THE REAL LIFE COMPANY

Financial Institutions (Resolution) Bill ("the Bill")

AIA Group's submission

AIA Group is the largest listed pan-Asian life insurance group and is incorporated, headquartered and listed in Hong Kong. As part of AIA Group, AIA Company Limited and AIA International Limited are both authorized insurers in Hong Kong and wholly owned subsidiaries of AIA Group Limited.

AIA Group strongly supports the development and promotion of effective and proportionate regulatory and supervisory measures designed to create greater financial stability. Initiatives which reduce systemic risk and encourage transparency will benefit the global financial system.

As background, we would like to refer you to our prior comment letters dated 3 April 2014 and 20 April 2015 made in response to the 2 consultation papers on An Effective Resolution Regime for Financial Institutions in Hong Kong jointly published by the Financial Services Treasury Bureau, the Hong Kong Monetary Authority, the Securities and Futures Commission and the Insurance Authority. We attach these 2 comment letters as Appendix 1 to this submission for your ease of reference.

We have reviewed the Bill and have the following key comments.

1. Clause 5(1)(a) provides that a contravention of a condition to authorisation as criteria for a financial institution to cease to be viable (financial institutions are subject to the resolution regime if they cease to be viable). There does not seem to be an element of materiality to the condition to authorisation. For example, a condition to authorisation may be that a financial institution may only be able to write or conduct certain regulated businesses. As currently drafted, it would seem that a single act of writing a type of business for which the financial institution has not been authorised could disproportionately result in such a financial institution being deemed to cease to be viable under Clause 5(1)(a). As such, we suggest that there be further refinements on the wording of this provision to add an element of materiality and proportionality. We note that Part 7 of the Bill sets up a tribunal to review any decision made by a resolution authority (with further appeal to the Court of Appeal) but

in practice, unintended consequences may have resulted. Any harm may have already been significant and irreversible and as such, we suggest clarification on this Clause 5(1)(a) would be more appropriate.

2. Clause 19 prescribes the application by the relevant resolution authority to make loss-absorbing requirements. This is a very general power and we suggest more certainty on the rules that will be put forward by the resolution authority to ensure that these requirements are proportionate and not excessive.

3. Clause 33 sets out 5 stablisation options. It is important to recognise that insurers do not typically provide short-terms functions to the financial system or wider economy in the same way as banks (unless the insurer owns a bank or is part of a banking group) and that there is no evidence that traditional tools (such as run off and the transfer of business via a portfolio transfer) would not be sufficient for resolution. While we do support the 5 stablisation options as additional tools for resolution authorities, these options should only be used in our view as a last stop measure so long as the exercise of these powers is not disproportionate and after traditional tools (such as run off and the transfer of business via a portfolio transfer) have been considered and deemed not to be sufficient.

4. Clause 153 provides that powers to gather information, inspect and investigate are exercisable whether or not the financial institution has ceased or is likely to cease to be viable and whether or not resolution has been initiated. As such these are very wide powers. The only limit seems to be under subparagraph (2) and this relates specifically to third parties. We suggest the Bills Committee consider inserting greater limits to avoid unintended consequences and disruptions (to businesses that are in no way under resolution or likely to be in resolution in the near future).

5. While we understand the Administration wishes to secure these reforms in a timely manner for the purpose of maintaining and enhancing Hong Kong's status as an international financial centre, we propose that consideration be made to allocate some time for the implementation should the Bill be passed. Importantly, resolution authorities should issue more details including guidelines on how the resolution powers under the proposed legislation will be exercised in practice. Financial institutions should be able to comment on these guidelines. Moreover more details other than set out in the proposed legislation would likely need to be addressed such as for example how the Resolvability Review Tribunal would in practice operate or how the resolution authorities would foster cross-border resolution co-operation.

It is critical that consultation with leading companies and industry practitioners continue and we look forward to further participation on the development of the resolution regime for Hong Kong.

THE REAL LIFE COMPANY

3 April 2014

AIA Group's comments on
An Effective Resolution Regime for Financial Institutions in Hong Kong

AIA Group is pleased to participate in the consultation process toward *An Effective Resolution Regime for Financial Institutions in Hong Kong*. Our comments herein are in respect of the Consultation Paper jointly published by the Financial Services and Treasury Bureau ("FSTB"), the Hong Kong Monetary Authority ("MA"), the Securities and Futures Commission ("SFC") and the Insurance Authority (the "Consultation Paper").

Introduction

The global financial crisis was an extraordinarily difficult time for regulators and policy makers the world over. Difficult company specific circumstances, that carried with them the potential for profound and far-reaching consequences, needed to be dealt with in very short time frames, with often incomplete information and in the face of tremendous uncertainties. There were neither easy nor obvious answers, nor were there risk-free options.

It must be acknowledged that a number of the world's largest and some of its best known banks and other financial institutions ("FIs") engaged in quasi-banking activities were at the heart of the events that lead to the crisis. The crisis also reflected a deep and systemic failure of financial sector regulation in a number of major jurisdictions. In many respects, the innovation that lead to wealth creation and massive inter-connectedness also created circumstances in which policymakers and regulators needed to confront and indeed prevent a cascading series of failures. These challenges were compounded by the difficulties presented by the need to organize rapid and fully effective resolution of failures in what were in most cases large and complex institutions operating across multiple jurisdictions. It was a situation without a precedent.

It is natural in the aftermath of these events to look for mechanisms to ensure that such circumstances do not happen again (accepting that no two crises will have exactly the same causation or follow the same course). This is best done once the immediate crisis is past and it becomes possible to take considered and proportionate steps to improve the arrangements for prevention and management of such crises. In doing so it is necessary to recognize that it is in the cyclical nature of economic progress that crises of greater or lesser intensity will occur from time to time. A strong resolution regime fits well with this approach.

AIA Group strongly supports the development and promotion of effective and proportionate regulatory and supervisory measures designed to create greater financial stability. Initiatives which reduce systemic risk and encourage transparency will benefit the global financial system as a whole.

Insurers – although their core businesses are at the low risk end of the spectrum compared with banks – stand to benefit from the greater stability and support for economic growth which should result. Insurers play an important role as an investor in the financial markets and as a risk absorber for society. However, radical reform always carries a risk of disproportionate and unintended consequences, and AIA sees it as very important to the stability of the Hong Kong economy and to the ability of Hong Kong to function effectively as an international financial sector that the measures introduced as a consequence of this consultation are proportionate and matched to need rather than theory.

In considering the development of a comprehensive resolution regime for Hong Kong, it is critical to remember that Hong Kong was not at the epicentre of the global financial crisis. No aspect of Hong Kong's regulatory regime failed, nor were Hong Kong institutions (and by this we mean institutions over which Hong Kong would have or be expected to have substantial control or for which Hong Kong would be broadly considered responsible) central to the events leading to the crisis. This does not mean that Hong Kong was unaffected: a number of the failed institutions had offices, employees and clients in Hong Kong. Rather, it is to say that before launching into radical revision of Hong Kong's regulatory regime (including its current 'resolution tool kit') the context of changes to the regime, including the performance of Hong Kong during the financial crisis, must be taken into account and weighed in the balance to determine what is necessary and proportionate by way of reform.

Hong Kong's reputation as an international financial centre is well deserved and an important aspect of the preservation of that status is to keep abreast of developments in international practice. Specifically it is important to be able to demonstrate compliance with the "key attributes" as enumerated by the Financial Stability Board ("FSB"). We would however argue that this is consistent with Hong Kong tailoring changes to its regulatory regime (and in this case to its resolution arrangements) to take account of Hong Kong's actual needs and not simply to incorporate principles and practices that have been adopted to deal with needs felt in other parts of the world for the sake of conformity and without regard to the specific needs and interests of Hong Kong.

With all of this in mind, AIA Group, **as the only multi-national financial institution truly headquartered in Hong Kong (being incorporated, listed and headquartered here)** is pleased to submit its comments on the Consultation Paper as set out below.

Chapter 1 – Introduction

One of themes that will be repeated throughout our response is that a resolution regime should not be considered an end in itself. Rather, it must be considered as a "last stop" on a continuum of tools available to the regulatory authorities. In the case of life insurance, in Hong Kong as in many other advanced jurisdictions, there already exist a number of tools which replicate resolution arrangements. These include Court-approved portfolio transfer, mandatory instruction to discontinue writing new business and compulsory run-off of existing obligations. Section 35 of the Insurance Companies Ordinance empowers the Insurance Authority to direct an insurer to take action in respect of its affairs, business or property or to appoint a manager empowered to carry on the business of the insurer and to do all such things as may be necessary for the management of its affairs, business and property. Furthermore, we understand the Government is proposing a Policyholder Protection Fund ("PPF").

Taken together these represent the key elements of a resolution regime for life insurance businesses and have been designed to reflect the extent to which, in the nature of life insurance, developments which undermine the financial health of a company only emerge over quite long periods, and typically allow ample time for regulatory-supervised remedies (which may on occasion include the merger of the institution with a stronger industry leader). It can therefore be argued that the existing statutory arrangements already provide a fully effective resolution process for most (but not all – as we shall discuss later in this response) of the normal business of insurance.

Paragraph 18 suggests that a contributing factor to the failures "was that owners and creditors expected that governments would have no option but to rescue their FIs if they got into difficulties". We suggest that compensation structures providing outsized incentives for short-term speculative gains (in banking but not in insurance) played a very much larger role in promoting over-exposure than the conviction that governments would stand ready to rescue in the event of failure. However, it is surely part of the core task of both policymakers and regulators to ensure that the emergence of such assumptions – particularly in respect of the equity and bondholders as distinct from retail customers of the bank – are held firmly in check.

Paragraph 21 points to interconnectedness of FIs as a critical factor requiring them to be preserved, or in the worst cases, 'effectively resolved' in order to prevent wider social and economic perils. While we agree with this, it is critically important that it be understood that all FIs do not pose the same risk and specifically that the profile of the liabilities of life insurers, being long-term, do not mirror those of banks. It is also incorrect to suggest that larger institutions are inherently more risky than smaller organisations. Such a premise ignores the potential benefits of geographic diversification.

We cannot stress too often the fundamental distinction between the risk profiles of retail banks, investment banks, life and general insurance companies, reinsurers and mutual fund companies. These are vastly different businesses in almost every respect relevant to the need for resolutions regimes. Their business models are wholly dissimilar.

The AIA Group, a group of companies that is engaged almost exclusively in the business of life insurance, when properly managed has few if any of the hallmarks of the risks associated with banks that include broad derivative portfolios and high degrees of leverage in order to generate profit. Insurance profit emerges very differently and while market movements can affect net profit, they have very limited impact on operating profit and core financial viability.

It must be acknowledged that in the period leading up to the crisis some insurance groups around the world did take on risks traditionally associated with investment banking or other financial services activities. For this reason, we believe that the focus by the IAIS on non-insurance activities in the context of determining which institutions are classified as Global Systemically Important Insurers ("G-SIIs") is the correct one. In other words, it is not simply a question of size but also of the underlying activities (and specifically the presence of non-insurance activities) that contribute to the need for incremental resolution arrangements. A very large pure life insurer presents less risk both of failure and of interconnectedness leading to wider economic damage, than does an insurer that is perhaps smaller but whose activities include "bank-like" activities, product portfolios with substantial guarantees and a willingness to take risks on things like currency to generate yield. Accordingly, the triggers for intervention in the case of life insurance are very different from those applicable to banks and must be clearly understood. The sheer size of an organization is by no means a reliable indicator of the potential for systemic risk.

