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Panel on Financial Affairs

Meeting on 18 April 2017

**Background brief on Financial Institutions (Resolution) Ordinance -
Commencement Notice and the Protected Arrangements Regulation**

Purpose

This paper provides background information on the Financial Institutions (Resolution) Ordinance (Cap. 628) and the Protected Arrangements Regulation ("PAR") to be made as subsidiary legislation under the Ordinance. It also summarizes the major views and concerns expressed by Members during scrutiny of the Financial Institutions (Resolution) Bill.

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 them out with public money, in order to allow the financial system to continue to function. This was necessary because of the reliance of individuals, businesses and governments on the services FIs provided and the inadequacy of existing tools for dealing with the failure of a systemically important FI.

3. To reduce the impact of failure of systemically important FIs, the Financial Stability Board ¹ published the "Key Attributes of Effective Resolution Regimes for Financial Institutions" which established new

¹ 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.

international standards for effective resolution regimes. These new standards required that public authorities be empowered to intervene to resolve FIs which become non-viable and whose failure would pose unacceptable risks to the continuation of critical financial services and wider financial stability. An effective resolution regime should provide alternative means of containing 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.

Financial Institutions (Resolution) Ordinance

4. The Legislative Council enacted the Financial Institutions (Resolution) Ordinance ("the Ordinance") in June 2016 to provide for the legal basis for the establishment of a cross-sectoral resolution regime for FIs in Hong Kong. Under the Ordinance, the Hong Kong Monetary Authority ("HKMA"), the Securities and Futures Commission ("SFC") and the Insurance Authority ("IA") are designated as 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. The Ordinance would come into operation on a date to be appointed by the Secretary for Financial Services and the Treasury ("SFST").

Initiation of resolution and stabilization options

5. After consulting the Financial Secretary, an RA may initiate the resolution of a within scope FI² if it is satisfied that all of the following conditions (i.e. the three conjunctive conditions) are met:-

- (a) the FI has ceased, or is likely to cease, to be viable;
- (b) there is no reasonable prospect that private sector action (outside of resolution) would result in the FI again becoming viable within a reasonable period; and
- (c) the non-viability of the FI poses risks to the stability and effective working of the financial system of Hong Kong, including to the continued performance of critical financial functions, and resolution will avoid or mitigate those risks.

² A within scope financial institution under the Financial Institutions (Resolution) Ordinance (Cap. 628) ("the Ordinance") refers to a entity in the banking sector, insurance sector, or securities and futures sector.

6. There are five stabilization options that an RA may apply to a within scope FI in resolving such FI. These options are:

- (a) transfer to a purchaser;
- (b) transfer to a bridge institution;
- (c) transfer to an asset management vehicle;
- (d) bail-in;³ and
- (e) transfer to a temporary public ownership ("TPO") company.

7. To enable resolution to be carried out successfully, RAs will be empowered to devise strategies for securing an orderly resolution for a within scope FI and make resolvability assessment to determine whether there are any impediments to the orderly resolution of the FI, and to require the FI to remove any substantive barrier to its orderly resolution. RAs will also be empowered to gather information from and inspect records or documents of within scope FIs, and carry out investigation on the FIs.

Safeguards

8. Pre-resolution creditors or pre-resolution shareholders treated less favourably in resolution than they would have been on a hypothetical winding up will be eligible for compensation (i.e. "no creditor worse off than in liquidation" ("NCWOL") compensation). Pre-resolution shareholders, pre-resolution creditors and the RA that has initiated resolution can make applications to the Resolution Compensation Tribunal ("RCT") for a review of a decision of an independent valuer on the valuation and the compensation amount. RCT is empowered to confirm or vary the decision or set it aside and substitute a fresh decision for it, or remit the matter back to the independent valuer.

Protected Arrangements Regulation

9. Financial market participants rely on a variety of financial arrangements to both mitigate credit risk exposure to counterparties and provide sources of

³ To provide for the bail-in option, the resolution authorities should be allowed to write down shareholders and certain unsecured creditors, and impose a debt-for-equity swap on certain unsecured creditors, in a manner that generally respects the hierarchy of claims in liquidation.

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 when an entity is under resolution and that the economic purpose of the arrangements is not undermined. The financial arrangements identified as protected arrangements under section 74 of the Ordinance 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.

10. Section 75 of the Ordinance provides that SFST may, for safeguarding the economic effect of a protected arrangement in connection with the making of a regulated Part 5 instrument,⁴ make regulations (i.e. PAR) prescribing requirements to be complied with by an RA. A regulated Part 5 instrument, as provided in section 74 of the Ordinance, means a Part 5 instrument that: (a) results in a partial property transfer being effected; or (b) contains a bail-in provision. The Government considers it important that PAR should be put in place and ready to become operational at the same time as the Ordinance is brought into operation. An exact of sections 74 and 75 of the Ordinance is in **Appendix I**.

11. HKMA, SFC, IA and FSTB jointly conducted a public consultation in November 2016 to gauge views on a set of proposed PAR. The major proposals are highlighted in the paragraphs below.

