CLIFFORD CHANCE

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(Reform) too big to fail? Second round of consultation on a resolution regime for financial institutions in Hong Kong is launched

In setting out the conclusions reached by the authorities after the first stage of consultation [1] (CP1), this second consultation paper (CP2) provides an overview of what the new regime will look like. It also seeks input on a number of specific areas, whilst explicitly reserving several key issues for a third, likely shorter, stage of consultation (CP3) later this year. The stated intention remains to put legislation before Hong Kong's Legislative Council by the end of 2015: the timing is tight but important, as this is the deadline set by the Financial Stability Board (FSB) for local implementation of its Key Attributes [2] by its member states, of which Hong Kong is one.

Timetable

- Second stage of consultation launched on 21 January 2015: responses due by 20 April 2015
- Third stage of consultation likely later this year: Hong Kong authorities waiting for guidance to be issued by the FSB and others on key issues such as bail-in and cross-border cooperation
- Stated intention is to put forward legislation before the end of 2015 (which is the FSB's deadline for implementation of its Key Attributes)

In this briefing we look at what can be deduced so far about the likely form and scope of the new regime. We also provide an overview of the topics which are proposed for discussion now and touch upon those which have been reserved for the third consultation.

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1 See our briefing http://www.cliffordchance.com/briefings/2014/01/too_big_to_fail_hongkongconsultsonfinancia.html

2 The FSB published its paper on Key Attributes of Effective Resolution Regimes for Financial Institutions in October 2011. In October 2014 the paper was re-issued with further guidance on key topics incorporated in annexes: http://www.financialstabilityboard.org/2014/10/r_141015/

Throughout, specialists from our cross-practice Financial Institution Recovery and Resolution Team provide their insights into the potential impact of these proposals for both global institutions and local banks.

Overview: what does CP2 do?

- Provides more detail on the scope of the proposed regime, which now definitively includes clearing houses, insurers, exchanges and locally incorporated holding companies;
- States that the proposed regime will be administered by the existing sectoral regulators;
- Details the supporting measures and powers needed to operate and resolve a financial institution (FI) – including the appointment of a resolution manager, the abrogation of certain insolvency rights and the ability of the resolution authority to provide support to a business post-transfer;
- Provides more detail on the scope of bail-in, but reserves final decisions on implementation, and on the operation of loss absorbing capacity, to CP3;
- Sets out a 'no creditor worse off than in liquidation' (NCWOL) regime, including how compensation will be assessed and who it will be assessed by, and how determinations can be appealed;
- Gives much more detail on the operation of a suspension of certain early termination rights;
- Details the powers the resolution authority will have to improve the resolvability of FIs, but there will be no global requirement for branches of non-Hong Kong FIs to be converted into subsidiaries; and
- Proposes automatic removal of certain individuals at an FI which is being resolved and the claw-back of remuneration (both fixed and variable) from those who have materially contributed to an FI becoming non-viable.

What do we know so far?

Scope

Hong Kong's resolution regime for financial institutions will be a single regime, applicable to the full range of financial institutions proposed in CP1. CP2 confirms that the resolution authority will have the ability to resolve all licensed financial institutions. The FIs under scope are:

- All authorised institutions, i.e. all licensed banks, restricted licence banks (RLBs) and deposit-taking companies (DTCs);
- Financial market infrastructures which are designated to be overseen by the Hong Kong Monetary Authority (HKMA) under the Clearing and Settlement Systems Ordinance (other than those which are owned or operated by the HKMA) and those that are recognised as clearing houses under the Securities and Futures Ordinance (SFO);
- Licensed corporations (LCs) which are themselves designated as non-bank non-insurer G-SIFIs (NBNI G-SIFIs), and LCs which are subsidiaries or branches of groups which are identified as being (or containing) G-SIFIs;
- Insurers which are subsidiaries or branches of global systemically important insurers (G-SIIs) operating in Hong Kong, and any insurer which it is assessed could be systemically significant or critical locally on failure;
- Locally incorporated holding companies and associated operating entities (AOEs), being those entities (regulated or not) which provide critical services to the failing FI;
- Branches of financial institutions incorporated outside Hong Kong; and
- Exchanges, due to the key roles which the Hong Kong Stock Exchange and Hong Kong Futures Exchange play in Hong Kong. The Securities and Futures Commission (SFC) will be responsible for the designation of systemically important recognised exchange companies.

