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21 December 2017

Legal Service Division
Legislative Council Secretariat
1 Legislative Council Road
Central, Hong Kong
(Attn: Ms Vanessa Cheng)

Dear Ms Cheng,

Banking (Amendment) Bill 2017

I refer to your letter dated 20 November 2017. The Administration's responses are set out in Annex for your information.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Eureka Cheung', written in a cursive style.

(Ms Eureka Cheung)
for Secretary for Financial Services and the Treasury

c.c.

Bills Committee Chairman
The Monetary Authority
Secretary for Justice

(Attn: Hon. Chan Chun-ying)
(Attn: Mr. Daryl Ho)
(Attn: Mr Michael Lam)
Mr Jonathan Luk)

Long title of the Banking (Amendment) Bill 2017

1. The Assistant Legal Adviser queried whether the long title of the Banking (Amendment) Bill 2017 (“Bill”) could reflect the related, consequential and other minor amendments, as contained in the Bill, to the Banking Ordinance (Cap. 155) (“Ordinance”). As set out in the long title of the Bill, the main object of the Bill is to amend the Ordinance to provide for recovery planning by authorized institutions; to change the limitations on authorized institutions’ exposures; to empower the Monetary Authority (“MA”) to make rules for such limitations; and to repeal two items of subsidiary legislation made under the Ordinance. To attain the main object, the Bill contains substantive amendments, and (as pointed out in the Assistant Legal Adviser’s letter) related, consequential and minor amendments, to the Ordinance. As all these amendments are necessary for the attainment of the main object of the Bill, we consider that the related, consequential and minor amendments are covered by the long title.

Clause 3 (section 2 amended (interpretation)) and clause 26 (Fourteenth Schedule amended (affairs or business of authorized institutions (“AI”) specified for purposes of definition of *manager*)

2. The different meanings in the definition of *financial exposure* in the new section 2(1A) (clause 3(6)) and the definition of *banking or other financial services* in the Fourteenth Schedule (clause 26) reflect different policy intents. For the new section 2(1A), the definition of *financial exposure* mirrors the meaning under the existing section 81 of the Ordinance. This reflects our policy intent and is a response to the industry’s request to keep the definition of *local branch* unaffected by the current legislative exercise. On the other hand, we have taken the opportunity to update the meaning of financial exposure in the definition of *banking or other financial services* set out in the Fourteenth Schedule to describe more accurately the affairs or businesses of an authorized institution (“AI”) specified for the purposes of the definition of *manager*.
3. On the definition of *off-balance sheet exposures*, the policy intent is that the term “off-balance sheet exposures” as referred to in paragraph (f)(iii) of the new definition of *banking or other financial services* should not be restricted to the items specified in column 2 of Table 14 in section 118 of the Banking (Capital) Rules (Cap. 155, sub. leg. L) because paragraph (f)(iii), as presently drafted, reflects more accurately the affairs or business of an AI specified for the purposes of the definition of *manager*.

Clause 4 – new section 68B (application)

4. The meaning of a “branch” in the proposed new section 68B(b) does not have the same meaning as “local branch” as defined in section 2(1) of the Ordinance. The definition of *local branch* in section 2(1) of the Ordinance excludes the relevant AI’s principal place of business. The word “branch” in the proposed new section 68B(b) should be given its ordinary meaning and includes the principal place of business of the AI concerned. It is therefore considered that

no amendment to section 68B(b) would be necessary.

Clause 4 – new section 68C (requirements to prepare, maintain and submit recovery plan)

(a) Meaning of “financial resources”

5. Financial resources of an AI include capital and liquidity resources, and such resources may be actual or contingent. A reference may be drawn to section 60A(1) of the Ordinance which states that financial resources of an AI include capital resources and liquidity resources.
6. In the context of the new Part XIIA on recovery planning, the purpose of restoring financial resources would be to help an AI to re-establish its liquidity and capital levels (and thereby its financial viability) when the AI comes under severe stress. This might be achieved through actual or contingent financial resources.¹
7. It should be noted that the concept of financial resources is well understood by the banking industry. During the two rounds of consultations on the proposed legislative amendments for recovery planning, no question was received in relation to such concept.