The fundamental principle of insurance is the law of large numbers – ensuring that "losses fall lightly on the many rather than heavily on the few"! Well managed insurers (with sound underwriting and asset/ liability management) reduce the relative risk of loss by insuring a large number of independent units of risks. Risk and volatility of loss may be furthered reduced within the basic insurance model by writing several lines of life or general business and by operating in more than one jurisdiction. Designing a resolution regime based exclusively on size would be against the basic insurance concept of the law of large numbers and the benefits of the diversification of risks.

A further fundamental difference is that sound life insurance underwriting requires the insurer to match closely the term of the assets held to support policies underwritten with the actuarially assumed term of the contract. In contrast the essence of banking is to maintain a controlled mismatch and to generate a net interest margin on the difference between short term deposits and longer term loans. It is this mismatch and the need for instant liquidity to meet depositors' calls for repayment that gives rise to the

possibility of liquidity crises occurring in response to actual or perceived deterioration in either the financial climate or the stability of the bank.

In contrast insurers with appropriate asset/ liability and liquidity management have a low liquidity risk. Policyholder contracts extend well into the future, often for several decades and the company is able to control the premature surrender value to match the payout with the underlying asset value. In addition, well run life insurers strive to eliminate maturity mismatch between assets and liabilities, allowing them considerable time for management action to be taken with a view to achieving an orderly recovery in response to market downturns. It is also relevant that in contrast to banks, which are heavily interdependent, insurers do not need to have strong connections in the form of lines of credit from banks and there is a lack of close business relationships between competing insurance companies. These characteristics thus limit the risk of contagion and the need for an incremental resolution regime for insurers.

A research paper released by the International Association of Insurance Supervisors ("IAIS") in November 2011 concluded that insurers engaged in traditional insurance activities were not a concern from a systemic risk perspective.

Accordingly, AIA argues that the focus of the resolution measures now under discussion should be on only those insurers who conduct systemically relevant activities, namely non-traditional and non-insurance or **NTNI** activities, and do so on a scale that poses a potential threat to the continuing viability of the insurer (or insurance group) and therefore the normal capacity to resolve these activities in an orderly manner. We believe that it would be a relatively remote possibility that a resolution authority would need to exercise an additional range of tools to those available currently in regards to an insurer operating a traditional life insurance business.

For all of the foregoing reasons, our view is that it is not appropriate to have a single cross-sectorial resolution regime in Hong Kong that takes in traditional insurance operations. To the extent that is considered desirable in the interests of inclusiveness to engage insurers in the process, then AIA argues that it be specifically tailored to apply to traditional life and general only in the exceptional circumstances that they are designated G-SIIs and have NTNI activities on a scale that poses a potential threat to the continuing viability of the overall insurance group.

It is perhaps relevant to note here, for the avoidance of misunderstanding, that although the former parent company of the AIA Group, American International Group or "AIG", was at the centre of the financial crisis it was **not the insurance operations of AIG that contributed to the group's collapse and ensuing bailouts.** The insurance operations of AIG were and remained in robust health throughout. Rather, it was the 'non-insurance' activities of AIG that brought about its troubles; and it was the

inherent strength and security of its insurance operations that provided the means to ultimately emerge from its troubles and repay government funds with interest.

One very important lesson to be learned from this episode is (we suggest) that arrangements have to be flexible enough to address the actual systemic threat. Remedies may often result in the erosion or even in extreme cases the existing shareholders' equity and bondholders' entitlements to finance the shortfall that generated the need for resolution. Given the wide powers available to the Insurance Authority and the courts and the profound consequences in resolution to shareholders and bondholders, every effort should be made to ensure that such resolution powers are only exercised when there is no alternative but resolution rather than as the default procedure for distressed entities. This is particularly true for life insurance companies where preserving long-term policyholder value is often the primary concern. The conclusion we draw is that it is a legitimate aspect of the role of prudential supervisors' of licensed insurers not just to ring-fence insurance assets and liabilities (as already happens) but also to monitor the parent group's exposure to higher risk financial sectors, and to ensure that where such exposure is taken on by a group, the scale of those activities is not disproportionate to the scale of its core business. There are no grounds, as we have stated above, to suppose that scale in a well-managed and well regulated life insurance operation is a source of systemic risk: the same is not true of banking-related activities which can result in an operation becoming 'too big to fail' and this is an area in banking where prevention is better than crisis resolution.

New international Standards for Effective Resolution Regimes

Reference is made (paragraph 24) to the requirement that "resolution authorities be empowered to: undertake a compulsory transfer of an entire FI, or of some or all of its business, to a third party acquirer or temporary bridge institution that is able to continue the transferred business; and to restore the viability of an FI by means of a bail-in."

We recognise that in dealing with non-insurance undertakings such as banks, speed in finding a solution will often be of the essence to prevent a contagious collapse of confidence and credit. At minimum where this applies to insurance companies and a transfer is found necessary and unavoidable, it is essential, particularly in the context of life insurance and the focus on long-term preservation of value rather than addressing short-term liquidity, that to the extent possible the continuing equity of all stakeholders is recognised and considered to the fullest extent possible.

Reference is made in paragraph 29 to past failures in Hong Kong. We note, and draw to your attention in support of the arguments we have put forward in the previous section, that none of the referenced failures is of a life insurance business. We would submit that a failure of the nature referenced would also be extremely unlikely to happen for a life insurer.

Accordingly, in considering how a resolution regime might impact on the various market participants, it is in our view incumbent upon decision makers to ensure that they clearly understand and take into account the fundamental differences between the business of banking and the business of insurance. The business models are fundamentally different; the risks associated with them are likewise fundamentally different; and these differences need to be recognised and enshrined in the statutory resolution processes.

Chapter 2 – International Requirements and Implementation

Under this international initiative, all resolution regimes must contain certain essential features under twelve "Key Attributes" so that "public authorities may act to resolve failing FIs in a manner that protects financial stability as well as public funds". We find these Key Attributes overly bank-centric and in this respect, they will require careful consideration and tailoring for the insurance sector. We note in paragraph 35 that in this regard, the FSB is still finalising guidance on how to implement the Key Attributes in relation to insurers and it would be appropriate to take these into consideration, when available.

Given that the consultation questions relating to the Key Attributes are embedded within Chapters 4 to 8 of the Consultation Paper, we have, for the ease of reference, addressed these questions as well as set out our comments and views on these Key Attributes under the same chapter headings below.

Chapter 3 – Existing Framework in Hong Kong

The Consultation Paper seems to focus on the perceived weakness caused by the absence within the current laws in Hong Kong of the power on the part of regulatory authorities, where an FI is failing, to override the rights of contract of third parties or those of shareholders.

We would note that while we appreciate the need for a resolution regime to enable quick action and ensure a comprehensive outcome, we likewise believe that the confidence that people have in the rule of law in Hong Kong, including the recognition of property rights and enforceability of contracts, has been a centerpiece of Hong Kong's growth and prosperity.

Accordingly, we believe that amendments to the law that would allow for a supervising authority to arbitrarily amend or override these rights are potentially destabilizing and that effective statutory safeguards should be put in place to prevent actions to diminish such rights.

Where practicable any new legislation to empower authorities to impose resolution regimes should draw to the maximum extent compatible with the need for speedy solutions on existing Court practice in a number of mature legal systems where courts have the ability, when considering plans for reorganization or arrangement of distressed companies, to issue orders that can alter the character of pre-existing rights, including those under contract or in respect of ownership (converting debt to equity for example or suspending or altering the terms under existing contracts). Streamlining of such processes is clearly necessary to meet the requirement for speed, but the need for equitable scrutiny - where necessary post facto - within the judicial system is an important ingredient in ensuring future confidence in Hong Kong as an international business centre.

In the context of insurance, we believe that this is more important now than ever before given the ongoing consultation toward an Independent Insurance Authority ("IIA"). Accordingly, this consultation process will need to take account of the emerging legislative changes that will give rise to the IIA rather than to proceed in isolation.

Chapter 4 – Scope of Proposed Resolution Regime

We note that the consultation suggests that the proposed Hong Kong regime will be all encompassing. What is not clear from the consultation is that the differences between the various business and their inherent risks is clearly understood and accounted for in the proposals.

Our concern remains, as will be repeated throughout, that the proposed resolution regime is being built around banks with the differences inherent in other lower risk businesses and other lower risk business models being largely ignored.

We are of the view that the scope of the resolution regime should apply only to the NTNI activities of insurers that pose a systemic risk, recognizing that the existing powers of the prudential supervisor give all powers needed to secure timely resolution of incipient problems within licensed insurers. This would include within the resolution regime activities which, if indeed undertaken by an insurer, might threaten the rest of the group and the larger financial system. While the insurance industry does provide important services to their policyholders and the broader economy, substitutability within the sector and the availability of existing appropriate resolution measures ensures continuity of cover of existing policyholders. Insurers do not typically provide critical short-term functions to the financial system or wider economy in the same way as banks (unless the insurer owns a bank or is part of a banking group). Accordingly, we believe that the powers proposed under this Consultation Paper, which appear to have been developed largely with banks in mind, go beyond what a resolution authority would typically require to address a failing insurer.

It is our view that it needs to be clearly established that a particular insurer has inherent in its operations the potential for systemic risk that might threaten the financial system before any resolution regime would be applied. For example, the resolution regime may be applicable to G-SIIs but should not be applicable to either internationally active insurance groups ("IAIGs") or insurers with systemic significance locally unless they have been assessed as G-SIIs by the FSB on account of their NTNI activities.

As well, the emphasis throughout the Consultation Paper on "critical financial services" which would include the provision of services and intra-group transactions makes the assumption that the entire core business of an insurer may be systemically relevant. It is suggested that in paragraph 256 that resolution may include the ring-fencing of such activities. Although insurers will sometimes determine on pragmatic commercial and risk management grounds to ring-fence the assets and liabilities hypothecated to traditional business lines, mandatory ring-fencing going beyond what is necessary within the insurance prudential supervisory regime would have an adverse effect in that it would reduce the diversification of insurance risks and the fungibility of assets rather than contributing incrementally to financial stability and the safety of insurance coverage.

It should be explicitly recognized that the fungibility of capital is necessary to support diversification across an insurance group and contributes to financial stability and the safety of insurance coverage. Care should be taken to avoid potential unintended consequences which may restrict fungibility. For example, resolution powers may be such that contractual agreements with reinsurers would be suspended. This may result in companies being unable to reinsure risk at affordable prices and tying up capital. To avoid unintended consequences, we suggest arrangements for resolution should be field-tested against a number of failure scenarios.

Question 1

Do you agree that a common framework for resolution through a single regime (albeit with some sector-specific provisions) offers advantages over establishing different regimes for FIs operating in different sectors of the financial system? If not, please explain the advantage of separate regimes and how it can be ensured that these operate together effectively in the resolution of cross-sectoral groups.

We note the proposal to establish a common framework for the resolution of FIs in Hong Kong and are encouraged that the Consultation Paper acknowledges that the differences between the different sectors that make up the financial services industry will require "sector-specific provisions". We believe that this is critically important in ensuring that whatever regime results from this consultation is appropriate for the various types of FIs active in Hong Kong but feel that the consultation paper does not go far enough in discussing the specific instances where "sector-specific provisions" will be appropriate or in setting out the bases for derogations. We have argued at some length that the proposals are overly "banking sector centric" and that not enough acknowledgement is given to the extent to which the core activities of licensed insurers fall into a separate category with very much lower scale-related systemic risk and a highly effective prudential supervision structure (in Hong Kong as in many other advanced financial centres) already fully operational.

We also note that in practice, a "common framework" can only achieve the desired result if there is a reasonable level of appropriate experience to be brought to bear by each authority to be empowered by such a change. It is not clear to us the extent to which any of the authorities to be empowered under a resolution regime of the kind suggested in the Consultation Paper has individuals with the requisite range and depth of experience to manage effectively and equitably the sweeping powers that they would be granted under such a regime.

