For discussion
on 18 April 2017

Legislative Council Panel on Financial Affairs

Financial Institutions (Resolution) Ordinance (Cap. 628) – Commencement Notice and the Protected Arrangements Regulation

PURPOSE

This paper briefs Members on the proposed commencement of the Financial Institutions (Resolution) Ordinance (Cap. 628) ("FIRO") and the Protected Arrangements Regulation ("PAR") to be made as subsidiary legislation under the FIRO.

BACKGROUND

2. The FIRO was enacted by the Legislative Council ("LegCo") in June 2016 and is to commence operation on a date to be appointed by the Secretary for Financial Services and the Treasury ("SFST"). The FIRO establishes a cross-sector resolution regime for within scope financial institutions ("FIs")[1] that is designed to meet international standards set by the Financial Stability Board, namely the *"Key Attributes of Effective Resolution Regimes for Financial Institutions"*. Once the FIRO comes into force, the Monetary Authority ("MA"), the Insurance Authority ("IA") and the Securities and Futures Commission ("SFC") will be resolution authorities ("RAs"), vested with a range of necessary powers to plan for the application of, and to apply, stabilization options[2] to non-viable, systemically important within scope FIs operating under their respective purviews. Ordinary insolvency

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[1] Within scope FIs include all authorized institutions, certain financial market infrastructures, certain licensed corporations, certain authorized insurers, settlement institutions and system operators of designated clearing and settlement systems, and recognized clearing houses. The scope of the FIRO also extends to holding companies and affiliated operational entities of within scope FIs.

[2] These stabilization options are: (i) transfer to a purchaser; (ii) transfer to a bridge institution; (iii) transfer to an asset management vehicle; (iv) bail-in; and (v) transfer to a temporary public ownership company.

proceedings are not a suitable mechanism for managing any possible failure of a non-viable systemically important FI in Hong Kong. Instead, resolution is designed to provide a credible alternative aimed at promoting and seeking to maintain the stability and effective working of the financial system of Hong Kong, including securing continuity of critical financial functions, whilst protecting public funds by imposing losses on the FI's shareholders and creditors.

THE PAR

3. Section 75 of the FIRO provides that the SFST may make regulations prescribing requirements to be complied with by an RA in making a regulated Part 5 instrument[3] to safeguard the economic effect of the following six types of financial arrangements that are defined as "protected arrangements" in section 74 of the FIRO –

(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.

4. Examples of "protected arrangements" include arrangements with a recognized clearing house ("RCH"), arrangements for set-off or netting of rights and liabilities with a counterparty under a master agreement, secured financing arrangements with fixed or floating charges, securitization and repurchase transactions. These arrangements are considered of fundamental importance to the operation of financial markets as financial market participants rely on them to both mitigate credit risk exposure to counterparties (e.g. set-off and netting arrangements) and provide sources of liquidity and financing (e.g. structured finance arrangements). It is therefore crucial that there is legal certainty that these arrangements would be afforded an appropriate degree of protection in resolution, the absence of which could cause a higher cost of funding or reduction in liquidity in the markets.

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[3] "Regulated Part 5 instrument" is defined in section 74 of the FIRO as a Part 5 instrument that – (i) results in a partial property transfer ("PPT") being effected; or (ii) contains a bail-in provision.

5. The PAR aims to address the possibility that the application of certain stabilization options may not safeguard the economic effect of protected arrangements, as action taken by an RA to effect a stabilization option could "split up" the assets, rights or liabilities constituting such arrangements. This possibility is considered most likely to crystallize: (i) where a partial property transfer ("PPT") is made by an RA through which some, but not all, of an entity's assets, rights and liabilities are transferred to a third party;[4] or (ii) on bail-in where liabilities are written down and / or converted without taking into account linked assets or rights entitled to be set off or netted under arrangements that are documented or otherwise evidenced in writing.

6. Before the FIRO commences operation, it is considered prudent to have the PAR ready to operate in order to provide legal certainty around the treatment of protected arrangements if an RA were to exercise its resolution powers.

