm	Yes	19
Resolve non-regulated financial holding companies	No	8
Resolve non-regulated operational entities	No	6
Impose temporary stay on early termination rights	No	4

\* As assessed by the FSB in its Thematic Review on Resolution Regimes. \*\* Number of other FSB member jurisdictions assessed to have the necessary powers as at April 2013 (excluding Hong Kong).

82. In cases where the aim is to stabilise parts of an AI’s business, such that only specific assets and liabilities will be transferred to a willing acquirer or to a bridge institution, the MA’s powers may also prove to be insufficient. Directions can be given to an AI, or a Manager may act, to sell or transfer *assets*, as recognised by the FSB in its assessment (see second row of Table 1). In some instances, however, successful execution of the transfer may still run up against a need to secure the consent of contractual counterparties where the terms of their contracts require their prior consent to transfer and assignment. It is considered that the MA’s existing powers under section 52 and the Manager’s powers do not override third party contractual rights.
83. Requirements to secure consent are likely to prove even more problematic, however, where the aim is to transfer *liabilities*. Securing continuity for an AI’s deposit-taking business, and in particular near to uninterrupted access to funds and accounts for depositors covered under the Deposit Protection Scheme (DPS), will be a priority in a majority of cases. It is doubtful, however, whether the MA’s existing powers are sufficient to support a transfer sufficiently quickly to achieve the necessary degree of continuity because the consent of individual depositors

<sup>34</sup> This table is adapted from “Table 2: Selected Powers for Resolving Banks in FSB Jurisdictions” of the Thematic Review on Resolution Regimes. See Footnote 13 for reference.

would need to be obtained before the burden of the obligation to repay their deposit could be assigned with certainty to another institution.<sup>35</sup>

84. So the MA's existing powers only partially satisfy the Key Attributes' requirement that the resolution authorities should be able to transfer "assets and liabilities...including deposit liabilities...to a solvent third party, notwithstanding any requirements for consent or novation that would otherwise apply". Recognising that the apparent limitations are greater in relation to liabilities, the FSB found that the MA's existing powers were not adequate to secure resolution by means of a bridge institution but could be used to carry out the transfer of legacy assets to an AMV.
85. It is also clear that existing powers would not deliver bail-in. At most the MA could direct an AI not to repay certain specified unsecured creditors for a time, but those creditors would retain their rights in respect of their debt.<sup>36</sup> A Manager appointed by the MA has power to "vary or rescind, any contract, agreement or other obligation" of the AI, but it is unlikely that this would allow for the steps necessary to secure bail-in either. The MA could not therefore secure the "write-down... [of] equity or other instruments of ownership of the firm, unsecured and uninsured creditor claims to the extent necessary to absorb the losses..." or the conversion of "all or parts of unsecured and uninsured creditor claims" into "equity or other instruments of ownership of the firm under resolution". The FSB concluded similarly.
86. The MA's existing powers to appoint a Manager could be drawn on in those cases where it appears appropriate to appoint someone to manage an AI in resolution in accordance with the objectives set by the MA. The FSB assessed, therefore, that the MA was empowered to "temporarily operate a firm".

(iii) *Corporate insolvency proceedings*

87. The general law on corporate insolvency applies to AIs wound up in Hong Kong with a few modifications as set out in the Companies Ordinance (Cap. 32) (CO)

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<sup>35</sup> Generally speaking, the "benefit" of a contract can be assigned without consent, unless the contract specifically requires otherwise, but the "burden" cannot be transferred unless "advance" consent has been given.

<sup>36</sup> As such, other consequences, which would further complicate resolution, may arise were an AI to follow such a direction (it could mean that in respect of particular unsecured creditors the conditions for seeking and securing a winding up petition had been met).

and the BO. These modifications: preclude a creditors' voluntary liquidation of an insolvent AI;<sup>37</sup> allow for the FS to petition for the winding-up of AIs, either at the direction of the Chief Executive in Council<sup>38</sup> or on his own initiative depending on the type of AI;<sup>39</sup> establish that where a petition for the winding up of an AI is presented to the Court by a person other than the FS, a copy of the petition must be served on the MA, and the MA shall be entitled to be heard on the petition;<sup>40</sup> and identify depositors as preferential creditors up to the limit set for cover under the DPS.<sup>41</sup>

88. Additionally, the DPS provides a measure of protection for depositors, by ensuring that in the event that a licensed bank (LB) fails, covered depositors will be protected up to a limit currently set at HKD500,000 per depositor per scheme member.<sup>42</sup> It is noted, however, that in the event that an entire AI enters into liquidation, the existing framework does not support a transfer of covered deposits out of a liquidation procedure to a third party willing and able to continue to provide associated services, as an alternative to payout.

## Insurers

### *(i) Nature of existing powers*

89. To support the delivery of the objectives set for the IA, in relation to promoting the general stability of the insurance industry and the protection of policyholders, powers are available under the Insurance Companies Ordinance (Cap. 41) (ICO) which can be drawn upon where an insurer's viability is in doubt.
90. The powers most directly relevant to resolution are those under section 35 of the ICO, which empower the IA to direct an insurer to take action in respect of its affairs, business or property or to appoint a Manager empowered to carry on the

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<sup>37</sup> Under section 122 of the BO a court order is required to wind up an insolvent bank in Hong Kong.

<sup>38</sup> The FS may petition for the winding-up of an AI (or former AI) under section 122(2) of the BO acting on a direction from the Chief Executive in Council.

<sup>39</sup> The FS may petition for the winding-up of restricted licence banks or deposit-taking companies (or former restricted licence banks or deposit-taking companies) under section 122(5) of the BO.

<sup>40</sup> Section 122(7) of the BO.

<sup>41</sup> Preferential creditors are identified under section 265 of the CO.

<sup>42</sup> Section 27 of the Deposit Protection Scheme Ordinance (Cap. 581) (DPSO).



business of the insurer and to do all such things as may be necessary for the management of its affairs, business and property.<sup>43</sup>

(ii) *Adequacy of existing powers to carry out resolution*

91. The supervisory intervention powers available to the IA are substantially similar to those available to the MA. As such, the IA would face broadly the same sorts of limitations in seeking to draw on these powers to carry out any resolution.
92. As in the case of the MA, it appears that it would be difficult for the IA to bring about a compulsory transfer of a failing insurer, or of some or all of a failing insurer's business, to a willing third party either directly or through use of a bridge institution. It is unlikely that by exercising its powers under section 35 of the ICO, the IA would be able to reliably secure a sale of the shares of the failing insurer to a willing acquirer (that is, the IA's powers could not be used to compel transfer of the shares or to override the need for a shareholders' resolution to approve the transaction).
93. The IA could seek to bring about a transfer of some assets and liabilities to a third party, or to a bridge institution, by directing an insurer to act or through an appointed Manager. However, it will likely be easier to bring about a transfer of *assets* under existing powers as compared with a transfer of *liabilities*. Where an insurer is failing, transferring portfolios of insurance policies may be a priority and so the Key Attributes say that this should be possible "without the consent of each and every policyholder". Under the existing statutory framework, transfers of general and long-term business have to be approved not only by the IA and the Court of First Instance respectively, but also by each and every policyholder transferred.<sup>44</sup> This requirement for policyholder consent could undermine efforts to secure a transfer either sufficiently quickly (or at all). The FSB's Thematic Review on Resolution Regimes also identified this gap in the existing framework (see Table 2 below).<sup>45</sup>

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<sup>43</sup> Under section 35 of the ICO, these powers become available when one of a number of conditions is satisfied, including where the IA considers that it is in the interests of existing (and potential) policyholders or the insurer has failed to satisfy an obligation to which it is subject under the ICO.

<sup>44</sup> These requirements are set under sections 24 and 25D of the ICO.

<sup>45</sup> See Annex D, Table 3 in the FSB Thematic Review on Resolution Regimes which considers "Powers to Resolve Insurers". See Footnote 13 for reference.

<b>Table 2: Selected powers for resolving insurers<sup>46</sup></b>	<b>Available in Hong Kong*</b>	<b>Wider availability (out of 23)**</b>
Effect portfolio transfer without consent of policy holder	No	19
Discontinue new business and run-off existing obligations	Yes	17

\* As assessed by the FSB in its Thematic Review on Resolution Regimes. \*\* Number of other FSB member jurisdictions assessed to have the necessary powers as at April 2013 (excluding Hong Kong).

94. The IA can, under section 27 of the ICO, require that an insurer cease to write new business and exercising this power could support the entry of an insurer into “run-off”. This could help to secure an outcome where an insurer’s contractual obligations for in-force business are honoured; but only to the extent that the insurer retains adequate resources to satisfy all outstanding claims against it. The FSB recognised that the IA could exercise its existing powers in this regard.
95. It seems clear that the IA’s existing powers are not sufficient to bring about bail-in, should that be considered appropriate, for the same reasons as outlined above with respect to the MA’s powers.
96. The IA may, however, be able to draw on its power to appoint a Manager to “temporarily operate a firm”, should that be applicable in a resolution context.

*(iii) Corporate insolvency proceedings*

97. The general law on corporate insolvency applies to insurers wound up in Hong Kong with a few modifications as set out in the CO and the ICO. Under section 45 of the ICO, a court order is required to wind up an insurer. A petition for winding up may be presented by ten or more policyholders, or the IA;<sup>47</sup> but where the petition is presented by a person other than the IA, a copy shall be served on the IA, and he shall be entitled to be heard on the petition.<sup>48</sup> Under the ICO, all insurers carrying out long term insurance business are required to maintain separate funds for that long term business. The assets of each fund can only be applied to meet the long term business liabilities within that fund, and cannot be applied for meeting the liabilities of other creditors.<sup>49</sup> As such, long term business claimants/policyholders are accorded protection if their insurer enters into liquidation. General business claimants are, on the other hand, afforded

<sup>46</sup> This table is adapted from “Table 3: RRP and Resolvability Assessments in FSB Jurisdictions” of the FSB’s Thematic Review on Resolution Regimes. See Footnote 13 for reference.

<sup>47</sup> Sections 43 and 44 of the ICO.

<sup>48</sup> Section 44 of the ICO.

<sup>49</sup> Sections 22 and 45 of the ICO.

preferential creditor status under the CO in the distribution of the assets of a general insurer in liquidation in respect of any claim (other than a claim for a refund of premium) made under or in accordance with a contract of insurance.<sup>50</sup> The Government recently set out its proposals for establishing a Policyholders' Protection Fund (PPF) and the associated legislative process is underway.<sup>51</sup>

### Licensed Corporations

#### *(i) Nature of existing powers*

98. In line with its objectives, including those relating to reducing systemic risks in the securities and futures industry and contributing to wider financial stability, the SFC is granted supervisory intervention powers under the SFO which can be drawn upon where a threat to the soundness of an LC has been identified.

99. The powers most directly relevant to resolution are those which, under sections 204 to 206 of the SFO, allow the SFC to issue restriction notices imposing prohibitions on an LC's activities or requiring it to carry on its business in a particular way<sup>52</sup> (including to deal with "relevant property"<sup>53</sup> in, and only in, a specified manner").<sup>54</sup>

#### *(ii) Adequacy of existing powers to carry out resolution*

100. It appears that the SFC would, however, face significant limitations in seeking to draw upon these powers to carry out resolution by means of one of the stabilisation options mandated by the Key Attributes. Indeed, the SFC considers that none of the resolution options required by the Key Attributes are available for use in relation to LCs; with the FSB reaching the same conclusion.<sup>55</sup>

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<sup>50</sup> Section 265 of the CO.

<sup>51</sup> See FSTB and IA (January 2012) "Proposed Establishment of a Policyholders' Protection Fund Consultation Conclusions", [http://www.fstb.gov.hk/fsb/ppr/consult/doc/Eng\\_final.pdf](http://www.fstb.gov.hk/fsb/ppr/consult/doc/Eng_final.pdf)

<sup>52</sup> Section 92(1) of the SFO.

<sup>53</sup> "Relevant property" means any property held by the LC on behalf of its clients and any other property which the SFC reasonably believes to be owned and controlled by the LC.

<sup>54</sup> The SFC may make use of these powers following the occurrence of various triggers including where use of the powers is considered to be in the interests of the investing public or in the public interest.

<sup>55</sup> See for example, Annex D, Table 1C of the FSB's Thematic Review on Resolution Regimes which summarises "Sector-specific Powers to Restructure and/or Wind-Up Securities or Investment Firms". See Footnote 13 for reference.

101. It does not appear that the power to issue restriction notices could be used to secure a transfer of a failing LC to a willing third party acquirer. A restriction notice may be made in relation to “relevant property” only and could not be used to compel shareholders to sell their shares in the LC; nor could the SFC secure the passing of a shareholder’s resolution to approve such a transaction.
102. A transfer of selected assets and liabilities to a third party or to a bridge institution would likely be difficult to achieve also, as restriction notices issued to this end would come into conflict with requirements for consent from (shareholders and other) affected parties, including for novation. This would likely preclude rapid transfers of, for example, client assets, to a third party willing to continue to provide the associated financial services.
103. For reasons similar to those considered above in relation to AIs, the restriction notice powers could not be used to carry out a write-down of liabilities or a debt-for-equity conversion (in other words to bring about bail-in) in respect of an LC.

*(iii) Corporate insolvency proceedings*

104. The SFC is afforded some powers to prepare for, as well as to bring about, the liquidation of an LC including, under section 212 of the SFO, the power to apply to court to wind up any corporation other than an AI, and, under section 213(2)(d) of the SFO, the power to apply to court for the appointment of an administrator. The primary purpose of the administrator, in addition to securing and administering the assets of the LC, would be to undertake an assessment of the LC to determine the appropriate next steps. In the event that the LC is insolvent or that it is assessed to be in the public interest that the LC should be wound up, the SFC under section 212(1) of the SFO is able to petition the court for a winding-up order (and, ahead of that, the SFC may petition for the appointment of a provisional liquidator). The Investor Compensation Fund (ICF) exists to provide compensation to investors who sustain a loss as a result of a default by an intermediary.<sup>56</sup>

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<sup>56</sup> Compensation of up to HKD150,000 per investor is available, payable to a qualified client of an LC that suffers a loss in relation to specified securities or futures contracts or related assets as a result of a default committed by the LC or its associated person. A “qualifying client” is a person for whom the LC provides a service but the definition excludes a long list of persons including institutional investors.

105. It is noted that the existing framework does not support a transfer of client assets out of a liquidation procedure to a third party willing and able to continue to provide associated services, as an alternative to returning them.

### Financial Market Infrastructure

#### *(i) Nature of existing powers*

106. The MA is responsible for oversight of those FMIs undertaking clearing and settlement of funds or securities, which are designated under the CSSO, and the SFC is responsible for supervising clearing houses recognised under the SFO. The CSSO and SFO provide the MA and SFC with a range of powers for use in relation to FMIs under their respective purviews.
107. The SFO empowers the SFC to impose conditions, amend, revoke or add new conditions on recognized clearing houses.<sup>57</sup> If the clearing house fails to comply with a requirement of the SFO or a condition for recognition, the SFC may withdraw the recognition of the clearing house or direct it to cease providing or operating clearing and settlement facilities.<sup>58</sup> Moreover, the SFC may, if it is satisfied that it is appropriate to do so in the interest of the investing public or in the public interest or for the protection of investors or for the proper regulation of a recognized clearing house, issue a “restriction notice” requiring a clearing house to take (or desist from taking) particular actions.<sup>59</sup> More specifically, the SFC may require the clearing house to: (i) amend, supplement or revoke its rules in accordance with the notice; (ii) take any such action relating to the management, conduct or operation of its business as may be specified in the notice; or (iii) desist from doing such act or thing relating to the management, conduct or operation of its business specified in the notice. The SFC may also, on the grounds mentioned above, issue 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 clearing house.<sup>60</sup> The SFO requires the SFC to consult with the FS prior to the exercise of any of these powers.

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<sup>57</sup> Section 37 of the SFO.

<sup>58</sup> Section 43 of the SFO.

<sup>59</sup> Section 92 of the SFO.

<sup>60</sup> Section 93 of the SFO.

108. Under section 13 of the CSSO, the MA may issue a direction to a system operator or settlement institution of a designated system “to take such action or do such act or thing” as the MA considers necessary to bring the designated system into compliance with the requirements set out under the CSSO.<sup>61</sup> This includes that the MA may, after consulting the FS and the system operator or settlement institution to whom the direction relates, direct that the operating rules of a system be amended as considered necessary to meet requirements set in this regard.

(ii) *Adequacy of existing powers to carry out resolution*

109. The existing powers available to both the SFC, in relation to recognized clearing houses, and the MA, in relation to clearing and settlement systems, are not intended for resolution and would not enable the SFC or the MA to bring about a sale of the shares in an FMI or the transfer of its critical activities to another viable FMI or to a bridge institution.

110. Under the CPSS-IOSCO Principles for Financial Market Infrastructures,<sup>62</sup> CCPs are required to protect themselves against the risk of member default in a number of ways, including by providing for recovery mechanisms such as default funds and loss allocation rules. It is intended that these mechanisms should help to further reduce the likelihood of any CCP, which suffers a severe shock, going on to become non-viable. At the same time, some risk would remain and so the Key Attributes say that it should be possible to secure any capital needed, over-and-above that provided through recovery mechanisms, by other mechanisms such as through bail-in powers.<sup>63</sup> The existing powers of the MA and the SFC are not sufficient to achieve such an outcome.

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<sup>61</sup> Under section 7 of the CSSO these requirements are specifically that: (a) the operations of the system are conducted in a safe and efficient manner calculated to minimize the likelihood of any disruption to the functioning of the system; (b) there are appropriate operating rules in place; (c) there are adequate arrangements to monitor and enforce compliance with the operating rules of the system, including arrangements regarding the resources available to the system operator; and (d) there are available to the system financial resources appropriate for the proper performance of the system’s particular functions.

<sup>62</sup> The CPSS and IOSCO ended the consultation on a consultative report on the “Recovery of financial market infrastructures” on 11 October 2013. The report provides guidance to FMIs such as CCPs on how to develop plans to enable them to recover from threats to their viability and financial strength that might prevent them from continuing to provide critical financial services to their participants and the markets they serve, <http://www.bis.org/publ/cpss109.pdf>. The final report is still pending.

<sup>63</sup> The FSB consulted on guidance on the application of the Key Attributes to non-bank financial institutions, see Footnote 21 for reference.

*(iii) Corporate insolvency proceedings*

111. The SFC (but not the MA) has powers in the SFO designed to allow it to prepare for, and bring about, the liquidation of an FMI which could be deployed in cases where it was appropriate. Where the necessary conditions have been met,<sup>64</sup> the SFC may apply to the court for the appointment of an administrator or petition the court for a winding-up order. The Key Attributes do not, however, envisage that there will be many circumstances where it will be appropriate to close and wind up an FMI by means of liquidation proceedings (and so no requirements are set in that regard).

Cross-sector issues

112. Across all sectors, under the existing framework, there remains a risk that the efforts of a regulator to bring about an orderly resolution could be undermined if other parties were to initiate pre-emptive or competing actions. In the case of AIs, for example, and as noted in paragraph 87, the MA has a right to be heard by the court considering a petition for the compulsory winding-up of an AI presented by a creditor. Notwithstanding this, the court could nevertheless determine that a compulsory winding-up order should be made and liquidation proceedings would then ensue.
113. It may be that actions taken by the regulators in seeking to resolve an FI could also trigger consequences that could undermine their efforts to stabilise it, in that the appointment of a Manager or administrator could conceivably result in contractual counterparties exercising early termination rights.
114. Furthermore, the scope of the regulators' existing intervention powers extends, as might be expected, to FIs only, including those which are branches of foreign FIs. It does not appear, however, that the existing powers could readily be used to take actions in support of resolution at the level of parent or intermediate holding companies or in relation to affiliated operational companies, in the manner envisaged by the Key Attributes.

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<sup>64</sup> Under section 213(1) of the SFO, the SFC will first need to establish that the FMI has contravened: (a) the provisions under the SFO (including subsidiary legislation made under the SFO); (b) any conditions imposed on it under or pursuant to the SFO; or (c) a notice given to it (e.g. a restriction notice issued under section 92 of the SFO); or that it appears to the SFC that it may contravene (a) to (c).

115. As outlined above, the existing supervisory intervention powers which may be called upon in a resolution context are more extensive in relation to AIs and insurers than they are for LCs and FMIs. Across all sectors, however, relatively significant limitations in the available powers mean that a majority of the resolution options, which it is now considered should be an integral part of any resolution regime, are not currently available in Hong Kong. The gaps in existing powers which have been identified mean that any one of the regulators could face substantial difficulties in trying to bring about an orderly resolution in the event that an FI becomes non-viable and its failure poses a risk to financial stability.
116. The following chapters outline, therefore, proposals to provide the necessary powers within a coherent cross-sector framework, supported by appropriate arrangements for governance, safeguards, and funding.



## CHAPTER 4 – SCOPE OF PROPOSED RESOLUTION REGIME

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

- the provision of a common framework for resolution (i.e. a single regime for FIs in key 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 companies of FIs, where particular conditions are met.

### **A single resolution regime for Hong Kong**

117. As outlined in Chapter 2, Key Attribute 1.1 says that “[a]ny financial institution that could be systemically significant or critical if it fails should be subject to a resolution regime that has the attributes set out in this document”. It is expected, therefore, that the standards be met, as appropriate in each jurisdiction, in relation to banks, securities firms, insurers and FMIs. The Key Attributes are not prescriptive, however, on whether member jurisdictions should establish one single or several sector-specific resolution regimes and there is a need to consider what would be most appropriate in a Hong Kong context.
118. Establishing sector-specific regimes might be preferable if the essential features of the resolution regimes suitable for use with banks as opposed to securities firms or insurers or FMIs were very different. A number of ways in which regimes do need to accommodate the differences that arise in the resolution of FIs operating in one or other sector have been identified by the FSB.<sup>65</sup> Even so, the Key Attributes set the same common standards across all sectors and as a result there appear to be more similarities than differences in terms of what is required; including in relation to the overarching objectives for resolution as well as the menu of resolution options that should be made available under a regime.

