For discussion
on 2 March 2015

Legislative Council
Panel on Financial Affairs

Second Stage of Public Consultation on Establishing an Effective Resolution Regime for Financial Institutions in Hong Kong

PURPOSE

This paper –

(a) seeks Members' views on the establishment of a cross-sector resolution regime for non-viable "too-big-to-fail" financial institutions[1] ("FIs") in order to enhance the resilience of the local financial sector and meet new international standards as set by the Financial Stability Board ("FSB"); and

(b) informs Members on the way forward.

BACKGROUND

2. During the recent financial crisis in 2008 and 2009, Governments in various jurisdictions spent unprecedented amounts of public money rescuing failing FIs. This has led to a series of international regulatory reform initiatives to enhance the resilience and stability of the financial system. One important initiative has been the setting of new international standards for effective resolution regimes by the FSB in its publication "Key Attributes of Effective Resolution Regimes for Financial Institutions" ("Key Attributes").[2] These

[1] For the purpose of this paper, the term "financial institutions" would include financial market infrastructures ("FMIs"), unless indicated otherwise.

[2] See FSB (2011), Key Attributes of Effective Resolution Regimes for Financial Institutions, http://www.financialstabilityboard.org/publications/r_111104cc.pdf. In October 2014 the FSB reissued the Key Attributes, incorporating guidance on their application to non-bank FIs. The Key Attributes themselves remain unchanged, but are now complemented by four new annexes covering: (i) Resolution of Financial Market Infrastructures (FMIs) and FMI Participants; (ii) Resolution of Insurers;

standards, which all FSB member jurisdictions are expected to meet by the end of 2015, require that public authorities be empowered to intervene to resolve FIs which become non-viable and whose failure, and entry into liquidation, would otherwise pose unacceptable risks both to customers relying on the critical financial services they provide as well as to wider financial stability. An effective resolution regime should provide alternative means of containing these risks, whilst also ensuring that the costs of failure (and resolution) can be imposed more effectively on the failing FI's shareholders and creditors rather than being met by public funds.

3. While each of the financial regulatory authorities in Hong Kong currently has a range of supervisory intervention powers for dealing with distressed FIs, there are significant gaps compared to the powers stipulated by the FSB for an effective resolution regime. This was confirmed by the International Monetary Fund ("IMF") in its assessment of Hong Kong's crisis management arrangements during the Financial Sector Assessment Program ("FSAP") in 2014, where the IMF concluded that steps to bridge the gaps should be considered a short-term priority.[3] Enactment of a new Bill will be required to establish an effective resolution regime and provide resolution authorities with the range of powers envisaged by the Key Attributes.

PUBLIC CONSULTATION

4. A first stage public consultation paper ("CP1") was launched in January 2014 with a three-month consultation period to April 2014. Over 30 submissions were received in response from the industry and the public. We also met with a number of trade bodies, professional associations and LegCo Members during the consultation period to listen to their views. The majority of respondents agreed that the proposed

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(iii) Client Asset Protection in Resolution; and (iv) Information Sharing For Resolution Purposes. See FSB (2014), http://www.financialstabilityboard.org/2014/10/r_141015/

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

reforms were important for Hong Kong's financial markets. Furthermore, many respondents stressed that Hong Kong, as a major financial centre, should implement a resolution regime meeting the standards set out in the Key Attributes in order to support coordinated and cooperative approaches to the resolution of cross-border FIs.

5. Much of the feedback focused on how best to implement the standards locally and we have duly considered the comments in further refining the proposals as summarised in the second stage consultation paper ("CP2") issued on 21 January 2015. The consultation paper can be downloaded from the website of the Financial Services and the Treasury Bureau[4], as well as from the websites of the Hong Kong Monetary Authority ("HKMA") (www.hkma.gov.hk), Securities and Futures Commission ("SFC") (www.sfc.hk) and Insurance Authority ("IA") (www.oci.gov.hk). Paragraphs 6 – 31 below outline the conclusions from CP1 and details of some of the proposals included in CP2.