(b) Circumstances under which an AI would be considered as “under severe stress”

8. An AI would be considered to be under severe stress if circumstances or risks pose a threat to its viability (e.g. a significant deterioration occurred or expected in its financial position).
9. As recovery plan is to be prepared and “owned” by an AI, it is the responsibility of the AI to devise and propose the approach to assessing the severity of stress faced by it in a range of scenarios as part of recovery planning. In practice (as observed through recovery plans prepared by AIs so far), a key element for monitoring the severity of stress in a range of scenarios is the setting and monitoring of appropriate recovery triggers, such as AI’s capital and liquidity positions or other key stress indicators (e.g. ratings downgrade). These indicators serve to alert the AI in identifying when it may need to consider implementing the recovery options detailed in its recovery plan.

(c) Frequency of submission of the recovery plan

10. The frequency of submission will be determined on a case-by-case basis. The policy intent of this is to allow the flexibility for the MA to specify the appropriate frequency of submission of the recovery plan having regard to the circumstances of each AI. Generally speaking, the frequency of submission

¹ Example of financial resources in relation to capital include ordinary shares, retained earnings and capital instruments that meet the criteria as set out in Schedules 4A, 4B and 4C of the Banking (Capital) Rules. In relation to the liquidity, this could include cash, central bank reserves or government bonds.

may depend on factors such as the size and complexity of an AI and whether material or frequent changes of its operations are expected.

(d) Recovery planning of overseas-incorporated AI

11. Generally speaking, an overseas-incorporated AI (including an overseas-incorporated AI with limited operations in Hong Kong) may be permitted to rely on its group recovery plan to the extent that the group plan adequately covers its branch operations in Hong Kong. It would not be considered appropriate, for instance, if an overseas-incorporated AI solely relied on its group plan where it did not sufficiently address risks posed to its local operations or reflect the market specificities. Specific guidance has been developed to facilitate the AIs' recovery planning.

Clause 4 – new section 68D (general power to impose requirements)

12. An AI's recovery plan should always cover how the risks posed to local operations would be contained following a shock. While the MA expects the local recovery plan coverage to be primarily focused on an AI's Hong Kong operation, the AI's recovery plan should not necessarily be limited to risks arising locally. For example, for an AI that is part of an overseas group, the MA has a legitimate concern with regard to the effects on the AI of recovery actions taken by the AI in respect of its operations outside Hong Kong. An AI's recovery plan should therefore take into account, as appropriate, the wider business of the group of which the AI is a member.
13. As regards the meaning of "management information systems" in the new section 68D(2)(b), we are of the view that it would not be necessary to define the term because a recovery plan is a plan owned by an AI. In this connection, it is for the AI itself to design and define a management information system that is fit for its purpose to support recovery planning, taking into account its own operations.
14. In addition, it should be noted that the concept of "management information system" is well understood by the banking industry. During the two rounds of consultations on the proposed legislative amendments for recovery planning, no question was received in relation to such term.

Clause 4 – new section 68E (requirement to revise recovery plan)

15. As the MA will specify the deficiency or impediment in the notice as per the new section 68E(2)(a) so that the AI can take that into account when it revises its recovery plan, the proposed power under the new section 68E(2)(b) would not be considered as intrusive in nature. Also, given that an AI may demonstrate to the MA how the deficiency or impediments identified is to be addressed pursuant to section 68E(2)(b), this process should effectively accord to an AI the opportunity to express its opinion.

16. We note that the Financial Stability Board’s (“FSB”) Key Attributes of Effective Resolution Regimes for Financial Institutions (“Key Attributes”) do not specify that financial institutions should provide comment in respect of an authority’s decision or direction in relation to recovery planning. Nevertheless, in practice, as in the case of other prudential matters, as part of ongoing supervisory dialogues it is expected that there would be discussions between the AI and the MA prior to the serving of a notice on the AI.
17. Having considered the above factors, we are of the view that it is not necessary to specify in the legislation to provide an AI with the opportunity to state its opinion on the MA’s requirement in the local context.
18. It should also be noted that the MA takes a proportionate approach to recovery planning of AIs. Pursuant to the new section 68D(4), in imposing requirements on an AI in relation to its recovery plan, the MA may have regard to the nature, scale and complexity of the AI’s operations. In line with this proportionate approach, in exercising the powers under the new section 68E(3), the MA would take into account the seriousness of the deficiencies and impediments identified, such as the extent to which these deficiencies and impediments fetter the AI’s ability to restore its viability and financial resources.

