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Panel on Financial Affairs

Meeting on 3 April 2018

Background brief on loss-absorbing capacity requirements under the Financial Institutions (Resolution) Ordinance

Purpose

This paper provides background information on the Financial Institutions (Resolution) Ordinance (Cap. 628) ("FIRO") and the loss-absorbing capacity ("LAC") requirements for authorized institutions ("AIs") under FIRO. It also summarizes the major views and concerns expressed by Members when issues relating to stabilization options under the resolution regime were discussed since the 2015-2016 legislative session.

Background

2. During the financial crisis which began in 2007/2008, a number of governments around the world intervened to support their largest financial institutions ("FIs"), including by bailing them out with public money, in order to allow the financial system to continue to function. This was necessary because of the reliance of individuals, businesses and governments on the services FIs provided and the inadequacy of existing tools for dealing with the failure of a systemically important FI.

3. To reduce the impact of failure of systemically important FIs, the Financial Stability Board [1] published the "Key Attributes of Effective Resolution Regimes for Financial Institutions" which established new international standards for effective resolution regimes. These new standards required that public authorities be empowered to intervene to resolve FIs which

[1] Financial Stability Board ("FSB") was established in April 2009 to coordinate at the international level the work of national financial authorities and international standard-setting bodies and promote the reform of international financial regulations. Hong Kong is a member of FSB.

become non-viable and whose failure would pose unacceptable risks to the continuation of critical financial services and wider financial stability. An effective resolution regime should provide alternative means of containing these risks and ensure that the costs of failure and resolution are borne by the failing FIs' shareholders and creditors rather than being met by public funds.

Financial Institutions (Resolution) Ordinance

4. The Legislative Council ("LegCo") enacted FIRO in June 2016 to provide for the legal basis for the establishment of a cross-sectoral resolution regime for within scope FIs in Hong Kong.[2] Under FIRO, the Monetary Authority ("MA"), the Securities and Futures Commission and the Insurance Authority are designated as resolution authorities ("RAs") to be vested with a range of powers necessary to effect the orderly resolution of a non-viable systemically important FI for the purpose of maintaining financial stability.

Initiation of resolution and stabilization options

5. After consulting the Financial Secretary, an RA may initiate the resolution of a within scope FI if it is satisfied that all of the following conditions are met:—

(a) the FI has ceased, or is likely to cease, to be viable;

(b) there is no reasonable prospect that private sector action (outside of resolution) would result in the FI again becoming viable within a reasonable period; and

(c) the non-viability of the FI poses risks to the stability and effective working of the financial system of Hong Kong, including to the continued performance of critical financial functions, and resolution will avoid or mitigate those risks.

6. There are five stabilization options that an RA may apply to a within scope FI in resolving such FI. These options are:

(a) transfer to a purchaser;

[2] Within scope financial institutions ("FIs") under the Financial Institutions (Resolution) Ordinance (Cap. 628) ("FIRO") include all authorized institutions, certain financial market infrastructures, certain licensed corporations, certain authorized insurers, certain settlement institutions and system operators of designated clearing and settlement systems, and recognized clearing houses. The scope of FIRO also extends to holding companies and affiliated operational entities of within scope FIs.

(b) transfer to a bridge institution;

(c) transfer to an asset management vehicle;

(d) bail-in; and

(e) transfer to a temporary public ownership ("TPO") company.

7. To enable resolution to be carried out successfully, RAs will be empowered to devise strategies for securing an orderly resolution for a within scope FI and make resolvability assessment to determine whether there are any impediments to the orderly resolution of the FI, and to require the FI to remove any substantive barrier to its orderly resolution. RAs will also be empowered to gather information from and inspect records or documents of within scope FIs, and carry out investigation on the FIs.

