

Hong Kong Resolution of Financial Institutions

July 2017

This memorandum sets out a high level overview of the more important practical points relating to Hong Kong's resolution of financial institutions, and includes some pointers for financial institutions to consider when progressing bail-in resolution planning.

1. Planning: Recovery and Resolution

- 1.1 Increased global focus on the question of how to resolve financial institutions in an orderly way has led to the development of recovery and resolution planning work, a central theme of which is to prepare financial institutions for stress situations and to plan for the steps that could be taken were a financial institution to reach a point of non-viability.
- 1.2 Two types of crisis-related planning are recovery planning and resolution planning.
 - (A) Recovery planning (which currently applies to authorized institutions (AIs) authorized by the Hong Kong Monetary Authority (HKMA)) has the aim of restoring financial strength and viability. In this scenario, the AI continues on a going-concern basis. Recovery planning involves identifying and documenting options that may be available to an AI in a stress scenario to continue. Options typically include asset and portfolio sales, liability management exercises, capital raisings and access to liquidity.

A recovery plan is prepared and 'owned' by the AI.

- (B) Resolution planning involves planning for the scenario where the financial institution has no reasonable prospect for recovery (e.g. it is likely to become no longer viable and there is little chance that it will recover through its own actions). Resolution planning involves identifying the financial institution's critical services and critical economic functions and preparing stabilization options for how to deal with the financial institution's business and functions in an orderly fashion. Stabilization options are considered further below.

A resolution plan is led by the resolution authority, involving an iterative process with the financial institution (who will provide substantial information and give views on stabilization options).

2. Relevant legislation

- 2.1 Hong Kong's resolution regime is governed by the Financial Institutions (Resolution) Ordinance (Cap. 628) (**FIRO**).
- 2.2 FIRO will be supplemented by subsidiary legislation. The only subsidiary legislation enacted thus far is the Financial Institutions (Resolution) (Protected Arrangements) Regulation (Cap. 628A) (the **Protected Arrangements Regulation**). The purpose of the Protected Arrangements Regulation is to seek to ensure that resolution does not impact upon the way certain types of market-critical contracts work - one

example being the netting provisions in certain Master Agreements.

- 2.3 FIRO and the Protected Arrangements Regulation come into effect on 7 July 2017.

3. Codes/Supervisory Policy Manual

- 3.1 For resolution planning, the HKMA issued a Resolution Regime Code of Practice CI-1 “Resolution Planning - Core Information Requirements” which was finalised on 29 May 2017.
- 3.2 Recovery planning was introduced for banks (i.e. Als) some years ago. See the HKMA Supervisory Policy Manual Module RE-1 (Recovery Planning).

4. Which financial institutions does FIRO apply to?

- 4.1 Broadly, FIRO applies to:

- (A) Banking sector entities: any AI, certain settlement institutions and system operators.
- (B) Insurance sector entities: any authorized insurer (authorized by the Insurance Authority) which is a global systemically important insurer or is a member of a group that has such an insurer.

On 21 November 2016, the Financial Stability Board (the FSB) listed the following as global systemically important insurers:

- (i) Aegon N.V.
- (ii) Allianz SE
- (iii) American International Group, Inc.
- (iv) Aviva plc
- (v) Axa S.A.
- (vi) MetLife, Inc.
- (vii) Ping An Insurance (Group) Company of China, Ltd.
- (viii) Prudential Financial, Inc.
- (ix) Prudential plc

No Hong Kong authorized insurer is currently listed as a global systemically important insurer, but certain of them are members of groups that include such an insurer.

- (C) Securities and futures sector entities: (i) any licensed corporation that is a ‘non-bank non-insurer global systemically important financial institution’ or that is a member of a group that has a global systemically important bank or a global systemically important insurer; and (ii) each recognised clearing house.

The FSB has not yet prepared a list of non-bank non-insurer global systemically important financial institutions, but the HKMA has (on 7 July 2017) been designated as the lead resolution authority for licensed corporations that are members of a group that include a global systemically important bank.

The current recognised clearing houses are:

- (i) Hong Kong Securities Clearing Company Limited
- (ii) HKFE Clearing Corporation Limited
- (iii) SEHK Options Clearing House Limited
- (iv) OTC Clearing Hong Kong Limited

- (D) Any financial institution, financial market infrastructure entity or recognized exchange company, in each case designated by the Financial Secretary.