We therefore submit that a single regime, applicable to banks, insurers and other FIs would <u>not</u> be appropriate given the different business model of insurers. Only certain markets surveyed in paragraph 72 of the Consultation Survey refer to insurers and we suggest that serious consideration be given to the fact that other jurisdictions have chosen to focus resolution powers more on banks and less on insurers. If the resolution regime is to apply to insurers, we are of the view that it should only apply to G-SII's which have significant NTNI activities which pose a systemic risk. This would allow for the regime to be tailored to the kinds of organizations that generally may require its application.

Questions 2 – 7

Given that these questions deal with the extension of a resolution regime to a variety of institutions engaged in activities in which we do not participate, we will defer comment to the many institutions that would be affected by the proposed changes and will instead confine our comments to the application of the resolution regime to insurance companies operating in Hong Kong.

Insurers

Question 8

Do you agree that it would be appropriate to extend the scope of the proposed resolution regime to the local operations of insurers designated as G-SIIs and/or IAIGs as well as those insurers which it is assessed could be critical or systemically important locally were they to fail?

Reference is made to the ongoing work of the IAIS in respect of large and systemically important insurers, as well as those that are active internationally. We note the acknowledgment that "it is generally accepted that insurers have a lower propensity to pose systemic risk on failure (as compared with banks)". However, it is also noted that "the crisis served as a reminder that some individual insurers provide these services on a scale such that they could be critical or systemic on failure". While no context is provided in respect of this statement, we assume that it refers at least to some degree to the events surrounding AIG.

While the AIA Group is no longer associated with or owned by AIG, there is a tendency (we think incorrectly) to refer back to these events in support of the thesis that insurers carry with them substantial systemic risk. As a result, it is very important to clarify important aspects of the AIG events.

First, it was not the life insurance operations that resulted in AIG falling into financial difficulty. Rather it was their non-insurance activities (i.e. NTNI activities). The activities that brought AIG into difficulty were contained in parts of the organization that mimicked the activities of investment banks. They were neither necessarily appurtenant to nor supportive of the operational life insurance businesses of AIG. Second, the life insurance operations of AIG provided financial stability and an ongoing flow of funds back to the parent during the crisis and ultimately provided substantial proceeds on disposal thereof, such that AIG was allowed to emerge from the crisis having repaid the various bailouts with interest.

Accordingly, we support the IAIS criteria as enumerated for determination of which entities ought to be considered globally systemically important. The focus of this analysis so far (we think properly) has been on the non-insurance activities of life insurers – not merely on the scale of their life insurance operations. If a very large life insurer does not possess the kind of inter-connectedness that poses systemic risk nor engages in non-core activities, it should not be said to have a risk profile indicative of other entities designated G-SIIs merely because of its scale. On the contrary, we believe it is clear that the diversification benefits of a large multi-national life insurer reduce risk.

We also note that consideration of these issues is happening alongside two other important consultations in relation to the regulation of insurers in Hong Kong. These are the consultations in relation to the creation of an IIA and in respect of proposed changes to the solvency regime applicable to Hong Kong insurers. We believe that detailed decisions about how (if at all) a resolution regime should operate in the context of the core business of insurers licensed in Hong Kong should follow the completion of these other important initiatives rather than precede them. Decisions taken prematurely could adversely impact the industry and will at the very least create potentially significant uncertainty.

While we appreciate the theory of extending the regime to the local operations of insurers designated as G-SIIs or IAIGs, our view is that the proposed resolution regime should only extend to the local operations of insurers designated as G-SIIs which have significant NTNI activities which pose a systemic risk. The existing regime would in our view be sufficient to cover the remaining insurance entities in Hong Kong.

Branches, holding companies and non-regulated operational entities

Branches

Question 9

Do you agree that branches of foreign FIs should be within the scope of the local resolution regime such that the powers made available might be used to: (i) facilitate resolution being undertaken by a home authority; or (ii) support local resolution?

While we have no objection to the application of any resolution regime to branches of foreign companies operating in Hong Kong, in our view such branches should only be subject to the local resolution regime if these entities are G-SIIs or have significant NTNI which pose a systemic risk. We note that for a local resolution regime to be effective in such circumstances there must be an adequate level of regulatory co-operation with the home authority including adequate and appropriate information sharing arrangements. If these elements do not exist, it will not be possible to coordinate a multi-jurisdictional response to any institution requiring resolution.

In our view, it is likely that in the event of a failure of a multinational FI, the governments of the various economies that are likely to be affected will almost certainly make local considerations paramount in dealing with resolution. Accordingly, Hong Kong must have similar powers in order to ensure that Hong Kong interests are properly considered.

That said, high-quality ongoing supervision of the activities of licensed insurers in Hong Kong together with an appropriate solvency regime, against which the performance of all market participants is regularly reviewed, are and should remain the best protection for Hong Kong's domestic interests.

Question 10

Do you see any particular issues that need to be taken into consideration in ensuring that the regime can be deployed effectively in relation to branches of foreign FIs where necessary?

We see a number of practical difficulties in this respect. In fact, the ability to act meaningfully to ensure that the interests of Hong Kong are appropriately addressed in a resolution context is likely to require relatively broad powers to act in respect of the business and undertaking of the local branch in Hong Kong. That will necessarily mean dealing with conflict of laws issues (with the home jurisdiction) as well as likely debate over assets, where they sit and who should have dominion over their disposition.

One of the stated policy goals of revising the resolution regime is to provide some level of harmony over international proceedings. However, the reality is more likely to involve various local governments acting first to ring fence assets available to satisfy local interests. In this context, Hong Kong should take the necessary steps to ensure that it is on an equal footing with others in this respect. We believe that Hong Kong should therefore take such steps as are required to ensure that its supervising authorities and ultimately its courts are able to make orders dealing with assets of a business to the extent that such assets can be rightly said to be connected to the Hong Kong business (in whatever form it takes).

<u>Holding Companies</u>

Question 11

Do you agree that extending the scope of the proposed resolution regime to cover locally-incorporated holding companies is appropriate such that the powers available might be used where, and to the extent, appropriate to support resolution of one or more FIs?

Many jurisdictions have regulatory regimes that contemplate financial holding companies and allow for their regulation. In principle this is a necessary aspect of a resolution regime but it is difficult to comment on how a resolution regime might function in respect of holding companies in the absence of an appropriate framework for their creation including clear authority concerning their regulation.

Non-regulated entities

Question 12

Do you have any initial views on whether it is appropriate to extend the scope of the regime to affiliated operational entities to help ensure that they can continue to provide critical services to any FIs which are being resolved?

This would be a dangerous area if such powers were to be used in respect of true "affiliated" companies as opposed to wholly-owned or controlled 'subsidiary' companies. If the intention is that it apply to the former, our concern would be that this could run counter to seminal principles of corporate law. One such principle is the doctrine of corporate personality – which put briefly means that the law treats each incorporated entity as a separate legal person.

There is no basis of which we are aware under the current law of Hong Kong that would allow the acts of one person to be attributed to another simply because such individuals are related. If however a corporate entity is wholly-owned by a company being put into formal resolution, one would assume that such a wholly-owned or controlled entity would properly be included in the broader process. However, for the regime to be structured in such a way as to permit a supervising authority to sweep a related entity into a resolution process simply because it is part of the same 'corporate family' seems to run counter to these important principles of law.

Once again, it is our view that ongoing supervision (including on outsourcing to related entities and third parties) should impose upon regulated entities the necessity to structure their affairs such that they are able to operate as a going concern in all circumstances. To the extent contracts are put in place in respect of such arrangements, it would be open to a supervising authority to insist that such agreements include provisions that the related entity is not permitted to withdraw services in the event the FI becomes the subject of a "resolution". Such contracts could be enforceable, if properly crafted, in the event of a resolution and this could be achieved without ignoring established principles of company law and the law of contracts and represent in our view a better solution to address the issue.

Chapter 5 – Governance Arrangements

Under Key Attribute 2 ("Resolution Authority") one or more public authorities should exercise the resolution regime powers and should be designated as "resolution authorities". We strongly agree that to act as a resolution authority, the authority must be operationally independent in this role and be adequately resourced but also ultimately subject to the need to operate within sound legal principles and subject to judicial review as an aspect of accountability.

We believe in fact that the burden of leading a resolution process is indeed likely to be an extremely "weighty" one. Given that it is expected that these regimes will only be used rarely and in the most extreme circumstances, we believe that this would be a heavy burden for the authorities when added to the ongoing work associated with supervising the various sectors of the financial services industry. For this reason, it will likely be necessary to "gear up" to be able to act meaningfully and decisively in the context of a resolution. Thought should also be given the ability of the resolution authority to be able to retain external expertise (including as to the costs thereof) in order to ensure that the most "current" experience is available as and when required.

On the subject of "operational independence", we agree with the broad principles espoused in the "Key Attributes", namely, that the "resolution authority should have operational independence consistent with its statutory responsibilities, transparent processes, sound governance and adequate resources and be subject to rigorous evaluation and accountability mechanisms to assess the effectiveness of any resolution measures."

There is simplicity in having one resolution regime apply to all FIs. However, as previously mentioned, the reality is that insurers operate under a vastly different business model than other FIs and the focus should be on any NTNI business. Where a bank is concerned, it is easy to say that priority should go to the insured depositors first, then unsecured creditors and finally shareholders. This may not necessarily be the case with insurers given the varied interests of and potentially serious impact on, in no particular order, policyholders, creditors, shareholders and reinsurers. Moreover, more guidance is required as to when existing tools should be used rather than resorting to the extended powers under a proposed resolution regime. Accordingly, the governance arrangements suggested in this Chapter require elaboration if they are to address the particular needs of insurers. In this regard, more clarity should be provided on a sector-specific proposal for insurers as suggested in Question 1.

Question 13

Do you agree that the conditions proposed for initiating resolution are appropriate in that they will support the use of the regime in relevant circumstances?

We would appreciate more clarity in terms of the use of the conditions for insurers before supporting the use of such a regime over existing (even with appropriate "improvements") tools. We reiterate that the scope of the resolution regime (as opposed to the use of the currently available facilities) should be limited to G-SIIs and their NTNI operations. Accordingly an insurer must be a G-SII in order to fall under the regime. As such, it would seem reasonable that a pre-condition for the conditions for initiating resolution (as opposed to using the currently available regime) be that an insurance company must have been designated a G-SII.

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Question 14

In particular, do you agree that it is appropriate that the first condition recognizes that non-viability could arise on financial *and* non-financial grounds (noting that resolution could occur only if the second financial stability condition is also met)?

We consider that the core purpose of a resolution regime is to prevent, or failing that to limit the impact of, financial systemic risk. Therefore we do not see the applicability of a resolution regime to circumstances which arise from non-financial grounds. Where such non-financial grounds exist to justify challenge to the continuance of an FI in operation (e.g. "fit and proper" tests for management) this is surely a matter for the prudential supervisor and therefore outside the scope of a resolution regime. In our considered view, there is a potential for extreme moral hazard in creating blanket powers for a resolution authority to override the supervisory and legal arrangements applicable to a licensed undertaking.

Question 15

Are the objectives which it is proposed should be set for resolution suitable to guide the delivery of the desired outcomes?

The objectives in the first phase of the Consultation are high level and until more detail has been provided in the second phase of the consultation, it is difficult to provide meaningful comment on whether the objectives are sufficient to achieve the desired outcomes.

Question 16

Do you agree that, in line with their existing statutory responsibilities and supervisory intervention powers, the MA, SFC and IA should be appointed to act as resolution authorities for the FIs under their respective purviews?