CP2 considers that it would be premature to conclude that asset managers should be excluded from the scope while their systemic relevance is under discussion by the FSB/IOSCO's NBNI G-SIFIs consultation document[3], where certain tests are proposed for assessing the global systemic importance of NBNI FIs.

The regime will be administered by the existing sectoral regulators: in the case of a group comprised of businesses which are overseen by more than one regulator a lead regulator will be chosen.

"I don't think there are any surprises with respect to the types of financial institutions that are to be within scope. However, it is promising that the resolution authorities intend to pursue a proportionate approach to resolution planning. In terms of the decision to have the regime administered by the existing sectoral regulators, the question mark must be whether the relevant regulator can put aside its underlying regulatory role in order to determine whether an FI is no longer viable and whether to pursue resolution. In the case of financial services groups operating across multiple sectors, the interplay between the sectoral regulators and the designated lead regulator will need to be carefully managed."

Mark Shipman,
Global Head of Funds and Investment Management,
Hong Kong

Conditions

The regime aims to permit intervention in a failing firm before it has reached balance sheet or cash flow insolvency and before its equity has been wiped out entirely, giving the resolution authority a range of practical and legal 'tools' that can be used to maintain an institution's critical functions and avert systemic disruption. CP2 confirms that the test proposed in the first consultation for assessing whether a vulnerable institution should enter resolution will be adopted. This comprises two conjunctive conditions:

- *Non-viability condition*: the FI is, or is expected to become, unable to meet the minimum regulatory requirements to which it is subject, and it is assessed that there is no reasonable prospect that private sector or supervisory action, outside of resolution, will result in the FI once again satisfying the relevant conditions; and
- *Financial stability condition*: the non-viability of the FI poses a threat to the continuity of critical financial services and to the general stability of the financial system.

In addition, CP2 provides for a further condition to be satisfied before a failing FI can be taken into temporary public ownership – namely, that an orderly resolution which delivers on the objectives set (see below) cannot be achieved through the use of any of the other resolution options available to the resolution authority under the resolution regime at that time.

[3] FSB/IOSCO Joint Consultative Document on Assessment Methodologies for Identifying NBNI G-SIFIs (January 2014): http://www.financialstabilityboard.org/wp-content/uploads/r_140108.pdf

Objectives

CP2 confirms that the three objectives set out in CP1 to guide the resolution authority decision-making process in resolution will be adopted:

- Promote and seek the stability and effective working of the financial system in Hong Kong;
- Seek an appropriate degree of protection for depositors, investors and policy holders; and
- Subject to pursuing the first two objectives, seek to contain the costs of resolution and, in doing so, protect public funds.

Citing concerns that a formal objective for the resolution authority to duly consider the impact of its actions on financial stability in overseas jurisdictions might conflict with the other resolution objectives, the authorities propose to require the resolution authority to duly consider this in the context of deciding how to apply their powers in respect of a cross-border resolution only. CP2 also seeks views on whether an additional objective specifically requiring the protection of client assets is required.

Resolution Options

CP2 confirms that the full menu of resolution options is to be adopted, which are not mutually exclusive and can be used in any combination (although the asset management vehicle option is likely to only be used in conjunction with another option):

- Sale of business option;
- Bridge institution option;
- Asset management vehicle option;
- Bail-in of liabilities option (discussed further below); and
- Temporary public ownership option.

CP2 also notes that guidance will be issued on how the resolution options available under the resolution regime will be used, and confirms that formal commencement of a resolution will be accompanied by the issuance of a public notice.

