

**For discussion  
on 1 March 2021**

**Legislative Council Panel on Financial Affairs**

**Financial Institutions (Resolution) Ordinance (Cap. 628) -  
Financial Institutions (Resolution) (Contractual Recognition of  
Suspension of Termination Rights – Banking Sector) Rules**

**PURPOSE**

This paper briefs Members on the Financial Institutions (Resolution) (Contractual Recognition of Suspension of Termination Rights – Banking Sector) Rules (“Rules”) to be made by the Monetary Authority (“MA”) as the resolution authority for banking sector entities<sup>1</sup> under the Financial Institutions (Resolution) Ordinance (Cap. 628) (“FIRO”).

**BACKGROUND**

2. The FIRO, which came into force on 7 July 2017, establishes a cross-sectoral resolution regime for within scope financial institutions (“within scope FIs”)<sup>2</sup> and is designed to meet the international standards set by the Financial Stability Board (“FSB”)<sup>3</sup> in its “Key Attributes of Effective Resolution Regimes for Financial Institutions”<sup>4</sup>. Under the FIRO, the MA, the Insurance Authority

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<sup>1</sup> Banking sector entities include all authorized institutions (“AIs”), and certain settlement institutions and system operators.

<sup>2</sup> Within scope FIs include all 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 the FIRO also extends to holding companies and affiliated operational entities of within scope FIs.

<sup>3</sup> The FSB is an international body established by the G20 in 2009 in the aftermath of the global financial crisis. It monitors and makes recommendations about the global financial system and promotes international financial stability by coordinating national financial authorities and international standard-setting bodies as they work toward developing regulatory, supervisory and other financial sector policies.

<sup>4</sup> Key Attributes of Effective Resolution Regimes for Financial Institutions, first issued in 2011 and updated in 2014.

and the Securities and Futures Commission are the resolution authorities for those within scope FIs operating under their respective purviews. The FIRO provides resolution authorities with various powers, which include the powers to apply stabilization options by making one or more Part 5 instruments<sup>5</sup> to resolve a non-viable within scope FI whose non-viability poses risks to the stability and effective working of the financial system of Hong Kong, including to the continued performance of critical financial functions.

3. In a resolution where one or more stabilization options are applied by a resolution authority 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. Should a termination right of a counterparty to a qualifying contract<sup>6</sup> nevertheless become exercisable, section 90(2) of the FIRO allows a resolution authority to temporarily suspend, for up to two business days, the termination right of a counterparty<sup>7</sup> to a qualifying contract, by way of provision in a Part 5 instrument.

4. Notwithstanding the above, 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 a resolution authority under section 90(2) of the FIRO unless the law of such jurisdiction expressly recognizes the resolution authority's action. Further, even if a court in a non-Hong Kong jurisdiction were to give effect to the suspension imposed under the FIRO, it could be challenging to effect such recognition in a timely fashion in order to best achieve the resolution objectives in Hong Kong. To address the issue of ensuring cross-border effectiveness of

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<sup>5</sup> A Part 5 instrument means a securities transfer instrument, a property transfer instrument or a bail-in instrument.

<sup>6</sup> A qualifying contract is a contract entered into by a within scope FI or a group company of a within scope FI (each a "qualifying entity" under the FIRO) under which the obligations for payment and delivery and for provision of collateral continue to be performed.

<sup>7</sup> Other than a financial market infrastructure which 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.

suspension of termination rights imposed under local rules or laws with respect to contracts governed by laws of other jurisdictions, the FSB has set out certain principles in its “Principles for Cross-border Effectiveness of Resolution Actions” (“FSB Principles”)<sup>8</sup>. The FSB Principles support, amongst others, contractual approaches to giving effect to cross-border resolution actions, which complement and support statutory frameworks.

## **THE RULES**

5. Section 92 of the FIRO provides that a resolution authority may make rules to require that the terms and conditions of a contract entered into by a qualifying entity contain a provision to the effect that the parties to the contract agree to be bound by any suspension of termination rights in relation to the contract imposed by the resolution authority under section 90(2) of the FIRO.

6. The Rules are to be made by the MA under section 92 of the FIRO, in his capacity as the resolution authority for banking sector entities under the FIRO. The Rules will apply to AIs incorporated in Hong Kong, their Hong Kong incorporated holding companies and certain group companies of the AIs, as discussed in paragraph 7 below. In developing the legislative proposals for the Rules, the MA has taken into account relevant international standards (in particular the FSB Principles) and approaches taken in other jurisdictions on similar requirements. The Rules are to be made to adopt the contractual approach, as advocated by the FSB, to recognize a suspension of termination rights under section 90(2) of the FIRO pursuant to section 92 of the FIRO.

