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Submission to the Consultation Paper on the Regulations on Protected Arrangements under the Financial Institutions (Resolution) Ordinance (Cap. 628) (the "Proposal")

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Introduction

The Financial Services and the Treasury Bureau of the Government of the Hong Kong Special Administrative Region, in conjunction with the Hong Kong Monetary Authority, the Securities and Futures Commission, and the Insurance Authority (the "**Authorities**") published a consultation paper (the "**Consultation Paper**") on 22 November 2016 in respect of the Authorities' intended approach to the regulations to be made under section 75 of the Financial Institutions (Resolution) Ordinance (Cap. 628) (the "**FIRO**"), which are designed to provide an appropriate degree of protection in resolution for a set of financial arrangements defined collectively as "protected arrangements" under section 74 of the FIRO.

This Proposal is made in response to the Consultation Paper with our comments and suggestions illustrated below. Terms defined or given a particular construction in the Consultation Paper or in the FIRO shall have the same meaning in this Proposal unless a contrary indication appears.

Q1. Do you agree with the proposed approach to protecting clearing and settlement systems arrangements in a PPT under the PARs?

We principally agree to the proposition to protect properties, rights or liabilities within a clearing and settlement or a clearing house, which means the Central Clearing and Settlement System (the "**CCASS**") in Hong Kong, with the purpose to keep the FMI free from disruption and to preserve its predictability and continuity. When a transaction is at the clearing and settlement stage, the CCASS is subjected to the T+2 settlement period for securities, hence the resolution authorities will be restricted from intervening the system during the period.

We agree to the view that preservation of predictability and continuity in the clearing and settlement system is of the utmost importance to the financial system. Hence, we believe that we could go further than the proposed level of protection suggested in the Consultation Paper. Rather than restricting resolution authorities from transferring "some but not all of the properties, rights or liabilities", we suggest that all sorts of disruption should be disallowed for effecting a PPT.

We believe, in most scenarios, there is no such urgency or necessity for the resolution authority to disrupt the CCASS in carrying out its functions and to retrieve the corresponding properties, rights or liabilities within the narrow time frame before the clearing and settlement process could be completed. The resolution authorities should be able to allocate the assets immediately subsequent to the completion of clear and settlement process, to which the value of the attached assets change during the time when they are held on trust at the CCASS. Further, even if it is possible for resolution authorities to transfer all of the properties, rights or liabilities held at the CCASS, we believe that the process of retrieving such assets will likely take more than 2 days as it takes time to allocate such assets and to conduct the relevant documentation, filing and transfers.

Given that smooth running of the FMI is of high importance in maintenance of status of Hong Kong as an international financial centre, in addition to the fact that there is no apparent need for resolution authorities to disrupt any sorts of clearing and settlement arrangements to achieve their objectives, we propose that the PARS shall offer protection to the clearing and settlement system in absolute terms such that resolution authorities shall not be able to disrupt any arrangements in any scenarios.

Q2. Do you agree with the proposed approach to defining and protecting secured arrangements in a PPT under the PARs?

The approach to protect rights on the secured arrangements in a PPT was illustrated in paragraph 17 of the Consultation Paper. In essence, secured arrangements are formed for the purpose of letting creditors to protect their credit interest under an agreement which allows them to take or retain ownership of assets (collaterals) in case of default (or in case of any other contractually defined enforcement events). We agreed to the proposition that such arrangements shall be subject to protection to preserve certainty of commercial contracts.

As secured arrangements are created upon private contractual relationships, this protection should be honored at the time of resolution. We agree to the propositions and objectives of providing protection, nevertheless we cast a doubt regarding the practicality of the control of such arrangement.

Paragraph 18 of the Consultation Paper suggested that the proposed approach of protection might lead to proliferation of floating charges, which should therefore be mitigated by resolution planning and resolvability assessment where such charges might be identified as an impediment to orderly resolution.

Section 13 of the FIRO suggests that the resolution authorities shall have a considerable degree of regulatory power to suggest strategies for the resolution planning for the financial institutions and cross-sectional groups that may hinder operation and business efficiency.