It is unclear whether the Financial Secretary will designate any such entities.

- 4.2 FIRO will therefore, we expect, focus on: (i) Als; (ii) licensed corporations that are members of a group that has a global systemically important bank; (iii) (to a lesser extent) authorized insurers that are members of a group that has a global systemically important insurer; and (iv) recognised clearing houses.

5. Background to Resolution

- 5.1 The FSB, which is an international body that monitors and makes recommendations

about the global financial system, established in November 2011 standards relating to recovery and resolution planning (known as the **Key Attributes**).

- 5.2 The Key Attributes form the basis on which FIRO was drafted.
- 5.3 The Key Attributes, which were drafted following the 2007-2008 global financial crisis, are intended to reduce the risks posed by systemically important financial institutions. This includes ensuring that no financial institution is regarded as ‘too big to fail’; and seeking to avoid financial institutions requiring government funding in the event of becoming non-viable.
- 5.4 Systemically important financial institutions are required to plan for ways to effect a resolution (or recovery) so that there is a ‘playbook’ agreed with the regulators on steps to take where a financial institution may approach the point of non-viability.
- 5.5 A core principle of the Key Attributes is that shareholders, subordinated creditors and (if required) ordinary creditors should bear losses ahead of the taxpayer if systemically important financial institutions become non-viable. This was not the case during the global financial crisis, where government bail-outs using taxpayer money were a common tool.
- 5.6 To ensure that resolution does not unduly cut across existing creditor expectations under insolvency laws, creditors (and shareholders) are entitled to compensation in the event that they are treated less favourably than would have been the case had winding up of the financial institution commenced immediately before its resolution. The idea is to put that creditor/shareholder in no worse a position than it would have been in on a winding up.
- 5.7 A specific Hong Kong feature added to FIRO is that the resolution authority may apply to the court for a remuneration clawback order against senior management of a financial institution (including those who may have a material impact on its risk profile). If the actions of senior management staff, carried out intentionally, recklessly or negligently,

materially contributed to the financial institution’s non-viability, then such staff’s remuneration (fixed and variable) may be clawed back, up to a maximum value of the remuneration paid within three years prior to resolution (extended to six years in the case of dishonesty).

Initiation of Resolution

5.8 A resolution authority (likely the HKMA) may only initiate the resolution if:

- (A) the relevant financial institution is likely to cease to be viable;

The phrase “ceasing to be viable” means:

(i) that by reason of contravention or failure, the removal of the financial institution’s regulatory authorisation is warranted; or (ii) that financial institution is unable to discharge its obligations required for it to effectively carry on its business; and

- (B) there is no reasonable prospect of private sector action; and

- (C) the non-viability of the financial institution poses risks to the stability and effective working of the financial system of Hong Kong, including to the continued performance of critical financial functions, and resolution will avoid or mitigate those risks.

Critical financial functions are activities or operations carried on, or services provided, by a financial institution on which third parties rely and where such activities, operations or services would, if discontinued, likely:

- (i) lead to the disruption of services that are essential to the economy of Hong Kong;
- (ii) undermine the general confidence of participants in the financial market in Hong Kong; or
- (iii) give rise to contagion within the financial system of Hong Kong,

for any reason including the size, interconnectedness, substitutability, complexity or cross-border activities of, or

the market share held by, the financial institution or members of its group.

Examples include payments, custody, certain lending and deposit-taking activities in the commercial or retail sector, clearing and settling, certain segments of wholesale markets, market-making in certain securities and highly concentrated specialist lending sectors.

- 5.9 If these conditions are not met, then the financial institution will not be subject to resolution. If it is insolvent, it may be wound up under the usual insolvency regime. Note that the insolvency rules applicable to banks and insurers provide for specific categories of preferential creditors on insolvency, in addition to those applicable to companies generally; for example deposits up to a specified value (in the case of banks) and claims under specified insurance contracts (in the case of insurers).
- 5.10 Where a financial institution may be resolved, the resolution authority has the right to decide instead to resolve the financial institution's holding company if, broadly, that would be more effective than resolving the financial institution itself.
- 5.11 Group companies that provide services (directly or indirectly) to the financial institution may also be resolved, where the group company provides services essential to the continued performance of 'critical financial functions' in Hong Kong and an orderly resolution of the financial institution (or holding company) cannot be achieved by any other means.

