Bills Committee on Financial Institutions (Resolution) Bill

Response to Matters Raised by Members at the Meeting on 31 March 2016

This paper sets out the Government's response to the matters raised by Members in relation to the Financial Institutions (Resolution) Bill (the Bill) at the Bills Committee (BC) meeting on 31 March 2016.

Schedule 3 – Securities transfer instruments

Section 4(1) of Part 1 of Schedule 3 to the Bill provides that a transfer of securities contained in a securities transfer instrument takes effect by operation of the Financial Institutions (Resolution) Ordinance (the Ordinance). It is noted that under the Stamp Duty Ordinance (Cap. 117), the sale and purchase of any Hong Kong stock is subject to stamp duty. The Administration is requested to clarify –

(a) whether a transfer of Hong Kong stock made under Schedule 3 of the Ordinance is subject to stamp duty; and

(b) if stamp duty is required to be paid, the rationale and justifications for imposing stamp duty on such a transfer which does not involve genuine trading of a stock.

2. Instruments for transfer of Hong Kong stock are subject to stamp duty. Under section 19 of the Stamp Duty Ordinance (Cap. 117) (SDO), any person who effects "a sale or purchase" of Hong Kong stock shall make and execute a contract note and causes it to be stamped. Under the current proposal in the Bill, a resolution authority may transfer securities issued by a prescribed entity (as defined in section 1 of Part 1 of Schedule 3) to a purchaser by making securities transfer instruments. According to the Inland Revenue Department, for any "sale or purchase" of Hong Kong stock involved in such transfer of securities, the securities transfer instruments concerned will be subject to stamp duty accordingly.

3. We recognize that the relevant stamp duty consequence arises not out of a normal commercial transaction but as a result of the exercise of an application of a stabilization option by a resolution authority to protect financial stability and the integrity of the financial system. Therefore, the

policy intention is that any stamp duty exemption may be granted on a case-by-case basis. Exemptions have to be justified on the merits of the case, and subject to the relevant mechanism under the SDO.

Schedules 3 and 4 – Effect of a transfer instrument

According to section 4(3) of Part 1 of Schedule 3 and section 4(3) of Part 1 of Schedule 4 to the Bill, a securities or property transfer instrument takes effect despite any restrictions (including a restriction requiring the sanction of the Court, or the approval of a regulatory body, for a transfer) arising under contract or legislation or in any other way. Some members are concerned about the overriding power of the provisions, in particular the power to override the sanction of the court and the restrictions imposed by legislation. The Administration is requested to: (a) review the provisions to address the above concern; (b) provide information on similar provisions adopted by overseas jurisdictions in their resolution regimes; and (c) explain under what circumstances the resolution authority would exercise such overriding power.

4. A resolution authority must be able to act quickly and decisively to initiate resolution and apply a stabilization option under the Bill in order to secure the continuity of critical financial services provided, and mitigate the risks posed to financial stability, by a failing, systemically important financial institution (FI). The sections of Schedule 3 (section 4(3)), Schedule 4 (section 4(3)) and Schedule 6 (section 3(2)) under consideration are designed to ensure that requirements for consent/approval that need to be observed in a transfer, or in a debt-for-equity restructuring, in a business as usual context do not prevent a resolution authority from effectively applying a stabilization option, given the urgent nature of resolution. It is expected that arrangements for the application of a stabilization option would need to be made within an extremely compressed timeframe, most likely over a "resolution weekend", in order that an instrument (effecting the application of the stabilization option) could be issued before the next market opening on Monday morning. Requiring a resolution authority to identify and obtain all consents/approvals that might otherwise need to be observed in a transfer, or in a bail-in (debt-for-equity restructuring), would severely restrict its ability to act sufficiently promptly to achieve the resolution objectives, including its ability to secure the continuity of critical financial services (such as customer access to monies on deposit; clearing and settlement, e.g. payroll and other payment functions; retail and business lending; and trade credit facilities) and to protect the stability and effective working of the local financial system, as it

would take time to secure the necessary consents/approvals, assuming they could be secured at all.

