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**Panel on Financial Affairs**

**Meeting on 1 March 2021**

**Background brief on proposed rules on contractual stays on termination rights in financial contracts for banks under the Financial Institutions (Resolution) Ordinance (Cap. 628)**

**Purpose**

This paper provides background information on the Financial Institutions (Resolution) Ordinance (Cap. 628) ("FIRO") and the proposed rules on contractual stays on termination rights in financial contracts for banks to be made under FIRO. It also summarizes the major views and concerns expressed by Members when issues relating to the application of stabilization options on financial institutions ("FIs") 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 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.

Financial Institutions (Resolution) Ordinance

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 FIs<sup>1</sup> in Hong Kong. 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, including applying the five stabilization options in the following two broad categories to a within scope FI when resolving such FI:

- (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) bridge institution ("BI");
  - (iii) an asset management vehicle; and/or
  - (iv) (as a last resort) a temporary public ownership ("TPO") 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.

4. FIRO came into operation on 7 July 2017.<sup>2</sup> Two pieces of subsidiary legislation relating to the implementation of the resolution regime, namely Financial Institutions (Resolution) (Protected Arrangements) Regulation (which prescribes requirements to be complied with by an RA when exercising certain resolution powers with a view to safeguarding the economic effect of specified financial arrangements) and Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements — Banking Sector) Rules (i.e. the loss-absorbing

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<sup>1</sup> 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.

<sup>2</sup> 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.

capacity rules ("LAC Rules") which prescribes LAC requirements for authorized institutions<sup>3</sup> ("AIs") and their group companies) came into operation in July 2017 and December 2018 respectively. Details of the above two pieces of subsidiary legislation are set out in **Appendix I**.

### **Rules on contractual stays on termination rights in financial contracts for banks**

5. Under FIRO, MA is the RA in respect of AIs. In a resolution where one or more stabilization options can be applied by an RA to a non-viable 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 by counterparties of an FI in a resolution will cause significant contagion effect to the financial markets, posing wider risks to the stability and effective working of the financial system. To address these risks, FIRO contains a provision that provides an RA with the power to suspend (i.e. "stay") for a specified period the termination right of a counterparty to a qualifying contract under certain circumstances. MA can make rules (i.e. Stay Rules) under the rule making power under section 92 of FIRO to provide for contractual stays on termination rights in financial contracts for AIs.

6. The proposed Stay Rules require AIs incorporated in Hong Kong and certain of their group companies to include an appropriate provision in certain non-Hong Kong law governed financial contracts to the effect that the parties to the contracts agree to be bound by a temporary suspension of termination rights that may be imposed by MA as an RA under section 90 of the FIRO. The Stay Rules are designed to address the cross-border risks to orderly resolution arising from the early termination of financial contracts governed by non-Hong Kong law, and in line with the contractual approach to giving effect to cross-border resolution actions advocated by the Financial Stability Board.<sup>4</sup>

7. The Hong Kong Monetary Authority ("HKMA") conducted a two-month public consultation on 22 January 2020 to gauge views on the detailed proposals on the proposed Stay Rules, and released the consultation conclusion on 31 December 2020.

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<sup>3</sup> Under Banking Ordinance (Cap. 155) ("BO"), an AI means a bank, a restricted licence bank ("RLBs") or a deposit-taking company ("DTCs").

<sup>4</sup> 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.

## **Major views and concerns expressed by Members**

8. The major views and concerns on issues relating to the application of the stabilization options under the resolution regime expressed by Members during scrutiny of the Financial Institutions (Resolution) Bill, Financial Institutions (Resolution) (Protected Arrangements) Regulation and Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements – Banking Sector) Rules are summarized in the ensuing paragraphs.

### Application of the stabilization options

9. Members sought clarification as to whether the stabilization options (e.g. bail-in, 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.