MAJOR PROPOSALS

Scope

6. The Key Attributes require that any FI "which could be systemically significant or critical if it fails" should be within the scope of an effective resolution regime. It is proposed that the scope of the local regime will extend to certain FIs based on an assessment of the risks that could be posed to the continuity of critical financial services and financial stability should they fail. While the primary focus in assessing the risks that might be posed by failure of FIs in each of the key sectors of the financial system is the local impact, the authorities[5] also acknowledge that fully implementing the Key Attributes implies setting the scope of the local regime to extend to FIs operating in Hong Kong that are part of cross-border groups (particularly those identified, as part of the FSB-led process, as being global systemically important financial institutions "G-SIFIs"). On these grounds it is proposed that scope would extend to:

[4] http://www.fstb.gov.hk/fsb/ppr/consult/resolutionregime.htm

[5] For the purpose of this paper, "the authorities" refers to the Financial Services and the Treasury Bureau, HKMA, SFC and IA collectively.

(a) all authorized institutions ("AIs") within the meaning of the Banking Ordinance (Cap. 155);

(b) most FMIs[6] designated under the Clearing and Settlement Systems Ordinance (Cap. 584) ("CSSO") and clearing houses [7]recognized under the Securities and Futures Ordinance (Cap. 571) ("SFO");

(c) certain licensed corporations ("LCs") (that is, from among LCs as defined in section 1 of Part 1 of Schedule 1 to the SFO); and

(d) certain insurers (that is, from among insurance undertakings that may conduct insurance business in Hong Kong by virtue of section 6(1) of the Insurance Companies Ordinance (Cap. 41)).

7. The majority of respondents agreed with the proposal in CP1 of setting a broad scope in relation to the banking sector, recognizing that the failure of even a relatively small bank could pose systemic risk through contagion in stressed conditions. The proposal of covering all AIs inside the scope of the regime is in line with that taken in jurisdictions such as the European Union ("EU"), including the United Kingdom ("UK"), Singapore and the United States ("US").

8. There was also broad consensus among respondents to CP1 on extending the scope of the resolution regime to FMIs designated under the CSSO[6] and clearing houses recognized under the SFO in light of their critical role in supporting payments, clearing and settlement in the Hong Kong markets. This accords with FSB guidance on the implementation of the Key Attributes in respect of FMIs, which clarifies that "[t]he presumption is that all FMIs are systemically important or critical, at least in the jurisdictions where they are located". Certain jurisdictions, including Singapore and the UK have brought systemically important or all domestic FMIs within scope of resolution regimes.

[6] Other than those which are owned or operated by the HKMA.

[7] The term "clearing house", as defined in the Securities and Futures Ordinance ("SFO"), includes securities settlement systems and central counterparties.

9. In this second round of consultation, we are consulting the public additionally on whether the scope of resolution regime should be extended to exchange companies recognized under the SFO that are considered systemically important to the effective functioning of the Hong Kong financial markets and, to this end, it is proposed that there will be an assessment and designation process by the SFC based on objective criteria to identify such systemically important recognised exchange companies. It should be noted that the Key Attributes do not require exchanges to be subject to resolution regimes. Although exchanges do not face the same credit and default risks similar to those associated with central counterparties, the price discovery and risk transfer functions which they perform are critical to the efficient and orderly functioning of financial markets. Depending on the market structure, the failure of an exchange could have a significant impact on financial markets, e.g. when the exchange is the only exchange for that particular market. Hence, taking into account the local market structure, in the unlikely event that a systemically important exchange were to fail, it would be prudent and pragmatic to have resolution powers over them to facilitate orderly resolution. Otherwise, to let them become insolvent could result in serious disruption to the financial markets concerned.

