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**Paper for the House Committee**

**Report of the Subcommittee on Financial Institutions (Resolution)  
(Protected Arrangements) Regulation and Financial Institutions  
(Resolution) Ordinance (Commencement) Notice 2017**

**Purpose**

This paper reports on the deliberations of the Subcommittee on Financial Institutions (Resolution) (Protected Arrangements) Regulation and Financial Institutions (Resolution) Ordinance (Commencement) Notice 2017 ("the Subcommittee").

**Background**

2. During the financial crisis which began in 2007/2008, a number of governments around the world intervened to support their largest financial institutions ("FIs"), including by bailing FIs out with public money, in order to allow the financial system to continue to function. To reduce the impact of failure of systemically important FIs, the Financial Stability Board<sup>1</sup> has published the "Key Attributes of Effective Resolution Regimes for Financial Institutions" to establish new international standards for effective resolution regimes. These new standards require that public authorities be empowered to intervene to resolve FIs which become non-viable and whose failure would pose

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<sup>1</sup> Financial Stability Board ("FSB") was established in April 2009 to coordinate at the international level the work of national financial authorities and international standard-setting bodies and promote the reform of international financial regulations. Hong Kong is a member of FSB.

unacceptable risks to the continuation of critical financial services and wider financial stability. An effective resolution regime is an alternative to existing insolvency proceedings which are unsuitable for dealing with the failure of a systemically important FI. An effective resolution regime can contain these risks and ensure that the costs of failure and resolution are borne by the failing FIs' shareholders and creditors rather than being met by public funds.

3. The Legislative Council ("LegCo") enacted the Financial Institutions (Resolution) Ordinance ("FIRO") in June 2016 to provide for the legal basis for the establishment of a cross-sector resolution regime for within scope FIs in Hong Kong.<sup>2</sup> Under FIRO, the Monetary Authority ("MA"), the Securities and Futures Commission and the Insurance Authority are the resolution authorities ("RAs") to be vested with a range of powers necessary to effect the orderly resolution of a non-viable systemically important FI for the purpose of maintaining financial stability. There are five stabilization options that an RA may apply to a within scope FI in resolving the FI, namely transfer to a purchaser, transfer to a bridge institution ("BI"), transfer to an asset management vehicle, bail-in, and transfer to a temporary public ownership company. FIRO will come into operation on a date to be appointed by the Secretary for Financial Services and the Treasury ("SFST") (section 1(2) of FIRO).

### **Financial Institutions (Resolution) Ordinance (Commencement) Notice 2017**

4. The Financial Institutions (Resolution) Ordinance (Commencement) Notice 2017 ("FIRO (Commencement) Notice 2017") was made by SFST, pursuant to section 1(2) of FIRO, to appoint 7 July 2017 as the date on which all provisions of FIRO (except for Part 8 (sections 144 to 148), section 192 and Division 10 of Part 15 (sections 228 to 232)) will commence. Part 8 (sections 144 to 148) of FIRO relates to the clawback of remuneration including the application to the Court of First Instance for a clawback order under section 145. Section 192 relates to the presentation of a winding up petition of a within scope FI or a holding company of a within scope FI to the Court of First Instance. Division 10 of Part 15 (sections 228 to 232) relates to consequential amendments

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<sup>2</sup> Within scope financial institutions ("FIs") under the Financial Institutions (Resolution) Ordinance (Cap. 628) ("FIRO") include all authorized institutions, certain financial market infrastructures, certain licensed corporations, certain authorized insurers, certain settlement institutions and system operators of designated clearing and settlement systems, and recognized clearing houses. The scope of FIRO also extends to holding companies and affiliated operational entities of within scope FIs.

to the Insurance Companies (Amendment) Ordinance 2015 ("IC(A)O"). The Government has advised that Part 8 and section 192 should come into operation after the Chief Justice has made the relevant court rules. Regarding the consequential amendments made to IC(A)O in Division 10 of Part 15, as the relevant provisions of IC(A)O have come into operation on 26 June 2017 before FIRO will come into operation on 7 July 2017, those amendments have become obsolete. It is, therefore, not necessary to bring Division 10 of Part 15 into operation.

### **Financial Institutions (Resolution) (Protected Arrangements) Regulation**

5. Financial market participants rely on a variety of financial arrangements to both mitigate credit risk exposure to counterparties and provide sources of liquidity and financing. In turn, these arrangements are vital to the daily functioning of financial markets. Therefore, it is important to provide legal certainty that such financial arrangements will be protected to an appropriate degree when an entity is under resolution and that the economic purpose of the arrangements is not undermined. The six types of financial arrangements identified as protected arrangements under section 74 of FIRO are:

- (a) clearing and settlement systems arrangements;
- (b) netting arrangements;
- (c) secured arrangements;
- (d) set-off arrangements;
- (e) structured finance arrangements; and
- (f) title transfer arrangements.