Safeguards

8. Pre-resolution creditors or pre-resolution shareholders treated less favourably in resolution than they would have been on a hypothetical winding up will be eligible for compensation (i.e. "no creditor worse off than in liquidation" ("NCWOL") compensation). Pre-resolution shareholders, pre-resolution creditors and the RA that has initiated resolution can make applications to the Resolution Compensation Tribunal ("RCT") for a review of a decision of an independent valuer on the valuation and the compensation amount. RCT is empowered to confirm or vary the decision or set it aside and substitute a fresh decision for it, or remit the matter back to the independent valuer.

Commencement of the Financial Institutions (Resolution) Ordinance

9. The Financial Institutions (Resolution) Ordinance (Commencement) Notice 2017 appointed 7 July 2017 as the date on which all provisions of FIRO (except for Part 8 (sections 144 to 148),[3] section 192[4] and Division 10 of

[3] Part 8 (sections 144 to 148) of FIRO relates to the clawback of remuneration including the application to the Court of First Instance for a clawback order under section 145. According to the Government, this part should come into operation after the Chief Justice has made rules, pursuant to section 145(8), regulating the practice and procedure of the Court in connection with applications made under section 145.

[4] Section 192 relates to the presentation of a winding up petition of a within scope FI or a holding company of a within scope FI to the Court of First Instance. According to the Government, this section should come into operation after the Chief Justice has made rules, pursuant to section 192(3), regulating the practice and procedure of the Court for giving effect to section 192(1).

Part 15 (sections 228 to 232)[5]) commence. FIRO commenced operation on 7 July 2017. The Financial Institutions (Resolution) (Protected Arrangements) Regulation which (a) sets out how an RA should treat each type of protected arrangement in resolution in order to safeguard the economic effect of the arrangement; and (b) prescribes specified exclusions of rights and liabilities from the scope of certain protected arrangements in order to provide flexibility for an RA to achieve orderly resolution also came into force on 7 July 2017.

Loss-absorbing capacity requirements for authorized institutions under the Financial Institutions (Resolution) Ordinance

10. Under FIRO, MA is the RA in respect of AIs. The resolution tools MA can initiate for a failing AI include bail-in which allows MA to write down or convert into equity certain liabilities of an AI in resolution, thereby restoring it to viability. Hence, AIs need to have sufficient LAC, which comprises regulatory capital and certain other liabilities that can readily bear loss in resolution, to facilitate the orderly use of bail-in stabilization option if they fail.

11. Section 19 of FIRO[6] empowers an RA to make rules prescribing LAC requirements for certain within scope FIs or their group companies. The Government considers that the development of LAC requirements should be prioritized for AIs given the size, systemic importance, level of concentration, and scale of critical financial functions provided by the banking sector in Hong Kong, and considering the development of international guidelines for LAC for banks. The Hong Kong Monetary Authority conducted a two-month public consultation on 17 January 2018 to gauge views on a set of proposed rules relating to LAC requirements for AIs under FIRO. The major proposals include the scope of institutions that will be covered, calibration of minimum requirements, eligibility criteria for LAC instruments, restrictions on the sale and distribution of LAC instruments and safeguards. According to the Government, subject to the outcome of the pubic consultation, it intends to introduce the rules as subsidiary legislation under FIRO into LegCo for negative vetting later in 2018.

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[5] Division 10 of Part 15 (sections 228 to 232) relates to consequential amendments to the Insurance Companies (Amendment) Ordinance 2015 ("IC(A)O"). According to the Government, as the relevant provisions of IC(A)O had come into operation on 26 June 2017 before FIRO came into operation on 7 July 2017, those amendments had become obsolete. It is, therefore, not necessary to bring Division 10 of Part 15 into operation.

[6] An exact of section 19 of FIRO is in **Appendix I**.

Major views and concerns expressed by Members

12. The major views and concerns on issues relating to the stabilization options under the resolution regime expressed by Members during scrutiny of Financial Institutions (Resolution) Bill, and the Financial Institutions (Resolution) Ordinance (Commencement) Notice 2017 and the Financial Institutions (Resolution) (Protected Arrangements) Regulation are summarized in the ensuing paragraphs.