Stabilization options

- 5.12 Where the resolution authority decides to resolve an entity, the stabilization options available are:
 - (A) transfer to a purchaser;
 - (B) transfer to a bridge institution;
 - (C) transfer to an asset management vehicle;
 - (D) bail-in; or

- (E) transfer to a 'temporary public ownership company'.

- 5.13 For most entities, the most likely stabilization option will be bail-in (which may be used in conjunction with other stabilization options). The other stabilization options are not considered further in this memorandum.

6. Bail-in

- 6.1 'Bail-in' refers to a process whereby the claims of shareholders and unsecured creditors are written down and/or converted into equity to absorb the losses of the failed financial institution and recapitalize the financial institution (or its successor). This is done in a manner that respects the hierarchy of claims prescribed in insolvency law, including that equity holder claims are written down before debt holder claims. Unlike a debt-for-equity swap, there is no requirement for consent of shareholders, creditors or management. The end result is to change the capital structure of the resolved financial institution so that what is left is a viable business.
- 6.2 As mentioned above, creditors (and shareholders) are entitled to compensation in the event that they are treated less favourably than would have been the case had winding up of the financial institution commenced immediately before its resolution. The idea is to put that creditor/shareholder in no worse a position than it would have been in on a winding up. The bail-in process will therefore be carefully structured to follow the insolvency creditor hierarchy so that any such claims by creditors (or shareholders) are limited.
- 6.3 There are limited categories of liabilities that cannot be bailed in (such as deposits covered by the deposit protection scheme (ignoring for this purpose the scheme's compensation limit of HKD500,000) and secured liabilities to the extent they are secured).

7. What does this mean for counterparties of financial institutions?

Post-commencement of resolution

7.1 Upon resolution, shareholders, then junior creditors, then ordinary creditors, may lose their holdings (or have the value of those holdings diminished). The resolution authority may bail-in or transfer all or part of the financial institution's business by using the stabilization tools.

7.2 The resolution authority also has power to make temporary suspensions of payment/delivery obligations. Certain resolution authority actions (and linked occurrences thereto) are deemed not to trigger defaults under contractual arrangements, and certain contractual termination rights may be suspended. Price sensitive information disclosures may be suspended in certain circumstances, and on-market trading in listed securities may be suspended or cancelled.

7.3 To reiterate, the main protection for counterparties under FIRO is that any pre-resolution creditor or pre-resolution shareholder of the resolved financial institution who has received, as a result of the resolution of that financial institution, less favourable treatment than would have been the case had winding up of the financial institution commenced immediately before its resolution was initiated, is eligible for compensation.

Pre-resolution

7.4 Counterparties may be affected by the provisions of FIRO even before the financial institution is resolved. Certain of the provisions are referred to below.

(A) S. 192 winding up petition

Notice of a petition for winding up by the court in respect of a financial institution within the scope of FIRO (or its holding company) must first be given to the resolution authority, which will result in a

delay of up to seven days. After the required delay, the petition must be presented to the court within a 14 day window. If the above procedures are not followed, the petition will be void.

(B) S. 150 Listco deferral of PSI disclosure

A listed financial institution (or a listed member of the financial institution's group of companies) may, by notice issued by the resolution authority, be required to defer disclosure of price sensitive information. This mechanism is subject to a number of safeguards, including that the resolution authority expects the financial institution will be subject to resolution. A similar mechanism may apply to certain counterparties to transactions involving the relevant listed company.

(C) S. 152 Listco suspension of on-market trading

If the resolution authority serves a notice under s. 150 of FIRO (referred to above), the resolution authority may also require a recognized exchange company to suspend all dealings in any securities of the relevant listed company.

(D) S. 151 deferral of Listco related Part XV SFO interests

The resolution authority may require the deferral of disclosure of interests/short positions of listed securities that would otherwise be made by directors and substantial shareholders under Part XV of the Securities and Futures Ordinance (Cap. 571).

7.5 Rules are expected to be made in due course requiring certain non-Hong Kong law contracts of within-scope financial institutions to contain terms that the counterparties recognise that bail-in and suspension of termination rights may be exercised by a Hong Kong resolution authority.

