TOO BIG TO FAIL? DETAILS OF HONG KONG'S NEW RESOLUTION REGIME

When the Financial Institutions (Resolution) Ordinance (FIRO) and the Financial Institutions (Resolution) (Protected Arrangements) Regulation becomes effective on 7 July 2017, the landscape in Hong Kong for the recovery and resolution of financial institutions will change significantly.

Key issues

- The new resolution regime and regulations change the landscape in Hong Kong for the recovery and resolution of within scope financial institutions.
- The objectives are to promote the stability and effective working of the financial system in Hong Kong, to protect deposits, insurance policies and client assets and to minimise the cost to the public.
- Financial institutions will need to revisit their current resolution plans.
- All market participants will benefit from understanding the new resolution regime and how it may impact them when they deal with financial institutions in Hong Kong.

Background

For many countries, the global financial crisis of 2008 exposed serious flaws in the powers of their governments and regulators to deal with the resolution and recovery of failing financial institutions. Faced with the unpalatable choice between using taxpayers' money for rescue or allowing the collapse of the financial system, governments used unprecedented amounts of public funds to rescue them.

Against this backdrop, the Financial Stability Board (the FSB) was tasked by the G20 with developing robust alternatives to publicly funded rescues.

In 2011, the FSB concluded that each member jurisdiction would need to establish a resolution regime that would enable authorities to act quickly to resolve a failing institution.

This was to be done in a way which would stabilise the local financial system and ensure the continued running of key parts of the failing business, whilst making sure that the cost of such resolution would fall on the shareholders and creditors of that institution and not on the public. An FSB report published in October 2011 set out the essential features, the "Key Attributes", that every resolution regime would have.

THE IMPORTANCE FOR HONG KONG

The international aspects of the Key Attributes are critically important for Hong Kong. Whilst Hong Kong is not the home of any global systemically important financial institution (GSIFI), of those identified by the FSB, 29 of the 30 GSIFIs are hosted in the city.

With the existing regulators (the Hong Kong Monetary Authority (HKMA), the Securities and Futures Commission (SFC) and the Insurance Authority (IA)) empowered to take on the role of resolution authority (RA) in their respective sectors, FIRO provides them with a range of tools to implement and execute the resolution of a failing within scope financial institution. FIRO also provides for regulations on certain key areas to be made separately.

In the case of a group comprised of businesses which are overseen by more than one Hong Kong regulator, one will be chosen as Lead Resolution Authority (LRA), depending on the main operations of the group.

OBJECTIVES

The four objectives set out in the two previous consultation papers relating to the establishment of a resolution regime in Hong Kong have been adopted, namely to:

- promote the stability and effective working of the financial system in Hong Kong, including the continuity of critical financial functions;
- protect deposits and insurance policies;
- protect client assets; and
- (subject to the above) protect public funds by containing the costs of resolution.

Citing concerns that a formal objective for the relevant RA to duly consider the impact of its actions on financial stability in overseas jurisdictions might conflict with the other resolution objectives, the regime proposes to require the relevant RA to duly consider this in the context of deciding how to apply its powers in respect of a cross-border resolution only.

POWERS

The powers range from requiring within scope financial institutions to pro-actively plan for resolution, removing impediments to resolution, navigating resolution and, where appropriate, recognising international resolution actions taken by resolution authorities outside Hong Kong. The relevant RA will have the ability to resolve all within scope FIs.

SCOPE

The breadth of entities that will be affected is all encompassing. Anyone who does any business with an FI could be affected.

The "within scope financial institutions" are:

- The **Banking** sector: authorised institutions (AIs) incorporated in Hong Kong and outside Hong Kong, settlement institutions or system operators

of designated clearing and settlement systems other than those owned and operated by the government;

- The **Insurance** sector: insurers which are subsidiaries or branches of global systemically important insurers (G-SIIs) operating in Hong Kong, and any insurers which it is assessed could be systemically significant;
- The **Securities and Futures** sector: licensed corporations (LCs) which are designated as non-bank non-insurer G-SIFIs (NBNI G-SIFIs) or which belong to a NBNI G-SIFI group, and LCs which are branches or subsidiaries of groups which are identified as being (or containing) G-SIFIs;
- **Locally incorporated holding companies and associated operating entities (AOEs):** those entities (regulated or not) which provide critical services to the failing financial institution;
- **Branches** of FIs incorporated outside Hong Kong; and
- **Exchanges**, due to the key roles which the Hong Kong Stock Exchange and the Hong Kong Futures Exchange play in Hong Kong, with the SFC responsible for the designation of systemically important recognised exchange companies.