Stabilization options

13. Members sought clarification as to whether the stabilization options (e.g. bail-in, TPO, mandatory reduction of capital, suspension of payment obligations, etc.) would deprive private property rights, which Article 105 of the Basic Law ("BL 105") sought to protect.

14. The Government explained that BL 105 did not prohibit lawful deprivation of property per se and protected the right to compensation for lawful deprivation of property. The second paragraph of BL105 further provided that such compensation should correspond to the real value of the property concerned at the time. The Government supplemented that section 33(3) of FIRO provided for payment of "real value consideration" to the person whose property was transferred when resolution was initiated. This provision stated that consideration that was fair and reasonable in the circumstances was due to the transferor in respect of any transfer under a Part 5 instrument (e.g. to the FI in a property transfer, or to the FI's shareholders in a share transfer). In addition, section 102 provided that pre-resolution creditors and pre-resolution shareholders were eligible for payment of NCWOL compensation where, as a result of the resolution of the FI, they had received, were receiving or were likely to receive less favourable treatment than would have been the case had the winding-up of the entity commenced immediately before its resolution was initiated. The Government considered that NCWOL compensation would provide fair compensation to the above-mentioned parties. Moreover, there was an appeal mechanism to RCT available to those aggrieved by any decision made by the independent valuer who undertook the NCWOL compensation calculation.

Transfer of protected deposits

15. Members enquired how MA, as an RA, when resolving a failed bank, would transfer the deposits held by the bank and ensure continued protection for the transferred deposits under the Deposit Protection Scheme Ordinance (Cap. 581) ("DPSO"). Members were concerned that if the transferee of the deposits was not a bank or a member of Deposit Protection Scheme ("DPS") (e.g. the transferee was a private sector purchaser or bridge institution ("BI")

that was not an AI), the transferred deposits might not be covered in the definition of "protected deposit" under DPSO.

16. The Government explained that in the event that MA transferred the deposit book of a failed AI, it would ensure that the deposits would only be transferred to an entity that was authorized to carry out deposit-taking business. MA would not transfer a deposit-taking business to an entity unless it was an AI because of the restriction under section 12(1) of the Banking Ordinance (Cap. 155) ("BO").[7] Moreover, it would be an offence under section 12(6) of BO if the entity carried on deposit-taking business in Hong Kong without being authorized as an AI. The transferee of the failing bank's deposits could be a private sector purchaser that was already authorized as an AI, or a BI established to receive the transfer of deposits, which was also authorized to carry out deposit-taking business under BO. As required by section 43 of FIRO, the BI would have to be established as a company that was wholly or partially owned by the Government.

17. As regards Members' concern about the protection for the transferred deposits if the private sector purchaser or BI also failed and had not made contribution to DPS, the Government explained that section 12 of DPSO provides that every bank was a member of DPS. Therefore, the private sector purchaser or BI, as a bank, was a member of DPS. Section 27 of DPSO specified the entitlement to compensation in respect of protected deposits in the event that a DPS member failed. The transfer of deposits to the private sector purchaser or BI did not negatively affect the pre-existing protection afforded to the deposits under DPSO. The deposits transferred would still be subject to the same statutory protection under DPSO. The statutory protections under FIRO or DPSO for deposits transferred by MA to the private sector purchaser or BI were not dependent on the entity having made any contributions to DPS as specified in section 15 of DPSO.

18. In light of Members' concern about the lack of explicit provision to mandate MA to transfer "protected deposits" to AIs, the Government undertook to conduct a review, as part of a future FIRO amendment exercise, to identify any statutory amendments which would be necessary to address the concern and more clearly reflect the policy intent of achieving continuity of DPS protection for "protected deposits" transferred from a failed DPS member to an acquirer.

