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Subcommittee on Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements — Banking Sector) Rules

Background brief

Purpose

This paper provides background information on the Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements – Banking Sector) Rules ("FIRO LAC Rules") made as subsidiary legislation under the Financial Institutions (Resolution) Ordinance (Cap. 628) ("FIRO"). It also summarizes the major views expressed by members when issues relating to loss-absorbing capacity ("LAC") requirements for authorized institutions ("AIs") under the resolution regime were discussed by the Panel on Financial Affairs ("FA Panel") in the 2017-2018 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 tools at that time for dealing with the failure of systemically important FIs.

3. 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 FIs¹ in Hong Kong which is designated to meet the international standards set by the Financial Stability Board² ("FSB") in its "Key Attributes of Effective Resolution Regimes for Financial Institutions". 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.

4. There are five stabilization options that an RA may apply to a within scope FI in resolving such FI. These options fall under the following two broad categories:

- (a) four transfer stabilization options, whereby some or all of the assets, rights or liabilities of, or securities issued by, a within scope FI, are transferred to –
 - (i) a purchaser;
 - (ii) a bridge institution;
 - (iii) an asset management vehicle; and/or
 - (iv) (as a last resort) a temporary public ownership company; and
- (b) the bail-in stabilization option, whereby certain liabilities issued by the within scope FI are written down or converted into equity so as to reduce the issuer's debt, thereby absorbing losses and recapitalizing the within scope FI.

5. To enable resolution to be carried out successfully, RAs will be empowered to devise strategies for securing an orderly resolution for a within

¹ Within scope financial institutions ("FIs") under the Financial Institutions (Resolution) Ordinance (Cap. 628) ("FIRO") include all authorized institutions ("AIs"), 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.

² 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.

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.

6. FIRO came into operation on 7 July 2017.³

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7. Under FIRO, MA is the RA in respect of AIs.⁴ MA can initiate a bail-in stabilization option for a failing AI to write down or convert into equity certain liabilities of the AI, thereby restoring the AI to viability. Hence, AIs need to have sufficient LAC,⁵ 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.

8. The FIRO LAC Rules are made by MA under section 19 of FIRO (extracted in **Appendix I**) to prescribe LAC requirements for AIs and their group companies. Under the FIRO LAC Rules, AIs are required to maintain minimum levels of LAC, which can be used to absorb losses and provide recapitalization resources to facilitate orderly resolution should the relevant AI ceases, or become likely to cease, to be viable. The Administration considers that the development of LAC requirements for AIs should be accorded priority given the size, systemic importance, level of concentration, and scale of critical financial functions provided by the banking sector in Hong Kong. The making of the FIRO LAC Rules is also necessary in keeping with the development of international guidelines on LAC for banks, in particular FSB's Principles on Loss-absorbing and Recapitalisation Capacity of global systematically important banks ("G-SIBs") in Resolution and Total Loss-absorbing Capacity

³ 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), section 192 and Division 10 of Part 15 (sections 228 to 232)) commence.

⁴ Under Banking Ordinance (Cap. 155) ("BO"), an AI means a bank, a restricted licence bank or a deposit-taking company.

⁵ Loss-absorbing capacity ("LAC") refers to: (a) regulatory capital (namely Common Equity Tier 1 capital, Additional Tier 1 capital and Tier 2 capital, all of which are defined under the Banking (Capital) Rules (Cap. 155L); and (b) other LAC-eligible liabilities that can be written down or converted into equity so as to reduce the issuer's debt, thereby shoring up its balance sheet.

Term Sheet. The availability of sufficient LAC instruments issued by within scope FIs is an essential prerequisite to the effective application of the bail-in stabilization option. LAC can also support the orderly resolution of a non-viable within scope FI where a transfer stabilization option has been applied to move some or all of the assets, rights or liabilities of, or securities issued by, that within scope FI to a transferee.

9. The major proposals of the FIRO LAC Rules include the scope of institutions that will be covered, calibration of minimum requirements, qualifying criteria for LAC instruments, restrictions on the sale and marketing of LAC instruments and other safeguards. The main provisions of the FIRO LAC Rules are set out in paragraph 24 of the LegCo Brief (File Ref: B&M/2/1/29/4/1C(2018)) dated 16 October 2018 issued by the Financial Services and the Treasury Bureau and the Hong Kong Monetary Authority ("HKMA"), and paragraph 40 of the Legal Service Division Report on Subsidiary Legislation gazetted on 19 October 2018 (LC Paper No. LS5/18-19). The FIRO LAC Rules were gazetted on 19 October 2018, tabled at LegCo on 24 October 2018 for negative vetting, and will come into operation on 14 December 2018.

Major views and concerns expressed by Members

10. The Administration briefed the FA Panel on the proposed rules on LAC requirements for AIs at the meeting on 3 April 2018. The major views expressed by members are summarized in the ensuing paragraphs.

Tax treatment of loss-absorbing capacity debt instruments

11. Panel members noted that the Inland Revenue Ordinance (Cap. 112) ("IRO") was amended in 2016 to provide debt-like tax treatment to Additional Tier 1 and Tier 2 capital instruments issued by AIs but other LAC-eligible liabilities were not covered in that amendment exercise as FIRO and the FIRO LAC Rules were not then in place. Hence the Administration proposed to amend IRO to remove tax uncertainty over other LAC-eligible liabilities to facilitate implementation of the FIRO LAC Rules. Enquiries were raised as whether the proposed tax treatment would cover LAC debt instruments (i.e. Additional Tier 1 and Tier 2 capital instruments and other LAC-eligible liabilities) issued by G-SIBs in Hong Kong.

12. The Administration responded that it would keep in view the development of relevant international regulatory standards and amend IRO for

effective implementation of new international standards and requirements where necessary. The amendments to IRO in 2016 covered both Hong Kong incorporated AIs and overseas AIs with branches in Hong Kong. In other words, regulatory capital securities issued by overseas AIs and Hong Kong incorporated AIs would receive the same tax treatment. In the proposed amendments to IRO in relation to LAC debt instruments, the proposed tax treatment would also cover Hong Kong incorporated clean holding companies of AIs which were subject to LAC requirement.

Public consultation on the legislative proposals on loss-absorbing capacity

13. Panel members sought details on the responses received during the two-month public consultation⁶ on the legislative proposals on LAC. The Administration advised that 10 responses were received during the public consultation, including a number of responses from the banking industry. Respondents from the banking industry had stressed the need to ensure consistency of the FIRO LAC Rules with the relevant international standards issued by FSB, and for HKMA to closely liaise with overseas RAs when implementing LAC requirements for cross-border AIs. HKMA advised that it would set out the implementation details of LAC requirements in a code of practice to provide guidance to AIs.

Latest development

14. At the House Committee meeting on 26 October 2018, Members agreed to form a subcommittee to study the FIRO LAC Rules.

Relevant papers

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

Council Business Division 1
Legislative Council Secretariat
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⁶ The Hong Kong Monetary Authority conducted a two-month public consultation from 17 January to 16 March 2018 on the legislative proposals on LAC.

**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.

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
3 April 2018	Meeting of the FA Panel	Administration's paper (LC Paper No. CB(1)724/17-18(06)) Background brief (LC Paper No. CB(1)724/17-18(07)) Minutes (paragraphs 45-48) (LC Paper No. CB(1)1178/17-18)
24 October 2018	The Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements – Banking Sector) Rules were tabled in the Legislative Council	Legislative Council Brief (File Ref: B&M/2/1/29/4/1C(2018)) Legal Service Division Report (LC Paper No. LS5/18-19)