The Creation of charges is a two-party commercial arrangement between the creditor and debtor. Given the recognition and protection to freedom of contract in Hong Kong, we believe that it would be difficult and unduly burdens the market if the resolution authority is empowered to intervene in individual commercial contracts terms to which type of charge should be created. We are concerned that it is impractical and impossible to attempt to control the types of charges that would be created pursuant to private arrangements and negotiations. We believe that market participants shall have the capability to determine which types of charges work best in securing their interests at the time the contract is entered into. This is not likely to be an area that resolution authorities shall intervene, given that they possesses limited information to accomplish their desired effects.

Further, despite being regulators of respective industry, in the course of developing the resolution planning, the resolution authorities may not have an accurate understanding of the financial status, business expansion and ongoing operational need of the FI. Resolution authorities will have to carry out sophisticated individual assessments of FIs before they could design an adequate resolution planning, which often involves multiple perplexed parameters to

be taken into consideration. We consider that such assessment duty imposes an unduly heavy burden on the part of resolution authorities with regard to the relative seriousness of this matter.

Q3. Do you agree with the proposed approach to protecting structured finance arrangements in a PPT under the PARs?

The Consultation Paper introduced the approach to protect the right on structured finance arrangements in a PPT under a PARs as mentioned in paragraph 24 of the Consultation Paper. Structured finance arrangements as defined under section 74 of the FIRO covers securitisation vehicles, of which covered bonds, asset-backed securities and asset-backed commercial papers are the most common forms of securitisation vehicles available in the market. We acknowledge the Consultation Paper's intention of not to cover unsecured structured products and it is consistent with the other proposed definitions in the Consultation Paper.

Rationale for the proposed level of protection

We recognise the rationale for the proposed level of protection in the Consultation Paper as a PPT in structured finance arrangement may tremble the confidence to structured finance market participants to the market. The resolution authority has responsibility to maintain a fair and orderly market, including a structured finance arrangement market. A PPT in some of the assets, rights and liabilities of the structured finance arrangements may harm the market participants as they are exposed to a different risk exposure parameters and the ability of the vehicle to sustain the promised cash flow stated in the arrangement may differ from the original terms after a PPT. PARs shall protect the structured finance arrangements by prohibiting partial assets, rights and liabilities PPT so as to ensure the market stability.

Proposed level of protection in PARs for structured finance arrangements

We welcome the proposal in paragraph 25 of the Consultation Paper that states if a foreign property is involved in the structured finance arrangement of which the resolution authority is unable to transfer, the resolution authority has the right to transfer the remaining constituent parts of the structured finance arrangement in Hong Kong. Despite this PPT arrangement will affect the interest (e.g. the certainty of the cash flow generated from the foreign property and the associated risk) of the structured finance arrangement investors, it offers the best protection to the market participants under such circumstances where investors may suffer a huge lost due to the non-transferable foreign properties involved in the structured finance arrangement.

Additionally, we agreed that deposits for deposit function shall always be available for a PPT as the major function of a FI to the financial market and the society is deposit taking. Although the "carve-out" option for the deposit component in structured finance arrangement will impose certain risk exposure and losses to the structured finance arrangement investors, the PPT of the

deposit component will help maintaining the order and operation of the financial market. This provision helps facilitating the resolution authority to have the power in achieving its aim in stabilising the market.

Yet, by comparing the proposed level of protection in the Consultation Paper with the level under EU BRRD, we realised that the proposed scope of protection under the Consultation paper did not protect the structured finance arrangement from the termination or modification through the use of ancillary powers of the assets, rights and liabilities which form part of the structured finance arrangement as stated under EU BRRD Article 79 (1)(b). Under the rationale for protection stated in paragraph 23 of the Consultation Paper, which stated that the assets, rights and liabilities of the constituent of the structured finance arrangement shall essentially to be kept as a whole in order to protect the market participants, if the use of the ancillary powers is not restricted, we deem that this is inconsistent with the proposed rationale and it will also restrict the ability of the resolution authority in effecting an orderly PPT. We suggest the authorities to evaluate the possibility to include the prevention of termination or modification of the assets, rights and liabilities through the contractual ancillary powers so as to provide a more comprehensive protection for the structured finance arrangement market.

Also, we propose to explore the possibility of a partial PPT in structured finance product WHEN the PPT of some of the assets, rights and liabilities will not, or within a predetermined range, affect the risk parameters, cash flow and structure of the structured finance arrangement. Under the abovementioned criterias, a PPT of some of the property, rights and liabilities which are, or a part of the structured finance arrangement may offer protection to both the creditors of the FIs and at the same time minimize the damage to the structured finance arrangements market.