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[7] Section 12(1) of the Banking Ordinance (Cap. 155) provides that no business of taking deposits shall be carried on in Hong Kong except by an authorized institution ("AI"). There are three types of AI, namely licensed banks, restricted licence banks ("RLBs") and deposit-taking companies ("DTCs"). Only banks may operate current and savings accounts, and accept deposits of any size and maturity from the public. RLBs and DTCs may only accept deposits of certain minimum high-values and are not primarily engaged in retail banking. Banks are members of DPS. RLBs and DTCs are not members of the Deposit Protection Scheme.

Latest development

19. The Government will brief the Panel on Financial Affairs on the proposed approach for introducing LAC requirements for AIs and the related tax treatments in Hong Kong at the meeting on 3 April 2018.

Relevant papers

20. A list of relevant papers is in **Appendix II**.

Council Business Division 1
Legislative Council Secretariat
29 March 2018

Extract of section 19 of the Financial Institutions (Resolution) Ordinance (Cap. 628)

19. Loss-absorbing capacity requirements

(1) A resolution authority may make rules—

(a) prescribing loss-absorbing capacity requirements for within scope financial institutions or their group companies; or

(b) for connected purposes.

(2) The loss-absorbing capacity requirement rules may provide for their application on an unconsolidated balance sheet basis to an individual entity or on a consolidated balance sheet basis to 2 or more entities grouped together by the resolution authority.

(3) Without limiting subsection (1), the loss-absorbing capacity requirement rules—

(a) may be of general or special application and may be made so as to apply only in specified circumstances;

(b) may make different provisions for different classes of entities;

(c) may give effect to standards relating to loss-absorbing capacity issued by an international standard-setting body, whether in whole or in part and subject to any modifications that the resolution authority thinks fit, having regard to the prevailing circumstances in Hong Kong;

(d) may apply, adopt or incorporate by reference, with or without modification, any document relating to loss-absorbing capacity issued by an international standard-setting body, whether in whole or in part and whether in force at the time of issue or as in force from time to time;

(e) may provide that a matter (***notifiable matter***) prescribed in the rules (including a failure to comply with a loss-absorbing capacity requirement rule) is a matter about which an entity specified in the rules for the purpose, must—

(i) as soon as practicable notify the resolution authority of the entity; and

(ii) provide particulars to that resolution authority on request;

(f) may specify the form that any loss-absorbing capacity is to take;

(g) without limiting paragraph (f), may specify criteria to be met by debt instruments issued for complying with loss-absorbing capacity requirements;

(h) without limiting paragraph (f), may require that debt instruments issued for complying with loss-absorbing capacity requirements contain contractual terms designed to promote recognition of their loss-absorbing characteristics and their eligibility to be the subject of a bail-in provision;

(i) may prescribe a loss-absorbing capacity requirement in the form of a range with upper and lower limits, and the circumstances under which the resolution authority of an entity may determine that a specific loss-absorbing capacity requirement within that range applies to the entity;

(j) may empower the resolution authority of an entity to vary, in accordance with a procedure set out in the rules and in circumstances set out in the rules, a loss-absorbing capacity requirement rule applicable to the entity;

(k) may provide that a decision, of a kind prescribed in the rules, made by a resolution authority may be reviewed by the Resolvability Review Tribunal, as set out in the rules, on the application of a within scope financial institution or group company to which the decision relates;

(l) may provide for the taking of remedial action in the event of an entity contravening the rules; and

(m) may contain any incidental, supplementary, consequential, transitional or savings provisions that may be necessary or expedient in consequence of the rules.

(4) An entity that, without reasonable excuse, fails to comply with a requirement applicable to it under the loss-absorbing capacity requirement rules to notify, or to provide particulars to, the resolution authority about a notifiable matter, commits an offence and is liable—

(a) on conviction on indictment to a fine of $2000000 and, in the case of a continuing offence, to a further fine at level 6 for every day during which the offence continues; or

(b) on summary conviction to a fine at level 6 and, in the case of a continuing offence, to a further fine at level 3 for every day during which the offence continues.

