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Consultation on Resolution Regime for Financial Institutions (including Financial Market Infrastructures) in Hong Kong

On 7 January 2014, the Hong Kong Monetary Authority ("**HKMA**"), Securities and Futures Commission ("**SFC**") and Insurance Authority ("**IA**") launched a 3-month consultation on establishing an effective resolution regime for financial institutions ("**FIs**"), including financial market infrastructures ("**FMIs**"). The proposed regime seeks to bring Hong Kong in line with the standards set in the "Key Attributes of Effective Resolution Regimes for Financial Institutions" ("**Key Attributes**") by the Financial Stability Board ("**FSB**").

Key Takeaways on the Resolution Regime Proposals:

- The new cross-sectoral resolution regime will cover all authorised institutions, certain licensed corporations, certain insurers and certain financial market infrastructures. The new regime augments the existing corporate insolvency process for FIs.
- Where a failing FI is assessed to be non-viable and poses a threat to financial stability, resolution authorities will be given wide powers to implement a range of resolution options to secure continuity for critical financial services and to protect financial stability.
- The ability to wind up a failing FI would be affected as any winding-up petition will be stayed for a limited period of time pending a decision by the resolution authority whether to initiate resolution.
- Resolution authorities may depart from *pari passu* treatment of creditors of the same class where justified by the objectives for resolution, subject to certain safeguards.
- Resolution authorities may temporarily stay early termination rights triggered by resolution.
- Secured or collateralized arrangements, set-off and netting arrangements, title transfer arrangements, structured finance arrangements and rules and arrangements within trading, clearing and settlement system relating to a participant's default will be protected.

Contents

Why does Hong Kong need a resolution regime?

Following the global financial crisis, it was recognised that the failure of large and interconnected FIs or FMIs had the potential to cause significant disruption throughout the financial system, thus undermining the effective functioning of the economy. At the same time, the use of public funds to rescue such institutions put public resources under financial strain. Recognising that a traditional insolvency regime has limitations in dealing with institutions the failure of which may pose a systemic risk, an international consensus was reached that a regime should be developed under which significantly important FIs should be allowed to fail in an orderly manner that does not impact financial stability, while at the same time preserving critical business functions.

To whom is the resolution regime proposed to apply?

A single cross-sectoral resolution regime (with some sector-specific provisions) is proposed covering:

- *all authorized institutions*: These would cover licensed banks, restricted licence banks and deposit-taking companies;
- *certain licensed corporations*: These would include licensed corporations which provide certain critical financial services or relevant activities on a material scale, or which are related to the 29 Global Systemically Important Financial Institutions identified by the FSB. The SFC defined the most relevant regulated activities as: (i) dealing in securities or futures contracts; (ii) asset management; and (iii) dealing in OTC derivatives or acting as a clearing agent for OTC derivatives. Licensed corporations undertaking at least one of these regulated activities would come under the regime, subject to a minimum size threshold to be decided on a later date. Licensed corporations which are branches or subsidiaries of Global Systemically Important Financial Institutions, or part of wider financial services groups, are also covered, regardless of whether these groups operate locally or cross-border;
- *certain insurers*: These would cover local operations of any Global Systemically Important Insurers and Internationally Active Insurance Groups with a presence in Hong Kong and insurers which are assessed could be systemically significant or critical locally were they to fail; and
- *certain FMIs*: These would include FMIs designated under the Clearing and Settlement Systems Ordinance or recognised as clearing houses under the Securities and Futures Ordinance ("**SFO**").

The Hong Kong resolution regime is proposed to be extended to cover local branches of foreign FIs to give effect to resolution by the home resolution authority or to support a local resolution of a branch. The regime proposes to allow resolution powers to also be used in relation to locally incorporated holding companies of FIs (even where they are not themselves authorised or licensed under the local regulatory framework) to support the resolution of

FIs, and potentially also affiliated operational entities to help ensure that they can continue to provide critical services to any FIs subject to resolution.