New and developed topics

Bail-in of liabilities and loss absorbing instruments – to be considered further in CP3

CP1 specifically reserved the concept of bail-in for the second stage of consultation: in light of the ongoing work taking place internationally on this topic and on total loss absorbing capability (TLAC), including with regards to ensuring bail-in is effective for use with insurers, financial market infrastructures and non-bank non-insurer financial institutions, CP2 offers some initial proposals for local implementation but states that the authorities intend to provide further detail in the third consultation.

Bail-in is an important resolution option because it is generally accepted that it would not be possible to carry out an orderly resolution of the largest and most complex FIs using the compulsory transfer powers. It is also a tool in combating 'moral hazard' as by placing shareholders and creditors first in line to bear the costs of failure it should motivate them to curb excessive risk-taking. It is noted in CP2 that a recapitalisation does not solve the underlying issues causing the FI to fail, and it is intended that these would be addressed through restructuring measures.

CP2 proposes that in the case of the bail-in of a failing FI a preliminary valuation would be undertaken by the resolution authority with a view to identifying those liabilities which might be subject to write-down (in the case of shareholders) and/or conversion (in the case of creditors), but which process should not be confused with an entirely separate proposed valuation exercise which would need to be undertaken in relation to the NCWOL compensation mechanism (see below). However, it is to be assumed that consistent with the NCWOL safeguard, any creditors or shareholders directly affected by the resolution must not be left worse off than if the whole firm had been placed into insolvency.

CP2 does confirm that there will be certain liabilities which will be excluded from bail-in, including those where there would be no exposure to loss in liquidation (such as those which are secured or benefit from a recognised protection scheme) and those where subjecting the liabilities to bail-in would be likely to undermine efforts to deliver on the objectives set for resolution (particularly, the objective of securing the continuity of critical financial services), and provides an initial list of excluded liabilities for consideration.

CP2 also reinforces the idea that bail-in should be conducted in a way which respects the statutory creditor hierarchy, with exceptions only being justified against the objectives set for resolution.

"Throughout Asia, including in Hong Kong, we continue to work with financial institutions looking to issue securities with contractual loss absorption terms for the purpose of enhancing their regulatory capital position. These securities provide for full or partial conversion or write-off when the institution reaches a point of non-viability, thereby absorbing losses when the institution is stressed. There is clearly appetite for these capital securities in the region, which saw some of the largest issuance volumes globally in 2014. Statutory bail-in will have a much wider reach, extending an ability to write-off or convert a debt into the realms of creditors who did not intend the nature of their instrument to be so fundamentally altered. Clearly something for investors to bear in mind.

In terms of implementation, whilst the Hong Kong authorities have included an overview of the FSB's proposals on total loss absorbing capital in CP2, they have postponed any decision on how these proposals would be implemented locally to CP3. Bail-in remains a hot topic, and it is prudent for the Hong Kong authorities to take a considered approach to the global discussion and ensure that Hong Kong's regime works in harmony with the majority international position."

Matt Fairclough,
Partner, Capital Markets,
Hong Kong

Counterparties: the stay on early termination rights

Consistent with the approach outlined in CP1 and with the approach taken in key jurisdictions, CP2 provides that the resolution authority should have the power to stay, from the moment of the issuance of the public notice of resolution to midnight on the business day after the issuance of the notice, early termination rights of counterparties to financial contracts with an FI in resolution, or related group companies. This is subject to eight prescribed conditions being met: these are set out in CP2 and cover issues such as the length of the stay, its application only to rights which arise because of the entry of the FI into resolution, the preservation of other rights, that rights to close out can be exercised immediately upon the expiry of the stay where the contractual conditions for termination are met, that the resolution authority cannot divide up or transfer individual financial contracts with a particular counterparty that are subject to a netting agreement and that the rights can, on the expiry of the stay, be exercised in respect of those financial contracts which are not transferred to a sound third party. Further detail is also provided on the types of 'financial contract' that would fall within the scope of the stay.