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<sup>65</sup> See Footnote 21 for reference.

119. This is helpful because establishing a common framework with a single regime, albeit one that accommodates sector-specific requirements, could have a number of advantages as it should better support resolution of any of the significant number of FIs which are part of wider financial services groups operating across multiple sectors of the local financial system. A single regime would be more appropriate, for example, in cases where an orderly resolution of one or more FIs is most likely to be successfully achieved if action is taken in relation to their group as a whole, as opposed to each constituent part being separately resolved. A single regime will also help to ensure a consistent approach so that any differences in the resolution arrangements applicable to FIs operating in one or other sector are limited to those which are specifically identified as being necessary or desirable.
120. It appears appropriate, therefore, to establish a common framework for the resolution of FIs in Hong Kong by establishing a single resolution regime through the passage of a single ordinance. It remains keenly recognised, however, that such a regime will need to accommodate certain sector-specific requirements.
121. The “single regime” approach proposed for Hong Kong is consistent with that recently adopted in several key jurisdictions. Whilst in the past, it was relatively common to establish sector-specific regimes (such as that in place for banks in the US for many years), more recent reforms have tended to take a cross-sector approach. In Singapore and the UK, for example, the scope of resolution regimes originally designed for use with banks, has been extended to cover non-bank institutions including FMIs (in both cases separate provision for insurers has been retained). In the US, the Dodd-Frank Act has established a single regime which extends across a diverse set of financial services groups, both banking and non-banking, including FMIs.

**Question 1**

**Do you agree that a common framework for resolution through a single regime (albeit with some sector-specific provisions) offers advantages over establishing different regimes for FIs operating in different sectors of the financial system? If not, please explain the advantages of separate regimes and how it can be ensured that these operate together effectively in the resolution of cross-sectoral groups.**

## **Setting scope in relation to FIs**

122. There is a need to set the appropriate scope of the resolution regime proposed for Hong Kong by determining which FIs, operating within the banking, securities and futures and insurance sectors, as well as which FMIs, should be covered. Where an FI is within the scope of the regime, it implies that if such an FI were failing and it was assessed that the necessary conditions for resolution (which are outlined further in Chapter 5) were met, it would be resolved drawing upon the powers made available under the regime.
123. As the primary motivation for establishing an effective resolution regime is to provide a means by which the risks posed to financial stability could be contained should any FI become non-viable, the following factors have been taken into account in devising the proposals in this chapter:
- (i) the extent to which FIs within each of the key sectors of the local financial system are likely to provide critical financial services or might otherwise pose a risk to financial stability in Hong Kong on failure, such that they should be within the scope of a local resolution regime;
  - (ii) how far there is a case for including FIs operating in Hong Kong within the scope of the local regime, to help contain risks that their, or their group's, failure might otherwise pose to financial stability in other jurisdictions in which they operate (as further considered in Chapter 8, being in scope may allow for use of the regime in Hong Kong to support resolution carried out by home authorities overseas);
  - (iii) the current degree of international consensus on how to implement the Key Attributes effectively in relation to FIs in each sector, as reflected in the guidance issued by the FSB as well as the progress made in other jurisdictions.

### Licensed banks

124. In considering the first of the factors identified in paragraph 123, it is apparent that a handful of LBs operating in Hong Kong provide a range of financial services which are critical (across the categories identified in Box A in Chapter 1). These services are relied upon to support the making and receiving of payments, the accumulation of savings as well as borrowing, risk management and payment,

clearing and settlement, by significant numbers of individuals and companies. In the unlikely event that any of these LBs were to become non-viable, the resulting discontinuity in the provision of these services could pose a significant threat to the stability and effective working of the local financial system and could have significant consequences for the real economy more generally. A larger number of LBs provide a more limited range of financial services and only in some cases do so to the extent that they could be considered “critical” in terms of the reliance placed upon them by individuals and companies.

125. At the same time, it is widely accepted that the non-viability of a medium- or small-sized bank providing few, if any, critical financial services may nevertheless have the potential to generate systemic risk in other ways. If such a failure occurred during otherwise benign conditions when confidence in the banking sector was high, it might be possible to achieve an orderly winding-up by means of liquidation proceedings. In more stressed conditions, however, the failure of the same small bank could seriously undermine confidence, resulting in a contagious run, with the potential to weaken other entities, particularly those seen to have a similar profile. As a result, the extent to which the failure of any individual bank could pose a threat to financial stability is “state contingent” (meaning that it is dependent upon the circumstances prevailing at the time) and therefore difficult to determine with any absolute degree of precision in advance.
126. In considering the second of the factors identified in paragraph 123 above, it is noted that a significant number of LBs sit within wider financial services groups which operate cross-border. The non-viability of one or more significant entities within these groups, or indeed of an entire cross-border banking group, could pose a threat to financial stability in a number of jurisdictions, including Hong Kong. Indeed, of the 29 global systemically important banks (G-SIBs) which the FSB identified in November 2013, some 26 operate in Hong Kong as LBs.<sup>66</sup> It follows that the risks posed should any of these groups get into difficulties could be contained more effectively if all of the significant entities through which they operate internationally are within the scope of resolution regimes, which meet the

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<sup>66</sup> See Footnote 18 for reference and the HKMA’s Register of Authorized Institutions and Local Representative Offices: <http://vpr.hkma.gov.hk/cgi-bin/vpr/index.pl>

standards in the Key Attributes, in their home and in all key host jurisdictions, including Hong Kong (see Chapter 8 for further details).

127. In relation to the third of the factors identified in paragraph 123, there is now a high degree of international consensus not only on the need for banks to be covered by a regime, but also on how best to structure and operate such regimes. As considered briefly in Chapter 2, and in more detail in Chapter 6, this stems in part from experience gained in those jurisdictions which have long had regimes in place for dealing with distressed banks (and have had cause to use them) notwithstanding that some specific aspects (such as bail-in powers) are somewhat more innovative.
128. In light of the need to ensure that all LBs whose failure could pose a risk to the stability and effective working of the financial system in Hong Kong are covered, as well as to ensure that, as a key host authority, Hong Kong is able to support coordinated resolution of cross-border banking groups, it is proposed that the scope of the local resolution regime should extend to *all LBs*. In a domestic context, this will ensure that any LBs whose non-viability is always likely to pose an unacceptable threat to financial stability are within the scope, but also that the regime covers those smaller FIs whose failure might pose such risks only in certain circumstances.
129. Although a relatively broad scope is proposed, it is not intended that the regime would be deployed automatically in the event that any LB becomes non-viable. Rather, the intention is that the conditions set for the use of the regime would necessitate consideration, as and when there were concerns as to the viability of an LB, of whether resolution is appropriate having regard to the risks posed to financial stability. In cases where such risks are assessed to be relatively low, it will continue to be the case that any failing LB could be closed and wound-up under a liquidation procedure (with payout of deposits covered under the DPS).
130. The proposed approach appears to be consistent with that taken in other FSB member jurisdictions. Resolution regimes with a scope extending to all banks have been established in a majority of such jurisdictions; and this is the case in all six of the selected jurisdictions (introduced in paragraph 72 in Chapter 2). Some, but by no means all, jurisdictions also explicitly tie the use of their resolution

regime (or the use of certain powers) to an assessment of the scale of the risks posed by failure, including to financial stability, with the assessment typically being undertaken as and when an FI nears a point of non-viability. This appears to be the case under the EU RRD as well as in existing regimes in the UK and US (in the other jurisdictions resolution powers might be deployed even where the risks posed to financial stability are lower).

### **Question 2**

**Do you agree that it is appropriate for all LBs to be within the scope of the regime (given it would only be used where a non-viable LB also posed a threat to financial stability)? If not, what other approaches to the setting of the scope of the regime, which ensure that all relevant LBs are covered, should be considered?**

### Restricted Licence Banks and Deposit-Taking Companies

131. It is proposed that the scope of the regime should also extend to restricted licence banks (RLBs) and deposit-taking companies (DTCs) on related, albeit slightly distinct, grounds. It is recognised that individual RLBs or DTCs may be less liable to pose risk to financial stability on failure as the nature and scale of their activities means that they are less likely, relatively speaking, to be providers of critical financial services to very significant numbers of individuals or companies or to become a source of contagion to other FIs. Nevertheless, it is conceivable that in very stressed conditions even the failure of one, or a series of, RLBs or DTCs could disrupt provision of niche services and could be a source of contagion.
132. Perhaps more importantly, just over a third of RLBs and DTCs are part of wider financial services groups which include one or more LBs and in some cases the orderly resolution of an LB might depend on resolution extending to all of the AIs in the group. Under the proposals made in relation to LBs, it might be possible to carry out resolution extending to RLBs and DTCs which are wholly-owned by an LB (by taking control of the LB, the resolution authority may be able to act in relation to its subsidiaries also). Carrying out resolution of any RLBs and DTCs directly will, however, require that these RLBs and DTCs are within the scope of the Hong Kong regime in their own right.
133. The most straightforward way of ensuring that all relevant entities are covered appears to be for all RLBs and DTCs to be brought within the scope of the regime

alongside all LBs. As before, being in scope does not imply that the regime would be deployed routinely in all cases of non-viability, as resolution would be undertaken following assessment of the risks posed to financial stability at the point of non-viability. The suggested approach appears preferable to one which relies on successfully identifying and designating individually in advance those RLBs and DTCs to be covered by the regime, as that process could be unduly complicated and prone to error (it is difficult to predict the future and the position could change over time). Any selective process may have unintended (and potentially distortionary) effects also, given that some RLBs and DTCs would then be in scope (and others not).

### **Question 3**

**Do you agree that it is appropriate for all RLBs and DTCs to be within the scope of the regime (given it would only be used where a non-viable RLB or DTC posed a threat to financial stability)? If not, what other approaches, which would ensure that all relevant RLBs and DTCs are covered, should be considered?**

#### Financial Market Infrastructures

134. Criteria are in place in the respective legal frameworks and policy mandates of the MA and SFC to identify those FMIs which should be subject to oversight or regulation. Under the CSSO, FMIs undertaking the clearing and settlement of funds or securities which are identified as being “material to the monetary or financial stability of Hong Kong or to the functioning of Hong Kong as an international financial centre” are designated for oversight by the MA. In turn under the SFO, the SFC may recognize a company as a “clearing house”,<sup>67</sup> after consultation with the FS, where it is satisfied that it is appropriate to do so in the interest of the investing public or in the public interest; or for the proper regulation of markets in securities or futures contracts. In furtherance of its regulatory objectives set out in the SFO,<sup>68</sup> one of the functions of the SFC<sup>69</sup> is to supervise, monitor and regulate the activities carried on by recognized clearing houses.

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<sup>67</sup> The term “clearing house”, as defined in the SFO, includes securities settlement systems and central counterparties.

<sup>68</sup> The regulatory objectives of the SFC set out under section 4 of the SFO include, among others, to: (i) maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry; and (ii) reduce systemic risks in the securities and futures industry.

<sup>69</sup> Section 5 of the SFO.

135. In the unlikely event that any of these FMIs were to become non-viable, the potential for severe systemic disruption would be very high. The FMIs play a critical role in supporting payments, clearing and settlement in the Hong Kong markets. Following the entry of any FMI into a liquidation process, the members of the failed FMI would likely find access to the associated financial services (and perhaps also their funds or other assets) suspended for a considerable period of time. Payment, clearing or settlement activities would be severely disrupted, and some financial markets may be forced to close temporarily. As a series of FIs are members of, and rely on access to, each FMI, and given links that exist between individual FMIs, the potential for contagion would also be relatively high.
136. An important consideration is also that post-crisis reforms have mandated the central clearing of standardised OTC derivatives trades resulting in an increasing degree of reliance now being placed on CCPs. These initiatives are designed to reduce aggregate risk arising from OTC derivatives as well as to bring about more effective management of the risk which remains. However, the risks to which CCPs themselves are exposed may be increasing at the same time that they are becoming more critical to the stability of the financial system.
137. In light of the risks that their failure could pose, there is now broad consensus internationally that it is a priority to ensure that all FMIs which play a critical role in financial markets should be brought within the scope of an effective resolution regime. This is consistent with the sector-specific guidance on implementation,<sup>70</sup> which clarifies that “[t]he presumption is that all FMIs are systemically important or critical, at least in the jurisdiction where they are located, typically because of their critical roles in the markets they serve.” The guidance states also that it is not necessary for FMIs which are “owned and operated by a central bank” to be within the scope of a resolution regime because public authorities would already have the necessary degree of control over such FMIs. Additionally, the guidance outlines sector-specific provision which may be needed to ensure that various types of FMIs can be resolved under a resolution regime, which otherwise meets the overarching standards set out in the Key Attributes (this will be drawn upon to

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<sup>70</sup> See Footnote 21 for reference.



ensure that the regime proposed for Hong Kong adequately accommodates FMIs as well as AIs).

138. As the FMIs designated under the CSSO and recognized clearing houses provide critical services to market participants and markets, it is proposed that they should all be brought within the scope of the proposed resolution regime (with the exception of those which are owned and operated by the MA). In the unlikely event that any of the FMIs within the scope of the regime were to become non-viable, the authorities would still need to consider whether use of the regime was actually justified at the time, having regard to the risks then posed to financial stability (in other words even in relation to this sector, use of the regime would not be automatic).
139. A number of other FSB member jurisdictions have either already extended the scope of their regimes to cover some or all FMIs or are in the process of doing so. Amongst the selected jurisdictions, regimes in Singapore and the US extend to a broad set of FMIs, whereas those in Switzerland and the UK currently target particular types (the UK's SRR currently extends only to CCPs, for example). Australia and the EU have recently consulted on how to ensure that FMIs are covered by appropriate resolution arrangements, and the UK has done likewise on extending scope beyond CCPs.

#### **Question 4**

**Do you agree that it would be appropriate to extend the scope of the proposed resolution regime to FMIs which are designated to be overseen by the MA under the CSSO (other than those which are owned and operated by the MA) and those that are recognized as clearing houses under the SFO?**

#### Licensed Corporations

140. Around 1,900 FIs, which carry out one or more regulated activities in the securities and futures markets in Hong Kong, are licensed as LCs by the SFC under the SFO.<sup>71</sup> The SFC is the relevant supervisory authority of all LCs, including those

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<sup>71</sup> These regulated activities are currently: dealing in securities (Type 1); dealing in futures contracts (Type 2); leveraged foreign exchange trading (Type 3); advising on securities (Type 4); advising on futures contracts (Type 5); advising on corporate finance (Type 6); providing automated trading services (Type 7); securities margin financing (Type 8); asset management (Type 9); and providing credit rating services (Type 10). Planned reforms relating to the regulation of the OTC derivatives market will create Type 11 (dealing

LCs which are subsidiaries of AIs. Where these same regulated activities are carried out by FIs already authorised as AIs, those AIs must be registered with the SFC as Registered Institutions (RIs) (but the MA remains the front line supervisory authority of these RIs). Under the proposals set out in relation to the banking sector, the market intermediary activities of an RI would be within the scope of the resolution regime by virtue of their being carried out within an AI.

141. The recent financial crisis confirmed that some market intermediaries, in particular those that are large and complex, may generate systemic risk on failure due to the critical financial services that they provide and via contagion to other FIs and FMIs.<sup>72</sup> As a result, a number of FIs which act primarily as market intermediaries appear on the FSB's list of G-SIBs and so must, according to the Key Attributes, be covered by effective resolution regimes.<sup>73</sup> It is anticipated that additional FIs acting primarily as market intermediaries will be identified in the on-going work being undertaken by FSB/IOSCO to identify global systemically important non-bank non-insurance financial institutions (NBNI G-SIFIs).
142. In a purely local context, however, and on the basis of the current risk profile of LCs, it appears that the likelihood that any individual LCs would pose systemic risk in Hong Kong, on failure, is low as compared with 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. It is however the case that a sizeable minority of LCs are part of domestic or cross-border financial services groups. In some cases, orderly resolution of these groups, both to contain systemic risk posed locally but also in other jurisdictions, might depend on it being possible to ensure that all group entities operating in Hong Kong can be made subject to a single resolution process.

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in OTC derivative products or advising on OTC derivative products) and Type 12 (providing clearing agency services for OTC derivative transactions).

<sup>72</sup> A series of systemically important investment banks got into difficulties in the US, for example. Lehman Brothers was allowed to enter liquidation, with what many assess to be negative consequences for financial stability. Alternative means were found to resolve or rescue a number of other investment banks (e.g. public money was used to facilitate an acquisition of Bear Stearns).

<sup>73</sup> As is the case in Hong Kong, some FIs acting as intermediaries in the financial markets are located within groups or entities that also hold an authorisation to undertake deposit-taking in their home jurisdiction and so some have been identified, alongside entities whose activities primarily relate to banking, as G-SIBs.

143. It is recognised that the resolution of market intermediaries can pose some sector-specific challenges, although it appears that the same broad toolkit, supplemented by some sector-specific requirements, can be used to bring about their orderly resolution. As noted in Chapter 2, the sector-specific guidance being developed by the FSB covers the appropriate protection of client assets in resolution.<sup>74</sup>
144. In the case of Hong Kong, it would appear unnecessary for the majority of LCs to be subject to the proposed resolution regime, given their relatively small-scale operations and limited capacity to pose a threat to financial stability, even in times of stress. Therefore, it may be more appropriate to set the scope of the regime in such a way that it extends to those LCs providing certain critical financial services or relevant activities on a material scale only. The most relevant 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<sup>75</sup> or acting as a clearing agent for OTC derivatives.<sup>76</sup>
145. The scope of the regime could be set in such a way that LCs undertaking at least one of the above mentioned regulated activities would be covered; subject to a minimum size threshold. Further consideration will be given to how such a threshold might be calibrated, including through observing developments in the FSB/IOSCO's work to identify NBNI G-SIFIs. But in any event, the resolution powers made available under the regime would only be used where it was determined by the resolution authority that placing a non-viable LC into insolvency would not serve to protect financial stability in Hong Kong.
146. To the extent that the methodology described in paragraphs 144 and 145 will exclude some LCs which are part of wider financial services groups, it may be advantageous to take steps to ensure that they could be made part of any resolution proceedings undertaken in relation to these groups operating either in Hong Kong

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<sup>74</sup> See Footnote 21 for reference.

<sup>75</sup> LCs with a Type 3 licence may engage in dealing in certain OTC derivatives without obtaining a Type 11 licence (to be created under the planned reforms relating to the regulation of the OTC derivatives market). As such, there may be a need to include LCs which deal in OTC derivatives with licences to carry out leveraged foreign exchange trading only.

<sup>76</sup> In addition to those identified here, providing automated trading services may also be considered a relevant activity. However, LCs engaged in this activity must also be licensed to perform either Type 1 or 2 regulated activities. As each of these regulated activities is proposed for inclusion, all firms with a Type 7 licence would already be captured.

or cross-border.<sup>77</sup> Consideration is being given to how to make provision for this most effectively, including whether it would be preferable to identify the relevant LCs within designated financial groups in advance. To ensure that, as a key host authority, Hong Kong is able to support the orderly resolution of G-SIFIs in particular, it is proposed that the scope of the local regime should extend to those LCs that are branches or subsidiaries of G-SIFIs.

147. The approach to setting the scope of the resolution regime in relation to this sector varies somewhat across the selected jurisdictions. It is expected that the EU RRD will require that all investment firms that undertake certain regulated activities and which exceed a specified size threshold<sup>78</sup> should be within the scope of resolution regimes, something already provided for in the UK (which extended the scope of the SRR in this regard in 2013). The powers available under the Dodd-Frank Act can be used in relation to any market intermediaries whose failure would pose a severe threat to financial stability. The scope of regimes in place in Singapore and Switzerland extends to all securities firms regulated by the MAS and FINMA respectively.

#### **Question 5**

**Do you agree that it is appropriate to set the scope of the regime to extend to some LCs?**

#### **Question 6**

**If so, and in order to capture those LCs which could be critical or systemic, should the scope be set with reference to the regulated activities undertaken by LCs? Are the regulated activities identified in paragraph 144 those that are most relevant? Is there a case for further narrowing the scope through the use of a minimum size threshold?**

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<sup>77</sup> Where these groups operate cross-border, the case for this and the conditions which would need to be met, are further considered in Chapter 8.

<sup>78</sup> More specifically, the EU RRD will extend to those investment firms which exceed a minimum initial capital requirement established under the EU Capital Adequacy Directive. By using this threshold, the RRD excludes from its scope smaller investment firms whose failure is considered highly unlikely to impact financial stability.

### **Question 7**

**Do you agree that the scope should extend to LCs which are branches or subsidiaries of G-SIFIs? Do you see 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?**

#### Insurers

148. Insurers provide financial services which allow individuals and companies to pool risks, thus supporting economic activity. The crisis served as a reminder that some individual insurers provide these services on a scale such that they could be critical or systemic on failure.<sup>79</sup> This is the case even though it is generally accepted that insurers have a lower propensity to pose systemic risk on failure (as compared with banks).<sup>80</sup> In light of the risks that may be posed, the IAIS is developing a framework for the group-wide supervision of internationally active insurance groups (IAIGs) which will include a module on crisis management and resolution.<sup>81</sup> The FSB has designated nine insurance groups as being global systemically important insurers (G-SIIs) and may add further FIs (particularly reinsurers) to this list in due course. The FSB has made it clear that all G-SIIs should be covered by resolution regimes meeting the standards set out in the Key Attributes.<sup>82</sup>
149. The insurance sector in Hong Kong is relatively sizeable and diverse. It appears that few insurers operating here do so with sufficient scale and complexity to be critical or pose wider systemic risk locally on failure. Nevertheless, some individual insurers may pose such risks locally and a number of internationally and

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<sup>79</sup> When American International Group, Inc. (AIG) got into difficulties in 2008, the Federal Reserve extended credit to avert its failure on an assessment that the consequences for both its 76 million customers as well as for wider financial stability would otherwise have been severe. See <http://www.newyorkfed.org/aboutthefed/aig/index.html#1>

<sup>80</sup> Some interconnections exist between insurers, and between insurers and other FIs, although the potential for a sudden loss of confidence and a contagious run is limited by the fact that maturity transformation and leverage tends to be lower and liabilities are less frequently on demand in the insurance sector. Interconnections may arise where insurers are part of wider groups containing banks for example, or through the provision by insurers of reinsurance or financial guarantees, or where insurers act as counterparties to derivatives transactions.