⁴ Part 5 instrument means any of the following instruments made under Part 5 of the Ordinance —

- (a) a securities transfer instrument;
- (b) a property transfer instrument;
- (c) a bail-in instrument.

Partial property transfer

Clearing and settlement systems arrangements

12. An RA will be restricted from transferring some but not all of the property, rights or liabilities of an entity in resolution in a way that will disrupt the operation of a clearing and settlement systems arrangement. Such arrangements will be further defined as a designated clearing and settlement system under the Payment Systems and Stored Value Facilities Ordinance (Cap. 584) or a clearing house recognized under the Securities and Futures Ordinance (Cap. 571).

Secured arrangements

13. An RA should not transfer any constituent part (e.g. property, right, liability, benefit etc.) of a secured arrangement without all other constituent parts. The secured arrangements should include those where security is by means of either a fixed or a floating charge and only "legitimate" secured arrangements⁵ will benefit from the protection.

Structured finance arrangements

14. An RA will be restricted from transferring some, but not all, of the property, rights and liabilities which are, or form part of, a structured finance arrangement. However, any deposits which form part of a structured finance arrangement will be carved out from the protection so that an RA can transfer the critical financial function of deposit-taking without the need to take into account the role of those deposits in a structured finance arrangement.

Set-off, netting and title transfer arrangements

15. An RA will be restricted from splitting 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 specific exclusions. The exclusions are rights or liabilities relate to (a) deposits, (b) subordinated debt, (c) transferable securities, (d) operating rights and liabilities, and (e) an award of damages or a claim under an indemnity relating to the undertaking of financial activity.

⁵ Arrangements not made in contravention of any other legal or regulatory requirement.

Bail-in

Set-off, netting and title transfer arrangements

16. 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 specific exclusions. The exclusions are (a) liabilities arising from any capital instrument issued by the entity in resolution, (b) liabilities arising from subordinate debt issued by the entity in resolution, (c) liabilities arising from an unsecured debt instrument that is transferable security issued by the entity in resolution, (d) 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 derivative contract, financial contract or qualifying master agreement, (e) unsecured liabilities owed to another member of the same group as the entity in resolution which do not arise from a derivative contract, financial contract or qualifying master agreement, (f) deposits which are not excluded from bail-in pursuant to section 2(b) of Schedule 5 to the Ordinance, and (g) liabilities which relate to a claim for damages or an award of damages or a claim under an indemnity.

Major views and concerns expressed by Members

17. The major views and concerns on issues relating to the stabilization options under the resolution regime expressed by Members during scrutiny of Financial Institutions (Resolution) Bill are summarized in the ensuing paragraphs.

Stabilization options

18. Members sought clarification as to whether the stabilization options (e.g. bail-in, TPO, mandatory reduction of capital, suspension of payment obligations, etc.) would deprive private property rights, which Article 105 of the Basic Law ("BL 105") sought to protect.

19. The Government explained that BL 105 did not prohibit lawful deprivation of property per se and protected the right to compensation for lawful deprivation of property. The second paragraph of BL105 further provided that such compensation should correspond to the real value of the property concerned at the time. The Government supplemented that section 33(3) of the Ordinance provided for payment of "real value consideration" to the person whose property was transferred when resolution was initiated. This provision

stated that consideration that was fair and reasonable in the circumstances was due to the transferor in respect of any transfer under a Part 5 instrument (e.g. to the FI in a property transfer, or to the FI's shareholders in a share transfer). In addition, section 102 provided that pre-resolution creditors and pre-resolution shareholders were eligible for payment of NCWOL compensation. The Government considered that NCWOL compensation would provide fair compensation to the above-mentioned parties who suffered loss as a result of the resolution, instead of the FI entering into liquidation. Moreover, there was an appeal mechanism to RCT available to those aggrieved by any decision made by the independent valuer who undertook the NCWOL compensation calculation.

Stamp duty exemption for Part 5 instruments

20. Members enquired whether securities transfer instruments issued by an RA would be subject to stamp duty under the Stamp Duty Ordinance (Cap. 117) ("SDO"). Members were of the view that there should be ex ante certainty on the stamp duty exemption for securities transfer instruments which would facilitate smooth conduct of resolution, especially since a stamp duty exemption might incentivize a private sector acquirer to consider acquiring part or all of the business of the failing or failed FI to facilitate a swift transaction. Members stressed that stamp duty exemption for the instruments would be justified on the ground that the transfers in resolution were to protect the financial stability of Hong Kong.

21. The Government advised that while such instruments would be subject to stamp duty, the policy intention was to grant exemption to the Part 5 instruments on a case-by-case basis recognizing that the relevant stamp duty consequence arose not out of a normal commercial transaction but as a result of the exercise of a stabilization option in protecting financial stability and integrity of the financial system of Hong Kong. The approach to implement this policy was to rely on an existing mechanism under section 52 of SDO whereby the Chief Executive might exempt or remit any stamp duty after taking into account the circumstances of the case and the transfers involved. That said, the Government agreed to look into how the stamp duty exemption policy would be effected in the context of the resolution legislative framework by developing appropriate amendments to the enacted Ordinance in a separate legislative exercise in the future.