PUBLIC CONSULTAION

7. The Financial Services and the Treasury Bureau, Hong Kong Monetary Authority, the IA and the SFC jointly conducted a two-month public consultation (from 22 November 2016 to 21 January 2017) on the proposed PAR. We engaged with key stakeholders during the consultation period, and received 11 submissions from industry associations, professional bodies and financial market infrastructures ("FMIs"). Respondents generally agreed with the approach to the PAR proposed in the consultation paper ("CP") whilst providing constructive, technical comments to enhance its efficacy. The consultation conclusion[5], setting out our responses to the comments received, was issued on 6 April 2017. The ensuing paragraphs summarise the key proposals and consultation conclusion relating to the proposed PAR.

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[4] A third party under a PPT could be: (i) a private sector purchaser; (ii) a bridge institution; or (iii) an asset management vehicle.

[5] See: http://www.fstb.gov.hk/fsb/ppr/consult/doc/consult_conclu_par_e.pdf.

KEY PROPOSALS AND CONSULTATION CONCLUSION

8. The PAR is to set out how an RA should treat each type of "protected arrangement" in resolution. It also identifies some limited and clearly specified exclusions[6] of rights and liabilities from the scope of certain protected arrangements. These exclusions are considered necessary to confer an appropriate degree of flexibility on an RA to achieve orderly resolution (e.g. to transfer certain critical liabilities such as deposits to secure continuity of access for depositors irrespective of rights or liabilities that may otherwise be entitled to be set off or netted against them). It also establishes the consequences should an RA inadvertently act in a manner inconsistent with the objectives of the PAR. The proposed approach to the PAR is largely modelled on that adopted by the United Kingdom ("UK") and that required by the European Union's Bank Recovery and Resolution Directive.

Partial Property Transfer

Clearing and settlement systems arrangements

9. Most respondents agreed with the proposed approach that broad protection should be provided to clearing and settlement systems arrangements in a PPT by restricting an RA from transferring some, but not all, of the assets, rights or liabilities of an entity in resolution under a PPT in a way that may disrupt the operation of a RCH under the Securities and Futures Ordinance (Cap. 571) ("SFO") or a designated clearing and settlement system ("DCSS") under the Payment Systems and Stored Value Facilities Ordinance (Cap. 584) ("PSSVFO").

10. A few respondents proposed expanding the scope of the definition of clearing and settlement systems arrangement to cover, in addition to RCHs and DCSSs, clearing arrangements between an entity in resolution and a clearing house that is not an RCH but which is authorized as an automated trading service under the SFO. We have carefully considered the proposal and are of the view that this is not necessary. The broad definitions of set-off

[6] It is important to note that even where rights and liabilities are carved out from the PAR, affected pre-resolution shareholders / creditors would still be safeguarded by the "no creditor worse off than in liquidation" ("NCWOL") compensation mechanism under the FIRO. The NCWOL compensation mechanism provides that pre-resolution shareholders / creditors of an entity in resolution should receive no less favourable a treatment in the resolution of an entity than would have been the case in a winding-up.

arrangements, netting arrangements and secured arrangements in the PAR, as suggested by a respondent, should in effect extend to a wide range of key relationships between an entity in resolution and FMIs and thus provide certainty that these arrangements will benefit from the protections afforded by the PAR. We consider that this approach is consistent with the practice adopted in other jurisdictions (such as the UK).

11. Having considered respondents' comments, we decided that, for legal certainty and clarity, the protection for clearing and settlement systems arrangements under the PAR will be refined to specify the arrangements of an RCH or DCSS that should not be disrupted in a PPT – which will be those arrangements protected by the insolvency override in sections 45(1) and 20(1) of the SFO and PSSVFO respectively.

Secured arrangements

12. There is broad consensus among the respondents on the proposed approach to protecting secured arrangements in a PPT which provides that an RA should not transfer any constituent part (i.e. assets, liabilities or benefit of security) of a secured arrangement without all other corresponding constituent parts. The proposed protection will extend to secured arrangements where security is by means of a fixed or a floating charge, insofar as the secured arrangements are legitimate (i.e. not made in contravention of any other legal requirement[7]).