<sup>81</sup> An IAIG is a large, internationally active group that includes at least one insurance entity. Proposed criteria for determining IAIGs include the size of the insurance group and the scale of international activity.

<sup>82</sup> See Footnote 18 for reference.

globally active insurers have operations in Hong Kong also. It is likely that the process of identifying IAIGs will confirm that a number have operations in Hong Kong as do some of those already identified by the FSB as being G-SIIs (which as noted must, according to the Key Attributes, be covered by resolution regimes).

150. Some countries have already acted so as to bring a relatively broad set of insurers within the scope of either common or sector-specific regimes (this is the case in Australia, Singapore and the US); whilst others are considering how best to do so (including the UK and the EU more generally). Meanwhile, there is growing clarity on how to accommodate sector-specific issues in the design and use of a regime extending to insurers, including as a result of the sector-specific guidance being developed by the FSB.<sup>83</sup>
151. It would appear beneficial to bring some insurers within the scope of the resolution regime proposed for Hong Kong both to take into account the risks that might be posed locally should an insurer become non-viable, and also to ensure that the local operations of cross-border insurers are subject to a local regime. In light of the above, it is proposed to set the scope of the regime for insurers in such a way as to cover: (i) the local operations of any G-SIIs and IAIGs with a presence in Hong Kong; and (ii) any insurer which it is assessed could be systemically significant or critical locally on failure. Consideration will be given as to how best to ensure that the relevant insurers are in scope.

**Question 8**

**Do you agree that it would be appropriate to extend the scope of the proposed resolution regime to the local operations of insurers designated as G-SIIs and/or IAIGs as well as those insurers which it is assessed could be critical or systemically important locally were they to fail?**

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<sup>83</sup> See Footnote 21 for reference.

## **Branches, holding companies and non-regulated operational entities**

### Branches

152. The non-viability of a foreign FI,<sup>84</sup> which operates in Hong Kong through one or more branches, may have significant consequences for local financial stability (as well as for relevant stakeholders such as local customers and creditors). It may be that in most such cases, the relevant home authorities will act to contain the risks posed not only domestically in the home jurisdiction but also in host jurisdictions, by undertaking resolution which stabilises the FI as a whole including its foreign branches. It cannot be taken for granted, however, that home authorities will always act in this way as in some cases they may lack either the necessary mandates or powers or indeed the incentives to secure an outcome that protects the public interest, and specifically financial stability, in host jurisdictions. In other cases, it may be that the exact circumstances of the failure make it difficult to coordinate in carrying out a cooperative resolution strategy which had been agreed in advance.
153. There is now broad consensus internationally that each resolution regime should provide sufficient flexibility to allow the authorities to respond to the particular circumstances of the case. Key Attribute 1.1 says, therefore, that “branches of foreign firms” should be within the scope of the resolution regimes of *both home and host jurisdictions*. It is envisaged that in most cases, a coordinated resolution led by the home resolution authority will better protect financial stability across all affected jurisdictions, and that in such circumstances host authorities would exercise the powers made available under their local resolution regimes to support a single group-wide resolution. Bringing the branches of foreign FIs into the scope of host regimes will mean that host authorities can act to support resolution being carried out by a home authority but also, importantly, that they will be in a position to undertake resolution directly as a fall-back where that is assessed to be appropriate to protect financial stability and the public interest locally. In choosing which course to pursue, consideration will be given to the objectives set for resolution, as outlined in Chapter 5, and the particular circumstances of the case.

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<sup>84</sup> FMIIs designated under the CSSO and clearing houses recognised under the SFO are domestic market infrastructures and hence, they are excluded for the purposes of discussion on extending the scope of the regime to branches of foreign FIs under this section.

154. As a major financial centre, Hong Kong plays host to a large number of foreign FIs operating as branches, so it is important that the authorities are able to act promptly to contain the risks which could be posed to local financial stability were any of these FIs to become non-viable. This is particularly important in relation to both the banking and insurance sectors, where at the end of 2012 some 141 out of 200 AIs and 71 out of 155 insurers operated in Hong Kong as branches of foreign groups. At end-June 2013, only 44 out of close to 2,000 LCs were incorporated overseas.<sup>85</sup> Accordingly, it is proposed that the scope of the local resolution regime should extend to branches of FIs incorporated outside of Hong Kong, in line with the approach taken to setting the scope in relation to each sector in turn. This will be with a view to ensuring that the regime can be deployed either: (i) to facilitate an orderly resolution being undertaken by a home authority; or (ii) to support a local resolution of the branch.
155. Setting the scope of the local regime such that it extends to branches of foreign FIs operating in Hong Kong appears to be consistent with the way in which the existing framework in Hong Kong seeks to contain the risks potentially posed in cases where a branch's head office gets into difficulties. Existing supervisory intervention powers, for example those available under section 52 of the BO, extend to the branches of foreign FIs and can be deployed as appropriate taking into account the particular circumstances of the case (including whether any stress is group-wide or confined more locally). Similarly in cross-border insolvency cases, the practice has been for courts in Hong Kong to decide whether to allow local winding-up proceedings to be pursued or whether to recognise proceedings being pursued elsewhere (taking into account the outcome in aggregate and, more specifically, what it would imply for local creditors).
156. Amongst the selected jurisdictions, some have already brought the branches of foreign FIs fully within the scope of their resolution regimes (Singapore, Switzerland) or are pursuing the necessary changes currently (Australia, EU). It is expected that, under the EU RRD, the scope of domestic regimes in each EU member state will extend to branches of foreign (or more specifically third-country) FIs, allowing for the recognition of resolution proceedings being undertaken in

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<sup>85</sup> It is noted that most of these entities' principal activities are in Hong Kong but they are incorporated overseas.



those third countries, as well as for actions to be taken directly by host member states.<sup>86</sup>

157. Some jurisdictions have sought to pursue reforms under which foreign FIs are required to convert branches into subsidiaries, including particularly where they are assessed to be critical or systemically-important. Bringing branches within the scope of the regime proposed for Hong Kong would appear to be a more proportionate approach than requiring that all foreign FIs, whose failure could pose such risks locally, convert into subsidiaries. At the same time, it is important to recognise that in cases where there is a need for the Hong Kong authorities to act directly to resolve a branch, resolution may be complicated by the fact that branches do not have their own legal identity and tend to depend to a very significant degree (financially and operationally) on their wider group.

**Question 9**

**Do you agree that branches of foreign FIs should be within the scope of the local resolution regime such that the powers made available might be used to: (i) facilitate resolution being undertaken by a home authority; or (ii) support local resolution?**

**Question 10**

**Do you see any particular issues that need to be taken into consideration in ensuring that the regime can be deployed effectively in relation to branches of foreign FIs where necessary?**

Holding companies

158. Resolution planning work being undertaken across FSB member jurisdictions suggests that the orderly resolution of some FIs will only be possible if the powers available under a regime can be deployed in relation to their holding companies also. It appears that this might be the case either where:

- (i) a holding company owns a number of regulated entities and it is assessed that it is more appropriate to carry out a single resolution of these entities

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<sup>86</sup> At the same time, it is intended that a legally-binding mechanism will be created within the EU under which member states which are home authorities will have primary responsibility for resolving branches located in other member states.

through action initiated at the level of the holding company (the FSB has described this as a “single point of entry” (SPE) approach<sup>87</sup>); or

(ii) one or more regulated entities in a group rely to a significant degree, financially or operationally, on a holding company such that securing continuity for some or all of their activities will depend on resolution powers being deployed in relation to the holding company also.

159. To support the resolution of FIs in such circumstances, Key Attribute 1.1 says that the scope of each regime should extend to “holding companies of a firm”. It is intended that it should be possible to act in relation to (locally-incorporated immediate, intermediate or ultimate) holding companies even where they themselves are not authorised or licensed under the regulatory framework. However, it is expected that resolution powers should only be deployed in relation to holding companies where, and to the extent that, it is considered appropriate to do so in support of the resolution of one or more FIs.
160. Initial analysis indicates that amongst those FIs operating in Hong Kong with locally-incorporated holding companies, there are likely to be some whose orderly resolution would depend on it being possible to carry out resolution at the level of, or otherwise involving, their holding companies.<sup>88</sup> Accordingly, it is proposed that the local regime should empower the relevant resolution authority to act in relation to these holding companies, where (and to the extent) it is considered appropriate to do so to bring about an orderly resolution of one or more FIs. (As considered further in Chapter 5, this implies a need to set specific conditions for initiating resolution in relation to holding companies).
161. The suggested approach appears preferable to the alternative under which FIs are required to make the structural changes necessary to ensure that their orderly resolution is possible even if their locally-incorporated holding companies remain outside of the scope of the regime. Removing the sorts of barriers to resolution outlined in paragraph 158 could imply restructuring so that FIs are grouped under a

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<sup>87</sup> See FSB (July 2013) “Recovery and Resolution Planning for Systemically Important Financial Institutions: Guidance on Developing Effective Resolution Strategies” for further detail on what a “single point of entry” approach implies, [https://www.financialstabilityboard.org/publications/r\\_130716b.pdf](https://www.financialstabilityboard.org/publications/r_130716b.pdf)

<sup>88</sup> For recognized clearing houses, this will include the recognized exchange controller if such exchange controller is the holding company of the clearing house.

single entity (which is itself within the scope of the regime) or that financial and operational dependencies of FIs on their holding company are reduced or eliminated. Barriers to resolution could of course also exist in relation to FIs which do not have locally-incorporated holding companies and, going one step further, there could be cases where it would actually be appropriate to require an FI to establish a locally-incorporated holding company to facilitate resolution.

162. Although powers to act in relation to holding companies were not commonly available before the crisis, a number of jurisdictions have subsequently secured the necessary enabling reforms or are in the process of doing so. The scope of regimes in Singapore, the UK and the US now extends to holding companies and it is expected that the EU RRD will require this of regimes in all EU member states. Recently, Australia consulted on extending the scope of their regime in this regard.

**Question 11**

**Do you agree that extending the scope of the proposed resolution regime to cover locally-incorporated holding companies is appropriate such that the powers available might be used where, and to the extent, appropriate to support resolution of one or more FIs?**

Non-regulated operational entities

163. The resolution of FIs may ultimately result in such FIs becoming separated from other entities in their wider group. Some FIs, however, rely on affiliated operational entities, located in the same or in a different jurisdiction, for the provision of a series of essential services (including, but not limited to, information technology). In these circumstances, efforts to secure the continuity of the critical financial services provided by an FI could be undermined unless some means can be found to ensure that relevant operational entities continue to provide essential supporting services at least for a period of time.
164. In seeking to ensure that an orderly resolution is possible in such cases of operational dependence, the new standards in the Key Attributes say both that:
- the scope of the resolution regime should extend to “non-regulated operational entities within a financial group or conglomerate that are significant to the business of the group or conglomerate” (Key Attribute 1.1); and

- it should be possible to ensure “continuity of essential services and functions by requiring other companies in the same group to continue to provide essential services to the entity in resolution, any successor or an acquiring entity” (Key Attribute 3.2).
165. Resolution planning work for FIs will help to determine to what extent individual FIs actually place reliance on affiliated operational entities in Hong Kong. In anticipation of this, consideration is being given to whether it should be possible to deploy powers available under the regime in relation to affiliated operational entities, in cases where that would support the resolution of one or more FIs, or whether it would be sufficient to provide for specific powers under which the resolution authority could direct affiliated entities to continue to provide essential services for a time. As before, absent making appropriate provision, there may be a need for FIs to make changes to the way in which they are structured and operate in order to reduce their day-to-day reliance on affiliated operational entities.
166. It appears that fewer FSB member jurisdictions have made provision at this stage with regard to operational entities (as opposed to holding companies), although some have signalled an intent to undertake the necessary reforms. In relation to the selected jurisdictions, powers are provided to impose continuity obligations on affiliated operational entities under the UK and US regimes. Meanwhile, in addition to requiring that regimes in each member state allow for the imposition of continuity obligations, it is proposed in the EU RRD that the scope of each regime should extend to affiliated operational entities (such that a fuller set of powers could be deployed where assessed appropriate).
167. It is intended that further consideration be given to this aspect of the regime and that firmer proposals be set out in the second stage consultation.

**Question 12**

**Do you have any initial views on whether it is appropriate to extend the scope of the regime to affiliated operational entities to help ensure that they can continue to provide critical services to any FIs which are being resolved?**

## CHAPTER 5 – GOVERNANCE ARRANGEMENTS

This chapter sets out proposals regarding the governance arrangements for the resolution regime in Hong Kong. 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.

### **Conditions for initiating resolution**

168. As outlined in earlier chapters, the proposed resolution regime is designed for use in cases where an individual FI is failing but where some or all of its activities need to be continued to protect the provision of critical financial services and the stability and effective working of the financial system. It logically follows that the conditions which would need to be met before any resolution is initiated should reflect this intended purpose.
169. Key Attribute 3.1 says that “[r]esolution should be initiated when a firm is no longer viable or likely to be no longer viable, and has no reasonable prospect of becoming so”. In a majority of cases, an FI which is failing is likely to be one whose *financial* viability has been undermined to such a degree that it may no longer be a going concern. In the case of FIs, such a point can be regarded as having been reached when they are no longer able to maintain financial resources adequate to satisfy the requirements set for the carrying on of regulated business and activities (and so ahead of the standard triggers for corporate insolvency). It is conceivable, however, that in a small number of cases an FI might become unable to continue to operate on other grounds. Non-viability may result if, for example, a regulator, in Hong Kong or elsewhere, determines that following a very severe breach of other requirements an FI no longer satisfies the conditions required for its continued authorisation or licence, or recognition granted under the SFO in the

case of a recognized clearing house, such that the removal of its permission to carry out regulated business or activities would be warranted. In turn, an FI which is, or is likely to be, no longer able to carry out regulated business or activities may be no longer viable (e.g. an LB may become unable to make or receive payments, and thereby unable to conduct its banking business regardless of whether it has the financial resources to do so).

170. Reflecting these considerations, it is proposed that a condition for initiating resolution under the proposed resolution regime for Hong Kong should be an assessment that an FI is, or is expected to become, no longer viable where this implies that it is, or is expected to become, unable to satisfy one or more of the conditions set in relation to the regulated business and activities it carries out. In the case of recognized clearing houses, the basis for such an assessment may be the conditions imposed for recognition and duties established under the SFO.<sup>89</sup> This proposal is described further in Box D below.
171. To ensure that resolution is undertaken only where necessary, it is proposed that any assessment of whether this first non-viability condition has been met should consider how likely it is that actions taken outside of resolution could restore the financial viability of the FI or, where relevant, enable it once again to satisfy other conditions set for the carrying on of regulated business or activities. The assessment should take into account not only how far any private sector (or supervisory) action might ultimately succeed, but also whether it would do so sufficiently quickly taking into account all relevant circumstances.
172. It will obviously not be possible to identify beforehand each and every circumstance in which the first non-viability condition will be met. However, to provide a greater degree of certainty, it may be appropriate for the resolution authority to issue guidance setting out further detail on how the conditions for use of the regime will be interpreted (in general and in relation to FIs operating in

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<sup>89</sup> Under section 38 of the SFO, a recognized clearing house has, among others, the duty to ensure so far as reasonably practicable, orderly, fair and expeditious clearing and settlement arrangements for any transactions in securities or futures contracts cleared or settled through its facilities, and that risks associated with its business and operations are managed prudently. In discharging its duties, it has to: (a) act in the interest of the public, having particular regard to the interest of the investing public; and (b) ensure that the interest of the public prevails where it conflicts with its own interest. It also has the duty to provide and maintain, at all times, adequate and properly equipped premises, competent personnel, and automated systems with adequate capacity, facilities to meet contingencies or emergencies, security arrangements and technical support for the conduct of its business.

different sectors of the financial system). Some factors considered relevant to an assessment of whether the first non-viability condition has been met are set out in Box E below for illustrative purposes.

173. Not all FIs meeting the first non-viability condition will need to be resolved, however. It will continue to be the case that some failing FIs could be closed and wound-up, in an orderly manner, through liquidation proceedings. Accordingly, it appears appropriate to set a second financial stability condition such that resolution of a non-viable FI will only be initiated where it will better serve to secure continuity for critical financial services, including payment, clearing and settlement functions, and to promote and maintain the general stability and effective working of the financial system as compared with liquidation. This would, as was considered in Chapter 1, require an assessment of how far any individual FI is a provider of critical financial services, including payment, clearing and settlement functions, as well as of the additional risks posed to financial stability, such as those arising due to contagion.
174. Subject to what is said in Chapter 8, in particular paragraphs 330 and 331 (also see the ensuing paragraph), the proposals outlined above would mean that resolution of an individual FI will be initiated *only* when it is assessed that both the first non-viability condition and also the second financial stability condition have been met (See Box D). In other words, it is not intended that any FI within the scope of the regime would be resolved solely on the grounds that it had become non-viable; but only where non-viability also poses a threat to continuity of critical financial services, including payment, clearing and settlement functions, and to the general stability and effective working of the financial system.
175. Paragraphs 330 and 331 of Chapter 8 deal with the situation of a Hong Kong branch or subsidiary of an overseas financial services group that is in resolution. The local entities of the cross-border group may be neither non-viable or not critical or systemically important in Hong Kong and therefore the conditions outlined in Box D would not be directly applicable. It is therefore additionally proposed in Chapter 8, and for the reasons set out there, that the local resolution authority should be able to use the local resolution regime in cases where:

- a home resolution authority is initiating resolution in relation to a cross-border group whose Hong Kong operations are within the scope of the local regime; and
- 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.

**Box D: Conditions for initiating resolution**

Resolution could be initiated only where it is assessed that both the first non-viability condition and second financial stability condition are satisfied:

(1) the first non-viability condition is 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

(2) the second financial stability condition is that 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.



176. The approach summarised in Box D above appears to be consistent with the Key Attributes and would result in the conditions set for resolution in Hong Kong being perhaps most similar to those included in the EU RRD and already in place in the UK. In both of these cases, resolution may be initiated where it is assessed that an FI is failing (including to meet the conditions of its authorisation) and where resolution is assessed as being necessary in the public interest having regard to a set of resolution objectives (including, although not limited to, financial stability). In the US, the resolution powers available under the Dodd-Frank Act can be used where it is assessed that: (i) an FI is in danger of default; (ii) no viable private sector solution is available; and (iii) failure would otherwise have serious adverse effects on financial stability in the US.
177. The wording of both conditions should accommodate the triggering of resolution in relation to those FIs which operate in Hong Kong as branches if, in line with the proposals set out in Chapter 4, these are within the scope of the local regime. As such, any assessment of whether the first non-viability condition has been satisfied in relation to the branch of a foreign FI would inevitably need to take into account the circumstances of its wider group; both in relation to the threat to its viability as well as the prospects for action being taken outside of resolution to mitigate this threat.
178. As outlined in Chapter 4, in a handful of cases the orderly resolution of a non-viable FI may only be achieved if it is initiated and then undertaken at the level of an FI's locally-incorporated immediate, intermediate or ultimate holding company. It is proposed, therefore, that the grounds for initiating resolution and taking action in relation to a holding company would be an assessment that:
- the non-viability and financial stability conditions have been met in relation to one or more FIs covered by the regime; and
  - the resolution of those FIs, in a manner that fulfils the objectives set for resolution, implies that resolution should be undertaken at the level of an immediate, intermediate or ultimate holding company.
179. This approach appears to be most consistent with the EU RRD proposals, and the regime in place in the UK, where action may be taken in relation to locally-incorporated holding companies where it is assessed to be necessary to support the

resolution of one or more FIs (and where the conditions for resolution are met in relation to those FIs). In the US, the Dodd-Frank Act allows for resolution to take place at the level of the holding company where the conditions for resolution are met in relation to a financial services group as a whole.

**Box E: Factors relevant to assessing that the first non-viability condition is met**

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.

### **Question 13**

**Do you agree that the conditions proposed for initiating resolution are appropriate in that they will support the use of the regime in relevant circumstances?**

### **Question 14**

**In particular, do you agree that it is appropriate that the first condition recognises that non-viability could arise on financial *and* non-financial grounds (noting that resolution could occur only if the second financial stability condition is also met)?**

### **Resolution objectives**

180. Once the conditions for initiating resolution have been met, the resolution authority will need to decide what form the resolution should take. This will necessitate consideration of the various resolution options available under the regime, outlined further in Chapter 6, to select an approach that appears most likely to serve the wider public interest given the specific circumstances of the case. The setting of the resolution objectives to which the resolution authority must have regard when using its powers will therefore be important in framing the public interest and guiding this decision-making process.
181. As the primary motivation in establishing a resolution regime is to help contain systemic disruption should an FI cease to be viable, it is proposed that a “financial

stability objective” be set for the use of the regime (see Box F below). The setting of such an objective means that resolution should take a form that seeks to minimise or counteract the risks posed by failure, as outlined in Chapter 1. That implies in turn that it should secure, so far as possible, the continuity of any critical financial services, including payment, clearing and settlement functions, provided by the FI as well as containing any wider risks posed to financial stability (e.g. through contagion).

