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BY EMAIL

Bills Committee on Financial Institutions (Resolution) Bill
Legislative Council Secretariat
Legislative Council Complex
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Hong Kong

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Dear Sirs,

Submission of Allen & Overy

We appreciate the opportunity to comment on the Financial Institutions (Resolution) Bill (**Bill**).

Overview

We consider the Bill in principle to be an essential development and evolution of the Hong Kong legal and regulatory regime.

The proposition underpinning the Bill is straightforward:

- **As a major international financial centre, Hong Kong has actively participated in the creation of an international consensus, administered by the Financial Stability Board ("FSB"), intended to prevent or significantly mitigate the effects of future major financial crises;**

- **The framework of the regime is as follows. If:**

  - **an institution is large or important enough to the global financial markets or Hong Kong that its failure is likely to have a destabilising effect on the Hong Kong market;**

  - **the institution looks likely to fail; and**

- **it would not be possible to rely on the normal insolvency regime to provide for its liquidation without triggering instability and the cessation of the provision of critical services to the market,**

then the Hong Kong resolution regime is designed to allow the regulators to take urgent steps in an effort to stabilise the situation.

Those steps would include transferring the ailing business to a commercial purchaser, parking it with a bridge institution or bailing in shareholders and creditors of the institution to reduce or even wipe out the institution's liabilities, allowing it to recover from the crisis.

Those measures would be used by the Hong Kong regulators themselves or in cooperation with regulators in other jurisdictions, subject to a key safeguard built into the Hong Kong regime that would give the Hong Kong regulators power not to cooperate with other jurisdictions if it was felt that Hong Kong creditors would be put at a disadvantage or instability would be created. Accordingly, there is no question of Hong Kong ceding any sovereignty to other jurisdictions, while the international regime has the potential to allow for cross-border cooperation to combat crises.

The regulators' ability to take steps with a view to ensuring the continuation of the provision of critical services and the protection of the Hong Kong market as a whole, has the additional feature of allowing the business of the failing institution to be continued, albeit potentially in a different form, which would typically protect customers and employees, as far as possible in such extreme circumstances.

The Bill is a vital demonstration of Hong Kong's continuing focus on its position as a major player in the international markets, balanced with its ability to protect its local market against instability, including against developments in other jurisdictions that could have an unfair and adverse knock-on effect on the Hong Kong market.

There are a range of issues needing to be dealt with in due course, including bail-in and total loss absorbing capacity, under subsidiary legislation/rules/guidance, all of a highly important nature, but it is of critical importance to put in place the framework under the Bill to allow that to be done on a measured basis in line with international developments.

Principal Issues

We have adopted a principles-based approach to our submission, given the urgent need for implementation of the new resolution regime, which we regard as essential for the continuation of Hong Kong's important role as an international financial centre.

Our comments are designed to home in on the crucial issues that need to be borne in mind in considering the implementation of the legislation.

The Place of the Resolution Regime in the Existing Legal/Regulatory Framework

The regime is intended to help address the problems created by large financial institutions that are so-called "too big to fail", which could significantly and adversely impact the stability of Hong Kong's markets in the event that they suffer some form of financial or other crisis that would prevent their continued provision of critical services and functions.

The regime is intended to effectively act as a filter between the normal market and the insolvency regime, allowing failing firms to be dealt with (including by appointment of a manager) or liquidated in the usual way where they will not have damaging knock-on effects for Hong Kong. However, where there is the possibility of the insolvency regime moving too slowly or not being able adequately to cater for the problems of the failing institution, the Bill provides a powerful set of measures that can be used to re-organise and/or re-capitalise the business so as to enable the institution as far as possible to be stabilised or allowed to fail in a controlled manner, and in a way which protects the Hong Kong market from reliance on government bail-outs of the troubled institution, adopting an industry-based approach rather than relying upon the injection of public money (unlike in earlier crises elsewhere).

The proposed legislation is broadly in line with the key attributes of a resolution regime advanced on an international consensual basis by the FSB in which Hong Kong actively participates. It is clearly important for Hong Kong to be seen to be continuing its active participation, not only from the perspective of its international standing, but also to allow Hong Kong to ensure that it has a sufficiently influential “place at the table” to protect its own interests, rather than to be reactive to developments from other jurisdictions.

Scope and Flexibility – Including Subsidiary Legislation

We consider that the scope of the incoming regime, including banks, insurance companies, securities and futures/brokerage entities and financial market infrastructures (including central clearing counterparties), together with the flexibility to name other types of entity (essentially “wild cards”) as being covered where the market evolves quickly to create new areas of risk, is the right approach. Those entities are covered insofar as they may have potential to destabilise the Hong Kong market in the event of their failure or likely impending failure and ideally with the market having been consulted beforehand, time permitting.

