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Paper for the House Committee meeting on 13 August 2021

**Report of the Subcommittee on Financial Institutions (Resolution)
(Contractual Recognition of Suspension of Termination Rights –
Banking Sector) Rules**

Purpose

This paper reports the deliberations of the Subcommittee on Financial Institutions (Resolution) (Contractual Recognition of Suspension of Termination Rights – Banking Sector) Rules ("the Subcommittee").

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 bailing out FIs with public money, in order to allow the financial system to continue to function. It was necessitated by 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.

Financial Institutions (Resolution) Ordinance

3. The Financial Institutions (Resolution) Ordinance (Cap. 628) ("FIRO") was enacted in June 2016. It provides for the legal basis for the establishment of a cross-sectoral resolution regime for within scope FIs¹ in Hong Kong. Under FIRO, the Monetary Authority ("MA"), the Securities and Futures Commission and the Insurance Authority are the resolution authorities ("RAs") vested with a range of powers necessary to effect the orderly resolution of a non-viable systemically important FI, having regard to the resolution objectives under section 8 of FIRO, including five stabilization options² which may be applied by making a Part 5 instrument³. FIRO came into operation on 7 July 2017.

Suspension of termination rights

4. Under section 90(2) of FIRO, RAs are empowered to temporarily suspend, for up to two business days, the termination right⁴ of counterparties (except where the counterparty is a financial market infrastructure⁵) to contracts entered into by within scope FIs or their group companies. The effect is that a

¹ Within scope financial institutions ("FIs") under the Financial Institutions (Resolution) Ordinance (Cap. 628) ("FIRO") include all authorized institutions ("AIs"), 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 The five stabilization options include 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: (a) a purchaser; (b) a bridge institution; (c) an asset management vehicle; and/or (d) (as a last resort) a temporary public ownership company; and a 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).

³ A Part 5 instrument means a securities transfer instrument, a property transfer instrument or a bail-in instrument.

⁴ Under the Financial Institutions (Resolution) (Contractual Recognition of Suspension of Termination Rights – Banking Sector) Rules ("the Rules"), "termination right" means "a right to terminate the contract; a right to accelerate, close out, set off or net obligations, or any similar right that suspends, modifies or extinguishes an obligation of a party to the contract; or a right to prevent an obligation from arising under the contract".

⁵ Under section 2(1) of FIRO, "financial market infrastructure" means "a multilateral system among participating financial institutions used for clearing, settling or recording payments, securities, derivatives or other financial transactions and includes any payment system, central securities depository, securities settlement system, central counterparty and trade repository".

counterparty cannot terminate and close out its positions solely as a result of resolution actions being taken by RAs.

5. The Financial Institutions (Resolution) (Contractual Recognition of Suspension of Termination Rights – Banking Sector) Rules ("the Rules") are made by MA, in his capacity as the RA for banking sector entities, pursuant to section 92 of FIRO, to ensure the effectiveness of a suspension of termination rights imposed under section 90(2) of FIRO with respect to contracts governed by laws of other jurisdictions. According to the Administration, the Rules are formulated in accordance with the approach recommended by the Financial Stability Board in its "Principles for Cross-border Effectiveness of Resolution Actions".

Financial Institutions (Resolution) (Contractual Recognition of Suspension of Termination Rights – Banking Sector) Rules

6. The main provisions of the Rules are summarized below:

- (a) a covered contract i.e. a financial contract listed in Part 2 of the Schedule to the Rules (e.g. a contract for the purchase, sale or loan of a transferable security) that (i) is entered into by an authorized institution ("AI") (i.e. a licensed bank, a restricted licence bank, or a deposit-taking company) incorporated in Hong Kong, a Hong Kong holding company or a related company of an AI incorporated in Hong Kong⁶ ("covered entity"); (ii) is governed by non-Hong Kong law; and (iii) contains a termination right exercisable by a counterparty, is required to contain a provision to the effect that the parties to the contract agree that the parties (other than an excluded counterparty⁷) will be bound by a suspension of termination rights in relation to the contract imposed by MA under section 90(2) of FIRO ("suspension of termination rights provision");

⁶ For a financial contract entered into by a related company of an AI incorporated in Hong Kong, the requirement only applies if the contract also contains an obligation that is guaranteed or otherwise supported by the AI or the Hong Kong holding company, that is a group company of the related company.