## **LEGISLATIVE PROPOSALS**

7. The Rules will apply to a covered entity, which is (a) an AI incorporated in Hong Kong; (b) a Hong Kong incorporated holding company of an AI incorporated in Hong Kong (that is not itself an AI) (“HK holding company”); or (c) a body corporate that is a group company of an AI incorporated in Hong Kong (that is not itself an AI incorporated in Hong Kong or an HK holding company) (“related company”).

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<sup>8</sup> Principles for Cross-border Effectiveness of Resolution Actions, November 2015.

8. Where a covered entity is to, on or after the initial day<sup>9</sup>, (a) enter into a covered contract or (b) renew or materially amend an existing covered contract<sup>10</sup>, the Rules will provide that the covered entity must ensure that the contract contains a contractual term or condition (made, or evidenced, in writing) to the effect that the parties agree in a legally enforceable manner to be bound by any suspension of termination rights in relation to the contract that may be imposed by the MA under section 90(2) of the FIRO (“suspension of termination rights provision”).

9. A covered contract, in relation to a covered entity that is an AI incorporated in Hong Kong or an HK holding company, will be defined as a financial contract which (a) is entered into by the covered entity; (b) is governed by non-Hong Kong law; and (c) contains a termination right exercisable by a counterparty other than an excluded counterparty<sup>11</sup>. For a covered entity that is a related company, an additional criterion of a covered contract is that the contract contains obligation(s) of the covered entity that are guaranteed or otherwise supported by an AI incorporated in Hong Kong, or an HK holding company, that is a member of the same group of companies as the covered entity.

10. A financial contract will be defined as a contract listed as follows or any combination of these contracts: (a) a securities contract; (b) a commodities contract; (c) a derivatives contract; (d) a currency contract; (e) a contract of a similar nature to a contract in point (a), (b), (c) or (d); or (f) a master or other agreement in so far as it relates to a contract in point (a), (b), (c), (d) or (e).

11. The Rules will adopt the same definition of “termination right” as under section 86 of the FIRO, which is (a) a right to terminate the contract; (b) 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 (c) a right to prevent an obligation from arising under the contract. This will ensure consistency between “termination right” under the Rules and the “termination right” that could be suspended by the MA under section 90(2) of

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<sup>9</sup> Under the Rules, “initial day”, in relation to a covered entity, or a covered contract entered into by it, means (a) the day on which the Rules come into operation; or (b) if it is not a covered entity on that day, the later day on which it becomes a covered entity.

<sup>10</sup> An existing covered contract means a covered contract that is entered into by a covered entity before the initial day.

<sup>11</sup> The scope of excluded counterparties under the Rules is proposed to cover financial market infrastructure, the MA, the Hong Kong Government, and central banks and governments of non-Hong Kong jurisdictions.

the FIRO.

12. The Rules will provide for an initial period for covered entities to comply with the requirement of ensuring that a suspension of termination rights provision is contained in covered contracts. It is proposed that, with respect to covered contracts entered into by a covered entity, the counterparties to which are solely (a) an AI; or (b) an FI (which is not an AI) that is a global systemically important bank on the initial day, the initial period will be 24 months. For any other covered contracts, the Rules will provide for an initial period of 30 months.

13. To facilitate implementation and provide for flexibility as needed, the Rules will also provide the MA with the powers to extend the initial period for a covered entity to comply with, and to exempt a covered entity from complying with, the requirement to ensure that a suspension of termination rights provision is contained in respect of one or more covered contracts if the MA is satisfied that it is prudent to do so. The MA may attach conditions to, or subsequently revoke or vary, an exemption or extension granted under the Rules.

## **PUBLIC CONSULTATION**

14. The Hong Kong Monetary Authority (“HKMA”) conducted a public consultation from January to March 2020 on the policy proposals for the Rules. A range of stakeholders have been engaged during the consultation period and 14 submissions were received from industry associations, professional associations, banks and others. Respondents indicated broad support for the proposed approach to the Rules whilst providing comments or seeking clarifications in relation to some technical aspects of the proposals. The consultation conclusion, released on 31 December 2020, explained appropriate refinements to the proposals as reflected in the legislative proposals set out in this paper. The HKMA conducted an industry consultation on the draft text of the Rules from December 2020 to January 2021. Respondents provided technical comments on the draft text of the Rules and indicated areas where further guidance is required from the MA. The HKMA would provide further implementation details in a Code of Practice to be issued in the future.

## **WAY FORWARD**

15. The finalisation of the Rules is underway. Our target is to table the Rules in the Legislative Council for negative vetting in the second quarter of 2021.

## **ADVICE SOUGHT**

16. Members are invited to note the proposals as set out in this paper.

**Financial Services and the Treasury Bureau**  
**Hong Kong Monetary Authority**  
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