Q4. Do you agree with the proposed approach to protecting rights to set-off or net under set-off, netting and title transfer arrangements in a PPT under the PARs?

The Consultation Paper introduced the approach to restrict PARs from splitting the rights and liabilities which is confined to rights and liabilities created by written contractual agreements having clearly specified nexus or link inter se, with a number of exclusions which the ability to transfer partial rights or liabilities being the crucial factor of certain resolution arrangements, and when the rights arises out of operations of law. We agree that such protection could effectively reduce risks and financial costs as well as the net risk exposure of counterparties to enhance market stability.

It is noted that the proposal suggested to protect set-off and netting rights and liabilities created by written contractual agreement having clearly specified nexus or link inter se, which is a tighter approach than the one adopted in the UK, and a broader group of protected rights than the approach in the US and EU. However, we are of the view that the proposed approach will give rise to uncertainties due to the grey areas arising from the process of determining whether such agreements share a “clearly specified nexus or link inter se”. Despite the desired effect of providing a wider range of protection, it is worried that the parties will necessarily have to seek independent legal advice prior to carrying out set-off and netting process, or would otherwise undertake a prudent approach.

In comparison, we find that the approach in the US and EU of protecting all “qualified financial contracts” as defined under relevant legislation will be a better approach to be taken due to the higher predictability and certainty. Whilst the qualified financial contracts will be clearly defined in the legislation, the width of protected class could be easily manipulated to cope with the intended scope of protection to be offered. Paragraph 38 of the Consultation Paper suggested that there will be difficulties in “identifying adequately and sufficiently precisely in advance all of the contracts that should benefit from the protection”. However, Section 210(c)(8)(D) of the Dodd-Frank Act demonstrated that it is possible to set out a comprehensive and exhaustive list of protected contracts and arrangements. It could serve as a reference in formulating the list of contracts subject to protection.

Alternatively, this section should adopt the the definition for the terms “financial contract”, which was not adopted in this section, to provide consistency in the operation of the arrangement. Furthermore, please refer to the proposed revision of the definition of “financial contract” in the response to Question 6.

In respect of the exclusions specified in paragraph 33, we acknowledged theirs ability to carry out effective PPT in manner consistent with resolution objectives or to ensure business certainty.

Q5. Do you agree with the proposed approach under the PARs to protecting rights to set-off or net under certain set-off, netting and title transfer arrangements in bail-in?

Bail-in is a way to rescue a financial institution when it experiences financial failure. In particular, the creditors and depositors of the financial institution will be made to take a loss on their holdings. "Excluded liabilities" will be excluded from bail-in for the protection of the counterparties as defined in Section 58(4) of the FIRO.

Bail-in aims to enable the resolution authority to write down shareholders and certain creditors to cover the failing FI's liabilities to restore its viability to continue providing critical financial services, in a manner consistent to the hierarchy of claims.

The Consultation Paper suggested that in furtherance to the section 58(4) "excluded liabilities", resolution authorities should additionally perform set off, netting and title transfer arrangements before the bail-in provision to close out derivative transactions, subject to a few exclusions.

It is noted that the proposed arrangements for the set-off, netting and title transfer in bail-in are essentially consistent with that mentioned in paragraph 30 to 42 of the Consultation Paper. We agree that there is a need to provide protection under the PARs as suggested for the continuity and stability of the financial system of Hong Kong. After the set-off, the number of creditors involved will be decreased, and the number of parties involved will be minimal for a better and more efficient bail-in provision, which will be more effective and convenient to the resolution authority, bringing benefits to the stakeholders. Without clear contracts for the counterparties to be entitled to set-off, netting or title transfer arrangements, the stakeholders may be subjected to credit risks or losses due to transaction costs. However, we would like for an elaboration on how the resolution authority to regulate that the FIs would close out its position by set-off, netting or title transfer arrangement within a short period to ensure that the liquidation process will be smoother and will not disrupt the continuity of the financial systems of Hong Kong.

