

Hong Kong Resolution of Financial Institutions

July 2017

This memorandum sets out a high level overview of Hong Kong's regime for the resolution of financial institutions and analyses what it means for counterparties of financial institutions.

We have prepared a separate memorandum targeted at financial institutions, which includes some pointers on 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.

2.4 In addition, the HKMA has issued a Resolution Regime Code of Practice and a Supervisory Policy Manual dealing with, respectively, resolution planning and recovery planning by banks (i.e. Als).

3. Which financial institutions does FIRO apply to?

3.1 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.

- 3.2 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.

4. Background to Resolution

- 4.1 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**).
- 4.2 The Key Attributes form the basis on which FIRO was drafted.
- 4.3 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.
- 4.4 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.
- 4.5 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.
- 4.6 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.
- 4.7 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

- 4.8 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.

- 4.9 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).
- 4.10 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.
- 4.11 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

- 4.12 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'.
- 4.13 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.

5. Bail-in

- 5.1 '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.
- 5.2 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.

- 5.3 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).

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

Post-commencement of resolution

- 6.1 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.
- 6.2 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.
- 6.3 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

- 6.4 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).

6.5 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.



Peter Lake
T +852 2901 7235
E peter.lake@slaughterandmay.com



Nick Bonsall
T +44 20 7090 4276
E nick.bonsall@slaughterandmay.com



Mike Ringer
T +852 2901 7351
E mike.ringer@slaughterandmay.com



George Silber
T +44 20 7090 5106
E george.silber@slaughterandmay.com

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