We take the point that the powers in respect of resolution must be invested in some organ of government to achieve the desired result in the case where an FI is failing. We repeat our earlier comments that it is reasonable to assume that the MA, SFC and Insurance Authority will need to gear up to take on these added responsibilities and ultimately, in the face of a failing institution, are likely to need to have access (and the authority to do so) to support from experts in the private sector. It should be noted, however, that whilst the Insurance Authority is a governmental organization and therefore potentially appropriate, the IIA is being set up as independent of government and therefore inappropriate for any such role.

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Chapter 6 – Resolution Powers

Any proposed laws for recovery and resolution must be proportional both to the likelihood of the occurrence of the events it is meant to mitigate and to the protection of ownership and other legal rights. It is our view that it would be relatively remote that a resolution authority would need to exercise an additional range of tools to what is available currently in regards to an insurer which has limited NTNI activities.

For insurers, the current tools include the mechanism of a court-approved portfolio transfer, the power to discontinue new business and run-off of existing obligations and other powers under section 35 including powers to appoint a manager to conduct the insurance business. Our view is that less drastic resolution powers may be more appropriate and proportionate to the inherent risks and the goals to be achieved. In our experience, traditional insurance activities and even some non-traditional activities that are no longer viable have typically been resolved satisfactorily through run-off and portfolio transfer procedures.

Some of the proposed measures for restructuring liabilities go beyond what is permissible under insurance supervisory law and there is no protection contemplated, such as review by the courts and independent valuations. We consider this to be an essential component of any future regime central to the protection of all stakeholders including policyholders. As we have proposed in our comments under Chapter 3, the resolution regime for Hong Kong should also consider the extent to which in the remote circumstance that an insurer is potentially subject to resolution, an insolvency court might play a lead role within appropriate empowering legislation. While this would require extensive consideration (and amendment to existing law), very much abbreviated timetables could be enforced (days as opposed to weeks or months) to ensure that the supervising authority can make application to that court to have a failing FI placed in a court protected process with the supervising authority as the "applicant". In other words, it may be possible to amend the existing powers to provide additional flexibility without dispensing with the current framework. This would not have to be the only option, but could be one path that a supervising authority could pursue to ensure transparency and equity of treatment.

Accordingly, our view is that the resolution regime for Hong Kong should include an insolvency court as an alternative with appropriate empowering legislation to ensure that the supervising authority (and perhaps only a supervising authority) can make application to that court to have a failing FI placed in a court protected process with the supervising authority as the 'applicant'.

The authority would need to present certain criteria to have such an institution placed under the protection of the court and upon approval by the court, the authority could then make application to have a court appointed management structure put in place. The court would have the power to suspend certain rights of creditors against the failing FI so that it can continue to provide the necessary services it provides, and the resolution authority could then take the time necessary (albeit under an expedited process set out in revised legislation) to present to the court for approval a proper resolution plan.

Other parties would have the power, at certain points in the process, to make submissions as to their concerns with any such plan, but the plan would not need to receive the approval of other stakeholders. It could ultimately be imposed as an order of the court.

Done properly, it could be relatively fast and legally effective and would have the benefit of a governance process already built into our system – albeit the legislation in support of such a process would need to be developed. The end result would be a process lead by the supervising authority for the relevant FI, supervised and administered by the courts with the benefit that it is more likely to be seen as transparent and better able to balance what will necessarily be competing rights and priorities.

Again, while this may not work in the context of an illiquid bank facing a run on the part of depositors, it may well be a preferred alternative in the context of a failing insurance company wherein preservation of the policyholders' long-term benefit would be a paramount concern.

Question 17

Do you have any views on how a resolution option allowing compulsory transfer of all or part of a failing FI's business could most effectively be structured and used?

We recognize the desire for speed, but our view is that in respect of insurers, the compulsory transfer of all or part of its business would be less transparent and therefore less able to balance competing rights and priorities as compared to a court sanctioned process. However, again, the question is whether or not the implementation of such a resolution option is warranted given the remoteness of a resolution authority needing to exercise such a power bearing in mind the business model of insurers and the difference between calming the market in the face of a "run" on a bank and preserving the long-term benefits to the policyholders of a failing insurer. We believe that the development of a resolution regime applicable to insurers should focus on the development of measures that would prove speedy and effective in dealing with NTNI operations.

Question 18

Do you have any views on how a resolution option allowing compulsory transfer of part of a failing FI's business to a bridge institution could most effectively be structured and used?

We have no specific concerns about the creation of a bridge institution to take control of a failing FI on a temporary basis, beyond the very practical concerns of who would run it, how it would operate and who would pay for its operation. Once again, the theory is fine, but operating such an institution in practice would take great depth of sector- and market-specific expertise and experience and almost certainly the injection, even if temporarily, of potentially large amounts of money. Moreover, in an insurance context, we note that the transfer of a business under the current powers provided to the Insurance Authority should be effective in winding-up a failed insurer and eliminate the need for a bridge institution.

Question 19

Do you have any views on factors which should be taken into account in drawing up proposals of the provision of a bail-in option for the resolution regime in Hong Kong?

We have no objection to the 'bail-in' option as described, which would appear to represent a forced conversion of certain forms of debt to equity. However, the concept raises many of the same concerns as would be raised in the context of a compulsory transfer. The reality is that in a failed FI, particularly a large one, there will be competing claims and these will need to be sorted out. We believe that it would represent a heavy burden for the resolution authority to manage these competing claims in the absence of support from the court system.

Question 20

Do you agree that there is a case for including a TPO option in the proposed regime?

It appears that the Key Attributes acknowledge the inherent difficulties in all of the aforementioned tools by proposing that jurisdictions consider a "Temporary Public Ownership" option. We see no reason why Hong Kong should exclude such an option from its tool kit, however, current insolvency laws allow for a company to be placed into a court protected process to prevent its immediate dissolution with caretaker management appointed.

Such an insolvency regime, administered by the courts, is intended to allow for a resolution authority to ensure that an important FI, that provides critical services, can be held together and continue providing such services while a long-term and orderly resolution is developed. The court process is also set up such that the interests of all stakeholders are taken into consideration in an open and transparent manner. We continue to view this as preferable to Public Ownership and as the most effective bridge to permit a resolution authority to then seek to apply the other available tools, like finding a buyer. We recognize however that, in the absence of material amendments to the current law in Hong Kong, such a process would likely be extremely lengthy.

Once again, we would suggest that consideration be given to the extent that insolvency law in Hong Kong could be amended to at least provide one avenue for resolution where circumstance are such that there is less need to "resolve" a failing institution 'over a weekend' than there is to preserve long-term value.

Question 21

Do you have any views on when it would be appropriate to make temporary use of an AMV in order to manage the residual parts of an FI in resolution?

We have no specific concerns and our comments relating to the use of an AMV are similar to those under Question 18 in respect of the need for a bridge institution.

Question 22

Do you have any views on how best to provide for a stay of early termination rights where these might otherwise be exercisable on the grounds of an FI entering resolution or as a result of the use of certain resolution options?

Our view is that this power must be limited but that it can be useful in certain scenarios. For example, derivatives are normally used in the traditional insurance business for pure hedging purposes (including in respect of responsible risk management activities like addressing currency or duration mismatches between policy liabilities and available long-term assets). In a stressed environment, typical derivative contract provision could exacerbate a situation as the operation of such provisions could leave the insurer without these risk mitigants in place. To limit the deterioration of the insurer's situation, a stay of early termination rights would be useful. However, it would be reasonable to provide in such circumstances that counterparties be put in no worse a position than had early termination applied, otherwise they are disadvantaged and there is an increase in contagion risks. We also note that these kinds of powers exist in advanced insolvency regimes supervised by courts of competent jurisdiction.

Resolvability

This Key Attribute suggests that an authority can force an FI to organize its affairs so that it might be more readily reorganized in the event of failure.

While we understand that authorities have a duty to regulate to achieve financial stability and that if they have well-grounded concerns on resolvability they ought to be able to require change, this power must be balanced against the fundamental right of the owners of a business to manage their business in the way that they see fit provided that they do so otherwise in accordance with the law.

It is reasonable in our view for an authority to ensure that appropriate levels of governance and operational efficiency and reliability are achieved. It is also reasonable to ensure that individuals in key roles are fit and proper to occupy such roles and that they continue to manage the business in a responsible fashion. However, care must be taken, and effective safeguards put in place, to ensure that such authority is not used to second guess management on operational issues.

Exercise of Resolution Powers

It is suggested that an authority should be able to initiate a resolution proceeding "without delay and that the potential for resolution to be delayed or reversed by legal actions taken by affected parties should be contained to some degree". We don't dispute that courts can be used by certain parties to elongate processes with a view to extracting concessions and that this can be less than ideal and that to the fullest extent possible, the exercise by the authority of their powers under a revised regime should not be subject to arbitrary or vexatious procedural wrangling.

We would however be supportive of a process that provides at least some expedited (even if substantially abbreviated by revised legislation) opportunity for affected parties to be heard and to be able to make submissions in an objective judicial forum distanced from the resolution authority with a view to ensuring an equitable outcome for all stakeholders.

Accordingly, the supervising legislation by which the authority would be bound should ensure that the authority has scope to advance a resolution process expeditiously. However, it should also place a requirement of reasonableness on the authority and provide some recourse within a process broadly designed to expedite resolution, to allow for parties affected to make abbreviated submissions concerning their interest to a judicial body distanced from the resolution authority.

Question 23

Do you have any views on how best to provide the supervisory or resolution authorities with powers to require that FIs remove substantial barriers to resolution?

It is difficult to answer that question in generic rather than specific terms. By definition an effective resolution regime is likely to give authorities wide powers to eliminate barriers to resolution and we propose safeguards to ensure ultimate equity of treatment that in practice should ensure ready acquiescence of stakeholder groups.

Question 24

Is the proposed approach to ensuring that third parties cannot act to pre-empt the resolution of a non-viable FI (including by means of a petition to initiate a winding-up) appropriate?

A third party would likely only petition a winding-up as a last resort. If the creditor is in a position to make the petition, the resolution regime would take precedence, if applicable. It would also be relatively straightforward to amend existing laws to require that the supervising authority of any FI must be included in any such petition by a third-party and be heard by a court prior to the granting of any such petition. In the event that any petition is frivolous or vexatious, the proceedings could be readily dismissed under existing laws.

It may be worth noting that some jurisdictions (including Indonesia) no longer permit anyone to petition an FI into bankruptcy without the consent of the relevant authority. Such a power written into revised legislation may address this issue.

Question 25

Do you have any views on how provision might be made to ensure that the residual part of an FI could be called on to temporarily support a transfer of business to another FI or bridge institution (in the manner described in paragraph 266)?

While the transfer of business to another FI is intellectually pleasing as an option as it can provide the most convenient means to ensure relative continuity of service, achieving such a transfer at no cost to the public is based on a major assumption: that the assets are in place in full to transfer so that the transferee institution is in a position to continue to provide the necessary services without diminution. Leaving aside the inherent systems issues associated with the example used of transferred bank accounts from one institution to another so that service could be resumed the next day, banks typically require intervention because they have liquidity problems and are unable to pay in the face of an impending "run on the bank". Accordingly, the obvious question is, "who pays to fill the hole"?

In the context of insurance, the products are different and there generally are not "runs" on insurance companies. It is not typically in a policyholder's interest to redeem a life insurance policy as the protection value associated with the policy is lost and depending on the duration that the policy has been in force, it may be difficult or impossible to replace. Even where the protection can be replaced, it will be unlikely that it can be replaced on anything like the existing terms. However, the transfer of an existing block of policies from one life insurance company to another will necessarily require detailed assessments of the quantum of assets required to support the policy liabilities and the availability (including consideration of any impairments) of such assets. This will take time and be subject to verification.