"Regulators and market participants have long been aware of the tension between the need for introducing a temporary stay on early termination rights to facilitate resolution of financial institutions and the importance of preserving legal certainty of netting arrangements, given its importance to risk management and effect on regulatory capital requirements. The industry will welcome the Hong Kong regulators' commitment to limit temporary stays to a maximum of 48 hours, which should help to avoid the uncertainty that has emerged in certain jurisdictions regarding enforceability of netting. The other key issue that needs to be addressed is how to ensure that a temporary stay imposed under Hong Kong law can be effective in another jurisdiction (and vice versa). As CFTC Chairman Timothy Massad has observed, it is a unique challenge to create a consistent regulatory framework for a global financial market through the actions of individual countries, each with its own legal traditions, regulatory philosophies, political processes, and market concerns."

Terry Yang,
Senior Associate,
Derivatives and Structured Products,
Hong Kong

Powers to improve an FI's resolvability

Although primarily focused on resolution, CP2 does provide more detail on the provisions for improving the resolvability of an FI. The authorities have confirmed that it is not intended that these powers be used to require blanket structural or other reform across FIs in scope, rather FIs will be assessed on a case-by-case basis, likely undertaken through resolution planning and resolvability assessments. The authorities have also confirmed that they would not expect to independently exercise powers to require a foreign FI operating in Hong Kong to enhance its resolvability unless the resolution authority had not been given sufficient information on how the group-wide strategy might impact group entities in Hong Kong or had substantiated concerns that the strategy would not deliver on the resolution objectives in Hong Kong. Given the differing needs and range of issues raised, CP2 proposes that the regime include a non-exhaustive list of measures which could be taken to improve an FI's resolvability, a draft of which is set out at pages 74-75 of CP2.

Supporting the resolution process

CP2 sets out a number of provisions designed to assist the resolution authority throughout the resolution process. For example, it includes proposals which support getting a failing FI into resolution and not insolvency, by providing that creditors of an FI be unable to petition for its winding-up unless they have filed a notice of their intention to do so with the resolution authority and the resolution authority has either determined whether or not to initiate resolution or the notice period (proposed at 14 days) within which the resolution authority must make its decision has expired. Interestingly, the CP2 proposal goes further than the position adopted in the UK, which provides that the winding-up petition can be made without the resolution authority having had 14 days notice. It also contains provisions enabling the resolution authority to operate and resolve the FI, which includes by way of the appointment of a resolution manager to act on its behalf.

It is also proposed that the authorities would have the power to defer or exempt compliance with various regulatory and disclosure requirements of a listed FI or a related listed entity. This is seen as necessary in order to prevent, for example, damage to public confidence before the resolution authority has been able to take resolution action or the necessary preparatory steps to any such resolution, or to prevent mandatory takeover offer requirements from being triggered.

CP2 also proposes that the resolution authority would have the power to suspend certain obligations of the FI, effectively imposing a moratorium on payments to general creditors and a stay on creditor actions from the time at which the public notice is issued announcing the formal commencement of the resolution process until, at the latest, midnight in Hong Kong on the business day following issuance (being the same timeframe as for the temporary stay on early termination rights discussed above).

Supporting the transferred business

Although the resolution authority will have the ability to resolve AOEs providing services to an FI in resolution that are essential to its continuing business, CP2 notes that often the same objectives could be met by setting out effective continuity provisions. CP2 therefore proposes that the resolution authority have the ability to require the continuation of the provision of such services from entities within the FI's group or to procure such services from a third party. Similarly, CP2 looks to apply this to the residual part of an FI in the case of a partial business transfer (whether directly or to a bridge institution). In order to overcome issues that would arise where such residual part of the FI enters into winding-up proceedings (because Hong Kong does not have anything akin to a corporate administration procedure), CP2 provides for both the appointment of a person to the residual FI to take control and manage the residual FI, and for the establishment of a service company into which assets and liabilities relevant to the transferred business could be moved, with both methods enabling support to be continued to be supplied to the transferred business. Views are sought by the authorities on these two proposed mechanisms.