Structured finance arrangements

13. The proposed approach to protecting structured finance arrangements in a PPT is that an RA should transfer all, rather than some, of the assets, rights or liabilities which are, or form part of, a structured finance arrangement. It is also proposed to carve out deposits to enable an RA to transfer the critical financial function of deposit-taking without the need to

[7] For example, a secured arrangement would not be recognized for the purposes of the PAR if it were made in contravention of section 119A(2) of the Banking Ordinance (Cap. 155) which provides that an authorized institution incorporated in Hong Kong must not, except with the approval of the MA, by whatever means create any charge over its assets if either – (a) the aggregate value of all charges existing over its total assets is 5% or more of the value of those total assets; or (b) creating that charge would cause the aggregate value of all charges (including that first-mentioned charge) over its total assets to be more than 5% of the value of those total assets.

treat those deposits as part of a structured finance arrangement. This exclusion facilitates an RA's ability to achieve orderly resolution by allowing for a prompt and decisive transfer of deposits. Respondents agreed with the proposed approach of protection.

14. While no specific comments in relation to the question asked in the CP were received, we propose to provide greater clarity that the PAR applies to the class of structured finance arrangements that are securitizations, whether established through a "true sale" or "synthetic" structure. The definition also covers the key roles of an entity in resolution in supporting the performance of a securitization structure.

Set-off, netting and title transfer arrangements

15. It is proposed that broad protection would be provided such that an RA should transfer all, rather than some, of the rights and liabilities that may be set-off or netted under written contractual set-off, netting or title transfer arrangements, to which the entity in resolution is a party, but with certain exclusions.[8] The proposed approach is intended to be similar to that adopted in the UK.

16. Having considered respondents' comments, we have refined the PAR such that it will apply to set-off, netting and title transfer arrangements that are documented or otherwise evidenced in writing (including where held electronically). This is to protect rights and liabilities entitled to be set off or netted under set-off, netting or title transfer arrangements and as such that have a nexus or link *inter se*, as opposed to much broader set-off and netting rights which could arise by operation of law, so as to offer greater clarity for an RA in identifying the relevant arrangements and to provide an appropriate degree of flexibility to split the critical financial functions from a failed FI's balance sheet quickly and decisively in a PPT.

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[8] These exclusions are rights and liabilities (i) relating to deposits; (ii) relating to assets in the form of receivables owed to the transferor by depositors (other than those owed in relation to a financial contract); (iii) relating to subordinated debts; (iv) relating to transferable securities; (v) arising under a contract other than in the course of undertaking financial activity; and (vi) relating to a claim for damages, an award of damages or a claim under an indemnity in connection with the undertaking of financial activity. It is considered important to exclude these items from the PAR so as to allow sufficient flexibility for an RA to meet the resolution objectives.

17. A few respondents sought assurance that the authorities' proposed approach to not protecting broad "sweeper" provisions and "walk-away" clauses under the PAR was not designed to undermine key close-out netting sets and fundamental provisions under master agreements. We have confirmed that the objective is not to affect the operation of well-established master arrangements which are relied on to a significant extent by financial market participants, but to (i) ensure that broad "sweeper" provisions which extend to any and all assets, rights and liabilities between a counterparty do not significantly limit the ability of an RA to effect a PPT (whilst respecting core close-out netting sets); and (ii) ensure that clauses entitling a non-defaulting party to make no, or only limited, payments even where it is a net creditor are not afforded protection, given that such clauses are not regarded as valid bilateral netting agreements for the purposes of the Banking Capital Rules (Cap. 155L). The approach is not intended to affect the "flawed asset" provision under section 2(a)(iii) of the International Swaps and Derivatives Association Master Agreement.

Bail-in

Set-off, netting and title transfer arrangements

18. Respondents generally agreed with the proposed approach that an RA should only make bail-in provision in respect of the net amount that the entity in resolution and its counterparty are entitled by contract to set off or net under set-off, netting or title transfer arrangements, but with certain exclusions[9] from the safeguard. The approach is intended to be consistent with that adopted in the UK.