We also understand the exclusions from the safeguard are necessary for the effectiveness of the bail-in stabilization procedures. The liabilities that are not subject to losses during liquidation and the liabilities that secured or off-balance assets will be excluded. The excluded liabilities while bail-in stabilizations included in the Consultation Paper are quite consistent with those in UK, therefore we are of the view that the exclusions are quite relevant.

However, we note that according to Article 55 of BRRD, the liabilities from the clearing and settlement systems arrangements are not included. We hereby suggest that liabilities from the clearing and settlement systems arrangements are related and should be included for the protection of the counterparties and the stability of the financial markets.

Q6. Do you agree with the proposed definition for the terms "derivative contract", "financial contract" and "qualifying master agreement" as set out in Annex C and used in paragraphs 45(iv), 45(v) and 47(i)?

The Consultation Paper introduced the terms "derivative contract", "financial contract" and "qualifying master agreement" and used in paragraphs 45(iv), 45(v) and 47(i). We basically agree on the definition of "derivative contract" as it matches with the generally accepted meaning of a contract of derivative. However, we suggest the following amendments to the definition of the terms "financial contract" and "qualifying master agreement".

Financial Contract

In respect of the definition of the term "financial contract", it should be broadened to include a wider scope of financial transactions. We refer to the definition of the term "qualified financial contract" in section 210(c)(8)(D) of the Dodd-Frank Act, which includes securities contracts, commodity contracts, forward contracts, repurchase agreements and swap agreements. We are of the view that "financial contract" and "qualified financial contract" refer to the same matter, so the two terms should have a similar coverage. Yet, the term "financial contract" does not cover forward contract (section 210(c)(8)(D)(iv)) and repurchase agreement (section 210(c)(8)(D)(v)) as the "qualified financial contract" does, so the coverage of "financial contract" should be broadened.

Provided that the Dodd-Frank Act was effective in July 2010, which is more than 6 years from now, and there is no substantial dispute regarding its coverage and scope of protection, we are of the view that the full adoption of the definition from the Dodd-Frank Act can enrich the Laws of Hong Kong. Also, the US is a developed and sophisticated jurisdiction, its definition should be able to accurately address the market need.

Furthermore, provided in section 210(c)(8)(D)(ii)(II), a securities contract does not include any purchase, sale, or repurchase obligation under a participation in a commercial mortgage loan. We are of the view that this clarification should be included in the definition of the securities contract to better illustrate the nature of the contract.

Qualifying Master Agreement

In respect of the definition of the term "qualifying master agreement", we are of the view that it is not accurately defined and should be amended.

Firstly, the definition is a repetition. On one hand, the definition includes a derivative contract, a financial contract, or a contract for the sale, purchase or delivery of the currency of Hong Kong or any other country, territory or monetary union. On the other hand, the usage of the term in

paragraph 47(i) is accompanied by the term of a derivative contract, financial contract. Effectively, the term merely provides an additional meaning of "a contract for the sale, purchase or delivery of the currency of Hong Kong or any other country, territory or monetary union".
Secondly, the definition is different from the generally accepted definition of a master agreement. Under section 210(c)(8)(D)(viii), a master agreement is an agreement that relates to any qualified financial contract or contains provisions of a qualified financial contract.

We suggest the following amendment:

(i) additional term, "currency contract", which contains the meaning of "a contract for the sale, purchase or delivery of the currency of Hong Kong or any other country, territory or monetary union", should be added; and

(ii) definition of the term "qualifying master agreement" should be amended to contain a similar definition as section 210(c)(8)(D)(viii).

Conclusion

We have observed that the Government has taken into account the laws and regulations of various jurisdictions when formulating the PARs. We appreciate that the Government intends to endorse internationally acceptable standards into the local regulations, with the purpose to maintain market stability and predictability by restricting the power of resolution authorities by recognition and endorsement of various types of protected financial arrangements. Further to the proposals that are mainly principle-based, we are of the view that the Government should also consider the practicality and implementation issues when formulating the actual regulations to govern the resolution authorities. Whilst the primary aim of identifying the protected arrangements is to preserve certainty and enhance clarity of existing market activities in light of PPT and bail-in, it is hoped that a balance could be reached between avoiding disruption to market and ensuring the ability for regulatory authorities to carry out PPTs and similar enforcement actions, which we believe that a detailed illustration of how such protected arrangements will be put in place will be issued to the relevant personnel and organizations when the FIRO comes into force in the near future.

- **End** -