8. What should within-scope financial institutions be doing?

- 8.1 Most within-scope financial institutions will be AIs.
- 8.2 The main thrust of work for an AI will be considering initial steps on preparing a Hong Kong resolution plan.
- 8.3 The writing of the resolution plan involves an iterative process with the HKMA. The first step the HKMA will take is to serve a notice on an AI requiring that certain core information be submitted to the HKMA within six months of receipt of the notice. More information is set out in the HKMA Code of Practice - CI-1 (Resolution Planning - Core Information Requirements). Relevant extracts of this Code of Practice are included in Schedule 1 to this memorandum.
- 8.4 The way in which an AI will approach resolution planning will be influenced by the operational continuity requirements in resolution. Extracts of FSB guidance on this topic are set out in Schedule 2 to this memorandum.
- 8.5 Some pointers for financial institutions to consider when progressing a bail-in resolution plan are set out below:

(A) Structuring queries

- (i) Where to bail-in?
- (a) Multiple point of entry (MPE)
 - (b) Single point of entry (SPE)
- (ii) What to bail-in?
- (a) Tier 1 capital (core capital - largely equity)
 - (b) Tier 2 capital (retained earnings; fixed asset revaluations; hybrid capital instruments; certain subordinated debt)
 - (c) Other subordinated debt
 - (d) Other total loss-absorbing capacity (TLAC)
 - (e) How to internally down-stream capital (including internal TLAC)

- (f) Problem of bailing in against senior creditors, including trade creditors

(iii) How to achieve a bail-in?

- (a) Hong Kong law
- (b) Non-Hong Kong law
 - Requirement (in due course) for non-Hong Kong law contracts to include bail-in language akin to Article 55 of the EU's Bank Recovery and Resolution Directive (**BRRD**)
 - Advanced choreography of cross-border resolution planning

(B) Leveraging off industry standard template language for Article 55 BRRD templates

- (i) ISDA
- (ii) LMA
- (iii) ICMA

(C) How to continue critical supply contracts during a period of doubtful solvency?

- (i) Looking internationally (which should be a good indicator of the Hong Kong regime), the FSB and the Bank of England (**BoE**) require:
 - (a) intra-group providers of critical shared services to have sufficient financial resources to facilitate operational continuity of critical functions in resolution; and
 - (b) recipients of third party critical shared services to have sufficient financial resources to ensure that the third party provider continues to be paid.
- (ii) In all cases, the financial resources should be sufficient to cover the stabilization phase of resolution and to facilitate the subsequent restructuring period
- (iii) A due diligence strategy should be implemented

(D) Removal of impediments to resolution

Impediments to resolution may require the consideration of:

- (i) (If relevant) working out how a write-off of tier 1 capital / tier 2 capital / subordinated debt at a holding company level will allow for bail-in of subsidiary level financial institutions (including risk of set-off at the holding company level)
- (ii) Ensuring clear ranking of liabilities to assist insolvency hierarchy analysis
- (iii) Liquidity
- (iv) Continuity of contracts in resolution: operational services (both within the group and by third parties); trading agreements; access to payment services and financial market infrastructures
- (v) Information systems and data requirements
- (vi) Post bail-in restructuring (e.g. unwind, third party transfer following a bail-in)

(E) Resolution planning work streams

A financial institution would likely consider the following resolution planning work streams:

- (i) Information flows to regulators
- (ii) IT systems
- (iii) Identifying “critical financial functions”
- (iv) Critical financial functions contractual due diligence
- (v) Intra-group
- (vi) External contracts
- (vii) Critical financial functions repapering
- (viii) “Article 55” repapering
- (ix) Business critical restructuring/changes to service providers
- (x) Capital structure
- (xi) Organisation of internal work streams



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Schedule 1

HKMA Resolution Regime - Code of Practice - CI-1 (Resolution Planning - Core Information Requirements)

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2. Approach to resolution planning

2.1 Overview

2.1.1 In order both to manage the volume of information and to tailor, to the extent practicable, the scope of information to be provided by individual AIs, the MA intends to categorise information for resolution planning purposes into “core” and “supplementary” information.

...

2.1.3 The MA will use the core information provided by an AI to identify the financial functions performed by the AI and assess which of them should be considered critical. The information will also enable the MA to gain the necessary in-depth understanding of the AI’s corporate group structure and the other material entities (see paragraph 3.2.5) within it, their key financial indicators, core business lines and the key legal, financial and operational dependencies intragroup.

...

