Deutsche Bank

<u>Bills Committee on Financial Institutions (Resolution) Bill</u>
Deutsche Bank written comments – 12 January 2015

I. Overview and general comments

Deutsche Bank (DB) welcomes the opportunity to provide written comments to the Bills Committee on the Financial Institutions (Resolution) Bill ("FIRB") and to attend the meeting on 19 January 2016. DB is a long-term strong supporter of the development of globally consistent resolution regimes, to deliver on regulators' aim that no firm should be considered "too big to fail".

To that end, we have engaged extensively through public consultations, meetings and industry fora on the development of the global Financial Stability Board ("FSB") Key Attributes for Effective Resolution Regimes ("Key Attributes") and supporting guidance, and with the development of the main legislation governing our group resolution plan – the European Union Bank Recovery and Resolution Directive ("EU BRRD") **–** and its associated implementing measures.

Over the last two years, we have fed in views both directly and via the Hong Kong Association of Banks and other trade associations to the Hong Kong Financial Services and Treasury Bureau and sectoral regulatory authorities on the development of the Hong Kong resolution regimes, consistent with our experience of those global and EU frameworks and of resolution planning generally. We responded to both public consultations, and can provide copies of those responses on request.

We strongly welcome the draft FIRB as the culmination of the consultation process, with an end result that is aligned with global standards and which draws on – and in some instances sets a new standard for – international best practice for resolution regimes. Not only is the FIRB consistent with the FSB Key Attributes, it also represents one of the strongest examples of how to achieve cross-border effectiveness of resolution. Our detailed comments on key areas are set out below, but overall we commend the Hong Kong authorities for bringing forward a well-crafted proposal which will support the objectives of the resolution regime.

II. Resolution planning & resolvability assessments

We support the provisions empowering the respective sectoral resolution authorities to require information to facilitate resolution planning. We welcome the decision to appoint a lead resolution authority where a firm has multiple regulated activities, and to require resolution authorities to share information and to coordinate amongst themselves and cross-border. Effective resolution requires both ex-ante coordination and clear and quick decision-making processes in a crisis.

We also support the requirement to conduct resolvability assessments and the powers to remove impediments to resolvability, as these are essential to ensure the credibility and feasibility of resolution plans. However, as the Bill recognises, this should only be where the impediments are "significant" and measures are "reasonably required" to remove or mitigate them, taking into account the difficulty of implementing the measure and its likely impact on the ongoing viability of the firm. We also welcome that firms will be able to make representations (e.g. with alternative proposals) and the set up of the proposed Resolvability Review Tribunal in case a firm wants the decision to be reviewed.

Finally, although this is not explicit in the draft Bill, we welcome the authorities' commitment that they will impose resolution planning requirements in a manner that is proportionate to the size, nature and complexity of a firm's activities in Hong Kong. In particular, it is beneficial that they intend to coordinate closely with foreign headquartered firms' group resolution authorities on resolution planning and that the draft Bill: i) allows the Hong Kong authorities to adopt a non-Hong Kong resolution plan in whole or in part; and ii) requires them to take into account the non-Hong Kong resolution plan when considering measures to remove impediments to resolvability in Hong Kong.

III. New power to bail-in certain liabilities

The power to write-down shareholders and creditors in resolution through bail-in is an important step towards ending perceptions that financial institutions are "too big to fail", as it ensures losses are absorbed by private resources rather than by public funds. Bail-in also plays an important market discipline role, as it increases incentives for investors to focus on a firm's risk of failure. The broad, statutory bail-in power proposed in the draft Bill ensures that write-downs are absorbed across a broad range of creditors, once equity and other capital is exhausted. This broad approach helps to limit the degree of write-downs required to absorb losses and stabilise the firm, which in turn helps to ensure that no creditor is left worse off than they would have been in insolvency; an essential principle for resolution, which is enshrined in the FIRB bail-in provisions.

We support the clearly defined list of exclusions in the draft Bill, which are focused on protecting liabilities which are either essential to: i) the day to day operations of the bank (e.g. to clearing, payment and settlement infrastructures, employee wages or short-term interbank liabilities); or ii) avoid contagion (e.g. deposits and client assets, whose inclusion in scope of bail-in may create risk of "runs", thereby destabilising the bank and preventing orderly resolution). In addition, we strongly welcome that close-out netting and certain other types of protected arrangements will be respected.

Given the very broad scope, we also in principle support the power to exclude additional liabilities at the point of resolution, as some (e.g. contingent liabilities like trade finance instruments) may not be possible to bail-in in practice, nor contribute to absorbing losses. Although, from a legal certainty point of view, it is better to have defined exclusions, we understand the desire to minimise exclusions and avoid incentives for firms to structure their liabilities to avoid bail-in (reducing loss-absorbing capacity). However, given that flexibility to depart from pari passu treatment is a change from insolvency practice, it will be important for the authorities to set out in more detail ex-ante the types of liabilities and circumstances in which exclusions would generally be applied.

IV. Other resolution powers & tools

We have no detailed comments on the other stabilisation options (sale/transfer, asset separation, bridge bank and temporary protection order), as these are broadly consistent with the FSB Key Attributes and other resolution regimes. The draft FIRB also includes important ancillary powers relating to resolution, in particular powers to impose a temporary stay on early termination rights in contracts and to ensure continuity of essential services – where provided by affiliated operating entities or by the firm itself in the case of sale/transfer, asset separation or bridge bank creation.