6. Actions taken by an RA to effect a stabilization option may "split up" the assets, rights or liabilities constituting protected arrangements, thus adversely affecting the economic effect of such arrangements. The "split up" is likely to arise: (a) when an RA makes a partial property transfer<sup>3</sup> to transfer some, but not all, of an entity's assets, rights or liabilities to a third party; or (b) on bail-in where liabilities are written down and/or converted without taking into account linked

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<sup>3</sup> A partial property transfer is defined under section 74 of FIRO as a transfer by a property transfer instrument of some, but not all, of the assets, rights and liabilities of the transferor.

assets or rights entitled to be set off or netted under arrangements that are documented or otherwise evidenced in writing.

7. Section 75 of FIRO provides that SFST may, for safeguarding the economic effect of a protected arrangement in connection with the making of a regulated Part 5 instrument, make regulations prescribing requirements to be complied with by an RA. A regulated Part 5 instrument, as provided in section 74 of FIRO, means a Part 5 instrument<sup>4</sup> that: (a) results in a partial property transfer being effected; or (b) contains a bail-in provision.

8. The Financial Institutions (Resolution) (Protected Arrangements) Regulation ("PAR") is made by SFST under section 75(1) of FIRO setting out how an RA should treat each type of protected arrangement in resolution in order to safeguard the economic effect of the arrangement. PAR also identifies some limited and clearly specified exclusions of rights and liabilities from the scope of certain protected arrangements in order to provide flexibility for an RA to achieve orderly resolution (e.g. to be able to transfer certain critical liabilities such as deposits quickly and decisively in order to secure continuity of access for depositors). PAR further establishes the consequences should an RA inadvertently act in a manner inconsistent with the objectives of PAR. According to the Government, the approach to PAR is largely modelled on that adopted by the United Kingdom and that required by the European Union's Bank Recovery and Resolution Directive. PAR will come into operation on the day on which Part 5 of FIRO comes into operation, i.e. 7 July 2017 (see paragraph 4 above).

## The Subcommittee

9. At the House Committee meeting on 19 May 2017, Members agreed to form a subcommittee to study PAR and FIRO (Commencement) Notice 2017. Hon CHAN Chun-ying was elected Chairman of the Subcommittee. The membership list of the Subcommittee is at the **Appendix**. The Subcommittee has held two meetings with the Government to examine the two pieces of subsidiary legislation.

10. To allow more time for the Subcommittee to study PAR and FIRO (Commencement) Notice 2017, the Chairman moved a motion at the Council

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<sup>4</sup> Part 5 instrument means any of the following instruments made under Part 5 of FIRO :  
(a) a securities transfer instrument;  
(b) a property transfer instrument; and  
(c) a bail-in instrument.

meeting of 7 June 2017 to extend the scrutiny period for the two pieces of subsidiary legislation to the Council meeting of 5 July 2017. The motion was passed.

## **Deliberations of the Subcommittee**

11. The deliberations of the Subcommittee are set out in the ensuing paragraphs.

### Financial Institutions (Resolution) (Protected Arrangements) Regulation

12. The Government has advised that a two-month public consultation on PAR was conducted in November 2016. The Subcommittee has enquired about the major views from the respondents and whether the Government has taken into account such views in finalizing PAR.

13. The Government has pointed out that respondents to the consultation generally agreed with the approach to PAR proposed in the consultation paper and provided constructive, technical comments to enhance its efficacy. The financial industry had no negative feedback on PAR and did not envisage any practical difficulties in its implementation. Most of the comments received relate to the definitions of the terms used (e.g. financial contracts) and the scope of protection. The consultation conclusion, which sets out the Government's comprehensive responses to the comments received, was released on 6 April 2017.

### Financial Institutions (Resolution) Ordinance (Commencement) Notice 2017

#### *Protections for deposits under the Financial Institutions (Resolution) Ordinance*

14. The Subcommittee notes that one of the resolution objectives under section 8 of FIRO is to seek to protect deposits of a within scope FI to no less an extent than they would be protected under the Deposit Protection Scheme ("DPS") on a winding up of the FI (section 8(1)(b) of FIRO). The Subcommittee has enquired about the specific protections for deposits under FIRO.