2.1.6 Any supplementary information required to be provided by an AI will be focused primarily on enabling the MA to make the preferred resolution strategy for the AI operational. Hence a significant part of the supplementary information can be expected to be AI-specific and resolution strategy-dependent. For example, where a resolution strategy involves a bail-in of liabilities, supplementary information regarding the location of liabilities eligible for bail-in within the AI’s group, their position in the creditor hierarchy and the form of their subordination are among some of the information likely to be required in order to make such strategy operational.

...

2.1.8 Once the MA has defined a preferred resolution strategy, resolvability assessments will support the MA in identifying potential impediments to orderly resolution and thereby define any actions needed to further refine and operationalise the preferred strategy. Resolvability assessments will be tailored by reference to the pre-conditions for orderly resolution under the preferred resolution strategy. For example, under a resolution strategy involving bail-in, sufficient loss-

absorbing capacity will be an important pre-condition for orderly resolution. Therefore, the MA will examine an AI's loss-absorbing capacity and liability structure in detail as part of a resolvability assessment in cases where bail-informs part of the preferred resolution strategy for that AI.

...

- 2.1.10 It is possible that information may be sought for the purpose of resolution planning, which is similar to that already collected in other regulatory reporting submissions. However, existing reporting returns do not typically request information from a resolution planning perspective, and therefore the information in the format currently collected may not be entirely suitable for this purpose. The MA considers it important to have information for resolution planning purposes provided in a single submission and on the same basis, both in terms of timing and consolidation.

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2.2 Application

General

- 2.2.1 ... The general expectation is that AIs will be required to submit core information within six months following receipt of a notice from the MA pursuant to section 158(1) of the FIRO. Submissions will be made in the format specified by the MA.
- 2.2.2 For those banks (and banking groups) designated as global systemically important banks (G-SIBs) by the Financial Stability Board (FSB), implementation of group-level resolution planning is being pursued according to an internationally agreed timeline. As a major host authority, with the vast majority of G-SIBs having banking operations in Hong Kong, the MA is fully supportive of this initiative, and therefore may require an AI that is a part of a G-SIB to submit information outside of the phase-in timetable or going beyond the content described in this chapter, with a view to facilitating group-level resolution planning. Similarly, the MA may require an AI that is part of an overseas headquartered financial institution other than a G-SIB, to submit information outside of the timetable or content described in this chapter for the purposes of facilitating its group-level resolution planning. Section 13 of the FIRO, in this regard, provides for the MA to adopt the whole or part of a global or regional group resolution plan to support a preferred resolution strategy.

...

- 2.2.6 Where the MA is acting as a host resolution authority of banking sector entities within a cross-border group, local resolution planning for AIs serves a number of purposes for the MA. In particular, the core information collected from such AIs will aid the MA in considering the suitability of any group resolution plan proposed by the home resolution authority and, in particular, whether such plan is consistent with the resolution objectives under the FIRO. In cases where the MA has determined that it is in a position to adopt the group resolution plan proposed by the relevant authority, the information submitted by AIs will assist the MA in designing measures to support and/or recognize any resolution action taken by the home authority in the case of a cross-border resolution. ...
- 2.2.7 Where the MA is acting as a home resolution authority, the core information collected regarding a locally incorporated AI's overseas branches or subsidiaries (as well as that collected for the local Hong Kong operations of the AI) will be important in resolution planning, including the development of a group resolution plan with the aim of ensuring continuity in critical financial functions carried out by the AI itself and its overseas branches and subsidiaries in resolution as the case may be.

3. Core information requirements

3.1 Overview

3.1.1 There are four main constituent parts to the core information which will be required for resolution planning purposes, namely:

- (i) Relevant entities and material entities;
- (ii) Core business lines and operating model;
- (iii) Dependencies;
- (iv) Financial functions.

...

3.1.4 ... In particular, the AI should officially designate a member of its Hong Kong executive management team with responsibility for the approval of the information submitted and subsequent coordination with the MA in relation to resolution planning for the AI. An AI should provide a high-level description of the arrangements for the collection, review and approval of information submitted to the MA for resolution planning purposes.

3.1.5 To ensure that local specificities are taken into account in a satisfactory manner, local executive management should always have a key role in coordinating and engaging with the MA in respect of resolution planning for an AI. ...

3.1.6 An AI should keep its core information up to date ...

3.1.7 Given that, as noted in paragraph 3.1.6, re-submissions would likely be required if there are significant changes to the business operation or group structure of the AI or its material entities, the MA would expect the AI to proactively notify the MA of any such significant changes, and to discuss with the MA a timeline for re-submitting the core information.