When will the resolution regime apply?

It is proposed that the resolution regime would be used as a last resort, if (i) an FI's or FMI's non-viability (due to financial or non-financial reasons) is assessed to no longer meet the minimum regulatory requirements to which it is subject and there is no reasonable prospect of other action (outside of resolution) being able to bring it back into compliance within a reasonable timeframe, and (ii) resolution will contain risks posed to financial stability and secure continuity for critical financial services.

Resolution can be initiated against a locally incorporated holding company if the non-viability and financial stability conditions outlined above are met in relation to FIs within the group and resolution should be undertaken at the holding company level.

In the case of a failing cross-border FI, even where these conditions are not met by its local branch or subsidiary, the resolution powers can also be invoked if the home authority's resolution proposal is assessed as being consistent with the objectives for resolution and not disadvantageous to local creditors.

Who are proposed to be the resolution authorities?

Sectoral regulators (HKMA, SFC and IA) would act as resolution authorities for FIs under their respective purviews. A lead resolution authority will coordinate resolution where a failing FI operates across multiple sectors.

What are the objectives of resolution?

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.

What are the proposed resolution options?

It is proposed that Hong Kong should provide for the full menu of resolution options set out in the Key Attributes. Proposed resolution options include:

- *Compulsory transfer of business to another FI*: This involves the compulsory transfer of all or parts of the business of a failing FI to another FI. In order to implement this, the resolution authority is proposed to have the power to determine which parts of the business are to be transferred and whether to effect the transfer through a transfer of shares in or assets and liabilities of the failing FI to the acquirer, and to carry out the above without the need for shareholders' consent or other affected parties. It is anticipated that shareholders would remain shareholders of the failing FI and would enjoy rights only over the residual part of the failing FI that had not been transferred

including the net proceeds of the transfer. The outcome for creditors of the FI will depend largely on whether the failing FI's business is fully transferred to a new FI or whether only a partial transfer is possible. It is unclear from the consultation paper how any compulsory transfer as part of a resolution would be reconciled with the current deposit protection scheme and the regime under the Transfer of Business (Protection of Creditors) Ordinance (Cap. 49) (which allows creditors to claim against the transferee of the business).

- *Use of a bridge institution*: This option may be used where it is not possible to find an immediate acquirer for the failing FI. This option involves a compulsory transfer of business, as a temporary arrangement, to a temporary bridge institution. The bridge institution is proposed to be in a form and purpose to be determined by the resolution authority. The resolution authority is to be given powers to transfer parts of the failing FI to the bridge institution in the manner described in 'Compulsory transfer' above. The bridge institution will continue to carry on the transferred activities until a more permanent solution is implemented e.g. transfer back to the private sector or winding up.

- *Statutory bail-in*: resolution authorities would be able to write down shareholders and certain unsecured creditors in a way that generally respects the hierarchy of claims in liquidation, and to effect a debt-for-equity swap on certain unsecured creditors. The authorities seek views as to whether a holding company should be included in the bail-in and what liabilities should be excluded from the bail-in. The consultation paper recognises that this approach is consistent with the approach taken internationally and does not set out detailed proposals. Instead, detailed proposals will be set out in the second stage consultation.

- *Temporary public ownership* ("**TPO**"): A TPO option may allow the government or resolution authority greater ability to restructure the failing FI and to make changes in how the FI is structured and operates. As compared with a publicly-funded rescue, TPO can be designed to ensure that losses can be imposed on shareholders and perhaps certain unsecured creditors to a certain extent. However, as this option involves the use of public funds, it should be used as a last resort if other options will not adequately protect financial stability and the risks posed to financial stability are very significant.