182. As outlined in Chapter 3, 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.<sup>90</sup> It is important, therefore, that where an FI is resolved under the proposed resolution regime, 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. Accordingly it is proposed that a second objective for resolution be set in this regard (see Box F below).
183. Setting objectives in relation to both seeking to maintain financial stability and providing a measure of protection to particular customers is in line with the standards in the Key Attributes. The proposed approach is consistent with practice elsewhere also; the FSB’s Thematic Review on Resolution Regimes found that most FSB member jurisdictions have taken the same approach as the selected jurisdictions (which have set such objectives).
184. As protecting financial stability will inevitably involve seeking to continue at least some of a failing FI’s activities (i.e. those assessed to be critical), resolution has the potential to be considerably less value destructive than liquidation. Even so, it may be appropriate to set a subordinate or supplementary objective that the resolution authority should, subject to pursuing the two objectives in paragraph 183, seek to contain the cost of resolution. Clearly any steps which can be taken to reduce overall costs, subject to securing orderly resolution, will benefit all parties

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<sup>90</sup> As outlined in Chapter 3, the limit for cover set under the DPS is HKD500,000 per eligible depositor per scheme member and under the ICF HKD150,000 per eligible investor. In the insurance context, there are presently two insolvency funds for the non-life statutory insurance policies covering motor vehicle third party claims and employees’ work-related injuries. A statutory scheme for a Policyholders’ Protection Fund is currently being developed. See Footnote 51 for reference.

who may otherwise be called upon to meet them. More specifically, it is clearly imperative that any potential implications for public funds are contained.

185. The setting of a subordinate or supplementary objective relating to cost appears to be consistent with the intent of the Key Attributes, which emphasise the need to minimise the overall costs of resolution, including by avoiding unnecessary value destruction, and more specifically, say that the costs falling on *public funds* in home and host jurisdictions should be minimised. Whilst the approach taken across other FSB member jurisdictions varies somewhat, a number have set objectives, or other requirements, designed to result in consideration of overall cost or, more particularly, the protection of public funds (including in the EU, Switzerland, the UK and the US).

**Box F: Resolution objectives**

The following resolution objectives are proposed:

- (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;
- (iii) subject to pursuing resolution objectives (i) and (ii), seek to contain the costs of resolution and, in so doing, to protect public funds.

186. Key Attribute 2.3 states that the resolution authority should, as either an objective or function, “duly consider the potential impact of its resolution actions on financial stability in other jurisdictions”. Therefore, consideration is also being given as 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. This is considered further in Chapter 8.

**Question 15**

**Are the objectives which it is proposed should be set for resolution suitable to guide the delivery of the desired outcomes?**

**Resolution authority**

187. Key Attribute 2.1 says that “[e]ach jurisdiction should have a designated administrative authority or authorities responsible for exercising the resolution powers over firms within the scope of the resolution regime (“resolution authority”)”. It is necessary, therefore, for one or more public authorities to be made responsible and accountable for using the regime. A necessary first step is therefore to determine who may be best-placed to discharge this function.
188. It is intended, under the framework described by the Key Attributes, that the resolution authority should play a central role in assessing whether the conditions set for the use of the resolution regime have been met and in initiating resolution accordingly. They would then be responsible for determining how best to approach resolution, having regard to the objectives set, and for ensuring that it is carried out in an orderly manner. The Key Attributes say that any resolution authority needs to have “operational independence” in the role and the capacity to discharge the associated functions effectively.
189. Several different models for allocating responsibility to public authorities can be identified. The one which is most common in other FSB member jurisdictions, and which appears most appropriate for Hong Kong, is to allocate responsibility to one or more prudential regulators. In Hong Kong, this would imply that each of the MA, SFC and IA would act as resolution authorities for FIs under their existing respective purviews. Arguably, discharging a resolution function is consistent with the existing prudential mandates of each of the MA, SFC and IA given these reflect a need to seek to secure a measure of protection for certain parties (depositors, investors and insurance policyholders) as well as the stability and effective working of parts, or all, of the financial system. Furthermore, the powers to be made available under the regime can be seen as filling gaps identified in each regulator’s existing supervisory intervention powers; leaving each regulator better placed to contain the risks posed should any individual FI go on to fail.

190. In practical terms, each regulator might be relatively well-placed to identify when the conditions for resolution have been met, given their on-going monitoring of the risks posed to the viability of FIs under their existing supervisory functions. Furthermore, these functions should have significant synergy with, and should support, the resolution planning needed for FIs on both a contingent basis in normal times and if and when risks to viability intensify. Indeed the HKMA is already participating in routine group-level resolution planning work for G-SIBs with a material presence in Hong Kong (this work is taking place within the CMGs established by the home authorities of those G-SIBs).
191. Clearly under this preferred model, which results in there being multiple resolution authorities, it will be important to ensure, as required by Key Attribute 2.1, that the “respective mandates, roles and responsibilities [of the resolution authorities] should be clearly defined and coordinated”. There will also need to be sufficient clarity over how resolution authorities will coordinate and cooperate in the resolution of any FIs which sit within financial services groups operating across multiple sectors of the local financial system. Arrangements to provide, in such circumstances, for “a lead authority that coordinates the resolution of the legal entities within that jurisdiction”, as required under Key Attribute 2.2, are further considered below.
192. Under an alternative model, which is found in a handful of jurisdictions, a single entity could be appointed to discharge the resolution function and this might result in the establishment of a specialist agency for the purpose. One advantage of this approach might be to facilitate the resolution of FIs within cross-sector financial services groups. At the same time, however, a specialist agency would not be without its own coordination challenges: means to ensure a clear allocation of responsibilities (and powers) and effective coordination and cooperation between the resolution authority and each of the sector-specific regulators would be needed. How to allocate responsibility (and powers) for the necessary resolution planning (in advance of, and in the run-up to, resolution) would need to be determined.
193. Concentrating responsibility in one place could leave a specialist agency better placed to build up the necessary expertise in resolution. On the other hand, separating this function from those of regulation and supervision could make it harder to build and maintain sector- and institution-specific knowledge. Use of a

specialist agency may allow for some economies of scale across the authorities, although again these might be cancelled out to some extent by the on-going costs of maintaining the agency (whose services would be called upon only extremely rarely).

194. As such, and as noted above, a model under which each of the sector-specific regulators is made responsible for the resolution of FIs under their respective purviews appears preferable for Hong Kong. The pros and cons of the approaches considered are summarised in Table 3 below.

<b>Table 3: Pros and cons of sector-specific and integrated resolution authorities</b>		
<b>Approach:</b>	<b>Sector-specific: MA, SFC &amp; IA act for FIs under their purview</b>	<b>Integrated: specialist agency acts for all FIs</b>
<b>Pros</b>	<ul style="list-style-type: none"> <li>- Consistent with existing prudential mandates (for a measure of protection and financial stability);</li> <li>- Resolution powers fill identified gaps in existing supervisory intervention powers leaving regulators better placed to contain risks posed by failure of an FI;</li> <li>- Well-placed to identify when conditions for resolution are met, given on-going monitoring of risks;</li> <li>- Similarly well-placed to carry out non-crisis resolution planning and step-up planning for resolution as risks intensify;</li> </ul>	<ul style="list-style-type: none"> <li>- Likely to facilitate resolution of FIs within groups operating across sectors of the local financial system;</li> <li>- Concentrating responsibility may make it easier to build and maintain necessary expertise in resolution;</li> <li>- Similarly concentrating responsibility may provide for some economies of scale;</li> </ul>
<b>Cons</b>	<ul style="list-style-type: none"> <li>- Creates a need for clear allocation of respective mandates, roles and responsibilities;</li> <li>- Also creates a need for effective coordination arrangements between the individual resolution authorities to support resolution of FIs operating cross-sector.</li> </ul>	<ul style="list-style-type: none"> <li>- Coordination challenges between the resolution authority and the regulators ahead of, and in the run-up to, resolution;</li> <li>- May be hard to build and maintain sector- and institution-specific knowledge;</li> <li>- Any economies of scale may be more than offset by the cost of maintaining an agency whose services are used only rarely.</li> </ul>



195. Consistent with the approach proposed for Hong Kong, the FSB’s Thematic Review on Resolution Regimes confirmed that a majority of member jurisdictions make their regulatory authorities responsible for resolution; resulting in one integrated or several sector-specific resolution authorities depending on their broader regulatory frameworks. On the other hand, some countries, including Canada and Malaysia, have pursued a model closer to the one seen in the US where a specialist agency is given responsibility for resolution.
196. Whichever model is adopted, the entity or entities responsible for resolution will need to maintain sufficient operational capacity to discharge the function effectively. This likely implies striking an appropriate balance between securing a level of permanent resource as well as having an ability to draw in additional resources quickly, and on a temporary basis, should it become necessary to do so.

**Question 16**

**Do you agree that, in line with their existing statutory responsibilities and supervisory intervention powers, the MA, SFC and IA should be appointed to act as resolution authorities for the FIs under their respective purviews?**

**Lead resolution authority**

197. Many of those FIs whose failure would be most likely to pose systemic risk are part of financial services groups active in multiple sectors of the local financial system. If, as proposed above, each of the MA, SFC and IA is appointed to act as a resolution authority with sector-specific responsibilities and powers, sufficiently robust coordination arrangements will be needed to deal effectively with the resolution of FIs within such groups. In this context, and to comply with Key Attribute 2.2,<sup>91</sup> the authorities are considering how best to provide for a lead resolution authority (LRA) arrangement for the local regime if a decision is taken to appoint the sectoral regulators as resolution authorities.
198. Ahead of setting out more detailed proposals on the LRA in the second stage consultation, it is noted that there is need to consider its role in relevant cases in decision-making on whether the conditions for resolution have been met and on

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<sup>91</sup> Which says that “[w]here different resolution authorities are in charge of resolving entities of the same group within a single jurisdiction, the resolution regime of that jurisdiction should identify a lead authority that coordinates the resolution of the legal entities within that jurisdiction”.

what form resolution should take. The LRA might be made responsible for seeking consensus across the relevant sector-specific resolution authorities; although some means of securing a single decision would be needed for cases where the resolution authorities cannot reach agreement. Alternatively, the LRA could be made more directly responsible for decision-making, after consulting the relevant sector-specific resolution authorities.

199. The LRA may also play some role in ensuring that resolution planning has been adequately carried out across the relevant FIs within a cross-sector group (which implies a need for as much certainty as possible on responsibilities in advance to allow for effective planning and other preparatory steps).
200. Further consideration will be given to the criteria which might help to identify when an LRA is needed and how to allocate this responsibility appropriately, taking into account the structure and activities of cross-sector groups and what this implies for the risks to financial stability posed by their failure. Ahead of doing so, it is noted that if the model for designating resolution authorities proposed in paragraphs 189 to 191 above is adopted, and for the same reasons outlined there, it may be preferable that one (or more) of the sectoral resolution authorities would act in this capacity.
201. The proposals to be set out in the second stage consultation will take into account any guidance produced by the FSB in this area and suitable models emerging in other jurisdictions. The FSB concluded in its Thematic Review on Resolution Regimes that few of the jurisdictions with multiple sector-specific resolution authorities had yet determined how to meet this particular standard.

### **Coordination**

202. Although any authority appointed to act as a sector-specific and/or LRA should have “operational independence” in the role, as required under Key Attribute 2.5, and be responsible for deciding whether and how to carry out resolution, it is clearly important that effective coordination arrangements are put in place with respect to other authorities who may have a role to play in resolution.
203. It is particularly important to ensure that coordination with the Government is effective, in light of its overarching responsibilities in relation to the financial

system and wider economy as well as for managing the public finances. As such, it is proposed that the resolution authority (and where relevant the LRA) should be required to consult a higher authority ahead of initiating and carrying out resolution. At the same time, it is important that this requirement does not compromise the effective implementation of resolution measures (Key Attribute 5.4 says that the “resolution authority should have the capacity to exercise the resolution powers with the necessary speed and flexibility”).

204. Additionally, the relevant authorities propose to set out in further detail in a Memorandum of Understanding (MOU) how they will achieve the necessary degree of coordination in operating the resolution regime. It is intended that such an MOU will also cover coordination on resolution planning.
205. This chapter has focused on governance arrangements in the domestic context. Matters pertaining to achieving an appropriate degree of coordination and cooperation in a cross-border context are considered in Chapter 8.

## CHAPTER 6 – RESOLUTION POWERS

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

- the menu of resolution options necessary under the regime to secure the orderly resolution of failing FIs which are critical or systemic;
- the relationship between the regime and existing corporate insolvency arrangements which should remain the default option in other cases.

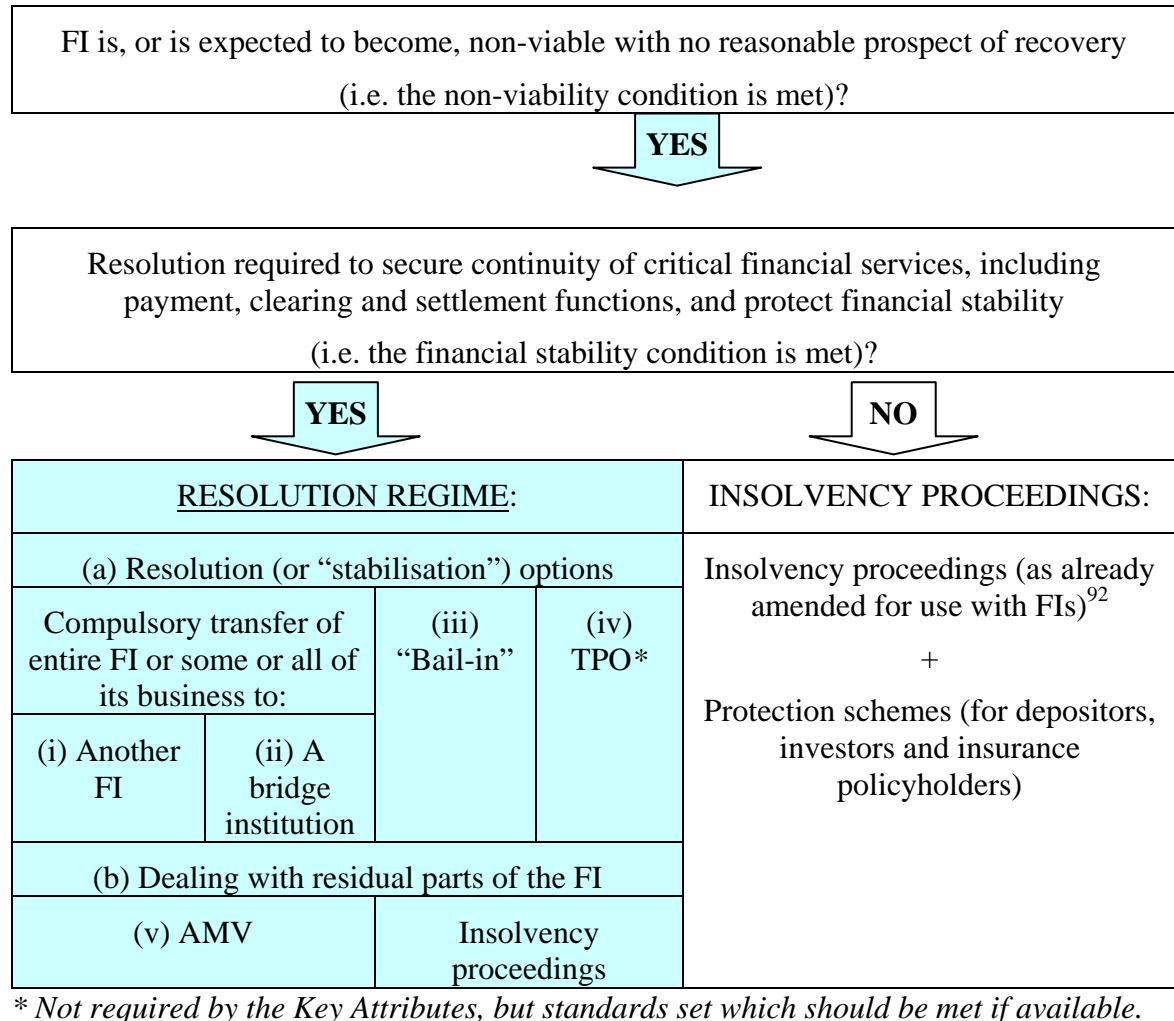
### Overview

206. As illustrated in Box G below, it is intended that the resolution regime should make available a menu of resolution options which can be drawn upon to stabilise those parts of a failing FI's business which need to be continued in order to protect critical financial services, including payment, clearing and settlement functions, and wider financial stability.
207. These resolution (or "stabilisation") options are primarily those which are now considered to be a necessary part of any resolution regime following the recent global financial crisis, and which accordingly the Key Attributes say should be made available. The Preamble to the Key Attributes says:
- "The resolution regime should include...stabilisation options that achieve continuity of systemically important functions by way of a sale or transfer of the shares in the firm or of all or parts of the firm's business to a third party, either directly or through a bridge institution, and/or an officially mandated creditor-financed recapitalisation of the entity that continues providing the critical functions".
208. Some of the options, such as a compulsory transfer of business to another FI or to a bridge institution, were in place in some jurisdictions ahead of the crisis and were successfully deployed (as such they might be considered to be relatively more "tried and tested" in those jurisdictions, at least in relation to FIs operating in particular sectors). Others, particularly bail-in, were developed following the crisis

to better ensure that regimes include options suitable for use with the largest and most complex FIs.

209. As noted in earlier chapters, in the event that an FI is failing but does not provide critical financial services and does not pose risk to financial stability, it is intended that it could, as now, be dealt with under existing corporate insolvency proceedings. As such, the proposed resolution regime would sit alongside these existing arrangements and, in the event that an FI within the scope of the regime were to get into difficulties, a decision would be needed, based on an assessment of the risks posed, as to whether it could be allowed to enter such proceedings or whether it should be resolved instead.
210. As per Key Attribute 3.8, it is intended that resolution authorities should be able to decide which of the resolution options outlined in Box G to draw upon, and how to deploy them, taking into account the specific circumstances of each case, and being guided by an assessment of what approach will fulfil the objectives set for resolution. Key Attribute 3.8 says that the regime should allow for these various options to be deployed either individually or in combination (i.e. one or more resolution options might be drawn on simultaneously or sequentially).
211. This chapter outlines why each of the resolution options required by the Key Attributes should be included within the regime proposed for Hong Kong. Where the options being considered are “tried and tested” in other jurisdictions (meaning that there is a relatively high degree of certainty on how best to structure and operate them), proposals are made in this consultation paper. Where there is a need to consider further the approach to be adopted locally, including taking into account on-going developments both internationally and in key jurisdictions, proposals will be set out in the second stage consultation.

**Box G: Overview of the proposed resolution regime for Hong Kong**



(i) *Compulsory transfer of an FI or of some or all of its business to another FI*

212. In some cases, a resolution authority may be able to bring about an orderly resolution by selling and transferring a failing FI in its entirety, or some or all of its business, to another FI which is willing and able to continue it. It is important that this resolution option is made available under the regime proposed for Hong Kong because it has a number of significant advantages.

213. Such a transfer will result in some or all of a failing FI’s business being stabilised and continued whilst also ensuring, importantly, that responsibility for this remains with the private sector. Where another FI is willing to acquire an *entire* failing FI, it does so with a view to continuing the failing FI’s activities and it will be obliged to honour any associated claims in full. As a result, and as outlined in Chapter 1,

<sup>92</sup> As noted in Chapter 3, modifications to corporate insolvency procedures have already been made under the CO and relevant sectoral ordinances as they apply to AIs, insurers and LCs in particular.

the customers of the failing FI are likely to enjoy better outcomes than would have been the case in insolvency. Had a failing AI entered liquidation, for example, depositors would have lost access to their accounts and funds, albeit with a measure of protection being provided as a result of any compensation paid under the DPS. By contrast, a transfer could mean that over the course of a weekend, deposit accounts and their credit balances would be moved to a sound FI, such that depositors could continue to access them as normal. Other customers transferred could also enjoy close to uninterrupted access to the financial services they rely upon. The transfer of the entire business of a failing FI to another FI could also contain other risks to financial stability, including by minimising the likelihood of contagion.

214. Inevitably in some other cases, potential acquirers may only be willing to take on some of the business of the failing FI. In such a case, it may not be possible to carry out resolution which secures continuity for all of the failing FI's customers or which ensures that all claims are honoured in full. The priority for the resolution authority in this case, would be to ensure that a "partial transfer" secures continuity for critical financial services, at the very least, and as such it may still effectively contain the risks posed to financial stability. The transfer of deposits covered by the DPS would be an obvious priority in this regard. If a sufficient degree of continuity cannot be achieved through a single transaction, the resolution authority may need to carry out several transfers or combine the use of this stabilisation option with others available under the regime.
215. As outlined in Box H below, powers to effect a compulsory transfer of some or all of an FI's business in resolution are already widely available in other FSB member jurisdictions and have been deployed relatively frequently in some. As such, it can be said to constitute a "tried and tested" approach to resolution.
216. Accordingly, it is considered important to include a compulsory transfer option in the regime proposed for Hong Kong. To accommodate this, and to meet the standards outlined in the Key Attributes, the regime will need to allow for the resolution authority to:
  - engage and reach agreement with potential acquirers, in order to sell an entire failing FI or some or all of its business;

- determine, where relevant, which parts of the FI to sell to the acquirer, and which to leave behind in the non-viable FI, guided by the objectives for resolution and the particular circumstances of the case;
- effect the resolution by transferring shares in, or selected assets and liabilities from, the non-viable FI to the acquirer;
- in the case of a partial transfer, make subsequent adjustments to the transaction, as necessary and with the agreement of the acquirer, by making additional transfers from the non-viable FI or by returning assets and liabilities to it;
- carry out all of the above without needing the consent of the shareholders or other affected parties and without needing to comply with all otherwise applicable procedural requirements under companies or securities law;<sup>93</sup>
- provide suitable safeguards, particularly in cases of partial transfer, to ensure that various parties are not significantly adversely affected (see Chapter 7 for a discussion of the safeguards proposed in this respect).

217. The objectives for resolution imply that transfers should be carried out on commercial terms, to the extent feasible in the circumstances, to help contain the costs associated with failure and resolution. The objectives also imply that the shareholders in all cases, and certain unsecured creditors under a partial transfer, should remain in the failing FI (providing means to impose losses on those parties who would have borne them had the FI instead entered liquidation). In such circumstances, these parties will no longer enjoy rights over the assets or liabilities transferred to the acquirer, but the proceeds, net of the costs of the transaction, should accrue to the benefit of the residual part of the failed FI in which they remain. In practice, it is relatively likely that following a transfer, the residual FI will be closed and wound-up through insolvency proceedings.<sup>94</sup> It is important to note that the safeguards being considered for the regime, which are outlined in Chapter 7, are designed to ensure that all of the parties, including those who

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<sup>93</sup> This will include requirements under the SFO, Listing Rules and Takeovers Code; see paragraphs 304 - 309.