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3.4 Dependencies

...

Internal dependencies

3.4.6 An AI should briefly describe, with supporting quantitative information where appropriate, the nature of key internal dependencies of material [group] entities that, if disrupted, would materially affect the funding or operations of the AI. Such dependencies could be operational, financial or legal in nature.

3.4.7 Operational dependencies could include the following:

- (i) Shared personnel, facilities, or systems among group companies (including information technology platforms, management information systems, risk management systems, and accounting and recordkeeping systems);
- (ii) Intra-group reliance on access to financial market infrastructures (“FMs”) (e.g. membership held by one entity upon which another entity relies for access or for the provision of certain services).

3.4.8 Financial dependencies could include the following:

- (i) Capital, funding, or liquidity arrangements;
- (ii) Cross-guarantees, cross-collateral arrangements, cross-default provisions, and intra-group and cross-product netting arrangements;

(iii) Risk transfers and booking arrangements.

3.4.9 Legal/structural dependencies could include intra-group reliance on licences to conduct certain regulated activities (e.g. licence held by one entity upon which another entity relies for the conduct of certain regulated activities).

External dependencies

3.4.10 An AI's external dependencies could be financial, operational or legal/structural in nature, including access to FMs, payments or IT services.

3.4.11 For each external provider identified, the following information should be provided:

- (i) The relevant entity that contracts with the provider;
- (ii) The jurisdiction of incorporation of the provider;
- (iii) Description of the material commercial contract terms, including any provisions for escalation of fees; and
- (iv) Description of any contractual termination and acceleration provisions.

3.5 Financial functions

Overview

3.5.1 The objective of seeking core information in relation to financial functions is to identify which of the material [group] entities' financial functions may be critical to the financial system in Hong Kong. The information will help the MA to develop a resolution strategy which is designed to ensure continuity in critical financial functions in Hong Kong.

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Critical financial functions

3.5.5 The concept of critical financial functions recognises that activities or operations carried on, or services provided, by the banking sector are relied upon by individuals and businesses for the conduct of their day to day activities and thereby underpin and support the functioning of the overall economy. Each individual AI may perform a number of these functions; and in some cases an AI may do so on a scale and in a manner that could be considered critical for the stability and

effective working of the banking system and indeed for the economy more broadly. This would be the case, for instance, where the distress of the AI and any disruption in the operation and the provision of the function would have material consequences for customers because there is no readily available substitute provider given the unique characteristics of the function or the critical mass of the scale upon which the function is provided.

3.5.6 Critical financial functions are activities or operations carried on, or services provided, by a material [group] entity on which third parties rely and where such activities, operations or services, if discontinued, would likely:

- (i) lead to the disruption of services that are essential to the economy of Hong Kong;
- (ii) undermine the general confidence of participants in the financial market in Hong Kong; or
- (iii) give rise to contagion within the financial system of Hong Kong,

for any reason including the size, interconnectedness, substitutability, complexity or cross-border activities of, or the market share held by, the material entity.

Examples include payments, custody, certain lending and deposit-taking activities in the commercial or retail sector, clearing and settling, certain segments of wholesale markets, market-making in certain securities and highly concentrated specialist lending sectors.

The above definition is derived from the FIRO, with reference to the definition of critical functions developed by the FSB in its Guidance on Identification of Critical Functions and Critical Shared Services. ...

...

3.5.8 Drawing upon the FSB's critical functions framework, the MA will collect core information on an AI's financial functions under five broad categories as specified in Annex 1, namely:

- (i) Deposits;
- (ii) Lending & Loan Servicing;
- (iii) Payments, Clearing, Custody & Settlement;
- (iv) Wholesale Funding Markets; and

(v) Capital Markets & Investments.

3.5.9 These five categories should initially capture the majority of financial functions performed or provided by AIs in Hong Kong. Nevertheless, AIs are encouraged to add into their core information submission any other financial functions not listed in Annex 1 (e.g. any functions specific to the Hong Kong financial system such as index calculation, tripartite repo system operation, and market making for Exchange Fund Bills and Notes) should they consider that their provision or performance of such functions may be deemed as critical financial functions.”