In order to achieve such a transfer, the transferee company will need to be convinced that it will receive sufficient assets to fund the future liabilities associated with the business that it will assume. If the transferee company is not convinced, someone will need to provide additional funds "to fill the hole" or policyholders will need to accept a diminution of benefits associated with their policies.

It should also be noted that FIs tend to come under extreme duress as a result of a combination of factors that include external shocks. In such times of broader economic upheaval, institutions with the resources (and desire) to acquire a failing institution are likely to be in short supply. Failing institutions often therefore need to be managed by some form of "caretaker" administration while an acquirer can be found. So it must be clearly understood that these kinds of transfers do not happen "overnight" and there may well be a need for government guarantees or financial injections in order to achieve the desired result. During the intervening period of uncertainty, government support for the failing institution is entirely likely to be necessary. So are things like "stay bonuses" for employees and other measures to steady the institution and facilitate an orderly transfer. Once again, someone will need to fund these payments. As we have pointed out previously in our responses these are all circumstances that can be accommodated within existing prudential supervision arrangements and without the time constraint that applies to failing banks where collapse through illiquidity or insolvency is typically imminent.

This is all to say that while compulsory transfer to a third party institution is an important part of any resolution regime, the manner in which it is presented is an oversimplification of how this is likely to work in reality for life insurers. While this option (i.e. compulsory transfer) is presented as the simplest option, it is not a straightforward process and will take typically months or longer to complete.

Paragraph 44 states that in light of the benefits presented, the Key Attributes require "that resolution authorities should be able to intervene to sell, and transfer, the entire FI, or the relevant parts of its business without needing the consent of ***any affected parties associated with the failing FI, including shareholder***" (emphasis added). This raises a fundamental principle of law - namely that the resolution authority can proceed without regard to rights of ownership. As the consequences may be profound, we suggest that bearing in mind once again that the preservation of policyholder value in an insurance context is likely to differ from the concerns of depositors in a banking failure, resolution powers should only be exercised in the context of a life insurer as a last resort where it is clear that systemic risk is likely.

While no doubt, the authority would only do so in extreme circumstances, affected parties will nevertheless seek recourse to the courts in Hong Kong and it is right that this recourse should be available. To that end, the authority will need to ensure almost pre-emptively that these powers are used judiciously and that the measures proposed are wholly necessary (i.e. that there is an emergency

and no other way to deal with the situation), reasonable in the circumstance and that the proposed actions go only as far as is required to address the emergency situation.

Once again, courts of competent jurisdiction exist to resolve competing claims between parties and we recommend that consideration be given to drafting the necessary legislation in such a way as to allow some support from the courts on contentious issues with strict and abbreviated timelines to which all participants must adhere.

Question 26

Do you attach any priority to pursuing reforms designed to ensure that the claims of protected parties (particularly those of depositors and investors) can be transferred out of liquidation proceedings, alongside those reforms being pursued to establish an effective resolution regime?

We note that the FSTB issued a consultation in April 2013 on corporate insolvency law. Our view is that it is important to consider the insolvency regime as one of the tools that may be used for resolution. It is transparent, reasonably established and well understood and able to balance what will necessarily be competing rights and priorities. Presumably, amendments could be made to permit the relevant authorities to commence proceedings that could be relatively fast and legally effective and would have the benefit of a governance process already built into our system and understood by market participants and the general public. As such, some focus should also be directed towards implementing changes to the insolvency laws in Hong Kong consistent with the resolution regime for G-SIIs. This need not be the only tool, but it could certainly be one additional avenue for a supervising authority to pursue and it would have the knock on benefit of providing a level of support for the relevant supervising authority as well as a level of insulation against future litigation by aggrieved stakeholders.

Chapter 7 – Safeguards and Funding

Question 27

Do you agree that a compensation mechanism is a necessary safeguard to ensure that shareholders and creditors are no worse off under resolution than they would have been in liquidation? Do you have any views on the factors which should be taken into account in designing a compensation mechanism?

Yes, we regard this as both sound in principle and important in practice as a facilitator of resolution processes. We are pleased that certain safeguards have been considered as part of the Key Attributes. We recognize that there is a need to balance competing interests and we continue to be of the view that to do so requires that those with the greatest experience be included the process.

A central function of the court system is to balance competing claims and interests and it is for this reason that we feel that consideration should be given to providing the supervising authorities with an updated and revised toolkit, which includes, at least as an option, the benefit of even-handed oversight from the courts to ensure that resolutions are achieved efficiently with due regard to the various interests that will always exist in cases where FIs fail.

Measures used to achieve the objectives of the regime should be proportional to the consequences of such measures. For example, potential losses may be imposed on shareholders and unsecured creditors if the assets of an insurer are transferred elsewhere or by writing down any claims of creditors and subsequent conversion into equity in a 'bail-in'. One mechanism may be to have such arrangements submitted at the behest of the supervising authority and reviewed and approved by a court of competent jurisdiction.

Question 28

Do you consider that any adjustments are needed to the existing framework for protecting client assets for the purposes of resolution?

We do not consider any adjustments necessary to the existing framework in the context of insurance for protecting client assets for the purposes of resolution.

Question 29

What types of "financial arrangements" do you consider as important to protect in resolution? Why is it important that those arrangements be protected?

We acknowledge that the financial arrangements set out under paragraph 291 are important to protect in resolution. We would agree that it would be important to protect these financial arrangements to the extent that the overriding purpose is to protect public confidence and financial stability.

Question 30

Do you agree that, in order to ensure resolution can be effected as swiftly as needed, there should be protection from civil liability for: (a) officers, employees and agents of the resolution authority, and (b) directors and officers of FIs acting in compliance with the instructions of the resolution authority, limited to cases where these parties are acting in good faith?

We agree that directors and officers of FIs acting in compliance, in good faith, with the instructions of the resolution authority should be protected from civil liability.

We agree with giving protection from civil liability to officers, employees and agents of the resolution authority provided that such persons do not, in the exercise of their powers, take actions that result in manifest abuse of process or unnecessary or unfair derogation of a party's rights. In these circumstances, we suggest the court should have a right to review and assess liability.

Question 31

What provisions should be made under the regime to fund resolution, with a view to ensuring that any call on public funds is no more than temporary?

Given the amounts that may be involved in resolving a globally systemically important financial institution ("G-SIFI"), it is quite likely that public financial support will remain an important component of resolution funding arrangements, albeit as a "last resort". For insurers, we note that there may be a PPF to which industry will contribute in the future. Given that the need for a resolution of a life insurer is a remote possibility, it is our view that a further levy from the insurance industry to fund resolution is not appropriate. Though it is understood that should a resolution exhaust or materially diminish the assets in any PPF, some form of one-time levy on the industry might follow a successful resolution. In this respect, however, we urge that the authority not create what is effectively a penalty for good behavior by levying fees solely based on size rather than risk.

Chapter 8 – Cross-Border Coordination and Information Sharing

Question 32

Do you agree that it is important that the resolution regime in Hong Kong supports, and is seen to support, cooperative and coordinated approaches to the resolution of cross-border groups given Hong Kong's status as a major financial centre playing host to a significant number of global financial services groups?

We agree with the benefit that can be derived from cooperation across borders. AIA Group is active in a host of markets and is a leading business and an important institution in many of those markets. We agree that active cooperation and coordinated approaches are required to resolve cross-border groups. Please also see our response to Question 23.

In our view, it would be more appropriate to prioritize the impact that proposed changes to the resolution regime are likely to have on Hong Kong domiciled and regulated FIs rather than on the relatively minor role that Hong Kong is likely to play in the resolution of a major multinational FI headquartered in the US, UK, Europe or elsewhere.

Question 33

Do you agree that the model outlined in paragraphs 331 to 333 to support and give effect to resolution actions being carried out by a foreign home resolution authority would be effective in supporting coordinated approaches to resolution where it is in the interests of Hong Kong to do so?

We understand that it would be desirable for the effective resolution of a G-SIFI that national regulators act collectively under a coordinated approach during a crisis. However, it is not clear in this Consultation Paper how this will be done in practice. In this context, more guidance is required.

Again, it is hard to imagine a scenario where national supervising authorities would not be compelled to consider local interests as paramount in any resolution process. Accordingly, it is unclear to us how much "coordination" could be achieved in practice. In our view, greater coordination in areas like solvency and accounting standards, as well as in permitting free flow of funds without adverse tax consequences would do more to prevent the need for a resolution and, in that sense, would be of greater value than a focus on coordination after the event.

Question 34

Do you consider that the powers proposed regarding information sharing strike an appropriate balance in terms of facilitating information sharing for resolution in both a domestic and cross-border context whilst also ensuring that all reasonable steps are taken to preserve confidentiality?

We would be very keen to see this increased sharing of information result in more consistency in the application of solvency regimes across jurisdictions. However, to be effective, there should be a discussion amongst regulators about the extent to which they are prepared to co-operate and share information with each other in the event of a failure involving a G-SII. Absent clarification on this point, work on group resolution and intra-group transactions will have limited value.

We recognise that authorities need access to adequate, timely information in order to make well-considered assessments of the stability and health of an FI. As such, legal and operational systems need to be adapted for the exchange of information outside a regulator's jurisdiction. However, whether the information is used domestically or provided to a foreign authority, this should take into consideration and balance the need to protect the confidentiality of information, particularly since it is likely that the information required may be of a sensitive nature. Information should be shared which is absolutely required and to only those within each authority that require it.

The legal framework should prohibit any disclosure of non-public company information to any recipient unless the proposed recipient agrees, and the relevant authority agrees to keep the information confidential and protect it from disclosure except where required by a court of competent jurisdiction or by law. The legal framework should also require the recipient to provide notice to a company prior to any legally compelled disclosure of non-public company information. Moreover, no privileges or confidentiality associated with information provided by an authority or an FI should be waived as a result of sharing the information with another authority. In addition, the rules on information sharing need to address the period of retention of the information shared.

Conclusion

It is important to note that Hong Kong was not at the center of the global financial crisis, nor were any of its institutions. Additionally both the nature of life insurance operations and extensive existing powers of prudential supervisors make the need for resolution regimes applicable to insurance business (as distinct from NTNI activities) remote. Accordingly, while it is in Hong Kong's interest to ensure appropriate alignment with relevant international practice, it will also be important to guard against taking actions simply because they are 'fashionable' as evidenced by activity elsewhere.

A resolution regime cannot and should not be viewed in isolation from other regulatory regimes or powers. The ongoing focus on ensuring solvency and responsible behavior ought to remain the central tenet of the evolving regulatory regime in Hong Kong. The resolution regime must therefore follow these broader prudential developments (like the development of the IIA and the evolution of a risk based capital regime) rather than lead them.

To this end, fundamental questions should be asked as to why certain institutions failed and how that could have been prevented. Such an enquiry could give rise to much more constructive supervisory powers than could be achieved by legislating for detailed structures for supervising failed institutions.

It is critically important to include in any resolution regime, consistent with the acknowledgement of a need for 'sector specific provisions' recognition that insurers have a business model very different from banking and that insurers engaged in traditional insurance activities are not a concern from a systemic risk perspective and to focus attention on any material non-insurance activities of G-SIIs.

It is also important to recognise that the Insurance Authority already has extensive powers that can address the failure of an insurer, including providing recourse to the courts to provide assurance that all interests are equitably protected. In most circumstances involving life insurers that are not G-SIIs, these existing processes are likely to be sufficient. Accordingly, recourse to the kinds of extraordinary powers contemplated should be limited to circumstances where there is a genuine systemic risk posed by the failing institution.

Accordingly, any proposed laws for recovery and resolution must be proportional to the likelihood of the realization of the risk it is meant to mitigate and by so doing give effective protection to ownership rights. We believe that the desire to have tools available that can expedite resolution in extreme circumstances is appropriate, but that such powers should only be used when there is truly an overriding need and opportunity to resolve an institution quickly and there is no practical alternative to taking such precipitous action.