<sup>94</sup> It is not intended that the resolution regime should prescribe what should happen to the residual FI ultimately; rather that this should be a matter for the creditors of the residual FI to consider (and possibly the shareholders). It is relatively likely, however, that one or more of these parties will assess that the residual FI satisfies the conditions set for insolvency and petition for a winding-up order (particularly so given that the FI in its entirety is no longer viable).



remain in the failing FI, are adequately protected. Central to this is the assumption that they should not be worse off than they would have been in a liquidation of the entire FI.

218. As outlined in paragraph 213, those parties whose claims and assets are transferred to the acquirer will fare better than in liquidation proceedings, on the whole, by becoming depositors, customers or creditors of the acquiring FI. To further ensure that this is the case, it is proposed that operational guidance for the use of this option should outline the process to be followed, and the factors to be considered, by the resolution authority with a view to ensuring that transfers only occur where the acquiring FI appears to be sufficiently sound, both financially and operationally, to take on the new business. Additionally, it is recognised that there may be a case for a temporary increase in the level of cover under the DPS in order to allow transferred depositors time to reallocate any balances over the coverage limit if they held deposits at both the failing and acquiring FI.
219. Despite its obvious advantages, this compulsory transfer option cannot be relied on exclusively. If there was a sudden deterioration in the condition of an FI, coupled with a need to act quickly to protect financial stability, it might prove impossible to find a suitable third party acquirer in time. Where a failing FI is large, or carries out a niche activity (such as acting as an FMI), the likelihood of finding an acquirer both willing and able to take on its business could be much reduced. In other cases, a transfer might be undesirable because of the risks posed to the acquiring FI or if it resulted in the supply of particular types of financial services becoming excessively concentrated in a single FI. It is clear, therefore, that the regime will need to provide for other resolution options also.

**Question 17**

**Do you have any views on how a resolution option allowing compulsory transfer of all or part of a failing FI's business could most effectively be structured and used?**

(ii) *Compulsory transfer of business to a bridge institution*

220. It is important that a reliable solution exists for those circumstances where the resolution authority assesses that it might be possible to find a third party acquirer for the business of a failing FI ultimately, but where this cannot be arranged immediately. There is broad consensus internationally, and the Key Attributes

therefore require, that regimes should allow for the transfer of some of a failing FI's business to a temporary bridge institution.

221. By taking on, and continuing, activities associated with the provision of critical financial services, and thereby protecting financial stability, use of a bridge institution can allow the resolution authority time to find a more permanent solution. Indeed with more time available to engage with interested parties, (and for those parties to conduct due diligence), as well as to allow for any necessary restructuring of the activities of the FI in resolution, it might prove easier to find acquirers willing to take on key parts of its business at a commercial price.
222. As outlined in Box H below, the powers necessary to make use of bridge institutions in the manner described are now widely available in other FSB member jurisdictions and have been successfully deployed in relation to small and medium-sized FIs. Following the crisis, it has also become clear that bridge institutions could play a role in supporting the resolution of large and complex FIs alongside the use of powers designed to bring about bail-in. Whilst a bridge institution which has taken on some of the activities of a failing FI might be recapitalised using statutory bail-in powers, an alternative approach would be to transfer all the assets but just some of the liabilities of the failing FI or its holding company to a bridge institution, to effect bail-in (see paragraph 234 for further details).
223. In order to obtain the benefits described above, it is proposed to include a bridge institution option in the resolution regime for Hong Kong, which should be capable of deployment in the cases described in paragraph 222. To accommodate this, and to meet the standards outlined in the Key Attributes, the regime will need to allow for:
  - a legal entity to be established to act as a bridge institution in a form and for a purpose to be determined by the resolution authority (given a bridge institution might be used in one of a number of ways to support resolution);
  - the resolution authority to be able to determine which parts of the failing FI (or its holding company) to transfer to the bridge institution and which to leave behind, guided by the objectives set for resolution and the purpose the bridge institution is to serve;

- the resolution authority to transfer the relevant assets and liabilities to the bridge institution initially (as well as to make subsequent adjustments either through additional transfers to the bridge institution or back from it to the failed FI as well as subsequent onward transfers from the bridge institution to third parties);
  - the resolution authority to exercise sufficient control over the operations of the bridge institution, to support the carrying out of the proposed approach to resolution;
  - the resolution authority to identify and implement the most appropriate exit strategy for the bridge institution;
  - all of the above to be carried out without the consent of the shareholders or other affected parties, and without the need to comply with all of the otherwise applicable procedural requirements under companies or securities law<sup>95</sup>, at least initially.
224. Where a bridge institution is used to support bail-in of certain unsecured creditors (as discussed in paragraph 222), the result may be that these creditors may own, at least temporarily, some or all of the shares of the bridge institution. Even so, it is important that the resolution authority remains in control until the point at which a viable FI emerges (which can then exit the resolution process).<sup>96</sup> In other cases, absent bail-in, it would seem appropriate that the bridge institution be owned by the resolution authority or by the Government.
225. In deciding what to transfer to a bridge institution, a resolution authority would, taking into account the objectives set for resolution, inevitably seek to transfer, at a minimum, those parts of the failing FI's business which support the provision of critical financial services. To reduce the risks associated with this option, (which arise where the resolution authority (or government) owns or is responsible for honouring the claims of the bridge institution), and to prepare for a future exit strategy under which these activities are returned to the private sector, it might also be appropriate for the bridge institution to take on other parts of the failing FI's business, which appear to be viable (or "good"). At the same time, and again with

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<sup>95</sup> See Footnote 93 for reference.

<sup>96</sup> While bail-in would serve to recapitalise the resolved FI, it is unlikely to address the root cause that led to its failure. Therefore, the resolved FI might also undergo a period of restructuring to restore viability.

a view to reducing the risks associated with use of this option, the resolution authority would look to ensure that shareholders, as well as certain unsecured creditors, remain in the failed FI alongside impaired (or “bad”) assets (as doing so should help to ensure that the assets of the bridge institution comfortably exceed its liabilities).

226. The implications for the parties transferred would be similar to those described in paragraph 213 in relation to a transfer of business to a third party acquirer. The resolution authority would seek to ensure that customers transferred enjoy close to uninterrupted access to the financial services they rely on. The bridge institution would take on responsibility for honouring their claims in full as well as those of any other counterparties and creditors transferred. In any case where an LB is being resolved, the transfer of deposits covered by the DPS would be a priority, implying that eligible depositors could continue to access their accounts (and credit balances) as normal.
227. As outlined above, this option would need to be deployed in a manner that results in shareholders, and certain unsecured creditors, remaining in the failing FI. These parties would no longer enjoy rights over the assets and liabilities transferred but may retain a claim to any proceeds, net of costs, generated by the eventual sale of the business back to the private sector (or, in cases where that proves not to be possible, generated by the business being wound-up). The objectives set for resolution would create an incentive for the resolution authority to seek an exit strategy which achieves a commercial price for the business in question. The other ways in which parties remaining in the failed FI (as well as any parties which are bailed-in) will be protected are outlined in Chapter 7 on safeguards.
228. It is important to note however that, at least absent bail-in, there may be cases where it would be neither feasible nor desirable to resolve a failing FI through use of a bridge institution. If the resolution authority assesses that it is ultimately unlikely, even with more time available, that an acquirer could be found, use of bridge institution may be inappropriate. Furthermore, where failing FIs are large and complex, a series of obstacles to resolution by this means exist also. It would be difficult, given the need to act quickly, to be selective about which of the assets and liabilities to transfer across to a bridge institution, for example. If the resolution authority instead chose to transfer the balance sheet in its entirety, it

would be forced to forgo the opportunity to ensure that creditors remain in the residual FI in sufficient quantities, alongside shareholders and any impaired assets, to reduce the risks associated with the transaction to an acceptable level. As such, it is clearly not desirable that reliance be placed solely on options allowing for a transfer of business to another FI directly or via a bridge institution. In other words, statutory bail-in powers are also necessary.

**Question 18**

**Do you have any views on how a resolution option allowing compulsory transfer of part of a failing FI's business to a bridge institution could most effectively be structured and used?**

*(iii) Statutory bail-in*

229. In the event that a very large and complex FI becomes non-viable, it is unlikely that it would be possible to transfer its entire business to an acquiring FI directly. Reliance on the use of a bridge institution to achieve this same outcome over a longer timeframe might also pose risks which are so material as to be unacceptable, for the reasons explained in paragraph 228 above. As such, and to avoid a situation where there would be no effective alternative but to nationalise, or effect a public rescue of, this type of FI, the Key Attributes say that it should be possible to carry out bail-in.
230. It is intended that a statutory bail-in option should enable the resolution authority to impose (i.e. without needing the consent of affected parties) a restructuring of the failing FI's liabilities in order to restore its viability such that it might continue to provide critical financial services. To this end, the regime should allow the resolution authority to write down shareholders and certain unsecured creditors, in a manner that generally respects the hierarchy of claims in liquidation and to the extent necessary to absorb losses incurred by the failing FI. The resolution authority should then be able to impose a debt-for-equity swap on certain unsecured creditors, again in a manner that generally respects the hierarchy of claims, to bring about a recapitalisation of the failing FI.
231. A bail-in option plays an important role, therefore, in ensuring that large and complex FIs can be resolved in a manner whereby the costs of failure and resolution can be imposed on the shareholders and certain unsecured creditors of

those large and complex FIs rather than on public funds. By removing the implicit public subsidy that otherwise exists,<sup>97</sup> the incentives on the shareholders and creditors to monitor and respond to the risks being run by such FIs should be improved. In turn, this strengthening of market discipline should help to reduce the likelihood of future failures and crises.

232. The inclusion of this option in the Key Attributes reflects broad international consensus that bail-in powers are a necessary part of any resolution regime. Such powers were not available in most jurisdictions before the crisis, and in a majority discussions are still on-going on how best to structure and operate such powers most effectively. Only a minority of jurisdictions have undertaken the necessary reforms to make this resolution option available so far, but France, Spain, Switzerland and the US have done so. EU member states have agreed a common approach, at least for banks and investment firms, for bail-in powers which would come into effect on 1 January 2016.<sup>98</sup> In October 2013, the UK indicated that it would pursue the legislative reform needed to implement this aspect of the RRD on an accelerated timetable.<sup>99</sup>

233. It is clearly important to ensure that the regime proposed for Hong Kong will support the orderly resolution of the largest and most complex FIs. It follows therefore that the statutory powers to support bail-in should be made available. At the same time, it seems desirable that the approach taken locally is consistent with that adopted in other jurisdictions. Whilst this consultation paper considers the overarching features of bail-in powers, it does not make detailed proposals for its adoption in Hong Kong. International developments will be observed and proposals will be set out on implementation of this aspect of the Key Attributes in the second stage consultation.

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<sup>97</sup> As described in Chapter 1, this subsidy exists where public authorities assess they have no alternative other than to rescue or nationalise a failing FI (as this typically results in an outcome under which shareholders may, and other unsecured creditors are likely to, do better than they would have in liquidation).

<sup>98</sup> See press statement of the European Parliament (12 December 2013), <http://www.europarl.europa.eu/news/en/news-room/content/20131212IPR30702/html/Deal-reached-on-bank-%E2%80%9Cbail-in-directive%E2%80%9D>

<sup>99</sup> To add a bail-in option to the toolkit of the existing SRR, it is proposed to amend the Financial Services (Banking Reform) Bill to provide for the necessary powers. See: [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/245755/HoL\\_Policy\\_Brief\\_-\\_Bail-In.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/245755/HoL_Policy_Brief_-_Bail-In.pdf)

234. It is noted that the Key Attributes intend that it should be possible to carry out bail-in by several different means. As an alternative to restructuring the liabilities of a failing FI directly, it should be possible to bail-in the liabilities of a *holding company* of a failing FI, with a view to ensuring that its group is adequately capitalised on a consolidated basis. In other cases, it might be appropriate to use bail-in powers to ensure that a bridge institution, to which some of the business of, or instruments of ownership in, a failing FI have been transferred, is adequately capitalised.<sup>100</sup>
235. In making a bail-in option available, therefore, it is necessary to determine which liabilities should be eligible for, and which excluded from, any bail-in. There is international consensus that some liabilities should be protected in all circumstances with a view to delivering on the objectives set for resolution. It is now widely accepted, for example, that it should not be possible to bail-in deposits covered under a deposit guarantee scheme, because these would not be exposed to losses in liquidation.<sup>101</sup> There is also debate on which other liabilities would need to be excluded, in some or all cases, to avoid undermining efforts to secure continuity for critical financial services and protect financial stability.<sup>102</sup>
236. It is recognised that use of a bail-in option will not be possible if a failing FI does not hold sufficient quantities of liabilities which may readily be bailed-in. Accordingly, the FSB is currently considering whether FIs should be required to hold sufficient quantities of liabilities which will provide for what is known as “gone concern loss absorption capacity” (or GLAC). In a recent report to the G20 leaders, the FSB indicated its intent to prepare, in consultation with standard-

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<sup>100</sup> Further details on how these various approaches to bail-in might work can be found in BIS,(June 2013) “A template for recapitalising too-big-to-fail banks”, [http://www.bis.org/publ/qtrpdf/r\\_qt1306e.pdf](http://www.bis.org/publ/qtrpdf/r_qt1306e.pdf) and a joint paper by the FDIC and the BoE (December 2012) “Resolving Globally Active, Systemically Important, Financial Institutions”, <http://fdic.gov/about/srac/2012/gsifi.pdf>

<sup>101</sup> Similarly that it should also not be possible to bail-in liabilities to the extent they are secured or relate to off-balance sheet items, such as client assets.

<sup>102</sup> In the proposals put forward in the UK, for example, the following liabilities would be permanently excluded: interbank liabilities with a maturity of less than seven days; those arising from participation in a settlement system or central counterparty; and certain liabilities in relation to employees as well as those to trade creditors. Beyond this, the resolution authority would be expected to carry out bail-in in a manner respecting the hierarchy of creditors, but would be able to depart from *pari passu* treatment where bail-in of particular liabilities would not be possible (over a reasonable timeframe) or could have a significantly negative effect on financial stability.

setting bodies, and by end-2014, proposals on GLAC for G-SIFIs, including on its nature, amount, location and disclosure.<sup>103</sup>

237. Where bail-in is effective in recapitalising a failing FI, its long-term viability may only be restored if action is also taken to address the underlying weaknesses that caused it to fail in the first place. As such, there is growing consensus that a “business re-organisation plan” should be produced by the FI, its management or an administrator appointed to act on behalf of the resolution authority.

**Question 19**

**Do you have any views on the factors which should be taken into account in drawing up proposals for the provision of a bail-in option for the resolution regime in Hong Kong?**

*(iv) Temporary public ownership*

238. Establishing a regime which makes available all of the options outlined above, will represent a major step towards ensuring that non-viable FIs can be resolved in a manner which seeks to protect both financial stability *and* public funds. At the same time, and as considered further in paragraph 255 below, some FIs may need to make changes to the way they are structured and operate before it would be possible to resolve them by means of any of the options described. Whilst work will be undertaken to ensure that large and complex FIs operating in Hong Kong can be resolved using the preferred resolution options, there may remain a risk, at least for a time, that the authorities could continue to face an uncomfortable choice between disorderly failure and publicly-funded rescue.
239. It appears appropriate, therefore, to consider the case for making available an additional resolution option which might better contain the risks posed to public funds as compared with a rescue involving the direct provision of funds to a distressed FI outside of resolution. To this end, regimes in several key jurisdictions include an option under which failing FIs can be taken into TPO including in Australia, Singapore and the UK. The Key Attributes do not

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<sup>103</sup> See Footnote 5 for reference.



specifically require that this resolution option be included in a resolution regime, but set some standards which should be met where it is made available.

240. An important advantage of making a TPO option available, at least as compared with a publicly-funded rescue, is that it can be designed in such a way as to better ensure that losses can be imposed on shareholders and perhaps certain unsecured creditors also (although likely not to the same extent as under bail-in). Furthermore, in taking full control of an FI under a TPO approach, a government, or resolution authority, would be better placed to identify and implement a more permanent solution, such as some form of restructuring ahead of returning the FI to the private sector.
241. At the same time, it is clear that this option should generally only be used as a last resort as the government, and its resolution authority, would essentially become responsible for continuing the activities of a large and complex FI which is failing; something which may entail substantial risk to public funds. It may be that this is why some jurisdictions such as Switzerland and the US have not made this option available, and are seeking instead to find means of ensuring that other approaches to resolution, particularly via bail-in, will be feasible for all large and complex FIs.
242. On balance, the authorities consider that it would be appropriate to include TPO as a fallback option in the regime proposed for Hong Kong. In a number of jurisdictions (including in Hong Kong as noted in Box C, Chapter 1), powers to allow for some form of TPO have been sought on an ad hoc basis in past crises. If there is a chance that this might be necessary in future, it would be preferable to secure these powers in advance to ensure that they operate within a fully articulated and coherent regime which has appropriate governance and safeguards in place. Securing the necessary powers in advance may also be preferable given that the very process of seeking the necessary emergency powers as and when needed could damage confidence, exacerbating the problem the authorities are seeking to address.
243. Clearly, if a TPO option is made available under the regime it will be important to set a higher threshold for its use, to ensure that it is only used as a “last resort” in cases where the risks posed to financial stability are very significant but where it is assessed that the other resolution options (e.g. compulsory transfer, bail-in) could

not be used to carry out resolution that fulfils the resolution objectives (as outlined in Box F, Chapter 5). If a TPO option is included in the regime, the threshold for its use will be addressed in the second stage consultation.

**Question 20**

**Do you agree that there is a case for including a TPO option in the proposed regime?**

(v) *Transfer to an asset management vehicle*

244. In a majority of cases it will be appropriate for the residual parts of a failing FI (in other words those parts not directly associated with the provision of critical financial services and which do not need to be continued in order to protect financial stability) to be dealt with by means of insolvency proceedings. In some cases, however, delivery on the objectives set for resolution may require that some of the residual parts of a failing FI's business be managed for a period of time instead until they can be sold on or wound-up over an appropriate timeframe. This is most likely to be the case where there is a substantial portfolio of assets whose rapid liquidation could have a materially adverse effect on one or more financial markets. Such an approach may also be appropriate where it is assessed that liquidation in short order could be unduly value destructive.
245. To accommodate this, the Key Attributes require that a resolution regime should allow the resolution authority to make use of an AMV and it is proposed that this option should be included in the resolution regime in Hong Kong. This may not imply a need for additional powers over-and-above those needed to carry out resolution by means of a compulsory transfer of business or the use of a bridge institution. Rather, the resolution authority would need to be able to use those same powers to transfer assets and liabilities to one or more legal entities established to act as an AMV for their management and eventual sale or orderly wind-down.
246. It is clearly important to ensure that the risks associated with this option are managed appropriately and so consideration is being given as to how any AMV might best be structured. The resolution authority would need to be able to exercise control over the vehicle although it is likely that the authority would seek to appoint a person to act on its behalf to manage it on a day-to-day basis. At the

same time, it appears appropriate that the risks associated with the portfolios being managed, given that assets in the portfolios may be impaired, remain with the shareholders and creditors of the failed FI. It may therefore be appropriate that these parties receive an equity stake in the AMV, rather than the failing FI receiving any upfront consideration upon the initial transfer of assets to the AMV.

### **Question 21**

**Do you have any views on when it would be appropriate to make temporary use of an AMV in order to manage the residual parts of an FI in resolution?**

### **Box H: Availability and use of key resolution options**

This box briefly considers the availability, and use, of the various resolution options outlined in this chapter, noting whether they are “tried and tested” or have been designed to address shortcomings identified during the recent crisis.

**Compulsory transfer of business to another FI** – A series of jurisdictions had these powers going into the crisis or have acquired them subsequently. In its Thematic Review on Resolution Regimes, the FSB found that 20 out of 24 member jurisdictions could use this option and some jurisdictions did so during the crisis, most notably the US where the FDIC resolved some 442 (mostly small and medium-sized) banks in this way between 2007 and 2012.<sup>104</sup> After acquiring the necessary powers in 2009, the UK’s BoE used them to transfer retail and wholesale deposits, and some mortgage lending and other fixed assets, out of a failed building society to a third party acquirer.<sup>105</sup>

**Compulsory transfer of business to a bridge institution** – A series of jurisdictions had the powers needed to carry out resolution in this way ahead of the crisis and some have acquired them subsequently (and some 15 out of 24 FSB member jurisdictions were assessed to have this option at their disposal in the Thematic Review on Resolution Regimes). In the US, the FDIC resolved two insured depository institutions in this manner between 2007 and 2012. In the case referred to above, the UK authorities transferred assets and liabilities relating to a particular business line of the failed building society to a

<sup>104</sup> Some 481 banks failed during this period in the US. See: <http://www.fdic.gov/bank/individual/failed/banklist.html>

<sup>105</sup> Under temporary powers, available for a year from February 2008, the UK authorities were also able to carry out transfers of business, predominantly retail deposits, to third parties from several failed FIs.

bridge institution (later transferring them to a third party acquirer).

**Statutory bail-in** – No major jurisdictions had the powers necessary to carry out bail-in ahead of the crisis, given this and other shortcomings in existing powers in relation to large and complex FIs, a series of jurisdictions resorted to publicly-funded bail-outs. Since the crisis, broad consensus has emerged on the need for bail-in powers, and several jurisdictions have made the necessary provision (France, Spain, Switzerland and the US). EU member states will be required to include this option in their regimes, and the UK is pursuing the necessary reform on an accelerated timetable.

**TPO** – Few jurisdictions had the powers necessary to carry out resolution by means of TPO ahead of the crisis, although some (e.g. the UK) passed emergency legislation to acquire such powers on a temporary basis. Since the crisis, several jurisdictions have chosen to make this option permanently available (e.g. Australia, Singapore and the UK) whilst other jurisdictions have chosen not to do so (Switzerland and the US).