10. CP2 proposes a more selective approach to setting the scope in relation to insurers and LCs (in light of the assessed risks that any failure of FIs in these sectors could pose). Although some respondents questioned whether insurers could be considered to pose systemic risk, there is now international agreement on a process for designating global systemically important insurers ("G-SIIs"). For insurers, it is proposed that the local branches and subsidiaries of those insurers identified by the FSB as G-SIIs and those insurers which it is assessed[8] could be systemically significant or critical locally on failure would be captured in scope. The EU is considering implementation in relation to insurers, but resolution regimes in Singapore and the US extend to all insurers and systemically important insurers respectively.

[8] In order to identify any insurers that may pose risk in a local context, reference will be made to the G-SIIs assessment methodology developed by the International Association of Insurance Supervisors and the guidance on identification of critical functions and critical shared services to be finalized by the FSB. The insurance-specific factors for considering local systemic importance may include, among others, size, interconnectedness, market share/concentration, substitutability and any other factors that the IA deems appropriate.

11. As for LCs, work is continuing at the international level to identify non-bank non-insurer ("NBNI") G-SIFIs. In the meantime, CP2 confirms the intent for the scope of the resolution regime to extend to LCs which are to be designated as NBNI G-SIFIs by FSB; and those which are subsidiaries or branches of G-SIFIs, or groups containing G-SIFIs. All, or a broad set, of investment firms are within scope of regimes in the EU and Singapore, whilst in the US only those designated ex ante as systemically important are covered.

12. It is also proposed that branches of overseas FIs operating in Hong Kong should be captured, in line with the way in which the scope of the regime is set for each sector,[9] with a view to ensuring that the local resolution authority could support a cross-border resolution being led by an overseas resolution authority while maintaining the ability to act independently to protect local stakeholders and local financial stability should that become necessary. Finally, the orderly resolution of one or more "in scope" FIs may be dependent on the resolution authority being able to undertake resolution at the level of a locally incorporated holding company[10] or to secure, from affiliated operational entities, continued provision of essential services (such as information technology) and CP2 outlines proposals to empower the resolution authority to take such action where justified.

13. It should be noted, however, that scoping in the FIs as mentioned above does not imply that they would be automatically resolved if they become non-viable, but resolution would rather be conditional upon an assessment of the risks posed at the point of failure (see paragraph 16 below). Also, the authorities are inclined to consider that the regime should provide the Financial Secretary ("FS") with a power to designate other FIs (not initially covered by the regime) as being within its scope where it is considered that systemic disruption could result were such other FIs to become non-viable.

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[9] That is, all AIs operating as branches would be within scope, whilst only those LCs which are branches of G-SIFIs, or groups containing G-SIFIs, and those insurers which are branches of G-SIIs would be within scope.

[10] Where a holding company owns a number of "in scope" FIs and it is assessed that it is more appropriate to carry out a single resolution of these entities through action initiated at the level of the holding company or where one or more "in scope" FIs 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.

Governance arrangements

14. It is proposed that each of the regulators, namely the HKMA, the SFC and the IA, be designated as the resolution authority responsible for exercising the resolution powers available under the regime in relation to the FIs or FMIs they respectively regulate or oversee. Performing a resolution function is consistent with the existing mandates of the regulators, given that these already reflect a need to seek to secure a measure of protection for certain parties (depositors, investors (in so far as client assets are concerned) and insurance policy holders) as well as the stability and effective working of parts, or all, of the financial system. A majority of the respondents to CP1 preferred this model over an alternative one, whereby a new single standalone cross-sector resolution authority would be established.