15. The Government has advised that the specific protections include the following:

- (a) all deposits (irrespective of amount) falling within the definition of "protected deposit" under the Deposit Protection Scheme Ordinance

(Cap. 581) ("DPSO") are excluded from bail-in (section 2(b) of Schedule 5 to FIRO). All deposits held by restricted licence banks ("RLBs") or deposit-taking companies ("DTCs") that would be protected deposits if RLB or DTC were a Scheme member are also excluded from bail-in (section 2(c) of Schedule 5 to FIRO);

- (b) certain obligations to pay certain deposit liabilities<sup>5</sup> are excluded from a suspension of obligations that may be imposed by an RA under section 83(1) of FIRO (section 84(1)(a) and (b) of FIRO); and
- (c) in case a deposit transfer is made from a DPS member to another, the protection afforded to pre-existing protected deposits with a transferee would not be affected and a transferred protected deposit from the transferor would continue to be a protected deposit for six months or until its original maturity date (if later than six months of the transfer date) (section 12(2)-(6) of Schedule 4 to FIRO). Upon the transfer of a protected deposit, along with any accrued interest up to the date of transfer inclusive, which amounts altogether to say HKD X, there will be a temporary increase in the amount of protected deposits under DPS at the transferee for that deposit account from HKD 500,000 to HKD (500,000 + X) but capped at a maximum of HKD 1,000,000 (section 12(7) and (8) of Schedule 4 to FIRO).

*Continued coverage under the Deposit Protection Scheme Ordinance (Cap. 581) for protected deposits transferred*

16. Hon James TO has enquired how MA, as an RA, when resolving a failed bank, would transfer the deposits held by the bank and ensure continued protection for the transferred deposits under DPSO. He is particularly concerned that if the transferee of the deposits is not a bank or a member of DPS (e.g. the transferee is a private sector purchaser or BI that is not an authorized institution ("AI")), the transferred deposits may not be covered in the definition of "protected deposit" under DPSO. He has also enquired if the transferred deposits would be protected by DPSO in the event that such entity failed,

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<sup>5</sup> Section 84(1)(a) excludes from any suspension of obligations imposed by a resolution authority under section 83(1) an obligation to pay the whole or any part of a protected deposit; whilst section 84(1)(b) excludes from the same, for a financial institution that is exempt from section 12(1) of the Deposit Protection Scheme Ordinance (Cap. 581), an obligation to pay a deposit covered by a deposit protection scheme, or other scheme of a similar nature, that protects deposits taken by it at its Hong Kong offices.

particularly noting that the failed entity might not have made any contribution to DPSO.

17. The Government has explained that section 12(1) of the Banking Ordinance (Cap. 155) ("BO") provides that no business of taking deposits shall be carried on in Hong Kong except by an AI. Section 13(1) of BO provides that the Financial Secretary ("FS") may exempt any person or class of persons from the restriction in section 12(1). There are three types of AI, namely licensed banks (hereafter referred to as "banks"), RLBs and DTCs. Only banks may operate current and savings accounts, and accept deposits of any size and maturity from the public. RLBs and DTCs may only accept deposits of certain minimum high-values and are not primarily engaged in retail banking. Banks are members of DPS. RLBs and DTCs are not members of DPS.

18. According to the Government, in the event that MA transfers the deposit book of a failed AI, it will ensure that the deposits will only be transferred to an entity that is authorized to carry out deposit-taking business. MA will not transfer a deposit-taking business to an entity unless it is an AI because of the restriction under section 12(1) of BO. Practically speaking, in the event of the transfer of deposits of a bank, given the restrictions under section 12(1) of BO and the limitations of deposits that may be taken by an RLB or DTC, the transferee will have to be a bank. It will be an offence under section 12(6) of BO if the entity carries on deposit-taking business in Hong Kong without being authorized as an AI. The transferee of the failing bank's deposits can be a private sector purchaser that is already authorized as an AI, or a BI established to receive the transfer of deposits, which is also authorized to carry out deposit-taking business under BO. As required by section 43 of FIRO, the BI will have to be established as a company that is wholly or partially owned by the Government.

19. As regards Mr James TO's concern about the protection for the transferred deposits if the private sector purchaser or BI also fails and has not made contribution to DPS, the Government has explained that section 12 of DPSO provides that every bank is a member of DPS. Therefore, the private sector purchaser or BI, as a bank, is a member of DPS. Section 27 of DPSO specifies the entitlement to compensation in respect of protected deposits in the event that a DPS member fails. The transfer of deposits to the private sector purchaser or BI does not negatively affect the pre-existing protection afforded to the deposits under DPSO. The deposits transferred will still be subject to the same statutory protection under DPSO. The statutory protections under FIRO or DPSO for deposits transferred by MA to the private sector purchaser or BI, are not dependent on the entity having made any contributions to DPS as specified in section 15 of DPSO.

