The Financial Institutions (Resolution) Bill

Submission of The Hong Kong Association of Banks

18 January 2016

Introduction

This paper sets out the views of The Hong Kong Association of Banks (***HKAB*** or ***we***) in relation to the Financial Institutions (Resolution) Bill (the ***Bill***), as published in the Hong Kong Gazette on 20 November 2015.

Assisted by Freshfields Bruckhaus Deringer, we have reviewed the Bill, solicited comments from members of HKAB and received feedback from various members of HKAB (each a ***Respondent***).

By way of background, the Bills Committee may be aware that a significant number of HKAB's members are branches/subsidiaries of global systemically important financial institutions (***G-SIFIs***) or are part of regional or global banking groups that provide the full spectrum of financial services, including securities-related activities and insurance.

Notwithstanding that many of HKAB's members are part of mixed activity groups, the primary focus of this paper is in the context of a resolution regime insofar as it affects banks and banking businesses.

We previously have submitted detailed responses to the consultation papers and consultation conclusions on proposals for establishing an effective resolution regime for financial institutions (***FIs***) in Hong Kong that were issued on 7 January 2014 (***CP1***), 21 January 2015 (***CP2***) and 9 October 2015 (***CP3***), and we are grateful that certain comments and views set out in those submissions have been reflected in the Bill.

In this paper we set out our specific comments on the Bill, following the order of the 'phases' of work described in the Bills Committee's work plan (in the form presented at the meeting of the Bills Committee on 5 January 2016). In the Schedule we have set out, for ease of reference, extracts of the provisions of the Bill to which references are made in this paper.

Introduction and Overarching Commentary

HKAB strongly supports the proposals in the Bill as being detailed, well-considered and consistent with the Financial Stability Board's (***FSB***) Key Attributes of Effective Resolution Regimes for Financial Institutions (***Key Attributes***).

The Bill provides a framework for a comprehensive resolution regime for FIs falling within its scope, which should protect domestic financial stability and creditors, and also provides a strong foundation for cross-border recognition and cooperation.

We have very few specific concerns with the drafting of the Bill as the extensive industry consultation that has taken place through CP1, CP2 and CP3 has materially addressed issues identified by our members. The remaining issues/concerns primarily relate to the detailed guidance and rules that have yet to be developed by the relevant authorities, for example:

- the broad statutory bail-in regime and its exclusions, where further detail is required in due course (e.g., further exclusions for/flexibility to exclude certain derivatives transactions and other liabilities that are complex, difficult to value and/or not loss-absorbing in bail-in, such as contingent liabilities);

- the provisions of the Bill which encourage cross-border cooperation on resolution planning and resolvability measures, and the statutory basis for cross-border recognition of resolution actions;

- the ancillary powers to impose temporary stays on contractual early termination rights and to ensure continuity of essential services;

- the rules in relation to total loss absorbing capacity (***TLAC***) requirements;

- there are concerns over feasibility of remuneration clawback for fixed pay and disincentives for taking on leadership positions that this power creates; and

- there is a desire for greater powers for resolution authorities to require operational continuity in resolution (e.g., over third party service providers and particularly the continuation of memberships of financial markets infrastructure).

We expect that these outstanding issues will be subject to future engagement with the banking industry by the relevant authorities and we acknowledge that the regulatory/legislative approach to some of these issues will develop in tandem with international developments. We do not expect all of these outstanding issues to be reflected in the Bill and we would not anticipate their absence from the Bill to cause any delay to the Bill's progress through the Legislative Council.

Respondents' Comments on the Bill

Phase 1 of the Bills Committee's Work Plan: Parts 1 to 4 (inclusive), 7 and 10 of the Bill

Respondents did not provide any specific comments or recommendations on these parts of the Bill.

Particular attention should be paid to future developments and documentation issued by the FSB in respect of TLAC requirements and to ensure that the Hong Kong regime is consistent with those rules. Banks operating in Hong Kong should not be subject to higher capital/TLAC requirements than banks in other jurisdictions with resolution regimes.

Phase 2 of the Bills Committee's Work Plan: Part 5 of the Bill

<u>Contractual recognition of bail-in</u>

Section 60 of the Bill permits a resolution authority to make rules to impose a requirement on a within-scope FI or a holding company of within-scope FI to contractually recognise that certain liabilities may be bailed-in.

The scope of such requirement imposing contractual recognition should be appropriate and proportionate, in terms of the "liabilities" and the within-scope FIs to which such requirement should apply.

HKAB broadly believes that such requirement should not apply or extend to contracts entered into by, or liabilities of, the FI or its holding company, if these entities are incorporated overseas and to the extent that they are already subject to equivalent/substantially similar requirements relating to contractual recognition of bail-in under the law of the jurisdiction in which they are incorporated or another G20 jurisdiction in line with the Key Attributes.