10. The Administration explained that BL 105 does not prohibit lawful deprivation of property per se and the right to compensation for lawful deprivation of property will be protected. The second paragraph of BL105 further provided that such compensation shall correspond to the real value of the property concerned at the time. The Administration supplemented that section 33(3) of FIRO provided for payment of "real value consideration" to the person whose property is transferred when resolution is initiated. This provision stated that consideration that is fair and reasonable in the circumstances is 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 are eligible for payment of "no creditor worse off than in liquidation" ("NCWOL") compensation where, as a result of the resolution of the FI, they have received, are receiving or are likely to receive less favourable treatment than would have been the case had the winding-up of the entity commenced immediately before its resolution is initiated. The NCWOL compensation would provide fair compensation to the above-mentioned parties. Moreover, there was an appeal mechanism to the Resolution Compensation Tribunal available to those aggrieved by any decision made by the independent valuer who undertook the NCWOL compensation calculation.

### Transfer of protected deposits

11. Members enquired how MA 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 expressed concern 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 a BI that was not an AI), the transferred deposits might not be covered in the definition of "protected deposit" under DPSO.

12. The Administration 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").<sup>5</sup> 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 will have to be established as a company that was wholly or partially owned by the Government.

13. As regards Members' concern about the protection for the transferred deposits if the private sector purchaser or BI also failed and had not made contributions to DPS, the Administration explained that section 12 of DPSO provided that every bank is 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 fails. 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.

#### Scope of authorized institutions subject to the loss-absorbing capacity requirements

14. Given that the objective of FIRO was to address the non-viability of FIs which were "too big to fail", thereby containing the risks posed by their non-viability to the financial stability of Hong Kong, some Members considered that small AIs should not be the targets of FIRO and covering such AIs under

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<sup>5</sup> Section 12(1) of BO provides that no business of taking deposits shall be carried on in Hong Kong except by an AI. There are three types of AI, namely licensed banks, RLBs and 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 the Deposit Protection Scheme ("DPS"). RLBs and DTCs are not members of DPS.

the LAC Rules would be inconsistent with the objectives of FIRO. These Members urged the Administration to consider that only global systemically important banks ("G-SIBs") and domestic systemically important banks ("D-SIBs") should be subject to the LAC Rules.

15. The Administration pointed out that according to section 2(1) of FIRO, all AIs are banking sector entities and hence within scope of FIRO. Nevertheless, no AI would be automatically subject to LAC requirements under the LAC Rules or the Code of Practice: Resolution Planning – LAC Requirements issued by HKMA. It was only where the failure of an AI was expected to pose a risk to financial stability, including to depositors, that it would be subject to LAC requirements. As a result, where an AI could demonstrate to MA that its failure could be managed via insolvency without posing risks to financial stability, it would not be subject to LAC requirements.

16. Regarding the suggestion that only G-SIBs and D-SIBs should be subject to the LAC Rules, the Administration responded that this would undermine the resolution objectives set out in FIRO and lead to increased risks for Hong Kong taxpayers and depositors. The key objectives of making banks resolvable was to avoid publicly funded bail-outs, and prevent insolvency of banks which might undermine the general confidence of participants in the financial market and thus adversely affecting financial stability in Hong Kong. The Administration stressed that the only realistic alternative to a publicly funded bail-out of or an insolvency of a bank was an orderly resolution. This would only be achievable if on failure a bank had sufficient LAC to provide the financial resources to support such a resolution.

### **Latest development**

17. The Administration will brief the Panel on Financial Affairs on the proposed rules on contractual stays on termination rights in financial contracts for banks at the meeting on 1 March 2021.