⁷ Under the Rules, "excluded counterparty" means a financial market infrastructure, the Monetary Authority, the Government of the Hong Kong Special Administrative Region, the government of a non-Hong Kong jurisdiction, or the central bank of a non-Hong Kong jurisdiction.

- (b) the initial period by the end of which a covered entity must comply with the requirement in subparagraph (a) is either 24 months beginning on the initial day for a contract where there are no counterparties other than an AI or a financial institution (other than an AI) that is a "global systematically important bank" within the meaning provided in FIRO ("GSIB"), or 30 months beginning on the initial day for any other contract. MA may extend such initial period, or grant exemption from requirements for a contract; and
- (c) other requirements to be complied with by a covered entity as well as offences e.g. a covered entity that, without reasonable excuse, fails to propose or implement a rectification plan acceptable to MA is liable on conviction to a fine at level 2 (i.e. \$5,000). The officer of a covered entity would only commit an offence if he/she has authorized or permitted, or was knowingly concerned in any way (whether by act or omission) in the commission of the offence by the covered entity.

7. The Rules were published in the Gazette on 25 June 2021 and tabled before the Legislative Council ("LegCo") at its meeting of 7 July 2021, subject to negative vetting by LegCo. The Rules will come into operation on 27 August 2021.

The Subcommittee

8. At the House Committee meeting on 2 July 2021, Members agreed to form a subcommittee to scrutinize the Rules. Hon Holden CHOW Ho-ding was elected Chairman of the Subcommittee. The membership list of the Subcommittee is at the **Appendix**. The Subcommittee held a meeting on 13 July 2021 with the Administration to scrutinize the Rules. The Subcommittee has invited written views from the public but did not receive any submission.

9. To allow more time for the Subcommittee to complete its work, a motion was passed at the Council meeting of 21 July 2021 to extend the scrutiny period to the Council meeting of 25 August 2021.

Deliberations of the Subcommittee

10. Members of the Subcommittee in general support the Rules which aimed to ensure the effectiveness of resolution actions. The deliberations of the Subcommittee are set out in the ensuing paragraphs.

Rationale and scope

11. Members have examined the rationale for requiring, under the proposed Rules, that the terms and conditions of a contract entered into by a covered entity contain a suspension of termination rights provision. Members have enquired about how the suspension of termination rights provision facilitates the implementation of a resolution regime in Hong Kong to strengthen financial stability.

12. The Administration has explained that in a resolution where one or more stabilization options are applied by an RA to a non-viable within scope FI, it is important that the contractual counterparties to the FI cannot terminate and close out their positions solely as a result of the FI's entry into resolution. Disorderly termination of contracts on a mass scale could frustrate resolution actions taken with respect to a non-viable within scope FI, thus causing significant contagion effects to the financial markets and posing wider risks to the stability and effective working of the financial system.

13. The Administration has further advised that FIRO empowers MA to temporarily suspend termination rights of counterparties to qualifying contracts entered into by qualifying entities that are banking sector entities, to prevent disorderly termination of contracts on a mass scale, which could cause significant contagion effects and frustrate MA's resolution actions. Where the relevant contracts are governed by non-Hong Kong law, there are uncertainties as to whether a court in a non-Hong Kong jurisdiction would give effect to a suspension of termination rights imposed by an RA under section 90(2) of FIRO unless the law of such jurisdiction expressly recognizes the RA's action. To address the issue of ensuring cross-border effectiveness of a suspension of termination rights imposed pursuant to section 90(2) of FIRO with respect to relevant contracts governed by non-Hong Kong law, the Rules give effect to cross-border resolution actions via a contractual approach, i.e. by stipulating that relevant financial contracts governed by non-Hong Kong law must contain a suspension of termination rights provision.