Interpretation of "clearing and settlement systems arrangements"

The drafting of the term "clearing and settlement systems arrangements" (section 74 of the Bill) does not make it completely clear whether such arrangements would cover clearing and settlement arrangements of domestic Central Clearing Counterparties (***CCPs***) as well as those of foreign CCPs with recognized equivalence.

Our view is that this term should cover arrangements for clearing and settlement of transactions within both domestic and overseas financial market infrastructures, and we request that the drafting in section 74 of the Bill be amended to clarify this point.

Additionally, the drafting of section 75(2)(e) of the Bill does not make it completely clear that only the net liability arising from terminated/closed-out "protected arrangements" (including derivative transactions, netting arrangements and title transfer arrangements) would bailed-in.

Based on CP3, we understand that the authorities' intention is that the "protected arrangements" in relation to bail-in are aimed at providing for secured and title transfer arrangements, and contracts with set-off or close-out netting provisions (including derivatives transactions) to be bailed in on a net basis. Accordingly, we request that the drafting in section 75(2)(e) be amended to clarify this point.

Suspension of contractual termination rights

Section 87 of the Bill states that this division applies to a within-scope FI and group companies of a within-scope FI.

Section 92 of the Bill permits a resolution authority to make rules that impose a requirement on a qualifying entity to contractually recognize the suspension of termination rights in relation to contracts entered into by it.

Respondents have indicated that the scope of any requirement to impose such contractual recognition should be appropriate and proportionate, in terms of the contracts and the qualifying entities to which such requirement should apply.

In particular, such requirement should not apply or extend to contracts entered into by a within-scope FI or any of its group companies, if the entity (i.e., within-scope FI or its group company) is already subject to substantially similar or equivalent requirements relating to contractual recognition of suspension of termination rights in the jurisdiction of its incorporation or in another G20 jurisdiction in line with the Key Attributes.

In relation to the implementation of rules relating to contractual recognition of bail-in and suspension of termination rights, some Respondents have emphasized that before such rules are made effective, the industry should be consulted on the draft rules and given sufficient time consider the impact of the proposed rules and provide comments thereon. In addition, it would be preferable for the implementation of any such rules to be in phases, as appropriate, on liabilities or contracts entered into from a specified date in the future.

Phase 3 of the Bills Committee's Work Plan: Parts 6 to 9 (inclusive), 8, 9 and 11 of the Bill

Respondents did not provide any specific comments or recommendations on these parts of the Bill.

Phase 4 of the Bills Committee's Work Plan: Parts 12 to 15 (inclusive) of the Bill

We note that no cap has been set on the maximum liquidity to be provided by the industry for the resolution of a non-viable within-scope FI. HKAB generally is of the view that it would be preferable to have certain parameters around the maximum potential liability for the industry, whether it is included in the Bill or in rules issued at a later date.

HKAB broadly agrees with the principles set out in section 185 of the Bill. However, HKAB is not completely in agreement with section 185(6)(a) of the Bill, which introduces a condition that a Hong Kong resolution authority must not recognize foreign resolution measures if the resolution authority is of the opinion that resolution would have an adverse effect on financial stability in Hong Kong. Equity of treatment between jurisdictions, and not specific treatment of any specific one, should be the general rule.

Conclusions

Overall, we strongly support the Bill and we look forward to further engagement in the legislative process and with formulation of applicable rules and guidance by the relevant authorities in due course.

The Hong Kong Association of Banks

Schedule

Extracts from the Financial Institutions (Resolution) Bill

60. Rules relating to liabilities

(1) For ensuring the effective operation of a bail-in provision in relation to a liability owed by a within scope financial institution, a resolution authority may make rules that impose a requirement on the within scope financial institution or a holding company of a within scope financial institution to ensure that the terms and conditions of a contract creating the liability contain a provision to the effect that the parties to the contract agree that the liability is eligible to be the subject of a bail-in provision.

(2) The rules may –
- (a) specify the liabilities, or classes of liabilities, to which the requirement applies;
- (b) specify the within scope financial institutions or holding companies, or classes of within scope financial institutions or holding companies, bound by the requirement;
- (c) require a within scope financial institution or holding company bound by the requirement to provide to the resolution authority an opinion from counsel or a solicitor that any provision included by it in contracts in compliance with the rules is legally enforceable; or
- (d) include incidental, consequential or transitional provisions.

