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Financial Institutions (Resolution) Ordinance – Safeguarding the stability of our financial infrastructure

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 ("HKMA"), the Securities and Futures Commission and the Insurance Authority (together "the authorities"), issued a consultation paper ("the Consultation Paper") on 22 November 2016 on their proposals for the regulation on protected arrangements ("PAR") to be made as subsidiary legislation under section 75 of the Financial Institutions (Resolution) Ordinance (Cap. 628) ("FIRO"). The authorities released a consultation conclusion subsequently on the public consultation relating to the PAR on 6 April 2017, with an intention to lend the FIRO itself to meeting the standards set by the Financial Stability Board. The authorities have already tabled the Regulation before the Legislative Council on 17 May 2017. The Regulation and the Ordinance will become effective on 7 July 2017 after the completion of the negative vetting procedure in the Legislative Council of Hong Kong.

This article will discuss the Consultation Paper and its conclusion.

Consultation Summary

Under the provisions set by the section 33 of the FIRO, effective resolution regimes for financial institutions ("FI") will be triggered resulting from the substantial financial disruptions of FIs. To mitigate the subsequent contagious impact, the authorities will also implement the following stabilization options:

(a) Transfer of ownership of a failing FI, or some or all of its business, to commercial purchaser(s);
(b) Transfer of some or all of the business of a failing FI to a bridge institution owned by the Government and controlled by the relevant resolution authority, so that the business may continue in the short term and be returned to the private sector subsequently;
(c) Transfer of some or all of the assets and liabilities of a failing FI to an asset management vehicle, potentially owned by the Government and controlled by the relevant RA, for their orderly winding-down or disposal over time;
(d) Officially mandated creditor-financed recapitalization (commonly known as "bail-in") to restructure the liabilities of a failing FI and restore its viability, and
(e) Temporary public ownership of the failing FI as a last resort

The Consultation Paper sets out the authorities' intended approach to pin down the arrangements to be made when the effective resolution regimes — such as transfer of ownership of a failing FI and officially mandated creditor-financed recapitalization — are prompted. The Consultation Paper is organized in two-folds. The former encourages a discussion on the appropriate degree of protection in resolution for a set of financial arrangements defined collectively as "protected arrangements" under section 74 of the FIRO, while the latter is dedicated to a conversation with regards to the remedial actions and financial arrangements to be taken when the FIs are with no voluntary intentions to breach the regulations.

The financial arrangements identified as "protected arrangements" under section 74 of the FIRO are: (i) clearing and settlement systems arrangements; (ii) netting arrangements; (iii) secured arrangements; (iv) set-off arrangements; (v) structured finance arrangements; and (vi) title transfer arrangements.

Asset Protection

A. **Clearing and settlement systems arrangements -** the authorities' proposed approach is that the PARs will restrict a resolution authority from transferring some but not all of the property, rights or liabilities of an entity in resolution under a Partial Property Transfer ("PPT") in a way that will disrupt the operation of a clearing and settlement systems arrangement.

B. **Secured arrangements -** the authorities' proposed approach is that the PARs will provide that a resolution authority, in effecting a PPT, should not transfer any constituent part of a secured arrangement without all other corresponding constituent parts.

C. **Structured finance arrangements** – In order to diversify the investment risk, the authorities suggested that an arrangement under PPT requires maintaining the flow of payments under the liabilities. It is further proposed that where foreign property forms part of a structured finance arrangement then, if a resolution authority is unable to transfer that foreign property, the resolution authority would not be prevented from transferring the remainder of the constituent parts of the structured finance arrangement by the protections afforded under the PARs. The Authorities further clarifies that the PARs apply to the class of structured finance arrangements that are securitizations, including both true sale securitizations and synthetic securitizations

D. **Set-off arrangements, netting arrangements and title transfer arrangements –** The authorities' proposed approach is to restrict a resolution authority under the PARs from splitting the rights and liabilities that may be set off or netted under written contractual set-off, netting or title transfer arrangements, to which the entity in resolution is a party; but with specific exclusions where the ability to transfer certain rights or liabilities that might otherwise be constituent parts of a set-off, netting or title transfer arrangement could be crucial for a resolution authority in meeting the resolution objectives.

Safeguards in Bail-in

After referencing the relevant UK legislation, the authorities suggested the PARs should specify the resolution authority can only bail in on the entity in resolution and its counterparties based on a net basis of the set-off, netting arrangement and title transfer arrangements. The resolution regime under the FIRO contains a range of legal tools necessary to resolve failing, systemically important

FIs, including compulsory transfer and bail-in powers. The authorities will work at the international level continuously to develop principles and procedures underpinning bail-in execution. The authorities will also continue to monitor relevant international developments and standards and seek to develop a process reflecting these as appropriate in Hong Kong.

Our View

From the 2008 financial crisis to the recent impact on the banking systems in the Eurozone, it all calls upon the concern on authorities around the globe dealing with the resolution of FIs improperly in the time of market tumults, thus causing secondary damages to investors eventually.

Indeed, the present consultation puts forward the aim of affording considerable protection to investors under extreme market conditions and maintaining the stability of the Hong Kong financial system. Should the present consultation be approved by the Legislative Council, the rules will act as a clear guidance in case of major problems encountered by large FIs in Hong Kong, in reducing the possibility of liquidation or the need to bail-out those FIs on the account of the taxpayers' money.

Despite the variety of financial products, we are of the view that the consultation has already made substantial efforts to maximise the population of protected investors by covering the majority of products that are commonly invested by individual investors who normally have a small investment amount. The Resolution authorities should also conduct regular review on the resolution arrangements to make sure that the scope of FIRO would be able to accommodate and cover the various new products on the market and to ensure consistency with international standards.

Conclusion

The present consultation will place reasonable limit on the power of resolution provided to the resolution authorities. This resonates with the objective of safeguarding the economic efficiency in the financial market's daily operation. The public consultation serves the purpose of gathering opinions on the scope and extent of different PARs, including specified exclusions, in order to avoid excessively restricting resolution authorities from executing secure and orderly resolution. Similar regimes have already been implemented in overseas counterparts for a period of time as a safeguard of the economic and financial development in a free manner. Accordingly, we concur with the consultation to a large extent so that Hong Kong could catch up with the international standard.

We wish that the new regulations could more clearly manifest the power of resolution authorities and accordingly reduce the risk posed by systematically significant FIs, whether based locally or overseas, and enhance the ability to overcome financial turbulence. By striking a balance between the scope of protection and public interest reasonably, Hong Kong will be able to strengthen its position as a leading international financial center.

If you have any further questions regarding this issue of CP insights or have any topic you would like us to cover, please submit your response here https://goo.gl/forms/gDLVThTmxGvMl4r12.

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