5. The Financial Stability Board (FSB)'s "Key Attributes of Effective Resolution Regimes for Financial Institutions" (KAs)[1] require that resolution authorities be empowered to "[t]ransfer or sell assets and liabilities, legal rights and obligations, including deposit liabilities and ownership in shares, to a solvent third party, notwithstanding any requirements for consent or novation that would otherwise apply" (see KA 3.2(vi)). Annex G of the FSB's recent Peer Review Report: Second Thematic Review on Resolution Regimes,[2] which focused on the range and nature of resolution powers available in FSB jurisdictions for the banking sector, identifies that the existing supervisory intervention powers available to the Hong Kong Monetary Authority (HKMA) under the Banking Ordinance (Cap. 155) (BO) have been assessed not to meet the standards set by KA 3.2(vi) because "in seeking to transfer assets, rights and liabilities [of an authorized institution ("AI")], neither the HKMA nor [a] Manager [appointed under section 52(1)(C) of the BO] has the legal authority to disregard any requirements for consent or novation that would otherwise apply". It is therefore incumbent on the authorities to provide that any such requirements for consent/approval that would otherwise need to be observed do not prevent a resolution authority from exercising functions under the Bill in order to achieve compliance with the standards set by the KAs.

6. There is no intention for the regime to exclude the ability of any persons affected by the acts of a resolution authority to seek judicial review of those acts (a resolution authority must always act reasonably in performing those powers and functions conferred on it by the Bill). However, in light of the concerns raised by Members, we can see that the sections of the Schedules cited in paragraph 4 above as drafted might be so interpreted as that the Bill seeks to make such provision. Therefore, in order to address the concern raised by Members, we propose to move a Committee Stage Amendment (CSA) to remove the text in parenthesis (i.e. "(including a restriction requiring the sanction of the Court, or the approval of a regulatory body, for a transfer)") from each of section 4(3) of Schedule 3, section 4(3) of Schedule 4 and section 3(2) of Schedule 6. However, as explained above, the remaining language in each of these sections is critical to the effective operation of the

[1] See: http://www.fsb.org/wp-content/uploads/r_141015.pdf

[2] See: http://www.fsb.org/wp-content/uploads/Second-peer-review-report-on-resolution-regimes.pdf

regime.

7. Annex I considers similar provisions that have been made under the resolution regimes in the United Kingdom (UK) and Singapore as well as in the European Union (EU)'s Bank Recovery and Resolution Directive. These provisions are similar to the proposed language under the Bill once the text in parenthesis as aforementioned is removed.

8. Turning to the question of when the powers may need to be relied upon, for example, at an earlier meeting of the BC, members raised that certain provisions in existing legislation may prevent a resolution authority from applying stabilization options in a timely, effective manner. The specific example cited was that of the Companies Ordinance (Cap. 622) (CO), which establishes requirements and restrictions relating to the reduction of a company's share capital. The Government responded that a resolution authority, in applying a stabilization option (through the making of a bail-in instrument, which may cancel an FI's shares for example), would not be constrained by these provisions of the CO, because of the effect of section 3(2) of Schedule 6 and indeed must not be so constrained given the need to be able to act promptly and decisively in an emergency situation where a failing FI has met the high threshold for initiating resolution, as established by Conditions 1, 2 and 3 under clause 25 of the Bill.

Schedules 3 and 4 – Removal of directors etc.

Section 7(1) of Part 1 of Schedule 3 and section 9(1) of Part 1 of Schedule 4 to the Bill respectively specify that a securities transfer instrument or a property transfer instrument may revoke the appointment of a person as a director, chief executive officer or deputy chief executive officer of a prescribed entity. However, sections 7(2) and 9(2) of Schedules 3 and 4 explicitly provide that the revocation of appointment does not terminate, or affect the rights of any party to, a contract of employment or services with the prescribed entity. Members express grave concern that the provisions may protect the employment of the directors or senior officers of the failing financial institution (FI) whose actions or omissions may have directly caused the non-viability of FI concerned. The Administration is requested to: (a) review the provisions to address members' concern; and (b) provide information on similar provisions adopted by overseas jurisdictions in their resolution regimes.