### **Relevant papers**

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

### **Two pieces of subsidiary legislation relating to the implementation of the resolution regime**

#### Financial Institutions (Resolution) (Protected Arrangements) Regulation

1. The Financial Institutions (Resolution) (Protected Arrangements) Regulation ("PAR") was made by the Secretary for Financial Services and the Treasury under 75(1) of the Financial Institutions (Resolution) Ordinance (Cap. 628) ("FIRO") to prescribe requirements to be complied with by a resolution authority when exercising certain resolution powers<sup>1</sup> with a view to safeguarding the economic effect of specified financial arrangements (defined together as "protected arrangements"). The six types of financial arrangement specified as protected arrangements under section 74 of FIRO are:

- (a) clearing and settlement systems arrangements;
- (b) netting arrangements;
- (c) secured arrangements;
- (d) set-off arrangements;
- (e) structured finance arrangements; and
- (f) title transfer arrangements.

2. PAR was gazetted on 12 May 2017 and tabled at the LegCo meeting of 17 May 2017 for negative vetting. PAR came into operation on 7 July 2017.

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<sup>1</sup> The Financial Institutions (Resolution) (Protected Arrangements) Regulation aims to address the possibility that the application of certain stabilization options may not safeguard the economic effect of "protected arrangements", as action taken by a resolution authority ("RA") to effect a stabilization option could "split up" the assets, rights or liabilities constituting such arrangements. The "split up" is likely to arise: (a) when an RA makes a partial property transfer to transfer some, but not all, of an entity's assets, rights or liabilities to a third party; or (b) on bail-in where liabilities are written down and/or converted without taking into account linked assets or rights entitled to be set off or netted under arrangements that are documented or otherwise evidenced in writing.

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

3. The Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements — Banking Sector) Rules ("LAC Rules") are made by the Monetary Authority under section 19 of FIRO to prescribe loss-absorbing capacity ("LAC") requirements for authorized institutions<sup>2</sup> ("AIs") and their group companies. Under the 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 (as opposed to other within scope financial institutions ("FIs")) 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 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.

4. The LAC Rules were gazetted on 19 October 2018 and tabled at the LegCo meeting of 24 October 2018 for negative vetting. The LAC Rules came into operation on 14 December 2018.

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<sup>2</sup> Under Banking Ordinance (Cap. 155), an authorized institution means a bank, a restricted licence bank or a deposit-taking company.

**List of relevant papers**

<b>Date</b>	<b>Event</b>	<b>Paper/minutes of meeting</b>
22 June 2016	The Legislative Council passed the Financial Institutions (Resolution) Bill	<a href="#">Hansard</a> <a href="#">The Bill passed</a> <a href="#">Report of the Bills Committee</a> (LC Paper No. CB(1)1032/15-16)
22 November 2016 and 6 April 2017	Consultation paper and consultation conclusion on protected arrangements regulations jointly issued by the authorities	<a href="#">Consultation paper</a> <a href="#">Consultation conclusion</a>
18 April 2017	Meeting of the FA Panel	<a href="#">Administration's paper</a> (LC Paper No. CB(1)777/16-17(05))  <a href="#">Background brief</a> (LC Paper No. CB(1)777/16-17(06))  <a href="#">Minutes</a> (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	<a href="#">Report of the Subcommittee</a> (LC Paper No. CB(1)1205/16-17)

<b>Date</b>	<b>Event</b>	<b>Paper/minutes of meeting</b>
17 January 2018	Consultation paper and consultation conclusion on rules for loss-absorbing capacity requirements for authorized institutions under Financial Institutions (Resolution) Ordinance issued by the Hong Kong Monetary Authority	<a href="#">Consultation paper</a>  <a href="#">Consultation conclusion</a>
3 April 2018	Meeting of the FA Panel	<a href="#">Administration's paper</a> (LC Paper No. CB(1)724/17-18(06))  <a href="#">Background brief</a> (LC Paper No. CB(1)724/17-18(07))  <a href="#">Minutes</a> (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	<a href="#">Report of the Subcommittee</a> (LC Paper No. CB(1)265/18-19)
22 January 2020	Consultation paper and consultation conclusion on rules on Contractual Stays on Termination Rights in Financial Contracts for Authorized Institutions	<a href="#">Consultation paper</a>  <a href="#">Consultation conclusion</a>