14. To assess the scale of the impact of the Rules on the financial sector and noting that the Rules will come into operation on 27 August 2021, members have enquired about the percentage of financial contracts governed by non-Hong Kong law among the total number of financial contracts entered into by AIs in Hong Kong, and whether and under what conditions a covered contract entered into before the commencement of the Rules is required to contain the suspension of termination rights provision.

15. The Administration has clarified that the Rules do not have any retrospective effect. A covered contract entered into before the commencement of the Rules would only be required to comply with the Rules when it is renewed or materially amended. While the Administration does not have the statistics on covered contracts in Hong Kong as requested by members, it has advised members that according to the responses received by the Hong Kong Monetary Authority ("HKMA") in its industry engagement, the majority of the financial contracts entered into by AIs in Hong Kong are governed by non-Hong Kong law.

Initial period for compliance

16. Members note that for a financial contract where there are no counterparties other than an AI or a FI (other than an AI) that is a GSIB, the Rules provided for an initial period of 24 months, at the end of which the covered entity must comply with the requirement of ensuring that contracts that are governed by non-Hong Kong law contain the suspension of termination rights provision (as mentioned in paragraph 11 above). Regarding the initial period for compliance, members have enquired about the date from which the 24-month period counts, the rationale for setting the minimum of such period at 24 months, and whether the period will give covered entities sufficient time to make relevant preparations for compliance.

17. The Administration has replied that the 24-month initial period for compliance for the relevant covered contracts of covered entities will begin on the commencement date of the Rules, i.e. 27 August 2021. It is envisaged that covered entities will have sufficient preparation time as they should start assessing whether their contracts have to contain the suspension of termination rights provision upon the commencement of the Rules. The Administration has further explained that the minimum initial period for compliance with the Rules was proposed to be 18 months in HKMA's earlier proposal during its public consultation from January to March 2020 and has been lengthened to 24 months as a result of comments received from the respondents.

Enforcement issues

18. The Rules require covered entities to ensure that covered contracts contain a suspension of termination rights provision. Members have enquired about HKMA's enforcement actions, in particular, in the case where the counterparty to a covered contract is in a jurisdiction that has not enacted any legislation to enable cross-border resolution actions; and whether the reluctance of the counterparty to a covered contract to comply with the Rules (due to, for example, the lack of relevant legislation in the counterparty's jurisdiction) could serve as a reasonable excuse for non-compliance.

19. The Administration has advised that the international community has arrived at a consensus on the establishment and implementation of a resolution regime. HKMA would liaise with the relevant authorities of non-Hong Kong jurisdictions on the implementation of the Rules as appropriate. If an AI fails to comply with the above requirements under the Rules and, in the opinion of MA, such failure poses a significant impediment to an orderly resolution of the AI, MA may serve a written notice on the AI pursuant to section 14 of FIRO requiring it to take measures that are in the opinion of MA required to remove the impediment.

20. The Administration has further advised that under section 16 of FIRO, an AI that has failed without reasonable excuse to comply with a written notice served under section 14 of FIRO commits an offence. Section 16 of FIRO provided for a fine of \$2,000,000 and imprisonment for five years. While the power under section 14 of FIRO may be exercised if MA is of the opinion that significant impediments to orderly resolution exist, HKMA would work closely with individual AIs on resolution planning with a view to identifying and removing any impediments to AIs' resolvability. HKMA will review non-compliant cases having regard to individual circumstances.

Recommendation

21. The Subcommittee has completed scrutiny of the Rules. Neither the Subcommittee nor the Administration will propose amendments to the Rules.

Advice sought

22. Members are invited to note the deliberations of the Subcommittee as set out above.

Council Business Division 1
Legislative Council Secretariat
12 August 2021

**Subcommittee on Financial Institutions (Resolution) (Contractual
Recognition of Suspension of Termination Rights – Banking Sector) Rules**

Membership list

Chairman Hon Holden CHOW Ho-ding

Members Hon Starry LEE Wai-king, SBS, JP
Hon Christopher CHEUNG Wah-fung, SBS, JP
Hon CHAN Chun-ying, JP
Hon CHEUNG Kwok-kwan, JP

(Total : 5 members)

Clerk Mr Derek LO

Legal Adviser Miss Joyce CHAN