(vi) *General powers*

247. In order for the resolution authority to be able to use one or more of the resolution options outlined above, it is necessary that the resolution regime make available a set of “general resolution powers” (as outlined in Key Attribute 3.2). The resolution authority would need to be able to take control of and manage an FI in resolution, including by exercising the powers of its shareholders and management. Whilst the resolution authority would need to be able to exercise these powers directly, there may also be cases where it would be appropriate to appoint a person to act on its behalf (e.g. an administrator). Similarly, the 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.<sup>106</sup>

248. To carry out resolution by means of a transfer of an entire failing FI or some or all of its business to a third party, the resolution authority would need to be able to transfer shares as well as assets and liabilities and legal rights and obligations of an FI in resolution “notwithstanding any requirements for consent or novation that

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<sup>106</sup> Although it may be appropriate to remove those directors and senior management who are assessed to be most directly culpable for the FI’s failure, 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.

would otherwise apply”. Powers to reduce, including to zero, the nominal amount of shares outstanding as well as certain liabilities, and to cancel shares or debt instruments issued by an FI in resolution, and thereafter convert certain liabilities into shares would be needed to carry out bail-in. Other powers may be needed to support deployment of the key resolution options described earlier in this chapter, and a more comprehensive list will be set out in the second stage consultation.

(vii) *Early termination rights*

249. The ability of the resolution authority to carry out an orderly resolution could be undermined if the initiation of the resolution process and exercise of the relevant powers were to trigger contractual acceleration, 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 result in a disorderly “race for the exit”, which could create market instability as well as undermine the prospects for a successful resolution designed to stabilise some or all of the activities of the FI.
250. It is therefore proposed, as required under Key Attribute 4.2, that provision be made in respect of the local resolution regime such that “entry into resolution and the exercise of any resolution powers should not trigger statutory or contractual set-off rights, or constitute an event that entitles any counterparty of the firm in resolution to exercise contractual acceleration or early termination rights provided the substantive obligations under the contract continue to be performed”.<sup>107</sup> In practice, this will mean that those counterparties whose arrangements are protected and preserved, either through their being transferred to an acquirer, or bridge institution, or through actions that restore the viability of the FI (particularly by means of bail-in), will not be able to exercise early termination rights (solely on the grounds of the resolution). In contrast counterparties remaining in the residual part of a failed FI will be able to exercise their early termination rights.
251. It is possible that the resolution authority will need a short window, of some hours or days, between taking an FI into resolution, and determining and communicating the form its resolution will take (including to allow sufficient time to identify

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<sup>107</sup> It is noted that such obligations might relate to those for payment, and delivery and return of collateral.

which assets, liabilities and legal rights and obligations to transfer). During this period, there would be uncertainty about whether any individual counterparty would end up in the stabilised or the residual part of the FI and whether they could expect that the substantive obligations under their contracts would continue to be performed. If counterparties were to exercise their early termination rights during this period, it could make orderly resolution very difficult. The sort of disorderly “race for the exit” referred to in paragraph 249 could occur, and the resulting changes in the failed FI’s balance sheet would make it very difficult for the resolution authority to determine how best to carry out resolution.

252. Therefore Key Attribute 4.3 says that “the resolution authority should have the power to stay temporarily such rights where they arise by reason only of entry into resolution or in connection with the exercise of any resolution powers”. A series of conditions for use of such a stay are also articulated including that:

- it should “be strictly limited in time (for example, for a period not exceeding two business days)”;
- it could only be used where the authorities are required, to “transfer all of the eligible contracts with a particular counterparty to a new entity and would not be permitted to select for transfer individual contracts with the same counterparty and subject to the same netting agreement” (safeguarding these sorts of financial arrangements is further considered in Chapter 7);
- “[f]ollowing 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”;
- counterparties should then be able to “close out immediately against the firm in resolution on expiry of the stay or earlier if the authorities inform the firm that the relevant contracts will not be transferred”;
- the stay does not interfere with “payment or delivery obligations to FMIs” such that “[i]f a firm in resolution fails to meet any margin, collateral or settlement obligations that arise under a financial contract or as a result of the firm’s membership or participation in an FMI, its counterparty or the FMI would have the immediate right to exercise an early termination right against the firm in resolution”.

253. It appears appropriate to provide for a temporary stay of this nature, coupled with the necessary safeguards, under the resolution regime proposed for Hong Kong. Further consideration will be given to this and proposals will be set out in the second stage consultation.<sup>108</sup>
254. A number of the selected jurisdictions have, or propose to secure, a power to implement a temporary stay on early termination rights. Such a power is in place in the US (until 5pm on the day following the announcement of an FI's entry into resolution<sup>109</sup>) and Switzerland (for 48 hours<sup>110</sup>). Under the EU proposals, all member states must provide for such a power (with the stay expiring at midnight on the business day following the announcement of its coming into effect).<sup>111</sup>

### **Question 22**

**Do you have any views on how best to provide for a stay of early termination rights where these might otherwise be exercisable on the grounds of an FI entering resolution or as a result of the use of certain resolution options?**

#### *(viii) Resolvability*

255. Even with the full range of resolution options available, it may not be possible to resolve some FIs in a manner that fulfils the objectives set for resolution (at least initially). This is because some FIs may be structured or operate in such a way as to create barriers to the effective use of the regime. In other words, some FIs are not adequately “resolvable”, implying that they would continue to pose risks to financial stability (and public funds) were they to fail. As such, Key Attribute 10.5 says 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 on-going business”. Clearly it

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<sup>108</sup> It is noted that it is not proposed that any general moratorium would come into effect on entry into resolution, given the purpose would be to secure continuity of the FI’s activities.

<sup>109</sup> See section 210(c)(10) of the Dodd-Frank Act.

<sup>110</sup> See Chapter 5 of Banking Insolvency Ordinance, BIO-FINMA, <http://www.admin.ch/ch/e/rs/9/952.05.en.pdf>

<sup>111</sup> See Article 63 of the June 2013 European Council text of the EU RRD. See Footnote 28 for reference.

is necessary that these powers be exercisable well before any threat to the viability of an FI has been identified.

256. There is a need to gain a greater understanding of the types of barriers to resolution which may need to be removed and progress is being made in that regard, including through the group-level resolution planning now being carried out for G-SIBs. As observed earlier in this chapter, ensuring that such FIs have sufficient readily bail-in-able liabilities may be important. More generally, some FIs may need to make changes to their legal or operating structure, or their business. This might include establishing a holding company or concentrating activities supporting the provision of critical financial services in certain legal entities within the group structure such that they might be separated out and protected more readily in resolution. Some FIs may need to reduce financial or operational dependencies on those parts of their group from which they might be separated in resolution (e.g. by limiting the scale of intra-group exposures).
257. Once the most significant barriers to the resolution of individual G-SIBs have been confirmed by the work presently underway in this area, the FSB will expect home and host authorities to act so as to ensure that they are addressed in a timely manner. Although the FSB's Thematic Review on Resolution Regimes concluded that not all jurisdictions had made available specific powers to require changes needed to improve resolvability, a number have or are in the process of doing so. It is important to ensure that the relevant authorities in Hong Kong are also suitably empowered to act in this regard as informed by the approach being taken in other jurisdictions.
258. At the same time, it is recognised that it will be necessary to ensure that such powers will be used in a proportionate manner. As such, and taking into account models being considered elsewhere, it may be appropriate that in requiring FIs to make changes, regard should be had to:
- (i) the extent to which it will otherwise be difficult to carry out resolution in a manner that fulfils the objectives set; but also
  - (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 the economy.



259. It also appears appropriate that after being formally notified of the results of a resolvability assessment, each FI should be allowed a reasonable period of time to consider the required changes and given the opportunity to suggest alternative ways of achieving the same ends for the consideration of the resolution authority.
260. Further consideration will be given to how best to provide for such powers under the resolution regime proposed for Hong Kong and firmer proposals will be set out in the second stage consultation.

**Question 23**

**Do you have any views on how best to provide the supervisory or resolution authorities with powers to require that FIs remove substantial barriers to resolution?**

*(ix) Relationship with existing corporate insolvency proceedings*

261. The proposals outlined in this consultation paper focus on a regime for use in cases where it is assessed that resolution of a non-viable FI should be undertaken to protect provision of critical financial services, including payment, clearing and settlement functions, and to contain risks posed to financial stability more generally. It is not intended that these proposals would have any material effect on the use of existing insolvency procedures in cases where the failure of an entire FI poses little threat to financial stability.
262. It is proposed, however, that on each occasion where there are significant doubts about the viability of an individual FI which is within scope of the resolution regime, the resolution authority should be given the opportunity to consider whether resolution should be carried out. It is further proposed that in those cases where resolution is deemed appropriate, the resolution authority should be able to act without delay to carry out the resolution. There is, therefore, a need to mitigate the risk that third parties could seek to pre-empt or frustrate resolution proceedings with potentially severe consequences for financial stability, other affected parties and the costs of resolution.
263. To manage these risks, it is proposed that any person intending to petition for the winding-up of an FI within the scope of the regime should be required to notify the

resolution authority before winding-up proceedings can commence.<sup>112</sup> The resolution authority would then be permitted a set period of time, perhaps up to 14 calendar days, to decide whether to instead initiate resolution (as well as to finalise any necessary preparations for that process). Any petition presented during this period would be stayed until the end of the period unless and until the resolution authority confirms that it has decided not to initiate resolution. It is recognised that in certain circumstances, including where the condition of an FI is rapidly deteriorating, the resolution authority may need to reach a decision on whether to initiate resolution more quickly.

264. As well as helping to meet the standards in the Key Attributes, the proposed approach is consistent with that adopted under the UK regime as well as that proposed in the EU RRD. In some of the other selected jurisdictions, the ability of creditors to petition for the restructuring or winding-up of certain types of FIs has been restricted to an even greater extent.<sup>113</sup>
265. Once a decision has been taken to initiate resolution, the resolution authority will need to act quickly (e.g. over a weekend) to implement one, or a combination of, resolution options, in order to provide sufficient certainty to affected parties on the treatment they will receive. This is because it is not intended that a general moratorium would come into effect on entry of an FI into resolution, either automatically or at the discretion of the resolution authority, as this would be inconsistent with delivering on the objective of securing continuity of critical financial services and protecting financial stability.<sup>114</sup>
266. As noted in paragraph 217, where resolution is by means of a partial transfer, it is not intended that the resolution regime would prescribe what should happen ultimately to the residual FI; rather that this should be a matter for the same parties as are empowered under the existing legislative framework to determine. It is noted, however, that in some jurisdictions (including in the UK and US) provision

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<sup>112</sup> Consideration will be given as to whether a mechanism for notifying the resolution authority needs to be provided for in relation to any other restructuring or insolvency proceedings which might be pursued in relation to an FI.

<sup>113</sup> In the US, for example, only the chartering agency or the primary federal regulator of an insured depository institution may initiate bankruptcy proceedings (i.e the institution's creditors may not).

<sup>114</sup> In this respect, resolution differs from other corporate insolvency proceedings, whether those are designed to bring about a restructuring or a winding-up.

has been made to ensure that the residual entity can be called on to temporarily support business transferred to a commercial acquirer or bridge institution. This could take the form of allowing for adjustments to assets and liabilities transferred, as well as on-going provision of essential services and facilities, ahead of any formal restructuring or winding-up of the residual FI.<sup>115</sup> Consideration will be given to whether similar provision is needed to support resolution carried out by means of partial transfers under the regime proposed for Hong Kong, and further details will be set out in the second stage consultation.

267. More generally, the Key Attributes consider it important that the arrangements in place for closing and winding-up failing FIs, which the resolution regime would sit alongside, are as effective as possible. The Key Attributes say that liquidation procedures and protection schemes should secure an appropriate degree of protection for depositors, investors and insurance policyholders. It is clarified that this implies not only that their claims are dealt with 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.
268. Being able to transfer deposits and client assets out of liquidation is considered desirable because, where it can be achieved sufficiently quickly, it could mean that the FIs' customers could have close to uninterrupted access to these resources. An additional benefit is that some of the franchise value associated with the deposit book, or client asset business, might also be preserved rendering the liquidation less value destructive. As noted in Paragraphs 88 and 105, the existing statutory framework does not provide for a transfer of deposits or client assets out of liquidation, but pursuing such reforms may be regarded as a lower priority in Hong Kong, at least for the time being, as compared with establishing an effective resolution regime (although respondents' views on this assessment would be welcome).

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<sup>115</sup> In the UK, for example, following a partial transfer, the residual part of a failed bank would 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 acquirer or bridge institution taking on other parts of the business (by allowing for subsequent adjustments to the initial transfer as well as by continuing to supply any other services and facilities necessary for the acquirer or bridge institution to operate effectively).

269. More generally, other initiatives underway to further strengthen protection scheme arrangements for depositors, investors and insurance policyholders will help to ensure that the default option for failing FIs remains the use of existing corporate insolvency proceedings.

**Question 24**

**Is the proposed approach to ensuring that third parties cannot act to pre-empt the resolution of a non-viable FI (including by means of a petition to initiate a winding-up) appropriate?**

**Question 25**

**Do you have any views on how provision might be made to ensure that the residual part of an FI could be called on to temporarily support a transfer of business to another FI or bridge institution (in the manner described in paragraph 266)?**

**Question 26**

**Do you attach any priority to pursuing reforms designed to ensure that the claims of protected parties (particularly those of depositors and investors) can be transferred out of liquidation proceedings, alongside those reforms being pursued to establish an effective resolution regime?**

## CHAPTER 7 – SAFEGUARDS AND FUNDING

This chapter considers the safeguards which might be incorporated into the resolution regime in Hong Kong, as well as options for meeting any costs. It covers:

- safeguards in the form of: (i) compensation where creditors' rights are adversely affected; and (ii) restrictions placed on how resolution powers can be used;
- how any costs of resolution, including those arising because compensation is due in respect of (i), might be met.

### **Safeguarding parties affected by resolution**

270. In the preceding chapters of this consultation paper, reference has been made to the safeguards which may be required as an integral part of a resolution regime.
271. The need for such safeguards arises in part because resolution authorities must be able to act quickly and decisively to secure continuity of critical financial services as well as to contain the wider systemic impact of an FI's failure. To achieve this, resolution regimes provide for powers which allow the resolution authority to act in a manner that affects contractual and property rights, and potentially the amount of any payment shareholders and creditors receive in resolution.
272. There is a clear need, therefore, for checks and balances to safeguard the position of those who may be affected by resolution. The safeguards also serve to provide market participants with a greater degree of certainty about how the failure and resolution of an FI may affect them, which is beneficial if not essential, for continued confidence in the financial system (as well as for its efficient operation).

### Respecting the creditor hierarchy

273. As far as possible, as per Key Attribute 5.1, “[r]esolution powers should be exercised in a way that respects the hierarchy of [creditor] claims” (i.e. the normal priority ranking that applies in liquidation). Adhering to this principle will help to ensure that in any resolution, creditors can expect to bear losses in the same order as would have applied under a liquidation process, reducing uncertainty about outcomes in resolution. Key Attribute 5.1 clarifies that “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”. Also, any preferences provided for in liquidation should be upheld and secured creditors should retain the benefit of their security.<sup>116</sup>

274. At the same time, Key Attribute 5.1 says that resolution regimes should provide for the “flexibility to depart from the general principle of equal (*pari passu*) treatment of creditors of the same class”. Such a departure may be “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”. As resolution seeks to secure continuity for those parts of a failing FI’s business associated with the provision of critical financial services, and given some liabilities are generated in the course of providing such services, an approach which resulted in these liabilities being written down could be counterproductive. Similarly, securing continuity for these and other viable parts of a failing FI’s business could better preserve value, as compared with liquidation, improving the chances that all creditors are made whole.
275. The importance of being able to depart from equal treatment can best be illustrated by an example. In some cases, the resolution authority might assess that resolution can best be achieved by selling a failing FI’s retail deposit business alongside some higher-quality assets of an equivalent, or nearly equivalent amount, to another FI (which is not willing to take on other assets and liabilities). At the same time, in relation to the portion of their deposit balances *in excess of* the limit set for cover under the DPS, retail depositors rank equally with other unsecured creditors in liquidation.<sup>117</sup> The acquiring FI commits to meet in full the claims associated with the liabilities transferred, and therefore retail depositors could expect to be made whole. A departure from equal treatment of creditors may have occurred, however, given other unsecured creditors, including other depositors, would remain in the

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<sup>116</sup> In Hong Kong, section 265 of the CO establishes that certain items will be paid out ahead of payments to other creditors in the winding up of a company including: (i) the costs of the liquidation process; (ii) certain amounts owing or relating to employees (e.g. unpaid wages, salaries, termination payments, employees compensation etc.); (iii) statutory debts due to the Government in the near-term (e.g. taxes and duties); (iv) in the case of the winding-up of a bank, eligible depositors up to a limit of the compensation they are due under the DPS (this is often known as “depositor preference”); and (v) in the case of the winding-up of an insurer, certain insurance and reinsurance claims.

<sup>117</sup> As noted in Footnote 90, deposits are preferred only up to the limit for compensation set under the DPS.

failed FI, with their returns to be determined.<sup>118</sup> The departure from equal treatment could mean that retail depositors enjoy better returns than other unsecured creditors (including other types of depositor) who otherwise occupy the same rank in the creditor hierarchy.

276. At the same time, as recognised by the Key Attributes, if the resolution authority is not able to depart from the equal treatment of creditors, it may not be able to carry out resolution in a way that best delivers against the objectives set for resolution. It is proposed, therefore, to set as a guiding principle for use of the regime for Hong Kong that the statutory creditor hierarchy should be respected and that departures from equal treatment of creditors in the same class should only be possible where they can be justified against the objectives for resolution.
277. Amongst the selected jurisdictions, resolution regimes in Australia, Switzerland, the UK and the US allow for departure from equal treatment of creditors, and the EU RRD will require that member states make similar provision. In several cases (UK, US and EU) it is made explicit that such departures may be permitted only where justified on specified grounds.

#### Providing for a compensation mechanism

278. Losses arising from failure may be imposed on shareholders and certain unsecured creditors by one of two means: either through their remaining in a failed FI, whilst some or all of its assets are transferred elsewhere, or by the writing-down of their claims and any subsequent conversion into equity in bail-in. It is important that the resolution authority has the ability to impose losses as described, as it ensures that these are borne (as would be the case in liquidation) by the shareholders and unsecured creditors of a failed FI rather than by public funds.
279. As noted in paragraph 184, resolution has the potential to be less value destructive than liquidation and so it is possible, even in cases where the resolution authority has departed from the principle of equal treatment of creditors within the same class, for all creditors to be better off than would have been the case in liquidation. In other cases, however, shareholders and certain unsecured creditors could be

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<sup>118</sup> Where the residual FI enters into a winding-up process, these returns would be a function of the net proceeds from the transfer as well as those generated by the disposal of other assets and their distribution to each class of liability holders according to their position in the creditor hierarchy.

made worse off by a particular approach to resolution as compared with liquidation. In the approach to resolution described in paragraph 275, for example, where retail deposits are transferred along with higher-quality assets of an equivalent, or nearly equivalent amount, to another FI, the creditors remaining in the failed FI in liquidation (with the lower-quality assets) effectively subsidise the depositors whose deposits have been transferred. The lower-quality assets may not be sufficient to meet the claims of the unsecured creditors remaining in the failed FI *to the same extent* as would have been the case had the entire FI entered liquidation. Any overall shortfall between the assets and liabilities of the failed FI, which would have been shared equally among depositors and other unsecured creditors had the FI been liquidated in its entirety, will be borne exclusively (as a result of resolution) by the creditors remaining in the residual entity.

280. To correct for this effect, Key Attribute 5.2 says that “[c]reditors should have a right to compensation where they do not receive at a minimum what they would have received in a liquidation of the firm under the applicable insolvency regime”; as noted in paragraph 12, this is increasingly known as the “no creditor worse off than in liquidation” (or NCWOL) safeguard. Absent such a mechanism, providers of funds to an FI (i.e. its creditors) will have no way of estimating their likely “loss given default” (LGD)<sup>119</sup> in a resolution scenario. They may, therefore, become unwilling to provide funds in future or would, at the very least, expect to be compensated for the increased uncertainty about the losses they might face in a resolution scenario. This may have implications for FIs’ funding costs and market efficiency.
281. The authorities therefore intend to give careful consideration as to how a compensation mechanism for parties affected by resolution could be structured most effectively, to meet the requirements of the Key Attributes. Proposals for this mechanism will be set out in the second stage consultation.
282. It is recognised that the compensation mechanism will need to be suitably independent and provide affected parties with a right of appeal. Consideration will be given to a model where an independent valuer is appointed and affected parties are given the right to appeal a valuation. It is noted that the intention would be for

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<sup>119</sup> LGD is a measure of loss in the event of counterparty default. It is often measured as a percentage of the actual losses (net of any credit protection (e.g. collateral)) against the total exposure to the defaulting party.



the valuation to be carried out as soon as reasonably practicable after the resolution action has been effected and with reference to the date of resolution. There will be a need to consider how compensation is calculated, and in particular the difference between the dividend received in resolution and the value of the property affected absent resolution. Consideration will be given also to setting high-level principles to guide the valuation process. In cases where, for example, an FI received extraordinary support (such as lender-of-last-resort funding) prior to resolution (or where the creditors claimed any expectation of future support) it would be desirable from a public policy perspective to disregard this.

283. In a majority of the selected jurisdictions (Australia, Switzerland, the UK and US) resolution regimes establish the right of parties affected by resolution to compensation (as do the EU RRD proposals). In most cases, the exact mechanism (and methodology) for assessing compensation will be specified at a later date (for example, by means of secondary legislation or guidance). The UK's resolution regime does however provide for the appointment of an independent valuer to determine compensation due and specifies that the dividend received in resolution must be compared with that which it is assessed would have been received had the failed FI immediately entered liquidation (with any extraordinary public support being disregarded).<sup>120</sup> Hong Kong has some experience in this regard, as acquisition ordinances passed to take several (failing) local banks into government ownership in the mid-1980s provided for compensation mechanisms for the shareholders of those banks.<sup>121</sup>

284. If it is determined that compensation is due to certain parties affected by resolution, a means of funding this will be needed. Alternative sources of funding are considered at the end of this Chapter.