The flexibility of the incoming regime to cater for the resolution of holding companies of an in-scope institution, and of service companies that provide the means to that institution to continue to discharge critical functions such as deposit taking, is an appropriate tool for the regulators. This allows them to tailor the response to a resolution scenario to fit the specific needs of a troubled institution, without the need to be overly prescriptive in terms of institutions’ structures or operations (which would damage Hong Kong’s competitive position as a desirable location in which to do business).

Resolution Authorities

It is clearly appropriate for the Securities and Futures Commission, the Hong Kong Monetary Authority and the Insurance Authority to be made responsible as the relevant resolution authorities to look after their respective regulated entities (or where appropriate for the relevant authority to act as lead resolution authority in the case of a cross-sector entity). The creation instead of a stand-alone resolution authority covering the range of institutional types and regulated activities would potentially be highly confusing for the market, costly and create additional operational overlap which would be highly unwelcome.

Resolvability Assessment and Resolution Planning

It is appropriate for the regime to provide for in-scope institutions to be assessed as to their structure and operations to identify any impediments within their organisation to the reasonably smooth operation of the regime in the event of a crisis affecting the institution. This allows for group structures to be reviewed for whether and how they can be manipulated during a resolution scenario. It is clearly important for safeguards to be built into the assessment given the far-reaching consequences and costs, particularly where it is indicated by the regulators that restructuring is required to ensure resolvability. The appeals procedure built into the new regime is designed to achieve the requisite transparency and accountability in respect of the process.

It is crucial that, hand in hand with the resolvability assessment provisions, it is recognised that:

- Larger institutions in Hong Kong have already been subject to ongoing discussions with the regulators with a view to identifying impediments to resolvability, albeit outside the bespoke legislative structure of the Bill, but under existing, more general, principles.

- There should be no major impediments left in Hong Kong law or regulation amounting to an obstacle or disincentive for institutions to engage in large scale outsourcing activities to “service companies” where that would allow structures to be simplified, operations to be streamlined and risks to be identified and assessed/managed, given the tremendous potential advantages arising from the establishment of such structures and the ability of the regime on its face to accommodate the service companies as “affiliated operational entities”. The HKMA’s current outsourcing supervisory policy manual will need to be updated to take account of such service companies.

- One issue that can be easily fixed by a simple change in the Banking Ordinance is to treat employees of service companies who provide the services to a bank as “employees” of that institution for the purposes of ensuring that the existing statutory obligations that apply to bank employees also cover employees of those service companies so as to avoid such employees falling into a gap in the legislation (and to remove an issue that is already present for “normal” outsourcings in any event).

Triggers

The overall form of the triggers has been consulted upon at length and is in line with the triggers recommended by the FSB. Our principal comment on the triggers to resolution (the “initiation” of resolution) relates to the need for politics not to be allowed to over-shadow the technical issues of whether an in-scope institution falls within the required conditions – we recognise that decisions over a resolution weekend will need to be taken on a very urgent basis as to whether the firm in question is or is likely to fail and otherwise falls within the relevant criteria. Accordingly, it is essential for the authorities to ensure that the market remains fully apprised of their thinking in terms of the level of the triggers, without compromising the flexibility of the regulators to use their powers to reduce or remove a problem.

In addition to the three resolution conditions, there are seven further triggers. As an overall comment, we consider that there is (almost inevitably) accordingly a high level of complexity through which to navigate before resolution is initiated:

- The Financial Secretary (**FS**) needs to be consulted in advance (unlikely to be an impediment to resolution in times of crisis, but more sensitive where there is a cross-border element).

- “Valuation” must be carried out before a stabilisation option is applied – practically, that means that the resolution authority – with its advisers – must act in a situation of extreme urgency.

- The authority can consider the effect of resolution on other group companies.

- The authority can consider the effect of resolution on other jurisdictions.

- (Where a holding company is to be resolved) the authority must be satisfied the conditions are met for the in-scope institution and orderly resolution would be more readily effected by resolution of the holding company.

- (Where an affiliated operational entity – service company – is to be resolved) the authority must be satisfied the conditions are met for the in-scope institution, the service company’s services are critical to continuity of essential services, and the authority cannot simply make directions to ensure continuity.

- The authority must issue a letter of mindedness to resolve an in-scope entity, including for example the reasons why, and allowing for representations to be made.