- *Transfer to an asset management vehicle* ("**AMV**"): Although the non-critical activities of a failing FI would normally be resolved through liquidation, the authorities consider that in some cases, certain residual parts of a failing FI's business (e.g. where a fire sale of its asset portfolio may be unduly value destructive) may need to be managed by an AMV controlled by the resolution authority for a period of time until they can eventually be sold or wound-up in an orderly manner. Shareholders and creditors of the failed FI may receive an equity stake

in the AMV so that the risks associated with such assets remain with them.

- *General resolution powers*: The resolution authority is to be given general resolution powers to take control of and manage the failing FI, including by exercising the powers of its directors and shareholders.

Is there proposed to be a general moratorium on entry into resolution? How does resolution fit in with existing corporate insolvency options?

There is not proposed to be any general moratorium upon entry into resolution whether automatically or at the discretion of the resolution authority as this would not be conducive to securing continuity of critical financial services and protecting financial stability.

To preserve the ability of resolution authorities to carry out an orderly resolution, it is proposed that any person intending to petition for the winding-up of an FI within the scope of the regime should have to notify resolution authorities before winding-up proceedings are commenced (the authorities are also considering if this needs to apply to other restructuring or insolvency proceedings). The resolution authority should be permitted a set period of time (e.g., 14 calendar days) to decide whether to initiate resolution. Any petition presented during that period should be stayed until that period expires. Once a decision has been taken to initiate resolution, the resolution authority will need to act quickly (e.g., over a weekend) to implement the relevant resolution option(s).

Would creditors be ranked differently in resolution as compared to liquidation?

In principle, the resolution authorities are to exercise their powers in a way that respects the hierarchy of creditor claims that apply in a liquidation. However, the resolution authorities are proposed to have the flexibility to depart from *pari passu* treatment of creditors of the same class where such a departure is justified by the objectives for resolution.

Whilst the authorities are of the view that, in general, resolution is superior to liquidation since the former may be less value-destructive and is likely to cause less disruption to the financial system, they recognise that certain safeguards should be put in place to protect the interests of all stakeholders. These include the requirement that resolution should provide outcomes for stakeholders, including depositors, investors and insurance policyholders, that are at least equal to what would have been afforded to them if an FI has entered liquidation. A mechanism to compensate creditors for any losses they might suffer over-and-above those they might have sustained in liquidation (the “no creditor worse off than in liquidation” safeguard) is proposed to be introduced.

How are client assets held by an FI entering resolution protected?

The consultation paper does not propose any changes to the existing framework under the SFO for protecting client assets, although in the course

of refining the proposals for the resolution regime, certain adjustments might be deemed necessary. The ultimate aim is ensuring that client assets held by an FI entering resolution can be either returned to the clients quickly, or transferred to an acquiring FI or bridge institution, in order to limit interruption to access to the assets.

Will the proposed resolution regime affect early termination rights?

It is recognised that the ability of the resolution authority to carry out an orderly resolution may be compromised if counterparties had an unfettered right to trigger early termination, acceleration or other close-out rights. It is hence proposed that entry into resolution and exercise of any resolution powers should not trigger statutory or contractual set-off rights or constitute an event that entitles any counterparty of the failing FI to exercise contractual acceleration or early termination rights, provided that the substantive obligations under the contract continue to be performed. So where there is a transfer to an acquirer or a bridge institution or a bail-in, it is proposed that parties will not be able to exercise early termination rights solely on the ground of resolution, but counterparties remaining in the residual part of a failed FI would be able to exercise their early termination rights.

Resolution authorities in Hong Kong are proposed to be given a power to temporarily stay termination rights. The Government has asked for views on how best to provide for such a stay. Detailed proposals will be set out in the second stage consultation. The consultation paper refers to the Key Attributes which provide that a 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 but subject to the conditions that: (i) it should be limited in time, (ii) it should be used where authorities are required to transfer all eligible contracts and not cherry pick between individual contracts with the same counterparty subject to the same netting agreement, (iii) early termination rights are preserved following transfer in case of subsequent independent default by the acquiring entity, (iv) close out should be permitted on expiry of stay or earlier if contracts will not be transferred and (v) counterparty/FMI will have the immediate right to early terminate if a failing FI fails to meet margin, collateral or settlement requirements in relation to its participation in an FMI.