74. Interpretation

In this Subdivision –

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

clearing and settlement systems arrangement (結算及交收系統安排) means an arrangement governed by the rules and directions relating to participation in the clearing and settlement of transactions within a financial market infrastructure;

netting arrangement (淨額結算安排) means an arrangement under which a number of claims or obligations can be converted into a net claim or obligation;

partial property transfer (局部財產轉讓) means a transfer by a property transfer instrument of some, but not all, of the assets, rights and liabilities of the transferor;

protected arrangement (受保障安排) means a clearing and settlement systems arrangement, a netting arrangement, a secured arrangement, a set-off arrangement, a structured finance arrangement or a title transfer arrangement;

regulated Part 5 instrument (受規管第5部文書) means a Part 5 instrument that –
- (a) results in a partial property transfer being effected; or
- (b) contains a bail-in provision;

secured arrangement (抵押保證安排) means an arrangement under which a person acquires, by way of security, an actual or contingent interest in the property of another;

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

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

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

title transfer arrangement (所有權轉讓安排) means an arrangement under which a person transfers assets to another person on terms providing for the other person to transfer assets if specified obligations are discharged and includes –

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

75. Regulations relating to protected arrangements

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

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

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

(a) impose conditions on the exercise of a power to make a regulated Part 5 instrument;
(b) require a regulated Part 5 instrument to include a specified provision, or a provision to a specified effect, relating to protected arrangements;
(c) provide for rights, assets, liabilities, claims or other matters to be classified not according to how they are described by the relevant parties but according to how they are treated, or intended to be treated, in commercial practice;
(d) require a resolution authority, in making a regulated Part 5 instrument that results in a partial property transfer being effected, to seek to ensure that the instrument does not have the effect of adversely affecting a party (other than the transferor) to a protected arrangement by separating or otherwise affecting the constituent parts of the arrangement;

(e) require a resolution authority, in making a regulated Part 5 instrument that contains a bail-in provision, to seek to ensure that the instrument does not have the effect of cancelling, modifying or changing the form of a liability covered by a protected arrangement in an amount in excess of the net debt, claim or obligation under the arrangement;
(f) specify remedial action to be taken by a resolution authority, or provide for other consequences to arise, if a regulated Part 5 instrument has an effect mentioned in paragraph (d) or (e); or
(g) make provision for determining the scope of coverage of a protected arrangement, taking into account the effect on the ability of a resolution authority to achieve the orderly resolution of an entity.

87. Application of Division

This Division applies to –
(a) a within scope financial institution; or
(b) a group company of a within scope financial institution.

92. Rules relating to suspension of termination rights

(1) For ensuring the effective implementation of section 90, a resolution authority may make rules that impose a requirement on a qualifying entity to ensure that the terms and conditions of a contract entered into by it contain a provision to the effect that the parties to the contract agree to be bound by any suspension of termination rights in relation to the contract imposed under section 90(2).

(2) The rules may –
(a) specify the contracts, or classes of contracts, to which the requirement applies;
(b) specify the qualifying entities, or classes of qualifying entities, bound by the requirement;
(c) require a qualifying entity bound by the requirement to provide to the resolution authority an opinion from counsel or a solicitor that any provision included by it in contracts in compliance with the rules is legally enforceable; or
(d) include incidental, consequential or transitional provisions.

185. Recognition of non-Hong Kong resolution actions

(1) This section applies if a resolution authority is notified of the taking of a non-Hong Kong resolution action.

(2) The resolution authority may make a recognition instrument, irrespective of whether the non-Hong Kong financial institution or non-Hong Kong group company to which the instrument relates is a within scope financial institution.

(3) A recognition instrument is an instrument that –
(a) recognizes the action; or
(b) recognizes part of the action but does not recognize the remainder.

(4) As soon as practicable after making a recognition instrument, the resolution authority must –
(a) send a copy of the instrument to the non-Hong Kong financial institution or non-Hong Kong group company to which the instrument relates;
(b) publish a copy of the instrument on its internet website; and

(c) cause notice of the making of the instrument to be published –
  (i) in the Gazette; and
  (ii) in 2 newspapers (one being an English language newspaper and the other being a Chinese language newspaper) chosen by the resolution authority to maximize the likelihood of the notice coming to the attention of persons likely to be affected.

(5) A resolution authority may only make a recognition instrument after having first consulted the Financial Secretary.

(6) A resolution authority must not make a recognition instrument if the resolution authority is of the opinion that –
  (a) recognition would have an adverse effect on financial stability in Hong Kong;
  (b) recognition would not deliver outcomes that are consistent with the resolution objectives; or
  (c) recognition would disadvantage Hong Kong creditors or Hong Kong shareholders (or both) relative to other creditors or shareholders of the entity in relation to which the non-Hong Kong resolution action has been taken.

(7) In deciding whether to make a recognition instrument, a resolution authority may take into account any fiscal implications for Hong Kong of the making of the instrument.

(8) A recognition instrument takes effect at the time, or on the date, specified in it.

(9) Subject to section 191, the making of a recognition instrument has no effect on the taking of any step for the winding up of an entity affected by the non-Hong Kong resolution action.