We have included the detail above in respect of the wide range of decisions to be taken and the procedures to be followed, on an urgent basis, to demonstrate the potential pitfalls inherent within the proposed system, recognising the need for decisive action, but also the flip-side: transparency and certainty of process, including clear guidance as to the overall policies, procedures and approaches, and the need for the market to be updated in a timely fashion as regards any changes.

Resolution Powers

As with the triggers to resolution, the stabilisation options available to the regulators have been canvassed in the consultation exercises, and they broadly follow the international norms. Our comment is more of a general comment that the powers are of a ground-breaking nature in terms of Hong Kong law, allowing for interference with property rights, unilateral transfers of assets and wiping out shareholders and creditors in a draconian manner. Accordingly, it is vital that the safeguards of compensation tribunal and other remedies (including protection of certain arrangements including secured, set-off, netting or title transfer arrangements) are available to disgruntled and disenfranchised shareholders and creditors, insofar as their treatment can be shown to leave them in a worse position than if the institution had been allowed to work through the liquidation process (the so called "no creditor worse off than in liquidation" concept). As a result, transparency in terms of the operation of the regime is key to ensure the trust of the market is maintained in the operation of the rule of law, rather than arbitrary decision-making to stave off a crisis. We consider that the checks and balances built into the proposed regime are broadly sufficient as a technical matter to achieve this, but openness and clearer principles and criteria on the part of the regulators are essential in terms of their overall policies and approach.

The Cross-Border Dimension

In many respects this is central to the efficacy of the incoming regime.

The FSB has worked towards building a highly complex interlocking international approach to resolution planning and implementation, which includes both statutory recognition and support through contractual recognition. It relies upon mutual trust among jurisdictions and similar key attributes underpinning the resolution regimes of different jurisdictions as its core.

It can properly be said that Hong Kong's particular market structure, where 29 out of the 30 G-SIBs (globally systemically important banks) is organised through or includes a branch structure in Hong Kong, raises complex and crucial issues for Hong Kong's role in resolution. Where a G-SIB operates through a branch, that means that in principle, where there is a resolution scenario, the power lies with the home resolution authority, who would be able to dictate to a great extent the commencement and evolution of the resolution weekend.

If Hong Kong were to simply embrace the overall principle of full international cooperation in the context of a future crisis, without more, it could potentially be exposed to unilateral, arbitrary actions and requirements by the home authorities of the G-SIBs on a broad range of critical fronts, particularly in the event of a wider crisis.

The Bill has therefore been designed so as to reduce this issue from being a problem for Hong Kong by allowing Hong Kong to assess the resolution action of an overseas authority and, if the relevant Hong Kong authority decides that the overseas authority's actions are consistent with Hong Kong's regime and would not prejudice Hong Kong creditors, then support could be given to the overseas authority. Recognition is not automatic.

In this regard, the hoops to be gone through as a protective screen for Hong Kong include:

- The FS must first be consulted.

- A recognition instrument must be issued by a Hong Kong resolution authority recognising all or part of the foreign resolution actions.
- No or partial support will be given if in the resolution authority's opinion:
  - there would be an adverse effect on Hong Kong's financial stability;
  - the outcomes would not be consistent with Hong Kong's resolution objectives; or
  - Hong Kong creditors or shareholders would be disadvantaged relative to their offshore equivalents.
- The authority can take into account the fiscal implications for Hong Kong.
- The resolution authority needs to be satisfied that Hong Kong shareholders and creditors could claim compensation in the offshore jurisdiction.

There is as a result, it is fair to say, effectively a series of escape clauses for Hong Kong should it be decided that there would be prejudice and instability created by the offshore action. That is not to say that Hong Kong would or should adopt a protectionist stance; rather that it is envisaged that Hong Kong would go along with an offshore resolution action to the extent that it was shown to be consistent with fair and appropriate treatment of Hong Kong stakeholders. That is consistent with how Hong Kong would expect to be treated in the context of resolution action taken by Hong Kong that needed to be supported in other jurisdictions. It is important to note that Hong Kong retains the right to initiate its own resolution actions against in-scope institutions, even where their head office is overseas, if there is an impending crisis and the home jurisdiction has not acted, and the Hong Kong authorities are of the view that action is needed to protect Hong Kong's interests.

Mutual trust is of critical importance, but the international environment has been designed with a view to maximising as far as possible the harmony of individual regimes; establishing that infrastructure makes it more likely that the concepts of smooth cross-border resolution would be adhered to in a crisis, but that cannot of course be guaranteed.

Should you wish to discuss this submission in further detail, please contact Ms Yvonne Siew (yvonne.siew@allenovery.com) or Mr Alan Ewins (alan.ewins@allenovery.com).

Yours faithfully,

Allen & Overy