Schedule 2

FSB Guidance on Arrangements to support Operational Continuity in Resolution issued on 18 August 2016

- “4.2 The firm’s service model needs to provide operational continuity in the two stages of resolution:
- (i) [stabilization] (the point at which resolution tools are applied); and
 - (ii) wind-down and/or restructuring (the period in which the firm is wound down or restructured to create a viable business model, for example, by divesting or winding down legal entities or business lines), recognising that the exact restructuring needs will depend on, amongst other things, the circumstances that led to the firm’s failure and market conditions at the time of resolution.
- 4.3 Thought should also be given in resolution planning about how to manage the transition from ‘business as usual’ to the operation of a firm in resolution.
- 4.4 To provide operational continuity in the two stages of resolution, the following arrangements could be considered. Most or all of the arrangements should be relevant for all of the service delivery models discussed above, although the way in which they are implemented will need to be adapted to the specific model in question.
- (i) **Contractual provisions** - Firms should have clearly and comprehensively documented contractual arrangements and SLAs [(service level agreements)] for both intra-group and third party critical shared services which, to the greatest extent possible, remain valid and enforceable in resolution provided there is no default in payment obligations. This is discussed further under the following subsection on ‘Contractual provisions’.
 - (ii) **Management information systems (‘MIS’)** - All arrangements and models should be supported by a clear taxonomy of shared services and the maintenance of up-to date mapping of services to entities, businesses and critical functions. MIS should allow for timely reporting on the provision or receipt of critical shared services on a legal entity and line of business basis, including information about ownership of assets and infrastructure; pricing; contractual rights and agreements; and outsourcing arrangements.
 - (iii) **Financial resources** - Intra-group providers of critical shared services (including where the services are provided within regulated entities) should have **sufficient financial resources to facilitate operational continuity of critical functions in resolution. Where an entity relies on third party critical shared services, the service recipient should**

have sufficient financial resources to ensure that the third party provider continues to be paid. In all cases, the financial resources should be sufficient to cover the [stabilization] phase of resolution and to facilitate the subsequent restructuring period.⁹ Communication with a third party service provider as regards to continued payment can help manage the risks of early termination.

Footnote 9: Recognising that the resolution group (or resolution groups) may be ‘right sized’ during the restructuring phase, as parts of the business are sold or wound down, and that recapitalised entities may have access to sources of liquidity (see the FSB’s Guiding principles on the temporary funding needed to support the orderly resolution of a G-SIB, ... []).

- (iv) **Robust pricing structures** - Cost and pricing structures for services should, to the extent permitted by tax and legislative requirements, be predictable, transparent and set on an arm’s length basis with clear links, where relevant, between the original direct cost of the service and the allocated cost. The cost structure for services should not alter solely as a result of the entry into resolution of the service recipient. This arrangement is relevant for the provision of critical shared services through an intra-group service company (to ensure the service company is financially viable on a standalone basis) or through a regulated entity (to ensure that the documentation could form the basis of an external contract if the regulated entity is restructured in resolution).
- (v) **Operational resilience and resourcing** - Critical shared services should be operationally resilient and have sufficient capacity (for example, human resources and expertise) to support the restructuring phase following the failure of a group entity or group entities. Firms and authorities should plan for the retention of critical employees necessary for the provision of critical shared services in resolution. In any event, critical shared services should not be unduly affected by the failure or resolution of other group entities.
- (vi) **Governance** - Critical shared services should have their own governance structure and clearly defined reporting lines. Where services are provided by a division of a regulated entity, for example, this could entail some element of independent management and responsibility at board level. Critical shared service providers should have sufficient governance oversight or planning and contingency arrangements to ensure that services continue to be provided in resolution without relying on senior staff from certain business lines that may be wound down or that may no longer form part of the same

group. The governance arrangements relating to critical shared services could be assessed by the firm's internal audit function.

- (vii) **Rights of use and access** - Access to operational assets by the critical shared services provider, the serviced entities, business units and authorities should not be disrupted by the failure or resolution of any particular group entity. In some cases, this may require that operational assets essential to the provision of critical shared services are owned or leased by the same legal entity providing those critical shared services (that is, by the regulated entity or by the intra-group service company, depending on the model used). Where this is not the case, contractual provisions to ensure rights of access could be considered. Service recipients should also not be restricted from using shared assets directly where appropriate. Continued access to IT, intellectual property and operational services during the restructuring period (for example, through Transitional Service Agreements, as discussed under 'Contractual provisions' below) should be considered as part of resolution planning.