(5) An entity that, without reasonable excuse, fails to comply with a requirement applicable to it under the loss-absorbing capacity requirement rules to take remedial action in the event of the entity contravening the rules, commits an offence and is liable—

(a) on conviction on indictment to a fine of $2000000 and, in the case of a continuing offence, to a further fine at level 6 for every day during which the offence continues; or
(b) on summary conviction to a fine at level 6 and, in the case of a continuing offence, to a further fine at level 3 for every day during which the offence continues.

(6) If an entity commits an offence under subsection (4) or (5), an officer of the entity also commits an offence under that subsection if the officer—
(a) authorized or permitted the commission of the offence by the entity; or
(b) was knowingly concerned in any way (whether by act or omission) in the commission of the offence by the entity.

(7) An officer who commits an offence under subsection (4) or (5) is liable—
(a) on conviction on indictment to a fine of $2000000 and to imprisonment for 5 years and, in the case of a continuing offence, to a further fine at level 6 for every day during which the offence continues; or
(b) on summary conviction to a fine at level 6 and to imprisonment for 2 years and, in the case of a continuing offence, to a further fine at level 3 for every day during which the offence continues.

(8) An officer of an entity may commit an offence under subsection (4) or (5) whether or not the entity has been prosecuted for, or found guilty of, an offence under that subsection.

(9) In this section—
Basel Committee (巴塞爾委員會) has the meaning given by section 2(1) of the Banking Ordinance (Cap 155);
International Association of Insurance Supervisors (國際保險監督聯會) means the body, whose general secretariat is based in Basel, Switzerland, that sets international standards for insurance supervision and includes any successor body of that body;
International Organization of Securities Commissions (證券委員會國際組織) means the international association of securities regulators, whose general secretariat is based in Madrid, Spain, that sets international standards for securities markets and promotes information exchange and cooperation among its members and includes any successor body of that association;

international standard-setting body (國際標準訂立團體) means—

(a) the Financial Stability Board;
(b) the Basel Committee;
(c) the International Association of Insurance Supervisors;
(d) the International Organization of Securities Commissions; or
(e) any other body that issues international standards relating to loss-absorbing capacity;

loss-absorbing capacity (吸收虧損能力), in relation to an entity, means a financial resource—

(a) that the entity maintains or to which it has unconstrained access and that may, but need not, include class 2 securities issued by the entity and loans made to the entity; and
(b) that is capable, in the event of the entity ceasing, or becoming likely to cease, to be viable, of being used to absorb losses of the entity and contribute to the restoration of its capital position.

Appendix II

List of relevant papers

Date	Event	Paper/minutes of meeting
22 June 2016	The Legislative Council passed the Financial Institutions (Resolution) Bill	Hansard The Bill passed Report of the Bills Committee (LC Paper No. CB(1)1032/15-16)
22 November 2016 and 6 April 2017	Consultation paper and the consultation conclusion on protected arrangements regulations jointly issued by the authorities	Consultation paper Consultation conclusion
18 April 2017	Meeting of the FA Panel	Administration's paper (LC Paper No. CB(1)777/16-17(05)) Background brief (LC Paper No. CB(1)777/16-17(06)) Minutes (paragraphs 29-41) (LC Paper No. CB(1)1344/16-17)
17 May 2017	Subcommittee on Financial Institutions (Resolution) (Protected Arrangements) Regulation and Financial Institutions (Resolution) Ordinance (Commencement) Notice 2017	Report of the Subcommittee (LC Paper No. CB(1)1205/16-17)

Date	Event	Paper/minutes of meeting
17 January 2018	Consultation paper on rules for loss-absorbing capacity requirements for authorized institutions under Financial Institutions (Resolution) Ordinance issued by the Hong Kong Monetary Authority	Consultation paper