15. If several regulators are to be designated respectively as resolution authorities, and in light of the requirements of the Key Attributes, there is a clear need for a lead resolution authority ("LRA") to co-ordinate resolution in cases where a failing FI or its group operates in multiple sectors of the local financial system. In this regard, it is proposed that the FS be empowered, following a recommendation based on the sectoral regulatory authorities' assessment of the relative systemic importance of the FIs in the group, to designate (once the legislation has passed) one of the regulators to act as an LRA for each cross-sector group containing multiple FIs. The LRA would be responsible for consulting and coordinating with the other sectoral resolution authorities to plan for and achieve an orderly resolution of the FIs in the group, and would also assume an ultimate decision-making role in the event that a consensus could not be reached. Additionally, whilst the Key Attributes require that the resolution authority should be operationally independent in the role, under the local regime the resolution authority would be required to consult the FS ahead of initiating resolution of a failing FI. This reflects similar requirements under the existing ordinances governing the MA and the SFC whereby they consult the FS before exercising certain powers available to them.

16. As mentioned at paragraph 13, resolution will not be triggered lightly or automatically when an FI becomes non-viable. The intention

with regard to the use of the regime is to set a high threshold such that the regime would only be used where an "in scope" FI is assessed to be non-viable, with no reasonable prospect of timely recovery again, and that resolution will serve to contain risks posed by its non-viability to the continuity of critical financial services and the wider financial system. There was relatively broad support for this approach among respondents to CP1, and for the proposed objectives to be met by the resolution authority when using the available powers to carry out an orderly resolution.[11]

Resolution powers of the resolution authorities

17. There was a high degree of consensus amongst respondents to CP1 that the local resolution regime should provide the full menu of resolution options, required under the Key Attributes, which allow a resolution authority to step in and take prompt and decisive actions to stabilise and restructure an entire FI, or key parts of its business, without the consent of shareholders and creditors. These options, designed to deliver continuity of the critical financial services provided by an FI and to protect wider financial stability, are –

(a) the compulsory transfer of ownership of a failing FI, or of some or all of its business, to one or more commercial purchasers willing and able to make such an acquisition and continue the relevant business;

(b) where a transfer as envisaged in (a) cannot be achieved immediately, through a transfer of some or all of the business of a failing FI to a "bridge institution", owned by the Government and controlled by the relevant resolution authority, so the business may continue in the immediate to short-term (and returned to the private sector subsequently);

[11] CP1 proposed that in exercising its powers the resolution authority should have regard to the following resolution objectives: (i) promote and seek to maintain the general stability and effective working of the financial system in Hong Kong, including by securing continued provision of critical financial services, including payment, clearing and settlement functions; (ii) seek an appropriate degree of protection for depositors, investors and policyholders; and (iii) subject to pursuing resolution objectives (i) and (ii), seek to contain the costs of resolution and, in so doing, to protect public funds.

(c) the compulsory transfer of some or all of the assets and liabilities of a failing FI to an "asset management vehicle", potentially owned by the Government and controlled by the relevant resolution authority, for their orderly wind-down or disposal over time;

(d) an officially mandated recapitalisation or "bail-in" to restore the viability of a failing FI.

18. Options (a)-(b) above have been either long available in certain jurisdictions (such as the US) or were introduced during the recent crisis (in the UK amongst other EU countries). Respondents to CP1 broadly agreed with the proposals on their local adoption. Following the crisis, there was an increasing recognition of the need to also make available a statutory "bail-in" option, in order to better ensure that resolution of the largest and most complex FIs is possible. Resolution planning for many global systemically important banks ("G-SIBs") identified by the FSB now envisages that resolution would be conducted by means of one or more bail-ins (at the level of the group holding company or one or more operating companies). In this context, the FSB is currently consulting on establishing common minimum requirements for G-SIBs in relation to minimum total loss absorbing capacity ("TLAC") to facilitate execution of bail-in.

19. Where the threat to financial stability is severe and where it is assessed that the other resolution options (outlined in paragraph 17 (a) to (d) above) cannot be used to safely resolve an FI, it is proposed that, as a last resort, it should be possible to take a failing FI into temporary public ownership. Some other jurisdictions have included a temporary public ownership option in their regimes (the EU, including the UK, has done so).