### **Question 27**

**Do you agree that a compensation mechanism is a necessary safeguard to ensure that shareholders and creditors are no worse off under resolution than they would have been in liquidation? Do you have any views on the factors which should be taken into account in designing such a compensation mechanism?**

<sup>120</sup> The NCWOL mechanism provided for in the UK under the Banking Act 2009, as well as under the temporary legislation which preceded it, has been used several times.

<sup>121</sup> See Box C, Chapter 1 for details.

## Protecting client assets

285. Key Attribute 4.1 says that “[t]he legal framework governing...the segregation of client assets should be clear, transparent and enforceable during a crisis or resolution of firms, and should not hamper the effective implementation of resolution measures”. This is considered to be a necessary precondition to help ensure that client assets held directly or indirectly by an FI entering resolution can be either rapidly returned to investors or transferred to an acquiring FI or bridge institution so as to be able to provide (close to) uninterrupted access to the assets as well as any associated financial services.
286. Under 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.<sup>122</sup> The framework under which they are protected may be described as being a “trust regime” whereby “client securities”<sup>123</sup> and “client money”<sup>124</sup> placed with an LC are held on trust for clients and are required to be held in segregated accounts.<sup>125</sup> 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<sup>126</sup> do not apply to “client money” held by an AI.
287. It is not currently proposed that changes be made to the existing framework for protecting client assets, although in the course of refining the proposals for the resolution regime, it may become apparent that some adjustments are either desirable or necessary so as to ensure that client assets can be adequately protected, and transferred if necessary, to effect resolution.

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<sup>122</sup> The definition of client assets under the SFO appears to be in line with the FSB consultative document (see Footnote 21 for reference) which provides that client assets typically include: (i) money entrusted to or received by a firm on behalf of a client; (ii) financial instruments entrusted to or received by a firm on behalf of a client; (iii) client collateral, that is, assets received from a client and held by a firm for or on behalf of the client to secure an obligation of the client (other than under a transaction where title to the assets is transferred to the firm); and (iv) assets arising from transactions entered into by a firm on behalf of a client.

<sup>123</sup> As defined under Schedule 1 to the SFO.

<sup>124</sup> As defined under Schedule 1 to the SFO.

<sup>125</sup> IOSCO provides further detail on the various types of client asset protection regimes in different jurisdictions in its March 2011 report “Survey of Regimes for the Protection, Distribution and/or Transfer of Client Assets: Final report”, <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD351.pdf>

<sup>126</sup> The Securities and Futures (Client Money) Rules (Cap. 571I) do not apply to client money of an LC that is in a bank account established and maintained by a client of the LC in its own name.

**Question 28**

**Do you consider that any adjustments are needed to the existing framework for protecting client assets for the purposes of resolution?**

**Protecting other types of financial arrangement**

288. It is important that resolution authorities have sufficient discretion to make decisions about how to split up the balance sheet of a non-viable FI, determining which parts of the business to transfer and which to leave behind, in cases where it is neither feasible nor desirable to stabilise the FI in its entirety. At the same time, it is recognised that this creates potential for contractual rights and obligations which collectively constitute “financial arrangements”, to be separated from one another or dealt with in a way that undermines the economic purpose of those financial arrangements.
289. In some cases, these financial arrangements may have been designed, and may be relied upon, by market participants to limit their exposure to loss in the event of the failure of an FI which is their contractual counterparty. This would be the case where creditors have sought to protect themselves through security arrangements or where counterparties have sought to do likewise through set-off and netting arrangements. In the absence of any safeguard, and given the potential for resolution (particularly where it involves partial transfers of business) to undermine such arrangements, market participants would not be able to rely on these risk mitigation techniques to provide the same degree of protection in resolution as in liquidation. In turn, to compensate for the additional uncertainty created by the prospect of resolution, the price of debt or other financial contracts issued by FIs to, or entered into by FIs with, third parties may increase. Furthermore, if actual treatment in resolution were to deviate from expectations it could be detrimental to financial stability through, for example, contagion.
290. Recognising this, 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”. Consideration is being given, therefore, to identifying those “financial arrangements” in use in Hong Kong which may need to be protected. There is a need to strike an appropriate balance as the greater the restrictions imposed on the resolution

authority, the more the obstacles to carrying out a successful resolution increase, including because the share of an FI's balance sheet over which the resolution authority is able to exercise resolution powers will shrink. It is also noted that the time and resources needed to plan for resolution protecting those arrangements may increase, and of course will depend on FIs being able to provide the necessary information on the constituent parts of relevant "financial arrangements" in a timely manner (see Chapter 8 for proposals regarding the information needed to support the planning for, and carrying out of, resolution).

291. Taking into account the financial arrangements identified in Key Attribute 4.1, as well as those afforded protection in other jurisdictions, consideration is being given to providing safeguards in respect of the following:
- Secured (or collateralised) arrangements: under which creditors seek to protect themselves under an agreement which allows them to take or retain ownership of assets in the event that a debt owed to them is not repaid (or on other contractually defined enforcement events);
  - Set-off and netting arrangements: under which counterparties seek to mitigate credit risk by calculating and setting-off amounts owed to each other under one or more contracts to produce a single net sum;
  - Title transfer arrangements: which similarly seek to mitigate credit risk by linking an obligation to repay one or more debts with an obligation of the lender to redeliver collateral;
  - Structured finance arrangements: which comprise a collection of separate contracts, each of which is required for the arrangement to operate as a whole (in Hong Kong, this might include securitisation programmes, for example, where the liabilities of the programme are "secured" against a collateral pool);
  - Rules and arrangements within trading, clearing and settlement systems: which are designed to minimise the effect of a participant's default, such as those relating to settlement finality, transfer orders or processes to be observed on the default of a participant.
292. The exact list will require further consideration, but it is proposed that a safeguard should be provided which restricts the use of resolution powers in a manner that effectively undermines the purpose and economic effect of the types of financial

arrangements to be protected. In the majority of cases, this likely implies a need to ensure that the relevant assets and liabilities, legal rights and obligations, are kept together in any resolution, with all being transferred (or not), and that contracts underpinning the arrangements be maintained (and not modified or terminated).

293. Faced 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. In some cases the resolution authority may be able to restore the protected financial arrangement by carrying out a further transfer that reverses the original transfer. An alternative approach, in relation to set-off and netting arrangements, would be 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.
294. This approach to protecting specified financial arrangements of the types outlined above is similar to that provided for under the UK resolution regime as well as the proposals set out in the EU RRD.

### **Question 29**

**What types of “financial arrangements” do you consider as important to protect in resolution? Why is it important that those arrangements be protected?**

295. It is noted that beyond those financial arrangements identified for protection, it is unlikely that the resolution authority would choose to set off assets and liabilities relating to an individual customer where these arise simply because the customer relies on an FI for a range of financial services. Although these sorts of claims would be set off in liquidation,<sup>127</sup> doing so in resolution could render some forms of resolution unviable (potentially undermining efforts to secure continuity of critical financial services and protect financial stability). In particular, it is important that the resolution authority retains sufficient flexibility to transfer retail deposits to a willing acquirer without being under any obligation to transfer or otherwise set off those deposits against loans which depositors may have from the FI.

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<sup>127</sup> Pursuant to the mandatory set-off rules under section 35 of the Bankruptcy Ordinance (Cap. 6) as applied to companies pursuant to section 264 of the CO.

## **Safeguarding other parties**

### *Employees*

296. As outlined in Chapter 1, because resolution seeks to stabilise and secure the continued operation of some or all of a failing FI's activities, it is likely to better protect the employees of the FI as compared with liquidation. Some resolution options may result in all of a failing FI's employees enjoying continuity of employment, on the same terms and conditions, either within the same FI or a successor FI.<sup>128</sup> This is in contrast to liquidation where, because the FI's business will cease and its activities will be wound-up, most employees could expect to have their contracts terminated. In the event it is only possible to continue some of a failing FI's activities in resolution, an acquiring FI will likely want to retain those employees who support the carrying on of such activities. At the same time, employees who have claims on the residual FI, including those who are not transferred would retain the existing rights and protections currently provided for employees of companies that enter into liquidation. In Hong Kong, this would mean that such employees retain the preference given to parts of their claims under the CO and their ability to apply to the Protection of Wages on Insolvency Fund Board for payment within the specified limits.

### *Resolution authority and its staff*

297. Key Attribute 2.6 requires 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.” Otherwise, concern over potential liability under legal action could effectively constrain the resolution authority from taking and acting to implement difficult decisions which would otherwise be in the public interest. The same issue may arise in relation to parties that the resolution authority chooses to appoint to act on their behalf (e.g. an administrator as mentioned in paragraph 247).

298. Accordingly it is proposed that protection from civil liability be provided to the resolution authority and its officers, employees and agents for anything done, or

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<sup>128</sup> This would be likely in cases where either the entire FI is transferred to an acquiring FI or where bail-in restores the viability of the failing FI.

omitted to be done, by them in good faith in the exercise of their resolution functions. Pursuance of such functions is a legitimate aim and the immunity would not be absolute but would be restricted to actions and omissions taken “in good faith” in the performance of resolution functions. This proposal is consistent with the position which currently exists for the regulatory authorities in Hong Kong vis-à-vis their duties under their respective governing ordinances. Each of the MA, SFC and IA have protections under the BO, SFO and ICO respectively, providing indemnity or immunity from legal liability for acts or omissions taken in good faith in the exercise of their functions.<sup>129</sup> Such protections are also consistent with requirements set under other international standards.<sup>130</sup>

299. Further consideration will be given to the need to extend immunity to foreign resolution authorities or their officers who provide information or take actions in support of Hong Kong resolution proceedings, subject to the existence of an acceptable degree of reciprocity as assessed by the resolution authority in Hong Kong. This should incentivise (or at least remove a disincentive) for overseas resolution authorities to provide assistance to Hong Kong. Such an extension would entail consideration of any constitutional implication.

*Directors and officers of a failed FI*

300. Furthermore, Key Attribute 5.3 requires that the “[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”. It is clearly intended that the safeguard should extend solely to protection from civil liability in relation to actions taken in good faith to comply with the decisions or instructions of the resolution authority. Absent such protection, directors and officers may be unwilling to support the resolution authority in its efforts to carry out resolution or may insist on negotiating personal indemnities before doing so. This could act as a serious impediment to the timely execution of resolution, given that the resolution authority is likely to rely, to some

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<sup>129</sup> See, for example, section 127 of the BO; section 380 of the SFO; and section 55A of the ICO.

<sup>130</sup> Core Principle 2, Essential Criteria 9, of the “Core Principles for Effective Banking Supervision” published by the Basel Committee on Banking Supervision in September 2012, states, for example, that “laws provide protection to the supervisor and its staff against lawsuits for actions taken and/or omissions made while discharging their duties in good faith. The supervisor and its staff are adequately protected against the costs of defending their actions and/or omissions made while discharging their duties in good faith”. See: <http://www.bis.org/publ/bcbs230.pdf>

degree, on these parties to implement it. It is proposed therefore that under the resolution regime directors and officers of an FI be protected in this regard but not in respect of other actions or indeed failures to act.

**Question 30**

**Do you agree that, in order to ensure resolution can be effected as swiftly as needed, there should be protection from civil liability for: (a) officers, employees and agents of the resolution authority, and (b) directors and officers of FIs acting in compliance with the instructions of the resolution authority, limited to cases where these parties are acting in good faith?**

**Legal remedies and judicial action**

301. In order to secure close to uninterrupted provision of critical financial services and to protect financial stability more generally, Key Attribute 5.4 says that “[t]he resolution authority should have the capacity to exercise the resolution powers with the necessary speed and flexibility, subject to constitutionally protected legal remedies and due process”. This implies that consideration should be given to ensuring that an appropriate balance is struck such that legal remedies and due process are recognised and protected but do not unduly hinder the swift deployment of resolution powers to achieve the resolution objectives which are considered to be in the public interest.
302. Additionally, Key Attribute 5.5 says 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”. This implies that it is necessary to stay any actions by affected parties which could 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.
303. It also implies 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. Such appeals might, for



example, be made to an independent tribunal whose members may have a blend of judicial and insolvency / resolution expertise. How to make appropriate provision in this regard will be further considered (alongside consideration of the provision of an appeals process for NCWOL decisions (see paragraph 282)).

### **Safeguarding the integrity of financial markets**

304. Key Attribute 5.6 says 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”.
305. Listed corporations in Hong Kong are subject to certain disclosure requirements, in order to maintain fair, orderly and efficient financial markets, under the SFO,<sup>131</sup> takeover provisions in the Code on Takeovers and Mergers (Takeovers Code)<sup>132</sup> and the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited established by HKEx (Listing Rules).<sup>133</sup> Under these requirements, a listed FI which is failing and aware that steps are being taken to prepare for its resolution, or a listed FI which is seeking to acquire some or all of the failing FI’s business, may feel obligated to disclose that information. Any such disclosure could, however, undermine prospects for orderly resolution by damaging confidence and triggering a run on the failing FI before the resolution authority is ready to resolve it.
306. Further consideration will be given to the full set of disclosure requirements and the extent to which and how best to provide temporary exemptions from, or a postponement of, them in resolution. Ahead of doing so, it is noted that several precedents exist; for example, section 307D of the SFO already contains a number of “safe harbours” from disclosure requirements arising under section 307B of Part XIVA of the SFO. These safe harbours include, similarly on financial stability grounds, where a listed LB has received liquidity support in Hong Kong from the

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<sup>131</sup> See Part XIVA of the SFO.

<sup>132</sup> See General Principle 6 of “The Code on Takeovers and Mergers”, [http://www.sfc.hk/web/EN/pdf/sfcRegulatoryHandbook/EN\\_H622.pdf](http://www.sfc.hk/web/EN/pdf/sfcRegulatoryHandbook/EN_H622.pdf)

<sup>133</sup> See Chapters 13, 14 and 14A of the “Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited”, [http://www.hkex.com.hk/eng/rulesreg/listrules/mbrules/Documents/consol\\_mb.pdf](http://www.hkex.com.hk/eng/rulesreg/listrules/mbrules/Documents/consol_mb.pdf)

Exchange Fund or the LB, or another group company, has received liquidity support from an overseas central bank. Furthermore, under section 307F, the SFC may make rules to prescribe circumstances in which the disclosure requirements under section 307B would not apply.

307. It is noted that Key Attribute 5.6 says that any exemption from, or postponement of, disclosure requirements should be temporary. Therefore the authorities will seek to ensure that an FI which is resolved (and which remains a listed corporation) or an acquiring FI (which is a listed company) will again become subject to standard disclosure requirements as soon as is reasonably possible after initiating resolution.
308. For similar reasons to those discussed in paragraph 300, it may also be necessary to provide safeguards, such that directors and senior management of the FI should not face regulatory or legal action where the act of not disclosing inside information/price sensitive information or not complying with false market disclosure obligations was taken in good faith and at the instruction of the resolution authority.
309. Amongst the selected jurisdictions, the EU RRD establishes that the public disclosure of any pre-resolution marketing exercise<sup>134</sup> (which would otherwise be required under the Market Abuse Directive (MAD)) can be delayed by an FI, which would otherwise be under the obligation to disclose.<sup>135</sup> The UK resolution regime, after implementation of the EU RRD, will also operate under this framework.

### **Safeguarding public funds**

310. It will be apparent from earlier sections of this consultation paper that a central motivation for the new standards set out in the Key Attributes, and for establishing

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<sup>134</sup> A pre-resolution marketing exercise would be used to assess the market appetite for acquiring some, or all, of the failing FIs business, including all critical financial services.

<sup>135</sup> See European Council text of the EU RRD, Article 33(2), see Footnote 28 for reference, and EU Directive 2003/06/EC, Article 6(1), <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2003:096:0016:0025:EN:PDF>. It is noted that the MAD also provides for a temporary exemption from disclosure requirements where doing so might prejudice the FI's interests (see EU Directive 2003/06/EC, Article 6(2)) and a further EU directive identifies a non-exhaustive list of the "legitimate circumstances" under which this might apply; see EU Directive 2003/124/EC, Article 3, [http://www.esma.europa.eu/system/files/MADImplDir\\_2003\\_124.pdf](http://www.esma.europa.eu/system/files/MADImplDir_2003_124.pdf)

a resolution regime, is that it should support the orderly resolution of failing FIs in a manner which better protects not only financial stability but also public funds. As summarised in paragraph 271, a resolution regime provides the means by which the costs of failure, and of resolution, can be imposed on the shareholders and creditors of the failed FI rather than ultimately being picked up by the public purse.

311. At the same time, it is however recognised that it may not (and indeed likely will not) be possible to conduct all stages of resolution without the resolution authority having at least some temporary access to public funding. This may be necessary to provide short-term liquidity to support continuation of the activities of the FI around the time of the resolution (given market sources of funding for the FI may have dried up). Additionally, the effect of the NCWOL safeguard outlined in paragraph 280 is that the creditors of the failed FI can ultimately only be called upon to contribute to the costs of resolution up to the point to which they would have borne losses had the FI instead been liquidated in its entirety. There may be cases where the costs of resolution exceed those which can be borne (on a NCWOL basis) by a failing FIs' creditors.
312. Recognising this, 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”. It is therefore considered necessary to make some provision for such recoveries and Key Attribute 6.3 says that “[j]urisdictions should have in place privately-financed deposit insurance or resolution funds, or a funding mechanism for *ex post* recovery from the industry of the costs of providing temporary financing to facilitate the resolution of the firm”.
313. Further consideration will be given as to how such recoveries could be made under the resolution regime proposed for Hong Kong and firmer proposals will be set out in the second stage consultation. Ahead of doing so, and to inform the debate about the most appropriate approach locally, the approach taken across other FSB member jurisdictions is briefly summarised below.

314. It is relatively common for a contribution to the costs of resolution to come from one or more protection schemes established to protect depositors, investors or insurance policyholders.<sup>136</sup> The maximum contribution which such schemes can make may be tied to an estimate of the (sometimes net) outlays that would have been faced had an FI instead entered liquidation. It is noted that the existing DPS and ICF, and planned PPF, could not be called on to make a meaningful contribution to the costs of resolving a large and complex FI currently and it is not proposed they should be called upon as a source of resolution funding in Hong Kong.
315. There is increasing discussion internationally on the merits of establishing separate resolution funds (built up over time through levies on FIs). This approach has the benefit of ensuring that any FI which goes on to fail has previously contributed to the fund (helping to reduce the extent to which “survivors pay”). To the extent that FIs are also required to pay risk-based levies into any such fund, it may incentivise individual FIs to mitigate the risks posed by their own activities and so help to lean against moral hazard. It is noted that only a handful of jurisdictions have chosen to establish such funds so far, but it might be anticipated that others will follow (under the EU RRD, for example, member states would be required to do so).
316. As noted by the Key Attributes, a further option would be to provide a mechanism for the recovery of the net costs arising in any resolution from surviving FIs, once it is apparent precisely how much needs to be recouped. However, if this approach were relied upon solely, the failed FI would not have made any upfront contribution to the fund nor would there be an opportunity to impose a risk-based levy. Greater reliance would also have to be placed on there being a reliable source of temporary financing (given a standing fund would not be maintained). This model has been adopted in the US under the Orderly Liquidation Authority provided for under the Dodd-Frank Act. It is noted that an ex post levy on the industry was also used to recover costs incurred by the Hong Kong Government for the failure of the futures exchange and clearing house in 1987.<sup>137</sup>

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<sup>136</sup> The FSB’s Thematic Review on Resolution Regimes reported that this was the case in 18 out of 24 FSB member jurisdictions in relation to one or more sectoral protection schemes. See Footnote 13 for reference.

<sup>137</sup> Repayment was made through a transaction levy on the Hong Kong Futures Exchange, a special levy on the Hong Kong Stock Exchange and from payments and recoveries from defaulting market participants. See Footnote 16 for reference.

317. In practice, it is possible that some combination of these approaches could be adopted, for example, allowing for a call on a resolution fund and then, to the extent necessary, allowing for an additional ex post levy on the industry to recoup any additional costs. The most appropriate approach (single or combination) will be further considered and proposals will be set out in the second stage consultation.

**Question 31**

**What provisions should be made under the regime to fund resolution, with a view to ensuring that any call on public funds is no more than temporary?**

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

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

### **Challenges of cross-border coordination**

318. The decades preceding the global financial crisis saw a rapid growth in the globalisation of finance. Cross-border capital flows increased significantly and global FIs expanded their operations in, and thereby helped to create interdependencies between, growing numbers of jurisdictions. Legal and policy frameworks capable of supporting the resolution of FIs whose failure might pose significant risks to financial stability in multiple jurisdictions did not develop at the same pace. Processes for dealing with failing FIs remained very much national, rather than international, concerns.
319. When a number of cross-border FIs failed in the last financial crisis, it became clear that there were significant obstacles to resolving them in a manner which protected financial stability across the various jurisdictions affected. Most lacked resolution regimes with the scope or powers necessary to resolve large and complex FIs, even where their operations were predominantly domestic. The challenges of resolving cross-border entities were greater still given that any existing powers had only domestic reach and little time had been spent considering whether and how home and key host authorities could coordinate and cooperate in deploying their respective powers to stabilise the constituent parts of a cross-border group.<sup>138</sup> As a result, some home authorities found themselves rescuing entire cross-border groups at substantial cost to their own taxpayers. In other cases, home authorities acted to stabilise only the local operations of a group, regardless of the effect on financial stability in host jurisdictions.