As we discussed under Chapter 3, we see no reason why Hong Kong should exclude insolvency proceedings as at least one of a series of options for resolution from its overall tool kit. The insolvency laws in a number of jurisdictions other than Hong Kong allow for a failing enterprise to be placed into a court supervised process to prevent its immediate dissolution with caretaker management appointed. Such an insolvency regime, administered by the courts, is intended to allow for a resolution authority to ensure that an important FI, that provides critical services, can be held together and continue providing such services while a long-term and orderly resolution is developed. We continue to view this as a viable (and perhaps a preferred) alternative where practicable. In the context of an insurance company, where preserving policyholders longer-term interests is likely to be paramount to the more immediate concerns presented by an illiquid deposit taking institution, a properly structured insolvency proceeding may well provide a preferred alternative and an effective bridge to permit a resolution authority to then seek to apply the other available tools, like a transfer of business insurance liabilities and assets to another insurer.

AIA Group looks forward to receiving the consultation conclusions and participating in the second stage of the consultation as well as any other participation in respect of these proposals.

20 April 2015

AIA Group's comments on the Second Consultation Paper on
An Effective Resolution Regime for Financial Institutions in Hong Kong

AIA Group is pleased to continue its participation in the consultation process toward *An Effective Resolution Regime for Financial Institutions in Hong Kong*. Our comments herein are in respect of the Second Consultation Paper jointly published by the Financial Services and the Treasury Bureau, the Hong Kong Monetary Authority, the Securities and Futures Commission and the Insurance Authority on 21 January 2015 ("**CP2**") and are further to the comments we submitted on 3 April 2014 on the First Consultation Paper ("**CP1**"). Unless otherwise indicated, the abbreviations we have used below will have the same meaning as defined in CP2.

Introduction

We recognise the effort undertaken and support for reforms to develop a comprehensive resolution regime in line with emerging international practice. While the proposals for the regime are being further refined and developed through CP2 and other processes including the third stage consultation process, we wish to reiterate three main themes we first raised in CP1.

The first is that any changes to the regulatory regime in Hong Kong generally, or the resolution regime specifically, **must take into account factors unique to Hong Kong** rather than simply grafting principles accepted elsewhere onto the Hong Kong regime.

Secondly, we believe that although the resolution regime would apply if an FI is assessed as systemic, it is still critical to recognize the focus should be on non-traditional non-insurance ("**NTNI**") activities on a scale that poses a potential threat to the continuing viability of the insurer (or insurance group). As we indicated in our comments to CP1, the fundamental principle of insurance is the law of large numbers. Well managed insurers (with sound underwriting and asset/liability management) reduce the relative risk of loss by insuring a large number of independent units of risk. Moreover, sound life insurance underwriting requires an insurer to match closely the term of the assets held to support policies underwritten with the actuarially assumed term of the contract. With these and other factors, it is our view that traditional insurance activities are not a concern from a systemic risk perspective. Accordingly, any regime that would force on insurers a level of oversight tailored to bank or bank-like activity has the potential for unintended consequences without providing obvious benefit.

Thirdly, to the extent possible, the resolution regime **should be considered as the "last stop" to be used only after considering the application of a range of other tools** available to regulatory authorities.

There already exist a number of tools which replicate resolution arrangements in Hong Kong. These include Court-approved portfolio transfer, mandatory instruction to discontinue writing new business, compulsory run-off of existing obligations, the power to direct an insurer to take action in respect of its affairs, the power to appoint a manager empowered to carry on the business of the insurer and, when implemented, the Policyholder Protection Fund. Additionally, existing solvency laws in many countries have proven to be adequate in the vast majority of insurance failures. Experience has shown that where a true insurance company (as distinct from financial groups that include insurance but undertake substantial NTNI activities) has failed, its wind-down has not posed any systemic risk to the financial system and insurance companies' wind-downs and exits from markets have been conducted in an orderly manner. Typically, policyholders have, at worst, suffered only a limited loss.[1] **We see no reason why Hong Kong should not make any necessary amendments to insolvency proceedings so it could be effectively be one of a series of options for resolution from its overall tool kit.** We continue to view this as a viable (and perhaps a preferred) alternative where practicable.

With these key themes in mind, AIA Group as the only multi-national financial institution truly headquartered in Hong Kong (being incorporated, listed and headquartered here) is pleased to submit its comments on CP2 as set out below.

Chapter 1 – Scope of the Resolution Regime

Single regime

It is important to reiterate our view set out in CP1 that **it is not appropriate to have a single cross-sectorial resolution regime in Hong Kong** that takes in traditional insurance operations. While we appreciate the acknowledgment of sector specific accommodations to reflect the different characteristics of the various types of FIs, our expectation would be that these measures should be thoroughly discussed with industry and discretely agreed upon.

For example, the proposal in paragraph 38 where the authorities may convert branches to locally incorporated subsidiaries is drastic. Experience from the trouble created by the 'non-insurance' activities of American International Group ("AIG") shows that arrangements were flexible enough to address the actual systemic threat. Given the wide powers already available to the Insurance Authority and the courts and the profound consequences to resolution to shareholders and bondholders, every effort

[1] A summary of resolution and impact of a section of high-profile insurance failures can be seen in Table 3 of Insurance and Resolution in Light of the Systemic Risk Debate published by The Geneva Association in February 2012.

should be made to ensure that such resolution powers are only exercised when there is no alternative but resolution rather than as the default procedure for distressed entities.

Licensed corporations

Question 1

Do you agree with the revised scope of the regime in respect of LCs as set out in paragraph 29?

We confine our comments to the application of the resolution regime to insurance companies operating in Hong Kong.

Insurers

Question 2

Do you have any views on the factors that should be taken into account when assessing the local systemic importance of insurers?

We agree with the position of the authorities not to extend the resolution regime to IAIGs and automatically capture within scope any local entities that are identified as IAIGs, or that are a local branch or subsidiary of a cross-border entity identified as an IAIG. We agree that reference should be made to whether the entity is a G-SII and use the same factors used in that assessment to determine whether an insurer is systemically significant or critical locally on failure. The criteria and weighting currently used by the FSB should be replicated. They are as follows:

- Size (5%);
- Global activity (5%);
- Interconnectedness (45%);
- NTNI (40%); and
- Substitutability (5%).

We disagree with the proposal in paragraph 32 as the factors do not align with the FSB criteria and do not have any weightings. In other words, our view is that the analysis should be the same as those used by the FSB and that market share/concentration and "other factors" should not be included. As we previously mentioned, size should not be a factor, if at all, given that the fundamental principle of insurance is the law of large numbers. As well, traditional insurance activities have a high degree of

substitutability and limited interconnectedness with the rest of the financial system. Hence, the focus, as we expressed previously, should be on the NTNI activities of an insurer.

As such, we believe that the criteria should be clearly and tightly defined and mirror the FSB criteria and weightings.

Question 3

With a view to ensuring that all FIs which could be critical or systemic on failure are within scope of the regime, and recognising that the risks posed by any given types of FI may change over time, do you agree that providing the FS with a power to designate additional FIs as being within scope is appropriate?

We agree that risks may change from time to time and a particular FI may be within or outside scope at certain times. However, we are of the view that such an assessment should be consistently conducted using the same criteria used to determine whether an FI is considered systemically important using accepted international criteria like those used by the FSB. Only in very rare circumstances where there are in fact new risks which are significant enough to pose a risk to the continuity of critical financial services and wider financial stability should an additional power be given to the FS. As such, this power of the FS must be constrained such that its exercise is equitable and proportional to the likelihood of such a risk.

Locally incorporated holding companies and affiliated operational entities

Question 4

Do you agree that in cases where one or more FIs within scope of the regime are part of mixed activity groups, the presumption should be that resolution will be undertaken at the level of a locally incorporated FSHC? And that resolution at the level of a locally incorporated MAHC would be undertaken only in exceptional circumstances where orderly resolution cannot otherwise be achieved?

We agree with these proposals so long as it is clear that it would neither be desirable nor necessary for the resolution authority to use resolution powers in relation to companies, within a mixed-activity group, operating outside of the financial sector.

Question 5

Do you agree with the proposed definition of, and approach to, setting the regime's scope in respect of, AOEs?

As we indicated in our comments to CP1, it would be a dangerous area if such powers were to be used in respect of true "affiliated" companies as opposed to wholly-owned or controlled 'subsidiary' companies. Our concern remains that this runs counter to seminal principles of corporate law. One such principle is the doctrine of corporate personality – which put briefly means that the law treats each incorporated entity as a separate legal person. There is no basis of which we are aware under the current law of Hong Kong that would allow the acts of one person to be attributed to another simply because such individuals are related. It is our view that ongoing supervision (including on outsourcing to related entities and third parties) should impose upon regulated entities the necessity to structure their affairs such that they are able to operate as a going concern in all circumstances.

Question 6

Do you have views on how AOEs might be more precisely defined, without restricting the resolution authority's ability to achieve orderly resolution of an affiliated FI?

Please see our response above to question 5.

Exchanges

Question 7

Do you agree that it would be appropriate to extend the scope of the proposed resolution regime to recognized exchange companies that are considered systemically important to the effective functioning of the Hong Kong financial market?

As noted in paragraph 50, there is no requirement under the Key Attributes to include exchanges in the resolution regime. Should the resolution regime apply to exchanges, it could provide certainty to our shareholders and bondholders in the very rare circumstance of a collapse of the Stock Exchange of Hong Kong Limited in that there would continue to be an exchange on which our securities would be freely traded. However, any inclusion of stock exchanges in the resolution regime in Hong Kong should be in line with best practices internationally.

Question 8

Do you agree with the factors to be taken into consideration in designation of systemically important recognized exchange companies set out above? Do you have suggestions as to what other factors should also be taken into consideration?

We would generally agree with the factors set out in paragraph 58 however more clarity should be proposed on what process the SFC would take to determine other factors it deems appropriate and what these factors would be.

Chapter 2 – Governance Arrangements

Conditions for initiating resolution

Our view on initiating resolution are that the conditions must be material enough to warrant intervention. **Entry into resolution must not occur before an insurer has reached the point of non-viability as this may result in adverse consequences.**

A premature entry into resolution would rule out a number of recovery options that might produce a better outcome for the insurer and its policyholders (including run off and portfolio transfer). While an insurer is balance sheet solvent, it should be possible to address it as a viable concern, with the encouragement of the IA where necessary. As the winding-up of an insurer is generally not as time-sensitive as in the case of banking, recovery plans are a much more viable option for a failing insurer than for a bank. Importantly, action taken by the IA in a severe crisis should not be the very thing that tips an organisation past the point of non-viability. It is important to avoid the situation where insurers are placed in resolution unnecessarily, when other supervisory action would be appropriate.

Given the long term nature of the insurance business and the continuum of actions that can address a failing insurer, there should be a distinction between the scope and purpose of recovery plans and resolution plans. Recovery planning should be aligned to the management and supervision of an insurance group as a viable concern. Resolution plans should address the remote situation where an unpredictable event leads to the failure of an insurer. The focus of resolution should in any case be on those actions that are necessary where the firm is no longer viable.

Finally, it is unclear what is a "reasonable timeframe" for an FI to again satisfy the relevant conditions of its license should it be unable to meet one or more of the conditions. In addition, there is no clear mechanism for appeal of these decisions made by the resolution authority. Therefore our view is that there must be a built in principle of proportionality and fairness within the conditions for initiating resolution.

Resolution objectives

Question 9

Do you have any views on whether it is necessary to introduce an additional resolution objective in respect of the protection of client assets considering the policy intention behind the drafting of resolution objective (ii) in paragraph 63?