20. A series of supporting powers is needed to ensure that resolution through the means outlined above is feasible. One such power proposed, as is required by the Key Attributes, is to empower the resolution authority to require an FI to remove any substantive barriers to their orderly resolution (as identified through resolution planning and resolvability assessment) resulting from the way in which an FI is

structured and/or operates. CP2 outlines a framework for such powers and recognises the need to further consider how a right of appeal for FIs might be structured most effectively.

21. A further example of supporting powers is that it is proposed to make provision under the regime so that counterparties of an FI in resolution may not exercise early termination rights in financial contracts with that FI, solely on account of its entry into resolution (assuming the substantive obligations under the contract continue to be performed).[12] Where such early termination rights were nevertheless exercisable, it is proposed that the regime would empower the resolution authority to impose a temporary stay on them, subject to clearly defined safeguards, to provide the resolution authority with a short window to determine the form that resolution should take.

Safeguards

22. CP1 outlined how resolution is likely to better protect a broad set of stakeholders, including depositors, investors (in respect of client assets held with FIs) and insurance policyholders, as compared with liquidation, since it implies that some or all of the business of a failing FI undergoing resolution will be stabilised, restructured and continued. As such, resolution should deliver an outcome where some or all depositors and investors (in respect of client assets) have reasonably unaffected access to their accounts, funds and assets. Similarly, resolution may secure continuity of cover for some or all insurance policyholders.

23. At the same time, and because securing orderly resolution requires that action be taken quickly and decisively to secure continuity and financial stability, resolution authorities must necessarily be empowered to act in a manner that can affect contractual and property rights. There is therefore a clear need for checks and balances, both to safeguard the position of those affected by resolution as well as to reduce, to the extent possible, uncertainty about the outcomes that resolution will deliver.

[12] Absent such a power, the termination of large volumes of financial contracts could result in broader market instability as well as undermining the prospects for an orderly resolution of the failing FI itself.

24. It is proposed to set, as a guiding principle for use of the regime, a requirement that the resolution authority respect the statutory creditor hierarchy when imposing losses on the shareholders and creditors of an FI in resolution. Notwithstanding this, the Key Attributes recognise that if the resolution authority is not able to depart from the equal treatment of creditors, it may be unable, in certain circumstances, to carry out resolution in a way that best delivers against the objectives set. It is therefore proposed that the resolution authority be able to depart from the equal treatment of creditors in the same class in resolution, but only where that departure can be justified against the objectives for resolution.

25. CP1 also noted the need for a "no creditor worse off than in liquidation" safeguard as in certain circumstances some creditors of a non-viable FI could conceivably be made worse off by a particular approach to resolution as compared with the treatment they would have received had the FI otherwise entered liquidation.

26. More details in respect of a proposed mechanism to provide creditors with a right to compensation where they do not receive at a minimum in resolution what they would have received in liquidation of the FI in question are set out in CP2, including the appointment of an independent valuer to calculate any compensation due to affected parties in line with certain fundamental valuation principles designed to ensure a fair and consistent approach. Proposals for an appeals mechanism in this regard are also outlined.

Funding

27. An important motivation for establishing a resolution regime is that it provides a means (including through the proposed "bail-in" resolution option) by which the costs of failure and resolution can be imposed on the creditors and shareholders of a failing FI rather than on taxpayers.[13] At the same time, and to meet the requirements set by the Key Attributes in this regard, CP2 proposes that funding arrangements be

[13] Shareholders and creditors of a failing FI would absorb losses were the FI to enter liquidation, but as indicated in the background section, the risks of allowing a critical and systemic FI to fail in this way are high and so publicly-funded rescues (or bail-outs) were common during the recent (and indeed previous) crises.

established under the regime to recover, from the wider financial market, any excess resolution costs that cannot be imposed on or met by the failing FI (and its shareholders and creditors). In light of respondents' clear preference for levies to any such funding arrangement to be raised "ex post" in the last round of consultation, the authorities' current thinking is to proceed on this basis. In the US, the Orderly Liquidation Fund operates with an ex post funding model, whereas EU Member States are required to make ex ante provision (supplemented by powers to raise extraordinary ex post contributions)..