9. We are considering the matter and will respond in due course.

Schedule 5 – Excluded liabilities

Clause 58(4) of the Bill provides that a power to make a bail-in provision may not be exercised in respect of any excluded liability. Excluded liabilities are defined in section 2 of Schedule 5 to the Bill to include, among others, any liability that is secured (i.e. section 2(l) of Schedule 5). Some members are concerned about the broad scope of section 2(l). The Administration is requested to consider specifying clearly in section 2(l) the kinds of secured liabilities that would be excluded from bail-in.

10. The term "secured" under section 2(l) of Schedule 5 is defined under section 1 of Schedule 5 as follows: "secured means secured against assets or rights of an entity in respect of which a bail-in instrument is made, or otherwise covered by collateral arrangements". Collateral arrangements are also defined under section 1 of Schedule 5 as including "arrangements under which an entity in respect of which a bail-in instrument is made transfers assets to another entity on terms providing for the transferee to transfer the assets if specified obligations are discharged".

11. The underlying thinking is to respect the treatment that such liabilities would be afforded in a winding up, where holders of a valid security interest would, generally speaking, be entitled to the benefit of that security. It would not be realistic to specify a list of all liabilities that could possibly be secured, given the range of FIs within scope of the regime and their various different business models. Furthermore, such a list could itself create scope for entities to structure liabilities such that they fall within section 2(l) of Schedule 5 and hence avoid the application of bail-in.

12. In terms of the kinds of liability that would fall within section 2(l) of Schedule 5, this could, for example, include an arrangement whereby an FI posts margin with a counterparty, and in doing so creates a security interest over the posted margin, to cover losses the counterparty may suffer as a result of the FI's default. In such a case, where the FI has entered into resolution its liability could not be subject to bail-in to the extent it is covered by the value of the collateral (as the counterparty should not be deprived of the benefit of the collateral). Another example could be where an FI has charged certain assets to secure payment of principal and interest on a bond issued by the FI.

13. The use of the wording "so far as it is secured" is designed to ensure that any portion of a secured liability which is not fully secured by the value of the assets over which it is secured, or covered by the collateral backing it, may be subject to bail-in to the extent that the value of the assets/collateral is insufficient. This is also designed to reflect the treatment of such liabilities in a winding-up.

14. In developing the provision in section 2(l), we have drawn on the approaches taken in the UK's resolution legislation, i.e. the UK Banking Act 2009. It is noted that the corresponding provision in the EU directive is similarly broad, albeit specifying that the term secured liabilities includes one specific example of "covered bonds". Our assessment is that this specific form of secured liability is cited in the EU directive because of the significant importance of covered bonds as a funding source in a number of European markets. We did not consider this approach to be necessary for the Bill since covered bonds are not typically issued in Hong Kong and we believe that the provisions as drafted are adequate to give effect to the underlying intention, as discussed above. Please refer to Annex II for the respective provisions extracted from the UK legislation and the EU directive.

Drafting issue

In the light of members' concerns, the Administration has agreed to:

(a) consider revising the Chinese rendition "內部財務調整文書" for the term "bail-in instruments" (e.g. replacing "調整" by "重整") to better reflect the urgency and seriousness of the situation where "bail-in instruments" will be made; and

(b) consider the need to set out clearly in the Chinese text of the Bill the concept of "內部財務調整文書" noting that there is no Chinese equivalent for the term in the Mainland and Taiwan.

15. We duly note the Members' views and confirm that we will move Committee Stage Amendments to amend "內部財務調整文書" to "內部財務重整文書" wherever the term appears in the Bill.