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<sup>138</sup> A review of obstacles to effective coordination in the resolution of cross-border banking groups can be found in the Basel Committee on Banking Supervision (March 2010) “Report and Recommendations of the Cross-border Bank Resolution Group”, <http://www.bis.org/publ/bcbs169.htm>

320. In the light of this experience, there is now a greater degree of consensus that the coordinated and cooperative resolution of a cross-border FI has the potential to better protect financial stability across home and host jurisdictions. Resolution planning work being carried out internationally to identify and agree approaches to resolution (or “resolution strategies”) for G-SIFIs, as required under the Key Attributes, suggests that such approaches could result in a significant share of a failing group’s activities being restored to a “going concern”; an outcome which could better preserve critical financial services and financial stability across multiple jurisdictions and preserve, rather than destroy, value. (The types of strategies being considered are summarised in Box I below).
321. An alternative model, where in a crisis home and host authorities take unilateral action designed to protect their own domestic interests, (including by ring-fencing local assets within each of their jurisdictions), has the potential to descend into a “run” on the group. This would likely precipitate a disorderly break-up and value destruction as significant parts of the business could become very much a “gone concern”. Furthermore, if prospects for a coordinated and cooperative solution appear low in advance of any actual failure, it is now much more likely that home, and some host, jurisdictions will seek to set prudential requirements designed to better protect their national interest in the event that a cross-border group fails. Requirements, for example, on global FIs to hold significantly more liquidity and capital in each jurisdiction would increase the costs of operating cross-border with potentially significant implications for economic development and growth.

**Box I: Resolution strategies**

Two (stylised) approaches to resolution are emerging from resolution planning work being carried out for each of the G-SIBs (as required under the Key Attributes).<sup>139</sup>

Under a “single point of entry” (SPE) approach, cross-border groups operating in a highly integrated manner might be resolved by a single resolution authority, probably in the home country, exercising powers in relation to the holding or parent company. Losses across the group could be absorbed and the group recapitalised through, for example, the write-down and bail-in of liabilities issued by a holding or parent company. If sufficient loss

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<sup>139</sup> See Footnote 87 for reference.

absorbency is available, operating subsidiaries could continue as going concerns securing continuity for most, if not all, of the group.

Under a “multiple point of entry” (MPE) approach, FIs with a decentralised structure (i.e. subgroups of relatively independent, separately capitalised and funded subsidiaries) might be resolved through resolution actions taken by two or more resolution authorities. This would likely result in the group being split on national, regional or functional lines. The options deployed in relation to the separate parts of the group could differ, with any combination of resolution options being deployed to achieve stabilisation or winding-up.

322. To avoid the sort of disorderly and costly break-up outlined in paragraph 321, the Key Attributes require that regimes encourage and support coordinated and cooperative approaches to resolution in a number of ways. The Preamble says that “[i]n order to facilitate the coordinated resolution of firms active in multiple countries, jurisdictions should seek convergence of their resolution regimes through the legislative changes needed to incorporate the tools and powers set out in these *Key Attributes* into their national regimes”. In other words, by ensuring that each national regime meets the same common standards, the deployment of common resolution tools in a coordinated manner should be feasible. Beyond this, Key Attribute 7.1 says that “[t]he statutory mandate of a resolution authority should empower and strongly encourage the authority wherever possible to act to achieve a cooperative solution with foreign resolution authorities”. Furthermore, Key Attribute 7.5 says that “[j]urisdictions should provide for transparent and expedited processes to give effect to foreign resolution measures”.

323. At the same time the importance of “reserving the right of discretionary national action if necessary to achieve domestic stability in the absence of effective international cooperation and information sharing” is recognised (Key Attribute 7.2). Whilst implementation of the Key Attributes should significantly improve the prospects for coordinated and cooperative cross-border action, there can be no guarantee that this will be forthcoming and workable in each and every situation. It may continue to be the case that individual jurisdictions lack the mandate, powers or incentives necessary to cooperate with their peers. Or the circumstances of a particular failure may be such that a coordinated resolution strategy, even one identified and agreed upon in advance, turns out not to be executable in practice.



324. In addition to requiring that member jurisdictions implement these aspects of the Key Attributes, the FSB has acknowledged a need to develop policy proposals “on how legal certainty in cross-border resolution can be further enhanced”; something it intends to do during 2014.<sup>140</sup> The results of this work will be taken into account in further refining the proposals for the Hong Kong regime, but set out below are some of the ways in which it appears that the local resolution regime could encourage and support coordinated resolution action where it is in the interests of Hong Kong to do so (whilst at the same time retaining flexibility for the resolution authority to take national action to safeguard the local interest where appropriate). It is noted that the resolution authority in Hong Kong will be acting as a host authority in a majority of these cases, given that a significant number of local FIs are subsidiaries or branches of foreign firms.

### **Supporting a coordinated approach to cross-border resolution**

325. As required by the Key Attributes, and proposed in this consultation paper, it is intended that the resolution regime for Hong Kong should meet the same common standards that other home and host jurisdictions are in the process of implementing. It is recognised that a coordinated approach to the resolution of a cross-border financial services group is only likely to be achievable where home and key host authorities ensure that all relevant FIs in each jurisdiction are within the scope of their resolution regimes with a full and comparable menu of resolution options and powers.

326. In a significant number of cases resolution planning is likely to confirm that G-SIFIs might best be resolved by means of an SPE approach to resolution, designed to stabilise most or all of the group’s global activities (see Box I above). It appears that in such cases, the home resolution authority will rely on the resolution authority in Hong Kong being able to exercise powers available under the local resolution regime in a manner that supports and gives effect to resolution being carried out at the group-level. This may be necessary, for example, to effectively enable the transfer of an entire FI, or some or all of its business, to a third party or bridge institution, where the business being transferred includes some combination

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<sup>140</sup> See Footnote 5 for reference.

of instruments of ownership, assets and liabilities and/or rights and obligations located in Hong Kong.

327. Absent an ability to make use of the local resolution regime to recognise and give effect to the actions of a home resolution authority, it may not be possible for the Hong Kong entities to be included in the group wide resolution designed to stabilise a cross-border group. Furthermore, the entry of a foreign parent company into a resolution process could trigger competing legal action in Hong Kong or the exercise of early termination, or cross-default, rights on a significant scale; something the local resolution authority would be unable to stay or resist. So whilst a group-level resolution could stabilise the majority of the cross-border group, there is a risk that the Hong Kong entities might instead enter a local liquidation process, which is likely to be unnecessarily value destructive. Furthermore, and as noted in paragraph 321, if a resolution regime in a host jurisdiction cannot be reliably deployed to support group-level resolution, some cross-border groups may begin to make, and home authorities might require, ring-fencing well in advance of any failure. Ultimately, there is a very real risk that this could mean that some groups reduce their footprint in such host jurisdictions pre-emptively.
328. The importance of being able to deploy the local resolution regime to support and give effect to a group-wide resolution is clear. However, it is clearly essential that any decision to use the local regime in this way should be contingent on an assessment, during the resolution planning phase and at the point of resolution, that a group-wide resolution is likely to deliver outcomes that are consistent with the objectives set for resolution locally (as outlined in Box F, Chapter 5).
329. Additionally, it would appear appropriate that before deciding to support resolution being carried out by a home resolution authority, the resolution authority in Hong Kong should be satisfied that local creditors will not be disadvantaged. This recognises that the legal frameworks in some foreign jurisdictions continue to give preference to creditors (including depositors, policyholders and other creditors) with local claims. This is not consistent with Key Attribute 7.4 which says that “[n]ational laws and regulations should not discriminate against creditors on the basis of their nationality, the location of their claim or the jurisdiction where it is payable”.

330. In order to ensure that the local resolution regime could be used to support resolution conducted by a home resolution authority in all likely scenarios, provision may be needed for the local regime to be initiated where either one or both of the conditions proposed for initiating resolution of the group’s local entities (as outlined in Box D, Chapter 5) *are not met locally*. 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.
331. As the conditions outlined in Box D, Chapter 5 would not be directly applicable, it is additionally proposed that the local resolution authority should be able to use the local resolution regime in cases where:
- a home resolution authority is initiating resolution in relation to a cross-border group whose Hong Kong operations are within the scope of the local regime; and
  - 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.
332. In cases where the resolution authority in Hong Kong is not satisfied that the group-wide resolution will meet the conditions in paragraph 331, but subject to the conditions outlined in Box D, Chapter 5 being met locally, it is clearly important that the resolution authority in Hong Kong retains the flexibility to deploy the powers available under the local regime to carry out resolution of the entities in Hong Kong directly. In line with the scope of the regime proposed in Chapter 4, the resolution authority would be able to act in relation to both locally-incorporated FIs and the branches of foreign FIs. It is proposed that guidance on use of the regime would note that where the local resolution authority plans to take “discretionary national action” in relation to the branch of a foreign FI, that “it should give prior notification and consult the foreign home authority” in line with Key Attribute 7.3.
333. In order to meet the requirements set by the Key Attribute 7.1 (outlined in paragraph 322), it proposed that the mandate for the local resolution authority should expressly permit and encourage cooperation with foreign counterparts on resolution matters. Additionally, consideration is being given as to whether, in line

with Key Attribute 2.3 (see paragraph 186), the resolution authority should be given an objective (or a function) to consider the potential impact of its resolution actions on financial stability in other jurisdictions. Such considerations would be relevant in cases where the resolution authority in Hong Kong is acting to support resolution being carried out by a home resolution authority as well as where it takes measures on its own initiative to protect local financial stability. It is not intended that this should result in the discretion of the local resolution authority to act in the domestic interest being restricted in any way. (Nor is it intended that it should place any undue burden on the local resolution authority in assessing the impact of its actions overseas).

334. The FSB identified in its Thematic Review on Resolution Regimes that “national legal frameworks for cross-border cooperation in resolution are, overall, less well-developed across all sectors than other areas of the KAs” and that “in most FSB jurisdictions, there are few or no relevant statutory provisions for coordination and cooperation for the effective resolution of cross-border firms”. Progress is gradually being made in addressing these gaps, however, and amongst the selected jurisdictions, the regimes in both Singapore and Switzerland provide for the resolution authority to support and give effect to resolution actions taken by foreign resolution authorities. It is anticipated that the EU RRD will require that all member states make provision for their domestic regimes to be used to recognise and enforce the actions of the resolution authorities in third countries where such actions support the objectives set for resolution under the RRD in the EU member state locally. It is noted, however, that it is expected that EU member states would only be mandated to consider the impact of their resolution actions on financial stability in other member states. Other jurisdictions are likely to strengthen these cross-border arrangements also, given that group-level resolution planning is identifying inadequate provision in this regard as an obstacle to the orderly resolution of cross-border FIs.

**Question 32**

**Do you agree that it is important that the resolution regime in Hong Kong 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?**

### **Question 33**

**Do you agree that the model outlined in paragraphs 331 to 333 to support and give effect to resolution actions being carried out by a foreign home resolution authority would be effective in supporting coordinated approaches to resolution where it is in the interests of Hong Kong to do so?**

#### **Information sharing**

335. In order both to plan for, and carry out, the resolution of an FI which operates across multiple sectors of the local financial system or in a number of different jurisdictions, it is essential that all of the authorities with a role to play in resolution are able to exchange relevant information in a timely manner. 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. It is also important, therefore, that receiving authorities should be subject to appropriate safeguards to protect the confidentiality of the shared information.
336. Legal obstacles to effective information sharing for the purposes of resolution are often greater in a cross-border context. Whilst existing legal gateways for information sharing between regulators may support information sharing for supervisory purposes, they may not extend to resolution. Commonly, as yet, the conduct of resolution functions is not specified as a ground for information sharing, nor are resolution authorities specifically named as parties with whom non-public information can be shared. This can present obstacles not only in cases where an authority other than a supervisor is designated as the resolution authority in a jurisdiction (which as noted in Chapter 5 may occur) but also because it does not support information sharing with the wider set of authorities who may have a role to play in resolution. These parties would include central banks, finance ministries and public authorities managing resolution funds or protection schemes.
337. Constraints on timely information sharing in both normal times and times of crisis, may jeopardise the ability of the relevant authorities to take coordinated actions which could lead to better outcomes for all concerned. Indeed, the prospects for unilateral action, of the sort described in paragraph 321 above, are likely to be greater in cases where the necessary information sharing does not occur.

Recognising its fundamental importance, the Key Attributes are supplemented by a set of Principles on information sharing for resolution purposes. These Principles outline the need for legal gateways, designed to support resolution, to be established subject to adequate confidentiality arrangements being in place.<sup>141</sup>

338. The approach adopted in the Principles has broad similarities to the existing framework governing information sharing by the regulatory authorities in Hong Kong under their respective ordinances. The similarities include the promotion of legal gateways for information sharing by reference to the functions performed by the recipients; the imposition of conditions by reference to the confidentiality obligations governing recipients; and the protection from liability of those providing the information in accordance with the legal gateways. These types of provision have worked satisfactorily in Hong Kong to date and, accordingly, it is proposed that a similar set of information sharing powers should be afforded to the resolution authority in Hong Kong. The powers would:

- permit disclosure of information by the resolution authority to other domestic and foreign authorities: (i) which themselves have functions relating to resolution; and (ii) where the information is necessary for the recipient authority to carry out specific functions relating to the resolution of an FI to which the information pertains. It is further proposed that a broad interpretation should be given as to which parties are “authorities with functions relating to resolution” such that it can extend beyond pure resolution authorities to include supervisory authorities, central banks, ministries of finance and public bodies administering resolution funds and protection schemes. This recognises the differences in the way resolution regimes are structured across jurisdictions and that authorities in addition to designated resolution authorities may also have important roles to play in resolution;
- require disclosure of information to be made conditional upon the recipient authority being subject to adequate confidentiality safeguards that are appropriate to the nature and the level of sensitivity of the information;
- allow the local resolution authority to impose conditions upon the recipient authority restricting onward disclosure of any information provided which

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<sup>141</sup> See Footnote 22 for reference.

pertains to an individual FI. For example, a condition could be imposed to the effect that onward disclosure may only be permitted with the “prior approval” of the resolution authority in Hong Kong;

- allow the resolution authority to take into account the extent to which the jurisdiction of a potential recipient authority has comparable legal gateways permitting disclosure to the resolution authority in Hong Kong and to other authorities with resolution functions in Hong Kong (i.e. to take into account how far there is a degree of “reciprocity” between the relevant jurisdiction and Hong Kong).

339. From the perspective of the resolution authority in Hong Kong as the recipient of information from overseas (and domestic) authorities, it is proposed that:

- the resolution authority and its current and former officers, employees and agents: should be made subject to legal requirements that they preserve the confidentiality of information received; will be required to restrict the use of information received to the purposes for which it is supplied; will be able to refuse to disclose information received (unless disclosure is otherwise required by law) to third parties where that disclosure has not been authorised by the providing authority; and will be subject to effective sanctions and penalties for breach of confidentiality requirements;
- the resolution authority and its current and former officers, employees and agents will be protected against criminal and civil actions for breach of confidentiality based on their disclosure of information if the disclosure was made in accordance with the legal gateways.

340. In addition to information sharing between authorities in support of coordinated resolution actions, another important aspect of information flows relates to the provision of relevant information by FIs. Planning for, and carrying out, resolution will require that FIs be able to produce the necessary information, in a sufficiently timely manner (e.g. the constituent parts of protected financial arrangements as noted in paragraph 290, details of liability structure, balance sheet valuations). This may, in turn, mean that FIs will need to invest resources in developing and maintaining the capacity to produce such information. As such, it is proposed that the local resolution regime should provide powers enabling the resolution authority

to require FIs to provide such information as the resolution authority considers reasonably necessary for resolution purposes, either periodically or in response to a request of the resolution authority, and to do so within a timeframe specified by the resolution authority.

**Question 34**

**Do you consider that the powers proposed regarding information sharing strike an appropriate balance in terms of facilitating information sharing for resolution in both in a domestic and cross-border context whilst also ensuring that all reasonable steps are taken to preserve confidentiality?**



## ANNEX: CONSULTATION QUESTIONS

### Question 1

**Do you agree that a common framework for resolution through a single regime (albeit with some sector-specific provisions) offers advantages over establishing different regimes for FIs operating in different sectors of the financial system? If not, please explain the advantages of separate regimes and how it can be ensured that these operate together effectively in the resolution of cross-sectoral groups.**

### Question 2

**Do you agree that it is appropriate for all LBs to be within the scope of the regime (given it would only be used where a non-viable LB also posed a threat to financial stability)? If not, what other approaches to the setting of the scope of the regime, which ensure that all relevant LBs are covered, should be considered?**

### Question 3

**Do you agree that it is appropriate for all RLBs and DTCs to be within the scope of the regime (given it would only be used where a non-viable RLB or DTC posed a threat to financial stability)? If not, what other approaches, which would ensure that all relevant RLBs and DTCs are covered, should be considered?**

### Question 4

**Do you agree that it would be appropriate to extend the scope of the proposed resolution regime to FMIs which are designated to be overseen by the MA under the CSSO (other than those which are owned and operated by the MA) and those that are recognized as clearing houses under the SFO?**

### Question 5

**Do you agree that it is appropriate to set the scope of the regime to extend to some LCs?**

### Question 6

**If so, and in order to capture those LCs which could be critical or systemic, should the scope be set with reference to the regulated activities undertaken by LCs? Are the regulated activities identified in paragraph 144 those that are most relevant? Is there a case for further narrowing the scope through the use of a minimum size threshold?**

### Question 7

**Do you agree that the scope should extend to LCs which are branches or subsidiaries of G-SIFIs? Do you see 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?**

#### **Question 8**

**Do you agree that it would be appropriate to extend the scope of the proposed resolution regime to the local operations of insurers designated as G-SIIs and/or IAIGs as well as those insurers which it is assessed could be critical or systemically important locally were they to fail?**

#### **Question 9**

**Do you agree that branches of foreign FIs should be within the scope of the local resolution regime such that the powers made available might be used to: (i) facilitate resolution being undertaken by a home authority; or (ii) support local resolution?**

#### **Question 10**

**Do you see any particular issues that need to be taken into consideration in ensuring that the regime can be deployed effectively in relation to branches of foreign FIs where necessary?**

#### **Question 11**

**Do you agree that extending the scope of the proposed resolution regime to cover locally-incorporated holding companies is appropriate such that the powers available might be used where, and to the extent, appropriate to support resolution of one or more FIs?**

#### **Question 12**

**Do you have any initial views on whether it is appropriate to extend the scope of the regime to affiliated operational entities to help ensure that they can continue to provide critical services to any FIs which are being resolved?**

#### **Question 13**

**Do you agree that the conditions proposed for initiating resolution are appropriate in that they will support the use of the regime in relevant circumstances?**

#### **Question 14**

**In particular, do you agree that it is appropriate that the first condition recognises that non-viability could arise on financial *and* non-financial grounds (noting that resolution could occur only if the second financial stability condition is also met)?**

#### **Question 15**

**Are the objectives which it is proposed should be set for resolution suitable to guide the delivery of the desired outcomes?**

#### **Question 16**

**Do you agree that, in line with their existing statutory responsibilities and supervisory intervention powers, the MA, SFC and IA should be appointed to act as resolution authorities for the FIs under their respective purviews?**

#### **Question 17**

**Do you have any views on how a resolution option allowing compulsory transfer of all or part of a failing FI's business could most effectively be structured and used?**

#### **Question 18**

**Do you have any views on how a resolution option allowing compulsory transfer of part of a failing FI's business to a bridge institution could most effectively be structured and used?**

#### **Question 19**

**Do you have any views on the factors which should be taken into account in drawing up proposals for the provision of a bail-in option for the resolution regime in Hong Kong?**

#### **Question 20**

**Do you agree that there is a case for including a TPO option in the proposed regime?**

#### **Question 21**

**Do you have any views on when it would be appropriate to make temporary use of an AMV in order to manage the residual parts of an FI in resolution?**

#### **Question 22**

**Do you have any views on how best to provide for a stay of early termination rights where these might otherwise be exercisable on the grounds of an FI entering resolution or as a result of the use of certain resolution options?**

#### **Question 23**

**Do you have any views on how best to provide the supervisory or resolution authorities with powers to require that FIs remove substantial barriers to resolution?**

#### **Question 24**

**Is the proposed approach to ensuring that third parties cannot act to pre-empt the resolution of a non-viable FI (including by means of a petition to initiate a winding-up) appropriate?**

### **Question 25**

**Do you have any views on how provision might be made to ensure that the residual part of an FI could be called on to temporarily support a transfer of business to another FI or bridge institution (in the manner described in paragraph 266)?**

### **Question 26**

**Do you attach any priority to pursuing reforms designed to ensure that the claims of protected parties (particularly those of depositors and investors) can be transferred out of liquidation proceedings, alongside those reforms being pursued to establish an effective resolution regime?**

### **Question 27**

**Do you agree that a compensation mechanism is a necessary safeguard to ensure that shareholders and creditors are no worse off under resolution than they would have been in liquidation? Do you have any views on the factors which should be taken into account in designing such a compensation mechanism?**

### **Question 28**

**Do you consider that any adjustments are needed to the existing framework for protecting client assets for the purposes of resolution?**

### **Question 29**

**What types of “financial arrangements” do you consider as important to protect in resolution? Why is it important that those arrangements be protected?**

### **Question 30**

**Do you agree that, in order to ensure resolution can be effected as swiftly as needed, there should be protection from civil liability for: (a) officers, employees and agents of the resolution authority, and (b) directors and officers of FIs acting in compliance with the instructions of the resolution authority, limited to cases where these parties are acting in good faith?**

### **Question 31**

**What provisions should be made under the regime to fund resolution, with a view to ensuring that any call on public funds is no more than temporary?**

### **Question 32**

**Do you agree that it is important that the resolution regime in Hong Kong 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?**

**Question 33**

**Do you agree that the model outlined in paragraphs 331 to 333 to support and give effect to resolution actions being carried out by a foreign home resolution authority would be effective in supporting coordinated approaches to resolution where it is in the interests of Hong Kong to do so?**

**Question 34**

**Do you consider that the powers proposed regarding information sharing strike an appropriate balance in terms of facilitating information sharing for resolution in both in a domestic and cross-border context whilst also ensuring that all reasonable steps are taken to preserve confidentiality?**