"CP2 proposes that the resolution authority would have broad powers to operate an FI during resolution, and envisages the appointment of a resolution manager to take on this role. Unlike the role of the NCWOL valuer, the skills and experience for this role are not set out in CP2, which only provides that the resolution authority would remain 'responsible' for ensuring that the resolution manager has the 'qualifications, ability and knowledge required'. It will be interesting to see who would be prepared to take on such a role, and therefore the extent to which appropriate indemnities will extend to such person."

Mark Hyde,
Global Head of Restructuring and Insolvency,
Hong Kong

Liability and claw-backs

CP2 identifies that the regulators currently have a mixed bag of powers when it comes to the removal of directors and senior management and the claw-back of remuneration. Whilst CP1 proposed a case-by-case approach to the removal of directors and senior management, CP2 changes tack and advocates for a blanket removal of certain persons, with the resolution authority retaining the discretion to remove more and the ability to appoint these persons as agents of the resolution authority to assist in the discharge of its functions.

Consistent with the approach taken in jurisdictions housing other major financial centres, CP2 proposes that the resolution authority have the power to bring claims in court for the claw-back of both fixed and variable compensation from any person whose actions or omissions caused or materially contributed to an FI becoming non-viable and so entering resolution.

"CP2 proposes that the FI's entry into resolution trigger an automatic removal of all existing directors and the FI's CEO (without reference to any wrongdoing), with the resolution authority being able to remove other senior management on a case-by-case basis. In order to retain corporate knowledge and the necessary expertise, the resolution authority can later appoint some directors and senior management to act as agents of the resolution authority. The concern must be that automatic removal could damage the business going forward, particularly where the directors and CEO of the FI are critical to its institutional relationships. Further, the loss of corporate knowledge would place a huge responsibility on the resolution authority - both in terms of deciding which senior management to keep and which to remove, and in running the business without the directors and senior team. The proposal put forward in CP1 of removing directors and senior management on a case-by-case basis would seem to be the best position and would provide the resolution authority with the necessary flexibility of continuing the business whilst determining which resolution option/s to pursue.

In relation to claw-backs, it is inevitable that, in line with the approach taken in other jurisdictions, there will be some form of claw-back of compensation from persons who materially contributed to the FI becoming non-viable. Claw-backs should not be based on job title, but rather upon actual decisions made – therefore, it is only right that any such claw-back be decided by a Court of competent jurisdiction which will provide individuals with a fair process and a right of appeal. I also think that a time limit should be imposed on the number of years preceding initiation of resolution in relation to which remuneration can be subject to claw-back – for example, two years."

Donna Wacker,
Partner,
Litigation and
Regulatory Enforcement,
Hong Kong

'No creditor worse off than in liquidation'

CP1 parked the detail of a NCWOL compensation mechanism for the second round of consultation, and CP2 duly delivers, setting out details on:

- Who will undertake the valuation;
- What assumptions will form the basis of the valuation;
- How compensation due will be funded; and
- What avenues will be available for affected parties to appeal a valuation.

CP2 proposes that a 'NCWOL valuer' be appointed, being an independent and conflict-free person, and goes on to set out detailed criteria for the appointment. In light of the criteria set, it is difficult to see this being anyone other than an experienced insolvency practitioner. CP2 does not address the remuneration of the NCWOL valuer and presumably this would fall to be addressed by the resolution authority on a case-by-case basis. The resolution authority would retain the power to dismiss a NCWOL valuer, but CP2 also provides for the establishment of a body to hear appeals, the Resolution Compensation Tribunal.