The RA's powers to require an FI to make changes to improve its resolvability include the holding companies of within-scope FIs. The use of such powers is subject to considerations to which the RA must have regard before issuing a direction. These considerations include how difficult it would be to carry out an orderly resolution of the FI if the contemplated measures were not taken and the likely impact of complying with the direction.

CONDITIONS

The regime aims to permit intervention in a failing FI 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. The test for assessing whether a vulnerable institution should enter resolution comprises three conditions:

1) the institution has ceased, or is likely to cease, to be viable;
2) there is no reasonable prospect that private sector measures (outside of resolution) would result in the institution becoming viable again within a reasonable period;
3) the non-viability of the institution poses risks to the Hong Kong financial system including the continuity of critical financial functions and resolution action will avoid or mitigate those risks.

STABILISATION OPTIONS

The full menu of resolution options has been adopted in the legislation. These are not mutually exclusive and can be used in any combination (although the asset management vehicle option is likely only to be used in conjunction with another option):

- Transfer of the failing FI or some or all of its business to a commercial purchaser;

- Transfer of some or all of its business to a bridge institution;
- Transfer to an asset management vehicle (AMV);
- Statutory bail-in – writing down shareholders and certain unsecured creditors; and
- Taking a failing FI into temporary public ownership (TPO), as a last resort. This requires approval from the Financial Secretary.

The Protected Arrangements Regulation sets out the arrangements for the protection of key financial contracts through resolution (including clearing and settlement systems arrangements, netting arrangements, secured arrangements, structured finance arrangements and title transfer arrangements) and the necessary constraints on the ability of the resolution authorities in order to give certainty as to the economic effect of the arrangements. It is also expected that the RAs will issue guidance and codes of practice to supplement of FIRO.

BAIL-IN

The bail-in option gives the RA the power to cancel, modify, write down or convert any liabilities of the within scope FI with the exception of "excluded liabilities".

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 under the compulsory transfer powers.

It is also a tool in combating *"moral hazard"* by placing shareholders and creditors first in line to bear the costs of failure it is intended to motivate those stakeholders to seek to curb excessive risk-taking. It was noted in the second consultation paper (CP2) that a recapitalisation programme does not solve the underlying issues causing the FI to fail, and it is intended that these would be addressed through restructuring measures.

Section 60 FIRO provides a contractual recognition of bail-in. It says that a RA may make rules requiring a within scope FI to include a provision in contracts creating liabilities to the effect that the parties to the contract agree that the liability is eligible to be bailed in. The regime is similar to Article 55 of the EU's Bank Recovery and Resolution Directive (2014/59/EU).

It is assumed that, consistent with the "no creditor worse off than liquidation" (NCWOL) safeguard (see below), 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.

There will be certain liabilities which will be excluded from bail-in. These include:

- secured liabilities, to the extent they are secured;
- short term inter-bank liabilities;
- deposits protected under the Deposit Protection Scheme;
- liabilities owed to suppliers of goods or services critical to the daily functioning of its operations; and
- liabilities arising from participating in designated clearing and settlement systems or services provided by a recognised clearing house.

The RAs' procedures for bail-in will be set out in a Code of Practice to be issued once the legislation comes into effect. The indication is that the procedures to be adopted will largely follow those of the UK Banking Act, allowing Hong Kong RAs to take a similar approach to that taken by their UK counterparts in implementing the bail-in option. The scope of liabilities and the classes of FI to which the requirement will apply will also be specified in the forthcoming rules.

CAPITAL INSTRUMENTS

Separate to the bail-in power in resolution, section 31 FIRO empowers the HKMA to mandatorily write off or convert capital instruments issued by AIs under the Banking (Capital) Rules (Cap. 155L) (BCR).

This applies when:

- the conditions to resolution are met;
- the RA (being the HKMA in the banking sector) has decided to initiate resolution and
- the principal amount of Additional Tier 1 (AT1) or Tier 2 (AT2) capital instruments has not been entirely written off or converted into ordinary shares in accordance with the point of non-viability provisions applicable to it.

A letter from the HKMA to all locally incorporated AIs dated 22 May 2017 was intended to draw attention to three consequential amendments relating to the qualifying criteria for such capital instruments.

The amendments require that for any capital instrument to be qualified as AT1 or T2, the terms and conditions of the instrument must contain a provision to the effect that the holder of the instrument:

- acknowledges that the instrument is subject to being written off, cancelled, converted or modified, or to having its form changed, in the exercise of powers under FIRO;
- agrees to be bound by any such write-off, cancellation, conversion, modification or form change; and
- acknowledges that the rights of the holder are subject to anything done in the exercise of those powers.