20. While section 12(1) of BO restricts entities from carrying on the "business of taking deposits" except AIs, Hon James TO is concerned that the "transfer of protected deposits" is not the same as "taking of deposits" and hence section 12(1) and (6) of BO may not be applicable. Besides, FS's power under section 13(1) of BO could override the restriction in section 12(1) and the transfer of deposits to a non-AI may be permitted. Mr TO has stressed the importance to include explicit provisions in FIRO stipulating that when MA effects a transfer of "protected deposits" of a failed DPS member, it must transfer those deposits to another entity that is authorized under BO and also a member of DPS. As an alternative, if such provisions could not be made in FIRO, he has suggested that the Government should introduce legislative amendments deeming the deposits transferred to a private sector purchaser or a BI as "protected deposit" under DPSO to achieve continuity of DPS coverage for such deposits. Specifically, Mr TO has requested the Administration to undertake that when resolving a failing bank, MA will only transfer the deposits to another bank, and will not invoke section 13(1) of BO; and that the relevant ordinances should be amended to address his concerns in a future legislative exercise. The Subcommittee has sought the Government's clarification on the restriction under section 12(1) of BO on MA in transferring deposits when resolving a failing bank, and the application of section 13(1) of BO in a resolution case.

21. The Government has reiterated that existing statutory protections would remain applicable to any transfer of deposits, including the restriction under section 12(1) of BO which clearly provides that no deposit-taking business can be carried on in Hong Kong except by an AI. MA, as an RA, has to act responsibly and rationally in accordance with the resolution objective in section 8(1)(b) of FIRO, and hence it will not, and cannot, transfer the deposit-taking business to an entity that is not an AI because this will be going blatantly against the restriction of section 12(1) of BO.

22. As regards the concern that the "transfer of protected deposits" is not the same as "taking of deposits" and hence section 12(1) and (6) of BO may not be applicable, the Government's legal position is that section 12(1) and (6) of BO is applicable to the "deposit-taking business" which clearly covers deposits transferred by an RA under FIRO.

23. On the application of section 13(1) of BO on a resolution case, the Government has clarified that from the perspective of MA as RA, it is not the policy intent to request from FS the grant of such an exemption. Since depositor protection is one of the important objectives of BO as stated in its Long Title, FS would in any case have due regard to making sure that the protected deposits in a resolution case would be transferred to a bank and hence a DPS



member. The policy intent is to achieve continuity of DPS protection for "protected deposits" transferred from a failed DPS member to an acquirer.

24. In light of the concerns raised by Hon James TO about the lack of explicit provision to mandate MA to transfer "protected deposits" to AIs, the Government has committed to undertaking a review, as part of a future FIRO amendment exercise, to identify any statutory amendments which are necessary to address the concern raised and reflect the above position with greater statutory certainty. The Government has agreed to confirm its position regarding section 12(1), (6) and section 13(1) of BO in paragraphs 21, 22 and 23 above at the debate on the motion to take note of the relevant report of the House Committee on consideration of subsidiary legislation and other instruments at the Council meeting of 5 July 2017.

### **Recommendation**

25. The Subcommittee has no objection to PAR and FIRO (Commencement) Notice 2017. The Subcommittee notes that the Government will not move amendment to the two pieces of subsidiary legislation. The Subcommittee also will not move any amendment.

### **Advice sought**

26. The Chairman of the Subcommittee made a verbal report on the deliberations of the Subcommittee at the House Committee meeting on 23 June 2017. Members of the House Committee are requested to note this written report.

Council Business Division 1  
Legislative Council Secretariat  
27 June 2017

**Subcommittee on Financial Institutions (Resolution) (Protected  
Arrangements) Regulation and Financial Institutions (Resolution)  
Ordinance (Commencement) Notice 2017**

**Membership list**

**Chairman** Hon CHAN Chun-ying

**Members** Hon James TO Kun-sun  
Hon WONG Ting-kwong, SBS, JP  
Hon CHAN Kin-por, BBS, JP  
Hon YIU Si-wing, BBS  
Dr Hon KWOK Ka-ki  
Hon Dennis KWOK Wing-hang  
Hon Christopher CHEUNG Wah-fung, SBS, JP

Total : 8 Members

**Clerk** Ms Connie SZETO

**Legal Adviser** Miss Winnie LO