Latest development

22. The Administration will brief the Panel on Financial Affairs on the proposal to legislate for PAR and the timetable for commencing the Ordinance at the meeting on 18 April 2017.

Relevant papers

23. A list of relevant papers is in **Appendix II**.

Council Business Division 1
Legislative Council Secretariat
13 April 2017

**Extract of sections 74 and 75 of the Financial Institutions (Resolution)
Ordinance (Cap. 628)**

74. Interpretation

In this Subdivision—

arrangement includes an arrangement that—

- (a) is formed wholly or partly by one or more contracts or trusts;
- (b) arises under, or is wholly or partly governed by, a non-Hong Kong law;
- (c) arises, wholly or partly, automatically as a matter of law;
- (d) involves any number of parties; or
- (e) operates partly by reference to another arrangement between parties;

clearing and settlement systems arrangement means an arrangement governed by the rules and directions relating to participation in the clearing and settlement of transactions within a financial market infrastructure;

netting arrangement means an arrangement under which a number of claims or obligations can be converted into a net claim or obligation;

partial property transfer means a transfer by a property transfer instrument of some, but not all, of the assets, rights and liabilities of the transferor;

protected arrangement means a clearing and settlement systems arrangement, a netting arrangement, a secured arrangement, a set-off arrangement, a structured finance arrangement or a title transfer arrangement;

regulated Part 5 instrument means a Part 5 instrument that—

- (a) results in a partial property transfer being effected; or
- (b) contains a bail-in provision;

secured arrangement means an arrangement under which a person acquires, by way of security, an actual or contingent interest in the property of another;

set-off arrangement means an arrangement under which 2 or more debts, claims or obligations can be set off against each other;

structured finance arrangement means an arrangement under which a person creates and issues an instrument under which some or all of the return or amount due (or both the return and the amount due) or the method of settlement is determined by reference to the price, value or other parameters, or changes in the price, value or other parameters, of financial assets or the occurrence or non-occurrence of a specified event and includes—

- (a) asset-backed securities;
- (b) securitizations;
- (c) asset-backed commercial paper;
- (d) residential and commercial mortgage-backed securities;
- (e) collateralized debt obligations; and
- (f) covered bonds;

title transfer arrangement means an arrangement under which a person transfers assets to another person on terms providing for the other person to transfer assets if specified obligations are discharged and includes—

- (a) a repurchase or reverse repurchase transaction; and
- (b) a stock borrowing or lending arrangement.

75. Regulations relating to protected arrangements

(1) The Secretary for Financial Services and the Treasury may, for safeguarding the economic effect of a protected arrangement in connection with the making of a regulated Part 5 instrument, make regulations—

- (a) prescribing requirements to be complied with by a resolution authority in making a regulated Part 5 instrument; or
- (b) for connected purposes.

(2) Without limiting subsection (1), regulations made under that subsection may—

- (a) impose conditions on the exercise of a power to make a regulated Part 5 instrument;
- (b) require a regulated Part 5 instrument to include a specified provision, or a provision to a specified effect, relating to protected arrangements;

- (c) provide for rights, assets, liabilities, claims or other matters to be classified not according to how they are described by the relevant parties but according to how they are treated, or intended to be treated, in commercial practice;
- (d) require a resolution authority, in making a regulated Part 5 instrument that results in a partial property transfer being effected, to seek to ensure that the instrument does not have the effect of adversely affecting a party (other than the transferor) to a protected arrangement by separating or otherwise affecting the constituent parts of the arrangement;
- (e) require a resolution authority, in making a regulated Part 5 instrument that contains a bail-in provision, to seek to ensure that the instrument does not have the effect of cancelling, modifying or changing the form of a liability covered by a protected arrangement in an amount in excess of the net debt, claim or obligation under the arrangement;
- (f) specify remedial action to be taken by a resolution authority, or provide for other consequences to arise, if a regulated Part 5 instrument has an effect mentioned in paragraph (d) or (e); or
- (g) make provision for determining the scope of coverage of a protected arrangement, taking into account the effect on the ability of a resolution authority to achieve the orderly resolution of an entity.

(3) Regulations made under subsection (1) may—

- (a) apply to protected arrangements generally or only to protected arrangements of a specified class;
- (b) specify principles related to protected arrangements to which a resolution authority must have regard in making a regulated Part 5 instrument; or
- (c) contain any incidental, supplementary, consequential, transitional or savings provisions that may be necessary or expedient in consequence of the regulations.

List of relevant papers

Date	Event	Paper/minutes of meeting
22 June 2016	The Legislative Council passed the Financial Institutions (Resolution) Bill	Hansard The Bill passed Report of the Bills Committee (LC Paper No. CB(1)1032/15-16)
22 November 2016 and 6 April 2017	Consultation paper and the consultation conclusion on protected arrangements regulations jointly issued by the authorities	Consultation paper Consultation conclusion