16. As has been discussed during BC meetings to date, in statutory bail-in, a resolution authority to impose the costs of an FI's non-viability on its shareholders and certain creditors through the write-down and/or conversion of

their claims with a view to recapitalizing the FI to a level that will enable it to continue to provide critical financial services in an almost uninterrupted manner. The underlying principle of bail-in is similar to a debt-for-equity exchange conducted under existing arrangements ahead of non-viability, with the key difference being that the consent of affected shareholders and creditors is not required for bail-in to be effected under the Bill. Both the English and Chinese texts of subdivision 5 of Division 1 of Part 5 and Schedule 6 to the Bill are relevant to the exercise of relevant powers by the resolution authority in order to achieve the aforesaid effect.

Financial Services and the Treasury Bureau (Financial Services Branch)
Hong Kong Monetary Authority
Securities and Futures Commission
Office of the Commissioner of Insurance
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Annex I

Application of a resolution option – Comparison of similar provisions in other jurisdictions[3]

UK – Banking Act 2009 (as amended)[4]	
Transfer of property, section 34 (Effect)	"(1) In this section "transfer" means a transfer provided for by a property transfer instrument. (2) A transfer takes effect by virtue of the instrument (and in accordance with its provisions as to timing or other ancillary matters). **(3) A transfer takes effect despite any restriction arising by virtue of contract or legislation or in any other way.** (4) In subsection (3) "restriction" includes— (a) any restriction, inability or incapacity affecting what can and cannot be assigned or transferred (whether generally or by a particular person), and (b) a requirement for consent (by any name). …"
Transfer of securities, section 17 (Effect)	"(1) In this section "transfer" means a transfer provided for by a share transfer instrument or order, by a mandatory reduction instrument or by a resolution instrument. (2) A transfer takes effect by virtue of the instrument or order (and in accordance with its provisions as to timing or other ancillary matters). **(3) A transfer takes effect despite any restriction arising by virtue of contract or legislation or in any other way.** (4) In subsection (3) "restriction" includes— (a) any restriction, inability or incapacity affecting what can and cannot be assigned or transferred (whether generally or by a particular person), and

[3] The provisions in the table below are quoted from the relevant legislation or directive (emphasis has been added in bold, underlined).

[4] See: Banking Act 2009: http://www.legislation.gov.uk/ukpga/2009/1/pdfs/ukpga_20090001_en.pdf and Financial Services (Banking Reform) Act 2013: http://www.legislation.gov.uk/ukpga/2013/33/pdfs/ukpga_20130033_en.pdf

	(b) a requirement for consent (by any name). …"
Bail-in option, section 48S (Resolution instruments: general matters)	"(1) **Provision made in a resolution instrument takes effect despite any restriction arising by virtue of contract or legislation or in any other way.** …"
EU – Bank Recovery and Resolution Directive[5]	
Resolution powers, Article 63 General powers, subsection (2)	"… (2) Member States shall take all necessary measures to ensure that, when applying the resolution tools and exercising the resolution powers, resolution authorities are not subject to any of the following requirements that would otherwise apply by virtue of national law or contract or otherwise: (a) subject to Article 3(6) and Article 85(1), requirements to obtain approval or consent from any person either public or private, including the shareholders or creditors of the institution under resolution; (b) prior to the exercise of the power, procedural requirements to notify any person including any requirement to publish any notice or prospectus or to file or register any document with any other authority….. In particular, **Member States shall ensure that resolution authorities can exercise the powers under this Article irrespective of any restriction on, or requirement for consent for, transfer of the financial instruments, rights, assets or liabilities in question that might otherwise apply**. Point (b) of the first subparagraph is without prejudice to the requirements laid down in Articles 81 and 83 and any notification requirements under the Union State aid framework. …"
Singapore – Monetary Authority of Singapore Act[6]	
Compulsory transfer of shares of pertinent financial institution	"… (6) **Notwithstanding any written law or rule of law, or anything in the memorandum and articles of association of**

[5]See: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN
[6]See:http://statutes.agc.gov.sg/aol/download/0/0/pdf/binaryFile/pdfFile.pdf?CompId:2f8327db-ac31-4f36-a061-aad7e5b346a2