- 4.5 In addition, firms should consider developing and maintaining an operational continuity 'playbook' that would describe the actions and steps in order to facilitate operational continuity following the entry of the firm into resolution.

Contractual provisions

- 4.6 Poorly designed or inadequate SLAs may represent a significant obstacle to operational continuity in resolution, and there is a risk that intra-group and third party SLAs will be terminated upon entry of a firm into resolution without any default in payment. These obstacles and risks can be mitigated by the following measures.

- (i) Services received from both third party and intra-group entities should be well documented and have clear parameters against which service provision can be measured. This should include details of the provider and recipient(s) of the service, the nature of service and its pricing structure. This should also include any onward provision to other entities or sub-contracting to third party providers. For services provided by a division of a regulated entity, SLAs should be sufficiently granular to allow them to form the basis of effective Transitional Service Agreements to facilitate post resolution restructuring that may be required.
- (ii) The terms of SLA service provision and pricing should not alter solely as a result of the entry into resolution of a party to the contract (or affiliate of a party). The resolution authority should be able to maintain the service contract on the same terms and conditions that were imposed prior to resolution for intra-group service contracts and,

to the extent permitted under applicable law, third party service contracts.

- (iii) SLAs should explicitly contemplate that services may be transferred or assigned in resolution. As long as payments and other obligations continue to be met, the service provider should not have a right of termination by reason of any such assignment or transfer.
- (iv) SLAs designed to provide service to a “group” should have clauses that as far as possible allow for the continued use of such products or receipt of such services by (former) group entities for a reasonable period of time following a divestment resulting from a resolution, in order to support group restructuring.
- (v) In the absence of an explicit statutory provision that prevents contract termination or contractual modification solely on the grounds of early intervention or resolution, SLAs should include explicit provisions that achieve the same outcome, subject to adequate safeguards and continuity of performance under the contract.

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Annex: Indicative information requirements to facilitate operational continuity

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2. Information requirements: Operational, legal and governance structure of critical shared services

- 2.1. A description of the operational, legal and governance structure of the service provider including, but not limited to:
 - a) Jurisdiction(s) where services are centralised;
 - b) Contracts governing the provision of services (see Annex Section 3 below for details), including a description of the pricing policies that govern the provision of services; and
 - c) Inventory, including location, of operational assets necessary to provide critical shared services.
- 2.2. For provision of services by an intra-group service company, analysis of actual and stressed financial condition of the service company(s) with a view to

assessing the ability to continue providing services through resolution, along with supplemental information including, but not limited to:

- a) Balance sheets, income statements and statement of cash flows;
- b) Projected liquidity, capital and cash flows of the service company through stressed conditions such as the failure and entry into resolution of one or more group entities to which intra-group services are provided; and
- c) Description of liquidity reserves including instruments, amounts, currencies, account information, custody arrangements, etc.

3. Information requirements: Contractual arrangements

3.1. Legal review of the terms and conditions of the contracts governing service provision should be conducted to assess the risks to service interruption. Types of contracts include: contracts for service, software license agreements, SLAs with affiliates, and property and equipment leases. Examples of information requirements to assess the risk to, and to facilitate, the continuity of critical functions could include, but are not limited to:

- a) Provider and the contracting entity in the group (distinguish between group-wide contracts and single legal entity contracts);
- b) Description of the service;
- c) Jurisdiction of service provision and law governing dispute resolution;
- d) Contract amount, guarantees, expiry date, termination rights, assignment clauses, change of control provisions, events of default, cure periods, material adverse change clauses;
- e) Description of arrangements to allow for services to be extended to acquirer(s) of the failed entity(s);
- f) Authorised users under software licenses;
- g) Software support arrangements (outsourced vs. internal); and
- h) Retention clauses and employment terms for critical staff.

- 3.2. A method to determine the relative priority of contracts in resolution should be considered. Factors affecting the priority of a contract may include:
- a) Delivery of a critical shared service would be jeopardised if the service provider's service were unavailable;
 - b) Ability and time required to replace the service provider (i.e., substitutability); and
 - c) Jurisdiction of the service provider.
- 3.3. A description of the governance framework along with the roles and responsibilities for each division that manages service provision arrangements. Supplier risk management frameworks can be leveraged in resolution to facilitate the continuity of service provision and manage service disruptions should they occur.”