Whilst recognising that the NCWOL valuation is hypothetical and therefore necessarily rests upon assumptions which might be FI and situation specific, CP2 sets out three 'valuation principles' which should apply in any NCWOL valuation:

- Valuation reference date: the earliest point at which it could be assumed the FI would have entered winding-up proceedings, had it not entered into resolution;
- Creditor hierarchy: the NCWOL valuer will be required to adhere to the statutory creditor hierarchy in order to produce valuations which reflect the amounts which creditors would have been entitled to had the FI entered into liquidation; and
- Provision of financial assistance: the NCWOL valuer will be required to disregard the provision of any financial assistance from the authorities, such as any provided through the Monetary Authority's role as Lender of Last Resort, so that individual creditors do not benefit from amounts which were paid in the interest of protecting financial stability in Hong Kong as a whole.

"To my mind valuation is both the most interesting and most difficult aspect of the proposed resolution regime. Of course, if the resolution regime is to operate on the basic fundamental premise that no creditor can be worse off in a liquidation, you have to have a methodology for determining whether or not that is the case; hence the proposal is that an independent valuer be appointed to undertake this task under three guiding valuation principles. There are, however, two particular difficulties with implementation of such regime. First, the valuation exercise of itself will in certain cases be extremely difficult and subjective such that I venture to suggest that two valuers undertaking the same exercise might well come up with differing results. Secondly, the valuer will be doing the exercise at a point in time in which it is very unclear what the final outcome of a liquidation would actually be whereas a challenge from a disgruntled creditor could be made sometime after the event with the considerable benefit of hindsight."

Mark Hyde,
Global Head of Restructuring and Insolvency,
Hong Kong

Protection of certain financial arrangements

CP2 reinforces the idea that certain types of financial arrangements, such as secured arrangements, structured finance arrangements and title-transfer arrangements should be protected such that the assets and liabilities do not become detached from each other. CP2 proposes that a remedy be introduced such that set-off and netting arrangements are enforceable notwithstanding a transfer of some but not all of the rights and obligations under a master netting arrangement. Given the complexity of these issues, CP2 proposes that the enabling powers be included in the legislation for the resolution regime, but that the detail is worked out in secondary legislation.

To come

Certain topics have been specifically reserved for the third round of consultation:

- Further detail on bail-in, to possibly include implementation of the FSB's conclusions on loss absorbing capacity;
- Protection of client assets in resolution (being re-considered in light of the FSB annex on client assets published in October 2014);
- Mechanisms for the recognition of cross-border resolutions actions and effective cross-border co-ordination; and
- More detail on how costs of resolution are to be funded.

Funding resolution

Although not making a decision, CP2 proposes that an ex post mechanism may be the most appropriate, namely one which recovers the costs of resolution once it is clear how much needs to be recouped. CP2 also sets out a non-exhaustive list of potentially permitted uses of the resolution funding arrangements which, perhaps controversially, includes the provision of capital to an FI under resolution, its subsidiaries, a bridge institution or an AMV, as well as, amongst other things, the payment of the administrative expenses of the resolution and the payment of NCWOL compensation. It is also proposed that the resolution authority have the power to determine how best to raise any necessary levies. Views on these proposals are sought, with further detail to come in CP3.

Cross-border resolution

In terms of cross-border issues, CP2 addresses some of the queries which arose out of CP1, but defers decisions until the FSB has considered the responses to its consultation on cross-border resolution launched in September 2014 and issued its guidance. The authorities recognise the importance of cross-border issues for Hong Kong and, whilst they will preserve the ability to act independently to resolve the local operations of an FI (whether a branch or a subsidiary), in CP2 they set out the beginnings of a framework within which actions can be co-ordinated cross-border. This includes recognising that both "recognition" and "support measures" will be required.

"The Hong Kong regulators have highlighted that any recognition of a foreign resolution regime in relation to a cross-border group with presence in Hong Kong will be subject to the resolution authority in Hong Kong determining that the foreign resolution authority will (a) deliver outcomes consistent with the objectives for resolution [in Hong Kong] and (b) not disadvantage local creditors relative to foreign creditors."

Terry Yang,
Senior Associate,
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