Legal framework conditions for cross-border cooperation

28. As demonstrated during the recent global financial crisis, the orderly resolution of systemically important cross-border FIs in a manner which protects financial stability across the various jurisdictions affected poses a significant challenge. Many jurisdictions lacked resolution regimes with the scope or powers needed to resolve large and complex FIs and too little time had been spent considering whether and how home and key host authorities could coordinate and cooperate in deploying their respective powers to stabilize the constituent parts of a cross-border group. When cross-border FIs got into difficulties, public authorities in home jurisdictions either found themselves rescuing the entire global group (via costly bailouts using public funds) or acted to stabilise only the local operations regardless of the effect on financial stability in host jurisdictions. The Key Attributes seek to provide for better outcomes if a cross-border FI ceases to be viable, including by ensuring that all home and key host jurisdictions adopt consistent resolution regimes and by securing enhanced coordination and cooperation in their deployment. It is important that Hong Kong, as a major international finance centre which hosts the operations of a large number of systemically important cross-border FIs,[14] secures, and is seen to secure, the necessary powers to enable the resolution authority to support cross-border resolution, in cases where providing such support is judged to be consistent with Hong Kong's legitimate interests.

[14] 29 out of the 30 G-SIBs and 8 out of the 9 G-SIIs identified by the FSB currently have operations in Hong Kong.

29. Work being carried out internationally to identify and agree approaches to the resolution of G-SIBs, which is also required under the Key Attributes, indicates that in many cases the most effective way of stabilising and securing continuity of their critical financial services could be a group-wide resolution (mostly by means of bail-in) carried out by the home jurisdiction and supported by key host jurisdictions. This approach has the additional benefit of reducing incentives for home and host jurisdictions to pre-emptively require that cross-border FIs make costly changes in advance of any failure, with a view to insulating operations in each jurisdiction from shocks elsewhere in the group and to ensure that they can be independently resolved.

30. On these grounds, the authorities consider it appropriate to allow for use of the local resolution regime in relation to the in-scope Hong Kong operation of a cross-border FI to recognize and/or support foreign resolution measures, conditional on an assessment that the outcomes delivered are consistent with the objectives set for resolution in Hong Kong and do not disadvantage local creditors relative to foreign creditors. Where these conditions are not met, the resolution authority in Hong Kong would retain the flexibility to use the powers available under the local regime to carry out resolution of local operations independently.

31. Work currently is on-going at the international level to provide guidance on how to implement the requirements of the Key Attributes relating to cross-border resolution.[15]

WAY FORWARD

32. As work is still continuing at the international level to provide guidance on how to implement certain aspects of the Key Attributes (i.e. establishing TLAC requirements to facilitate the execution of bail-in as

[15] FSB published a consultative document on cross-border recognition of resolution action on 29 September 2014. The consultative document proposes: (i) a package of policy measures and guidance consisting of some elements that jurisdictions should consider including in their statutory cross-border recognition frameworks in order to enable effective cross-border resolution as required by the Key Attributes; and (ii) contractual approaches to cross-border recognition that the FSB agreed to support and promote pending widespread adoption of comprehensive statutory frameworks. The consultation closed on 1 December 2014. FSB's target is to finalize guidance on core elements of statutory recognition frameworks by end-2015.

mentioned at paragraph 18 and mechanisms for the recognition of cross-border resolution actions and effective cross-border coordination), there may be a need to carry out a third, shorter, public consultation later this year. Subject to the outcome of the series of public consultations, we will endeavour to introduce legislative proposals into LegCo by the end of 2015.

ADVICE SOUGHT

33. Members are invited to comment on the proposal and note the way forward.

Financial Services and the Treasury Bureau (Financial Services Branch)
Hong Kong Monetary Authority
Securities and Futures Commission
Office of the Commissioner of Insurance
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