Authorities' ability to carry out an orderly resolution could be significantly impeded if resolution triggered early termination rights in contracts, or if essential services to support critical functions cease to be provided. Temporary stays on early termination rights are therefore important to avoid contracts being closed out upon a firm's entry into resolution. Given the intervention in contractual rights of imposing such a stay, this should be subject to appropriate safeguards, including a strict limitation to two days' duration, to protect netting rights. The safeguards contained in the draft provisions in the FIRB on suspension of termination rights are in line with other resolution regimes, although much of the detail relating to these and other protected arrangements remains to be worked out and reflected in detailed rules. This should support the cross-border effectiveness of this power (e.g. recognition of Hong Kong as an eligible regime under the ISDA resolution stay protocol).

One area not addressed explicitly in the draft FIRB, but which is in FSB guidance), is continuity of services from third party providers, and – in particular – financial market infrastructures (FMIs). Particularly in the case of FMIs, we believe that statutory powers to continue service provision may be needed in resolution, and authorities may wish to consider including these in the draft Bill. We note that the EU BRRD has statutory powers over third party service providers to require continuation of essential services, including FMIs, subject to certain safeguards and as long as payment obligations continue to be met. In addition, the EU BRRD has an explicit requirement for FMI memberships to be continued upon transfer to a purchaser or bridge bank in resolution.

V. Valuations, compensation and resolution funds

As mentioned above under bail-in, ensuring that no creditor is worse off than in liquidation (NCWOL) is a core objective for resolution regimes, and is rightly enshrined in the draft FIRB. In particular, we welcome the clarity that a comprehensive and independent valuation process will be undertaken to establish whether any creditor has been left worse off than in liquidation and is due compensation.

We welcome that the draft Bill sets out key principles for valuation, and provides for detailed regulations to further specify these principles and any underpinning assumptions to be made. However, it is unclear whether these regulations would be made in advance of or at the point of resolution. We agree rules are needed at the point of resolution (to specify certain details), but also encourage the development of detailed valuation rules ex-ante. This avoids potential uncertainty about the basis on which valuations will be undertaken, as without an objective basis for deviations between the initial valuation and the one to ensure NCWOL is respected, it increases the risk of legal challenge. This is particularly important given FIRB envisages different valuers for initial and NCWOL valuations. The European Banking Authority is developing valuation rules under the EU BRRD and we are supportive of this work being done in advance of needing to be implemented.

Finally, we strongly welcome that bail-in is the primary mechanism for absorbing losses and not resolution funding arrangements. This ensures that individual institutions have to bear the cost of their failure. We also welcome that where there are costs associated with resolution not met through bail-in the authorities will first rely on residual value realised by disposals or asset sales and any private sector funding that the firm under resolution can access, before deciding to impose industry levies. It is also welcome that in making regulations to impose a resolution funding levy, the Financial Secretary will apportion levies proportionate to a firm's size and systemic risk, and give consideration to timing – e.g. in case contributions need to be spread over time to avoid risk of contagion.

VI. Cross-border coordination & recognition

As already stated, we believe the draft FIRB is particularly strong on the statutory basis for cross-border cooperation and recognition. Of course, the primary objective of the Hong Kong resolution regime is rightly to preserve domestic financial stability, but in a situation where a foreign headquartered firm enters into resolution it is critical that Hong Kong authorities have the tools to facilitate a foreign resolution authority's resolution action. As noted by the FSB in their recent guidance on cross-border effectiveness[1], domestic authorities can either take supportive measures (i.e. resolution action in their own jurisdiction under the domestic regime) or recognition measures (i.e. take an administrative or judicial decision to recognise the foreign resolution action).

In our view, supportive measures have limitations, as they may require more coordination to ensure individual resolution actions are taken in different jurisdictions at the same time, which introduces execution risk. They also create legal risks where regimes are not entirely aligned, as they create a risk of creditors of the same class potentially receiving different treatment. Finally, the legal certainty created by statutory recognition can help to overcome uncertainties in the existing domestic regime for foreign insolvency recognition, which otherwise may create delays to foreign resolution actions while domestic courts decide whether to enforce them. Delay and legal challenge would jeopardise orderly resolution, when speed and clarity are essential.

We consider that the draft FIRB cross-border recognition provisions to be very well drawn - they provide flexibility for the Hong Kong authorities to recognise foreign resolution actions even where the regimes are not exactly aligned as they allow recognition where outcomes are broadly consistent with the Hong Kong resolution objectives. However, it also provides significant domestic safeguards,

[1] http://www.fsb.org/2015/11/principles-for-cross-border-effectiveness-of-resolution-actions/

by prohibiting the authorities from recognising foreign resolution if there would be an adverse effect on Hong Kong financial stability, or where Hong Kong creditors or shareholders would either receive treatment different from that of other creditors and shareholders of the firm, or do not have access to some form of mechanism to claim compensation in the event that they are worse off in liquidation.

VII. Conclusion

In summary, we believe the draft Bill ensures a comprehensive resolution regime is implemented in Hong Kong, supporting consistency with global standards and protecting domestic financial stability.