Rather than making the protection of client assets part of the resolution regime, the authorities should consider whether it would be more appropriate to change existing laws to provide for client assets placed with an AI not clearly held on trust to be held on trust for clients.

Resolution authority

As we indicated in our comments to CP1, we feel strongly that one or more public authorities should exercise the resolution regime powers. **The powers in respect of resolution must be invested in some organ of Government to achieve the desired result in the case where an FI is failing.** The authority must be operationally independent in this role and be adequately resourced but also ultimately subject to the need to operate within sound legal principles and subject to judicial review as an aspect of accountability. In respect of insurers, the Insurance Authority is a Governmental organisation and therefore potentially appropriate. However, the independent Insurance Authority (the "**IIA**") is being set up as independent of Government and therefore inappropriate for any such role. As indicated in paragraph 78 of CP2, the Government has overarching responsibilities in relation to the financial system and wider economy as well as for managing public finances. It should not pass on this responsibility to a non-Governmental institution or organisation independent of Government. While we recognize that a resolution authority independent of Government may have some advantages, on balance, there should be no question that the IIA should be aligned with the directives from Government. Accordingly, it is our view that the responsible resolution authority for insurers should be the FSTB.

Lead resolution authority

Question 10

Do you agree that an LRA should be designated for each cross-sector financial group containing "in scope" FIs by the FS once the legislation establishing the regime has passed?

Assuming the proposal by the authorities for a sectoral model in terms of the resolution authority stands, there remain concerns that in practice a LRA with expertise in one sector would not have the mandate or expertise to fully consider the needs and concerns of another sector for which it might not have had any experience regulating. Moreover, decisions made by a LRA would be open to criticism that they were made with bias to the sector in which the LRA is normally the regulator whether or not there is in fact any bias. It is critically important that the LRA be seen to act fairly. Accordingly, our view is that given the specific needs and interests of Hong Kong, the LRA should be a higher authority, namely the FSTB. The FSTB could still take advice as necessary from the IA.

Question 11

Do you agree that the designation of the LRA should be based upon the resolution authorities' assessment of the relative systemic importance of the individual 'in scope' FIs within a cross-sector financial group and that the resolution authority of the FI assessed to pose the greatest systemic risk be designated as the LRA for that group?

Our view remains the same as expressed above in that the LRA should be the FSTB.

Coordination: Consultation with a "higher authority"

Question 12

Do you agree that the role of the LRA should be one of coordination and, when required, ultimate decision-maker?

Our view is that the FSTB would be best placed to take on the role of coordinating the authorities and, when required, be the ultimate decision-maker.

Chapter 3 – Resolution Powers

Overview

We believe the proposed resolution powers go beyond what the IA needs to address a failing insurer. They are more commensurate with a risk of failure in the banking sector than in insurance. In comparison to banking, the likelihood of a failure in the insurance sector is relatively remote. Due to the nature of the insurance business, the winding-up of an insurer can occur over an extended period of time using existing tools such as 'run-off' or 'portfolio transfer'.

The process to wind-down an insurer need not be accelerated as insurance liabilities cannot usually be triggered voluntarily by policyholders and only manifest themselves over time and as a consequence of largely uncorrelated occurrences. Insurers are not likely to be confronted with immediate calls for cash. Historic experience suggest that orderly run-offs of failed insurers tend to give rise to relatively low lapse rates due to the numerous disincentives for life policyholders to lapse. Additionally, the liabilities in a run-off scenario mature over many years which allows for the recovery of market values of tied assets.

Compulsory transfer to a commercial purchaser

Temporary increase in DPS cover

Question 13

Do you agree that the proposals for providing temporary DPS cover should reduce the incentives for transferred depositors to withdraw excess balances immediately on completion of a business transfer in resolution?

In theory, we would agree that temporary DPS cover should reduce the incentives for transferred depositors from withdrawing excess balances immediately on completion of a business transfer in resolution. However, there is an associated question of whether temporary DPS cover should be provided to other depositors as a matter of equity and to prevent a contagion effect and our view is that the Government should factor in this possibility as well.

Statutory bail-in

Execution of a bail-in

Question 14

Do you have any views on the steps and processes, outlined in paragraphs 104 to 106, with a view to making the bail-in process operational?

The BoE's intended approach on how to execute a bail-in may be appropriate for banks within scope in England however the authorities should remain cognizant that insurers are different from banks particularly in that the assets of an insurer may be resolved over a longer term if the resolution regime is applicable and that Hong Kong has its own particular characteristics. For example, as we indicated above, the IIA does not have the same mandate as the BoE in respect of the people of Hong Kong and as such, our recommendation is for the FSTB to be the appropriate authority in respect of insurers.

Question 15

Do you have views on the scope of the bail-in power within the resolution regime and specifically on (i) the list of liabilities identified in paragraph 108 which would always be excluded from bail-in and (ii) the grounds for excluding further liabilities from any bail-in on a case-by-case basis as identified in paragraph 110?

We have no particular comments on the list of liabilities.

Question 16

Do you have views on how the list of excluded liabilities in paragraph 108 should be expanded to ensure that the bail-in option is suitable for use with FIs other than banks, and specifically in relation to insurers, FMIs and NBNI FIs?

We agree that what is important in carrying out resolution by means of bail-in is that the hierarchy of claims in liquidation are respected. Policyholders should rank above shareholders and unsecured creditors in the hierarchy of claims in the liquidation of an insurer. Priority of secured creditors must be respected, including assets secured under reinsurance security agreements and security agreements for derivatives counterparties. We have concerns with allowing resolution authorities to depart from the *pari passu* principle in treatment of creditors particularly in the treatment of equal classes of policyholders. Any departure from the *pari passu* principle will deter bondholders from investment in insurers. Therefore, any deviation from the principle should only be taken in circumstances where adherence to *pari passu* would produce perverse or blatantly unfair results. Further, given that it would likely be possible to most effectively resolve the assets of an insurer over a longer term, it would not in

our view be appropriate for the resolution authority to have a power in relation to insurers to expand the list of excluded liabilities as set out in paragraph 108.

Question 17

Do you have views on the proposed approach to bail-in of liabilities arising from derivatives as outlined in paragraph 111?

Derivatives are mainly used by insurers for the purpose of managing asset - liability mismatches arising in the normal course of operating in the business of life insurance. In our view, the derivative transactions of insurers should be treated such that no adverse consequences result in the event of a bail-in and there would be a need to adhere for safeguards protecting certain financial arrangements as set out in CP2.

Temporary public ownership

Question 18

Do you agree that an additional condition is required for TPO? Is the additional condition, proposed in paragraph 115, appropriate?

We have no comments.

Temporary stay on early termination rights in financial contracts

Question 19

Do you agree with the scope, timing and conditions proposed for temporary stays on early termination rights in financial contracts?

We agree that safeguards identified in paragraph 252 of CP1 should be considered given potential knock-on consequences to the counterparties of a failing FI. As to the scope and duration of any temporary stay please refer to our response to question 20.

Question 20

Do you have views on whether a temporary stay on early termination rights should apply solely to financial contracts or whether broader provision should be made?

We recognise that there is a tension between the need to introducing a temporary stay on early termination rights to facilitate resolution of FIs and the importance of preserving legal certainty of netting arrangements, given its importance to risk management and effect on regulatory capital

requirements. In the context of financial contracts like derivatives, mainly used by insurers for the purpose of protecting assets or hedging liabilities that sit on its balance sheet, for a stressed insurer, early termination would mean that it is left with no hedges in place potentially exacerbating its solvency position which could in turn negatively impact policyholders and other stakeholders. Our view is that a temporary stay may be useful in circumstances where it relates to derivatives which are used for pure hedging purposes, however, these must be used very selectively.

Question 21

Do you have views on whether there are other issues which need to be considered in relation to staying early termination rights in resolution?

Subject to our comments to question 24, the integrity of a commercial agreement with counterparties should not be undermined. A retroactive change in contract terms could destabilise the ordinary course of the going concern business. In other words, in difficult markets it could make it more difficult for FIs to find counterparties for legitimate transactions that would support the FIs financial health as a going concern if the counterparty had a reasonable expectation that the commercial agreement might not be honored in a resolution scenario.

Temporary stays on early termination rights in resolution of FMIs

Question 22

Do you have views on how best to implement a temporary stay of early termination rights such that it is effective in supporting resolution of FMIs in particular?

Given the complexity of this issue and the range of contracts that could be affected, we would suggest that this be an area of separate study before being included in any such regime.

Stays in relation to contracts of insurance

Question 23

Do you have views on the proposals for the temporary suspension of insurance policyholders' surrender rights, including the proposed duration of the suspension?

Unlike the sources of bank funding (depositors and other short-term creditors) who expect repayment on demand, the purchasers of most insurance products do not consider their insurance products to function as sources of liquidity. Furthermore, typical insurance policies and other policies either are not "surrenderable" or contain terms, like surrender charges which create disincentives to surrender or early withdrawal. Where policyholders have access to a cash surrender value, these amounts are a fraction of the face value of the contracts. This taken together with the inability of the insured to readily

replace coverage under the same conditions acts as a powerful disincentive. These conditions have proven effective in preventing a run. Market experience on surrenders during the last financial crisis shows that in major insurance markets such as the U.S., the E.U. and Japan, surrender rates actually decreased during the 2008 crisis, indicating that insurance products tend to add stability to markets in times of turmoil.[2] Therefore, while it is conceivable that some policyholders may act against their own best interest, the value of having such a tool at the authorities' disposal is relatively small. Accordingly, if such powers are given under the resolution regime, they should be used only when needed and only for such durations as required.

Question 24

Do you have views on the proposals for a temporary stay on reinsurers of an insurer or of another reinsurer in resolution to terminate or not reinstate coverage relating to periods after the commencement of resolution?

In terms of reinsurance agreements where a reinsurer is in resolution, any stay of a right to terminate and not reinstate coverage relating to periods after the commencement of resolution should be limited to a reasonable period for the insurer to obtain alternative coverage or at the option of the insurer, to terminate the coverage.

Powers to requirement improvements to an FI's resolvability

Question 25

Do you agree with the proposals set out above to provide the resolution authority with powers to require an FI to make changes to improve its resolvability?

Clearly these powers should be limited and carefully considered to avoid any unintended consequences particularly in the circumstances where there is no prospect of an FI being put into resolution. As we previously indicated in our comments to Chapter 2, there needs to be a distinction between recovery planning and resolution planning. Recovery planning should be aligned to management and supervision of an insurance group as a viable concern.

We agree that any such requirements to improve resolvability be subject to rigorous analysis and justification in which the costs and undesired outcomes are carefully considered, including the impact on other jurisdictions. We agree the FI must be given time to consider changes proposed by the resolution authority and there should be an appeals mechanism. Again, in terms of insurers, our view is that traditional insurance is not systemically risky and the resolution regime should only apply in exceptional circumstances where insurers have been designated G-SIIs and have NTNI activities on a

[2] *Surrenders in the Life Insurance Industry and their impact on Liquidity*, The Geneva Association, August 2012

scale that poses a potential threat to the continuing viability of the overall insurance group and then, only when they are in resolution.

We remain concerned that any requirement for insurers to align business units with legal entities would reach deep into the operations of an insurer. This could have a myriad of unintended and adverse consequences including in respect of tax and, capital efficiency. This should remain a matter for management to determine.

Relationship with existing corporate insolvency proceedings

Question 26

Do you agree with the proposal that the resolution authority should be notified of an intention to petition for an in-scope FI's winding-up and be afforded a maximum 14 day notice period to determine whether or not to initiate resolution before that winding-up petition can be presented to the court?

We have no objection to such a proposal.

Supporting the transferred business

Question 27

Do you have views on which of the approaches outlined in paragraph 141 above might best deliver continuity of services from a residual FI and which are essential to secure continuity of the business transferred to an acquirer?