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[9] These exclusions are (i) liabilities arising from any capital instrument issued by the entity in resolution; (ii) liabilities arising from subordinated debt issued by the entity in resolution; (iii) liabilities arising from an unsecured debt instrument that is a transferable security issued by the entity in resolution; (iv) unsecured liabilities arising from any instrument or contract which at the date it was issued, had a maturity period of twelve months or more and is not a financial contract, derivative contract or qualifying master agreement; (v) unsecured liabilities owed to another member of the same group as the entity in resolution which do not arise from a financial contract, derivative contract or qualifying master agreement; (vi) deposits which are not excluded from bail-in pursuant to section 2(b) or 2(c) of Schedule 5 to the FIRO; and (vii) liabilities which relate to a claim for damages, an award of damages or a claim under an indemnity. These exclusions are to facilitate an RA's prompt and decisive application of the bail-in stabilization option to those liabilities most likely to be subject to write-down under this power, with less likelihood of triggering further instability or contagion.

19. Several respondents commented on the definitions of the terms "derivative contract", "financial contract" and "qualifying master agreement" for the purposes of identifying those contracts which should be closed out to a net position by an RA before they may be subject to bail-in. Having considered the comments, we have fine-tuned the definitions of these terms to be more precise about the contracts that are intended to be covered by the PAR in the context of bail-in.

Consequences

20. The PAR also specifies consequences should an RA inadvertently act inconsistently with the objectives of the PAR in applying a stabilization option. To reduce the risk of such action occurring, the FIRO empowers an RA to undertake *ex ante* resolution planning which may cover, amongst other things, ensuring within scope FIs' Management Information Systems ("MIS") are capable of producing, with adequate speed and accuracy, information necessary to identify the constituent parts of protected arrangements.

21. Notwithstanding this *ex ante* work, there is still the potential for an RA to inadvertently take an action that is inconsistent with the PAR due to factors beyond the RA's control, e.g. due to deficiencies in an FI's MIS capabilities or definitional legal uncertainty in a transfer instrument. Therefore, we consider it important that the PAR should provide for consequences. These consequences differ depending upon the type of protected arrangements affected. In short, they provide for: (i) an affected party's position to be restored to the position as if an RA had acted consistently with the PAR (e.g. through a supplemental or reverse transfer of assets, rights or liabilities for secured or structured finance arrangements); (ii) counterparties to continue to operate as if the RA had acted consistently with the PAR (e.g. in relation to set-off and netting rights); or (iii) for a transfer to be void to the extent that it disrupts the operation of a clearing and settlement systems arrangement. Whilst emphasizing the importance of the *ex ante* work to mitigate the risks, respondents broadly understood the need for the backstop consequences.

COMMENCEMENT OF THE FIRO AND THE PAR

22. Our target is to bring the FIRO into force as soon as practicable in order to put the resolution regime in operation and confer on the RAs the necessary powers for undertaking resolution planning and to ultimately seek to preserve the stability and effective working of the financial system of Hong Kong in the unexpected event of a systemically important FI becoming non-viable. As proposed in the CP, we plan to commence the FIRO shortly after the subsidiary legislation on the PAR is in place within 2017.

23. Notwithstanding the commencement of the FIRO, we will continue to work on the necessary processes and procedures to implement the resolution regime and make within scope FIs resolvable in practice. Such work includes developing further rules and regulations to be made under FIRO (e.g. on loss-absorbing capacity requirements, contractual recognition requirements, etc.); conducting resolution planning and resolvability assessments for within scope FIs; and formulating resolvability standards for within scope FIs (e.g. with respect to their information reporting capabilities). In the course of undertaking these tasks, we will closely monitor and take into account developments of the relevant international standards and guidelines, and engage the relevant stakeholders and industry players as appropriate.

LEGISLATIVE TIMETABLE

24. We will table the PAR and the FIRO commencement notice before LegCo for negative vetting in Q2 2017.

ADVICE SOUGHT

25. Members are invited to note the legislative proposals as set out in this paper.

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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