EARLY TERMINATION

FIRO recognises that an orderly resolution may be jeopardised if counterparties to a failing FI have unfettered rights to trigger contractual termination, acceleration or close-out rights under a contract.

The ancillary powers within FIRO give the relevant RA a short window to determine the form that resolution will take by empowering the relevant RA to temporarily suspend the rights of creditors, including:

- suspension of payment, delivery obligations and enforcement of security (section 83);
- temporary stay on early termination rights (section 90);
- notice required to the relevant RA before filing winding up petition (section 192).

"Bail-in is one of the key resolution tools that we have seen focus on from regulators and resolution authorities in other jurisdictions, and to see this mirroring the international position here in Hong Kong was expected. We await further details on Hong Kong's specific approach to bail-in in the secondary code of practice."

Matt Fairclough
Partner, Capital Markets,
Hong Kong

Section 89 provides that a crisis prevention measure taken in relation to a within scope FI or group company does not of itself trigger an event of default provision under a contract.

The **suspension of payment and delivery obligations** outlined in section 83 applies to a contract to which the FI or a subsidiary of the FI is a party. Suspension is temporary, beginning form when the suspension notice is published until no later than midnight in Hong Kong on the business day following the publication.

The **temporary stay on early termination rights** outlined in section 90 applies only to the rights of a counterparty to a contract under which the failing FI continues to perform its obligations for payment and delivery and for provision of collateral. The stay lasts only until midnight on the following business day. After the period of stay, early termination rights can be exercised for those contracts that are not transferred to a sound third party such as a commercial purchaser or a bridge institution.

Under section 192, written notice must be given to the RA of a person's intention to **petition for the winding-up** of a within scope FI. The RA has 7 days to decide whether to initiate resolution, following which the petitioner has 14 days to file the winding up petition with the Court of First Instance.

NO CREDITOR WORSE OFF THAN IN LIQUIDATION (NCWOL)

Section 96 provides that a "NCWOL" valuer be appointed, being an independent and conflict-free person, with the criteria for the appointment set out in Schedule 2 of FIRO. In light of the criteria set, it is difficult to see this being anyone other than an experienced insolvency practitioner. The "Resolution Compensation Tribunal" will be established to hear appeals and has the power to dismiss a NCWOL valuer.

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

- Valuation reference date: the FI would have entered winding-up proceedings immediately before its resolution was initiated;
- 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 been wound up; 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 HKMA'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.

TLAC REGIME

The legislation sets out a framework for a total loss-absorbing capacity (TLAC) regime in order to (i) provide a means to accommodate the TLAC standards applicable to global banks; (ii) make provision for TLAC for other non-global banks, and (iii) enable the extension of TLAC to FIs in other sectors. Going forward, RAs will be authorised to make rules on TLAC, adopting international

standards to the extent considered desirable or appropriate in local circumstances.

FSB TLAC standards require that locally material subsidiaries of a globally systemically important bank maintain a level of "internal" TLAC, but local branches are regarded as being covered by the TLAC requirement applicable to the legal entity as a whole. The authorities will consider how to implement the FSB TLAC standard in Hong Kong once it is finalised, but confirm that the present intention is to mirror the HKMA's approach in not imposing branch capital requirements (meaning that branch TLAC would not be required).

CROSS-BORDER ISSUES

Given the cross-border nature of the business of an FI, there may be issues if a RA attempts to bail-in a liability that is governed by the laws of a different jurisdiction or resolve an FI that is subject to resolution processes elsewhere. FIRO addresses this by providing for a recognition process and supportive measures to give effect to foreign resolution actions.

The recognition process is not automatic. The RA must first consult the Financial Secretary before making a recognition instrument. The RA must not make such an instrument if recognition would have an adverse effect on the financial stability of Hong Kong or would disadvantage Hong Kong creditors or shareholders.

ADVICE FOR FIS

With FIRO becoming effective on 7 July 2017, within scope financial institutions will need to carefully but quickly update their current resolution and recovery plans to ensure that descriptions of Hong Kong's legal and regulatory landscape remain correct and that any resolution plan appropriately reflects the approach and tools provided in FIRO.

Those issuing capital instruments need to ensure compliance with FIRO and the HKMA letter of 22 May 2017.

Whilst discussions between many within scope financial institutions and their RA in Hong Kong have been ongoing for some time, the implementation of FIRO is likely to bring renewed focus and scrutiny on this area in Hong Kong over the coming months.

The commencement notice can be found here, FIRO here and the Protected Arrangements Regulation here.

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