Will the proposed resolution regime affect security, set-off or netting arrangements?

The authorities recognised that certain financial arrangements may be undermined by resolution (particularly partial transfers of business). Such arrangements are:

- secured or collateralized arrangements;
- set-off and netting arrangements;
- title transfer arrangements;
- structured finance arrangements; and

- rules and arrangements within trading, clearing and settlement system relating to participant's default e.g. settlement finality, transfer orders or default management process.

Consideration is being given to protecting such arrangements and restricting the use of resolution powers which could effectively undermine the purpose and economic effect of such arrangements. It is envisaged that this would normally require keeping the relevant assets and liabilities, rights and obligations together in a resolution and maintaining the related contracts (without modification or termination). In the event that the safeguard is breached, corrective action could be taken to restore the protected financial arrangement (e.g. reversing a transfer or allowing set-off or netting).

The authorities noted that beyond these protected arrangements, a resolution authority may not set-off assets and liabilities of an individual customer which arise from using a range of financial services of the failing FI (unlike the case of a liquidation when set-off would be mandatory). This allows the resolution authority to retain the flexibility to implement a partial business transfer or an asset transfer without being obliged to set-off against obligations arising from other parts of the business of the failing FI. Therefore, set-off/netting agreements would become more important from the point of view of a counterparty who wishes to ensure that its set-off/netting arrangements with an FI would be preserved in the event of a resolution of the FI.

How will any resolution be funded?

The consultation paper states that further consideration will be given as to how resolutions will be funded, with more concrete proposals to be set out in the second stage consultation. However the approach taken is likely to be guided by the FSB's Key Attribute 6.3, which says that "jurisdictions 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." Any future proposals are also likely to be informed by (and be a combination of) the approaches taken in other FSB member jurisdictions, such as:

- *Establishing a separate resolution fund, built up through levies on FIs*: The consultation paper states that 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"). It may also incentivise FIs to mitigate risks posed by their activities. However only a handful of jurisdictions have chosen to establish such funds so far, but there might be more to come – for example, under the EU Recovery and Resolution Directive, member states would be required to do so.
- *The recovery costs to be borne by surviving FIs*: However, under this approach, 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. This model has been adopted in the US under the Dodd-Frank Act. It was 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.

The authorities however do not propose that the existing Deposit Protection Scheme and Investor Compensation Fund, and the planned Policyholders' Protection Fund, should be used as a source of resolution funding.

International co-operation

The authorities consider that the coordinated and cooperative resolution of a cross-border FI has the potential to protect financial stability in several jurisdictions. The authorities recognise the need for international co-operation and that it is important for the Hong Kong regime to meet the standards set internationally. It is proposed that the mandate for the local resolution authorities should expressly permit and encourage them to co-operate with their foreign counterparts, including a resolution authority in the home jurisdiction of the FI, on resolution matters. In some circumstances, this may necessitate triggering a resolution where not all the conditions for resolution have been met. At the same time, the resolution authority should be satisfied that local creditors will not be disadvantaged.

What next?

Comments on this consultation are due by 6 April 2014.

The current consultation is the first stage of a two-stage public consultation. A second stage consultation is scheduled for later this year after taking into account the comments received in the first stage. The second stage consultation will cover more specific details and the operation of the resolution regime e.g. structure and functioning of certain resolution options such as statutory bail-in powers and TPO, interface between corporate insolvency proceedings/other laws/securities regulations on the one hand and the proposed resolution regime on the other, compensation/right of appeal for creditors adversely affected by resolution, and suspension of creditor rights during initial stages of resolution.

The Government plans to introduce the legislative proposals into the Legislative Council in 2015.

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