For insurers, there already exists a power for a person to take control of, and manage, an insurer which is a mechanism which could be used to secure the continuity of the business.

Powers to suspend certain obligations

Question 28

Do you agree that the regime should empower the resolution authority to impose a temporary moratorium on payments to unsecured creditors and to restrict the enforcement of security interests in line with proposals set out above? Do you have views as to the exclusions to which this power should be subject?

We have no particular comments on this power so long as the timing of the stay is limited.

Appointment of resolution managers

Question 29

Do you agree that the regime should empower the resolution authority to appoint a resolution manager in line with the proposals set out above?

It would make sense to have a resolution manager with specific expertise providing assurance that resolution if required proceeds in an efficient and effective manner. The missing element however is that it is not clear what skills and experience are required to ensure this other than "qualifications, ability and knowledge required". More specificity is required in this regard.

Additionally, history suggests that the expenses associated with externally appointed 'managers' can dramatically adversely impact upon the residual value in the FI to satisfy its stakeholders. Accordingly, if such managers are to be appointed, they need to be carefully chosen and rigorously supervised.

Continuity of essential services

Question 30

Do you agree that the regime should provide the resolution authority with the necessary powers to secure the continuity of essential services as set out in paragraph 156?

We have no particular comments on this proposal other than our comment under question 6 that the resolution regime should not apply to AOEs.

Powers to remove directors and remuneration claw-back

Question 31

Do you agree that resolution should result in the automatic removal of all the directors, the CEO and Deputy Chief Executive Officer ("DCEO") (where relevant) of an FI in resolution and that the resolution authority should have powers to remove other senior management at its discretion?

It does not seem to be in the best interests of an FI to have an automatic removal of directors, the CEO and DCEO if the objective is to resolve the FI. These individuals would likely have critical institutional relationships and a wealth of corporate knowledge. By having an automatic removal, the prospect of effecting a quick resolution may diminish significantly as the loss of such relationships and corporate knowledge may indeed change how business is or can be conducted going forward. It would seem more prudent for this power to be exercised on a case-by-case basis.

Question 32

Do you agree that the resolution authority should be able to apply to the court to seek remuneration claw-back from those parties identified in paragraph 165 whose actions or omissions have caused or materially contributed to an FI entering resolution?

While it would seem that a person may be held accountable for the decisions he or she makes if such a decision materially contributed to an FI becoming non-viable, we would agree that only a court of competent jurisdiction would be the appropriate forum to consider any claw-back as it provides individuals with a fair process and a right of appeal.

Question 33

Do you have views on whether remuneration claw-back should apply to both fixed and variable remuneration (both vested and unvested) or only to variable remuneration (both vested and unvested)?

Practically, any remuneration claw-back for insurers should apply to unvested remuneration only, if at all. Insurance failures do not occur overnight. Rather, by the very nature of the insurance business, regulators and stakeholders can prepare and take action to contain the damage the failure can cause, and stop it from spreading through the system.

Question 34

In light of the practices adopted in other jurisdictions, do you have views on how far back in time a remuneration claw-back power should reach?

The time frame for how far back in time a remuneration claw-back power should reach should only be in the recent past. With all the existing powers regulators have to monitor the activities of FIs and the requirement for directors and management to be fit and proper, our view is that it would be difficult to justify a claw-back power reaching back further than a year.

Chapter 4 – Safeguards and Funding

Providing for an NCWOL compensation mechanism

We agree with the existence of a NCWOL compensation mechanism as this is an important safeguard however practically, there may be difficulties in its implementation.

Question 35

Do you agree that the indicative criteria to assess the independence and expertise of an NCWOL valuer, as set out in Box F, are appropriate and that a degree of judgment will be inherent in assessing whether these, or any other, factors are relevant in individual cases?

We have no particular comments on the criteria.

Question 36

Do you agree that the resolution authority should appoint the NCWOL valuer, guided by the indicative criteria set out in Box F?

The resolution authority should appoint the NCWOL valuer. We have no particular comments on the indicative criteria set out in Box F.

Grounds for removal of an NCWOL valuer

Question 37

Do you agree with the proposed grounds for removal of a NCWOL valuer, as set out in paragraph 174? Do you agree that the proposed mechanism for seeking removal on those grounds is appropriate?

We have no particular comments on this.

Question 38

Do you agree that the treatment of the outgoing valuer's work up to the point of removal is a matter for any incoming valuer, who should clearly explain that treatment in his/her final valuation?

We have no particular comments on this.

Valuation Principles

Question 39

Do you agree that the three overarching valuation principles identified in paragraphs 176 (i) to (iii) should be applied each time an NCWOL valuation is undertaken? Do you have views on other valuation principles that should underpin an NCWOL valuation?

We have no particular comments on the principles.

Question 40

Do you agree that the right to receive NCWOL compensation (if due) should be restricted to those creditors and shareholders who held liabilities of a failed FI as at the point resolution proceedings formally commenced and who suffer an economic loss as a direct result of the resolution authority's actions?

We have no particular comments on the criteria.

Timing of NCWOL compensation payments

Question 41

Do you have views on how a mechanism might be provided for to expedite the payment of NCWOL compensation due where at least part of any valid NCWOL claims can reliably be identified?

We have no particular views on this mechanism.

Appealing an NCWOL compensation valuation

Question 42

Do you agree that the RCT should be established under the regime to hear appeals of: (i) the shareholders and creditors of an FI in resolution; and/or (ii) the resolution authority against a NCWOL valuation?

We agree that an RCT should be established and that the regime have authority to hear appeals on the above-noted matters.

Composition of the RCT, Powers of the RCT and Appeals against determinations of the RCT

Question 43

Do you agree with the proposed composition of, and process for appointment to, the RCT?

We have no particular comments other than expertise should be developed by the RCT to address the matters that would come before it.

Question 44

Do you have any views on the powers that should be available to the RCT in addition to those identified in paragraph 186?

We have no particular comments on this.

Question 45

Do you agree that applicants should have the right to appeal against a determination of the RCT on a point of law, as set out in paragraph 187?

We agree that applicants should have a right of appeal against a determination of the RCT on a point of law.

Protecting other types of financial arrangement

Question 46

Do you have any further comments on the way in which it is proposed that the various types of protected financial arrangement would be safeguarded and remedies for inadvertent breaches executed?

We have no further comments at this point other than having decisions made on such arrangements being subject to the review and approval of a court of competent jurisdiction. We would also be interested in having a consultation on the technical details of which financial arrangements are protected (and any exclusions) and remedies for inadvertent breaches to be set out in secondary legislation.

Question 47

How could a similar safeguard be provided for to support use of the bail-in option?

A similar arrangement could be used in respect of bail-in. However, in an insurance context, we would suggest that protecting financial arrangements in bail-in should be carefully considered before use. Given that if authorities are looking to adjust creditor liabilities, as with writing down policy benefits, corporate structuring arrangements already exist and they require creditor and Court agreement. Since insurers' resolution happens in an extended period of time, this allows for such an agreement to be arrived at.

Protection from civil liability

Question 48

Do you have any views on the factors the authorities should take into account in developing effective protections from civil liability for: (i) the resolution authority and its staff and agents; and (ii) the directors, officers and employees of an FI in resolution in a cross-border context?

We agree that individuals whether part of the resolution authority or directors, officers and employees of an FI, as long as they are acting in compliance, in good faith, with instructions of the resolution authority, should be protected from civil liability under the proposed legislation.

Safeguarding the integrity of financial markets – exemptions from and deferral of disclosure and other obligations of a listed FI or related listed entities

Question 49

Do you agree with the proposal to provide the relevant authorities the power to defer or exempt compliance with the following requirements, as discussed above: (i) the disclosure requirements under Part XIVA and Part XV of the SFO, the Listing Rules and the Takeovers Code; (ii) the shareholders' approval requirements under the Listing Rules; and (iii) the general offer obligation under the Takeovers Code?

We agree that in the event that it is absolutely necessary for resolution, the relevant authorities have the power to defer or exempt compliance with the above-noted requirements.

Funding resolution

Question 50

Are the costs identified in Box G those that might, most commonly, be met through resolution funding arrangements established under the regime? Do you agree that these should be set out only in a non-exhaustive list to allow for the structuring of resolutions appropriate to individual FIs?

We have no particular comments on this.

Question 51

Do you agree that it would be appropriate to set overarching principles which would guide the resolution authority in setting levies to recover costs incurred in any individual resolution? Do you have views on what those principles should be?

We are of the view that levies should not be set to recover costs rather that these costs be borne by the Government.

Chapter 5 – Cross-Border Resolution and Information Sharing

Cross-border resolution

As expressed in our comments to CP1, our view is that active cooperation and coordinated approaches are required to resolve cross-border groups. In terms of the FSB cross-border CP, we note that the approach is starkly different in concept from the proposed risk-based capital framework ("**RBC Framework**") in Hong Kong as the FSB cross-border CP assumes capital may not be freely fungible or assets may not be freely transferable among group members. In contrast, under the RBC Framework, a total balance sheet approach is proposed for the assessment of capital adequacy requirements. Thus, this presupposes that capital is calculated on the basis that it may flow to other parts of the regulated group. Moreover, under the group level focus, an insurance group is considered a single integrated entity. We suggest that there should be some consistency in approach to avoid any conflicts or unintended consequences.

Question 52

Do you agree that it would be appropriate to set specific "cross-border conditions" which must be met before the local resolution regime may be used to support foreign resolution measures?

Our view is that as a condition, the approach which the foreign resolution authority proposes to adopt should deliver outcomes that are consistent with the objectives for resolution in Hong Kong and will not disadvantage local stakeholders (including policyholders, shareholders and creditors) relative to foreign stakeholders.

Question 53

Are the conditions identified in paragraph 239 above appropriate? Do you consider that in addition to being satisfied that foreign resolution measures are consistent with the objectives set for resolution locally, a further requirement should be set with regard to considering the fiscal implications?

It would make sense to also include this further requirement if other jurisdictions similarly have this condition under the FSB cross border CP.

Question 54

Do you have any views on how to accommodate the scenarios outlined in Box H above?

To resolve the FI locally, the appropriate resolution authority should take into consideration the conditions set out in questions 52 and 53 and resolution should take place through the resolution authority in Hong Kong.

Information sharing

For cross-border resolution to be effective, there should be increased sharing of information between regulators. As mentioned in our comments to CP1, the sharing of information should be built around a legal framework which would prohibit the disclosure of non-public company information to any recipient unless the proposed recipient agrees, and the relevant authority agrees to keep the information confidential and protect it from disclosure except where required by a court of competent jurisdiction or by law.

Conclusion

We are encouraged that the Consultation Paper acknowledges the differences between the different sectors that make up the financial services industry. We believe that this is critically important in ensuring that whatever regime results from this consultation is appropriate for the various types of FIs active in Hong Kong.

No new regulation with the potential severity of distorting the level playing field with competitors such as the resolution regime should be introduced without field testing focusing on the potential effects for the targeted companies, its clients and the respective market. Particularly, we are concerned about requirements that may be imposed on viable insurers prior to any resolution which should be tested for practicality.

We still consider our insolvency framework or a modification of same as one of the best measures concerning the restructuring of liabilities. This is because such a restructuring is likely to encroach on ownership rights and must comply with the principle of proportionality generally recognised in all legal systems based on the rule of law. In case possibilities exist to achieve a certain result, it is a generally accepted principle that the less burdening measure has to be taken.

AIA Group looks forward to receiving the consultation conclusions and participating in CP3, particularly being able to comment on the appeals mechanism mentioned in paragraph 210 for other decisions of the resolution authority, including ex ante changes to business practices, structure or operations to improve resolvability, as well as any other participation in respect of the proposed resolution regime.