– Certificate of transfer, section 30AAX	**the pertinent financial institution**, upon the certificate coming into effect — (a) any share of the transferor that is to be transferred under the certificate shall be transferred to and vest in the transferee, free from any claim or encumbrance, without other or further assurance, act or deed; and (b) the certificate shall have effect according to its tenor and be binding on any person thereby affected. (7) For the avoidance of doubt, the shares of the transferor shall be transferred to and vest in the transferee in accordance with subsection (6), notwithstanding the death or dissolution, the bankruptcy or winding up, or the mental or other incapacity, of the transferor. …"
Compulsory transfer of business of pertinent financial institution – Certificate of transfer, section 30AAT	"… (8) **Notwithstanding any written law or rule of law**, upon the date on which the transfer of the business (or any part thereof) of the transferor comes into effect under the certificate — (a) subject to subsection (10) — (i) the business (or any part thereof) shall be transferred to and vest in the transferee without other or further assurance, act or deed; and (ii) the certificate shall have effect according to its tenor and be binding on any person thereby affected; (b) all deeds, bonds, agreements and other arrangements subsisting immediately before that date which relate to the business (or any part thereof) and to which the transferor is a party shall continue in full force and effect, and shall be enforceable by or against the transferee, as from that date, as if the transferee had been named therein or had been a party thereto instead of the transferor; and (c) any proceedings or cause of action, by or against the transferor, pending or existing immediately before that date and relating to the business (or any part thereof) may be continued and shall be enforced by or against the transferee as from that date.

	(9) For the avoidance of doubt, the business (or any part thereof) of the transferor shall be transferred to and vest in the transferee in accordance with subsection (8), notwithstanding any incapacity of the transferor. …"
Compulsory restructuring of share capital of pertinent financial institution – Certificate of restructuring of share capital, section 30AAZA	"… (6) **Notwithstanding any written law or rule of law, or anything in the memorandum and articles of association of the pertinent financial institution**, upon the certificate coming into effect — (a) where the certificate provides for a reduction of the share capital of the pertinent financial institution — (i) the reduction of the share capital shall take effect without other or further act by the pertinent financial institution; and (ii) the certificate shall have effect according to its tenor and be binding on any person thereby affected; or (b) where the certificate provides for the issue of shares by the pertinent financial institution — (i) the pertinent financial institution shall issue the shares in accordance with the certificate; and (ii) the certificate shall have effect according to its tenor and be binding on any person thereby affected. …"

Annex II

Provisions from the UK Banking Act 2009 and the EU Bank Recovery and Resolution Directive relating to exclusion of secured liabilities from bail-in

UK - Banking Act 2009 (as amended)

Section 48B - Special bail-in provision:
"… (8) The following liabilities of the bank are the excluded liabilities referred to in subsection (7A)(a)—
…
(b) any liability, so far as it is secured;
…"

Section 48D - General interpretation of section 48B
"(1) In section 48B-
…
"secured" means secured against property or rights, or otherwise covered by collateral arrangements.
…
(2) In subsection (1)-
…
"collateral arrangements" includes arrangements which are title transfer collateral arrangements for the purposes of section 48**.**…"

Section 48 - (Power to protect certain interests)
"(1) in this section-
…
(b) "title transfer collateral arrangements" are arrangements under which Person 1 transfers assets to Person 2 on terms providing for Person 2 to transfer assets if specified obligations are discharged.…"

EU - Bank Recovery and Resolution Directive

Article 44 (Scope of bail-in tool): "…(2) Resolution authorities shall not exercise the write down or conversion powers in relation to the following liabilities whether they are governed by the law of a Member State or of a third country:

…
(b) secured liabilities including covered bonds and liabilities in the form of financial instruments used for hedging purposes which form an integral part of the cover pool and which according to national law are secured in a way similar to covered bonds;…"

Article 2(1) (Definitions): "...(67) 'secured liability' means a liability where the right of the creditor to payment or other form of performance is secured by a charge, pledge or lien, or collateral arrangements including liabilities arising from repurchase transactions and other title transfer collateral arrangements.
…"