Clause 4 – new section 68G (requirement to notify)

19. An AI is required to develop recovery triggers as one of the core elements in formulating its own recovery plan in order to take recovery action in a timely manner. The MA expects recovery triggers to be well defined and tailored to the full range of risks faced by the AI. Some generic examples of triggers include –
 - (i) Rating downgrade (or the expectation of a downgrade);
 - (ii) Widening of the spread of credit default swaps;
 - (iii) Substantial or sustained withdrawal of deposits;
 - (iv) Early redemption of liabilities by counterparties;
 - (v) Difficulty in obtaining funding or raising capital; and
 - (vi) Fall in regulatory capital and liquidity ratio.
20. Further examples of recovery triggers are available in the FSB’s guidance on recovery triggers and stress scenarios.
21. Under the new section 68G, an overseas-incorporated AI is required to notify the MA the occurrence of a trigger event as per defined in its recovery plan, even if such event does not relate to or pose any risk to its Hong Kong operations. In such circumstances, it is likely that after notifying the MA of the occurrence of a trigger event, no further action by the AI would be necessary if the trigger event is not relevant in the context of the AI’s Hong Kong operations.

Clause 4 – new section 68H (holding company of AI)

22. The ability to extend powers in relation to recovery planning to holding company of an AI is an international standard stipulated by the FSB in its Key Attributes. In general, an AI would be expected to develop its own recovery plan, but the decision to extend requirements to the holding company would be made on a case-by-case basis, taking into account the circumstances of the AI. One of the overarching considerations for imposing recovery planning requirements on the holding company of an AI include whether it is necessary or expedient to promote (i) the financial soundness and viability of the AI; or (ii) the general stability and effective working of the financial system in Hong Kong. For example, recovery planning may be better developed and maintained at the holding company level if there are operational interdependencies between an AI and other entities within the wider group that could be more effectively managed by recovery planning at the holding company level. Alternatively, for some AIs, the holding company may be better placed to respond to a crisis given the holding company's resources and any responsibilities that the holding company may have to the AI (e.g. commitment to provide capital or liquidity in times of stress to the AI).
23. Nevertheless, the Key Attributes does not specify the extra-territorial reach with respect to the standard. The approach proposed in the Bill is consistent with overseas jurisdictions, such as the European Union, where under the EU Bank Recovery and Resolution Directive, recovery planning requirements extend to "financial holding companies...that are established in the Union" (Article 1(d)). We are not aware of any examples in overseas jurisdictions whereby recovery planning would extend to a holding company which is incorporated outside its own jurisdiction.

Clause 9 – new section 81B (remedial action)

24. If an AI exceeds an exposure limit, we envisage that the AI will be required to bring the relevant exposure below the limit within a specified period of time. The MA will also see if the incident reveals any internal control weaknesses and, if so, the AI will be required to take actions to strengthen its internal controls.
25. It is expected that the remedial actions under the new section 81B(2) are more straightforward and the impact on the AI is more limited than those under sections 97E(2) and 97J(2). The remedial actions will mainly be asking the AI to reduce the relevant exposures. Section 81B(1) has already required the MA to enter into discussions with the AI before imposing the remedial actions so that the AI's views (e.g. the time needed to rectify the problem) can be taken into account among other relevant factors. We envisage that there should be little room for review of the remedial actions required. In contrast, a review mechanism is provided for breaches of the capital and liquidity requirements because they could reflect more complex and serious problems and the required remedial actions would likely be more complex and might have more impact on the AI in question. For example, if an AI's capital adequacy ratio falls short of the statutory minimum, it would call into question the viability of the AI and it

may be required to perform a host of remedial actions such as to raise capital, to dispose of certain assets or, if the case warrants, to restructure its business or to change its management.

Clause 9 – new section 81C (offence of failing to comply with prescribed notification or remedial action requirements)

26. The imposition of liability and penalties against the AIs in addition to their directors and senior management is consistent with other recent banking-related legislation such as the Anti-Money Laundering and Counter- Terrorist Financing (Financial Institutions) Ordinance (Cap. 615) and the Financial Institutions (Resolution) Ordinance (Cap. 628). We will review the treatment in other parts of the Banking Ordinance when those parts of the Ordinance require any amendment in the future.

27. As a person (i.e. an AI, director, chief executive or manager) charged under the new section 81C may invoke the defence available under section 126(1), we do not see a need to provide for the same defence again in the new section 81C. The approach is consistent with similar offence provisions in existing sections 97D, 97E, 97I and 97J.

**Financial Services and the Treasury Bureau
Hong Kong Monetary Authority
21 December 2017**