

Consultation paper | CP 20.01
22 January 2020

**An Effective Resolution Regime for
Financial Institutions in Hong Kong**

**Financial Institutions (Resolution) Ordinance
(Chapter 628)**

**Rules on Contractual Stays on Termination Rights
in Financial Contracts for Authorized Institutions**



HONG KONG MONETARY AUTHORITY
香港金融管理局

ABOUT THIS CONSULTATION PAPER

- (i) This consultation paper sets out the Monetary Authority’s policy objectives and proposals for making rules requiring the adoption of appropriate contractual provisions, in certain types of financial contracts that are not governed by Hong Kong law, to give effect to a suspension of termination rights that may be imposed by the Monetary Authority under the Financial Institutions (Resolution) Ordinance (Cap. 628).
- (ii) A list of the questions raised in this consultation paper is set out in the Annex. Interested parties are invited to submit comments on the proposals in this consultation paper as well as any other relevant or related matters that may have a significant impact on the proposals.
- (iii) Comments should be submitted in writing no later than 22 March 2020 through one of the following means:

Hard copy: Consultation on Contractual Stays
 Resolution Office
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 55th Floor
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 8 Finance Street, Central, Hong Kong

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- (iv) Any person submitting comments on behalf of any organisation is requested to provide the name of the organisation he/she represents. Please note that the names of the respondents, their affiliation(s) and the contents of their submissions may be published or reproduced on the website of the Hong Kong Monetary Authority and may be referred to in other documents. If you do not wish your name, affiliation(s) and/or contents of your submissions to be disclosed, please state this clearly when making your submissions. An automatic confidentiality disclaimer generated by your IT system on an e-mail will not, of itself, be regarded as indicating a wish for non-disclosure.

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Data Control Officer
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- (vii) Terms adopted in this consultation paper are used in a general sense to reflect the concepts underpinning the proposals in question, unless they have been defined or the context otherwise provides. When the relevant proposals are implemented in the form of legislation, it is possible that these terms may be modified or replaced in order to better reflect the precise policy intent of the proposals in the law or to aid or address issues relating to the legal interpretation of such terms, when used in the law.

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ABBREVIATIONS

AI	Authorized institution
AOE	Affiliated operational entities
FI	Financial institution
FIRO	Financial Institutions (Resolution) Ordinance (Cap. 628)
FSB	Financial Stability Board
FSB Principles	Principles for Cross-border Effectiveness of Resolution Actions issued by the FSB
G-SIB	Global systemically important bank
HKMA	Hong Kong Monetary Authority
ISDA	International Swaps and Derivatives Association, Inc.
ISDA JMP	ISDA Resolution Stay Jurisdictional Modular Protocol published by ISDA
ISDA UP	ISDA 2015 Universal Resolution Stay Protocol published by ISDA
Key Attributes	Key Attributes of Effective Resolution Regimes for Financial Institutions issued by the FSB
MA	Monetary Authority
RA-2	The FIRO Code of Practice chapter “The HKMA’s Approach to Resolution Planning” issued by the MA
Stay Rules	Rules to be made by the MA as a resolution authority pursuant to section 92 of the FIRO

1 OVERVIEW

- 1.1 The Financial Institutions (Resolution) Ordinance (“**FIRO**”) establishes a cross-sectoral resolution regime for financial institutions (“**FIs**”) in Hong Kong, which is designed to meet the international standards set by the Financial Stability Board (“**FSB**”) in its “Key Attributes of Effective Resolution Regimes for Financial Institutions” (“**Key Attributes**”)¹. The FIRO empowers the resolution authorities to effect the orderly resolution of a within scope FI, when it is or is becoming non-viable and upon certain specified conditions being met, for the purpose of maintaining financial stability while minimising the risks to public funds. The core powers include a menu of stabilization options which may be applied for an orderly resolution of a non-viable within scope FI, having regard to the resolution objectives² set out in the FIRO.
- 1.2 In a resolution where one or more stabilization options could be applied by a resolution authority to a non-viable FI, it is important that the contractual counterparties to the FI cannot terminate and close out their positions solely as a result of the FI’s entry into resolution. One of the lessons from the global financial crisis was that disorderly termination of contracts on a mass scale would cause significant contagion effects to the financial markets, posing wider risks to the stability and effective working of the financial system.
- 1.3 It has been recognised by global regulators that in order to address this risk, a resolution authority must be able to resolve a non-viable FI while avoiding triggering early termination or close-out of contracts solely as a result of the FI’s entry into resolution. In the Key Attributes, there are specific items that seek to address the early termination risks in contracts in a resolution context.
- 1.4 In line with the international standards set out in the Key Attributes, the FIRO contains specific provisions for addressing early termination risks in contracts.

¹ First issued in October 2011 and updated in 2014. For the latest version see: *Financial Stability Board, October 2014, Key Attributes of Effective Resolution Regimes for Financial Institutions*. Accessible at: http://www.fsb.org/wp-content/uploads/r_141015.pdf

² In exercising the stabilization options (and performing other functions under the FIRO), the resolution authorities must have regard to the resolution objectives set out in section 8(1) of the FIRO, which include, amongst others, (a) promoting and seeking to maintain the stability and effective working of the financial system of Hong Kong including the continued performance of critical financial functions; and (b) subject to the other resolution objectives, seeking to contain the costs of resolution and, in so doing, protecting public money.

In addition to a statutory power to suspend for a specified period the termination rights of a counterparty to a qualifying contract³ (other than a counterparty that is a financial market infrastructure), the FIRO includes the power for a resolution authority to make rules requiring the adoption of appropriate provisions in a contract of a qualifying entity⁴, to the effect that parties to the contract agree to be bound by the resolution authority's exercise of power to temporarily suspend (or 'stay') termination rights ("**Stay Rules**"). Under the FIRO, a termination right, in relation to a qualifying contract, is defined as (a) a right to terminate the contract; (b) a right to accelerate, close out, set off or net obligations, or any similar right that suspends, modifies or extinguishes an obligation of a party to the contract; or (c) a right to prevent an obligation from arising under the contract ("**termination right**")⁵.

- 1.5 Under the FIRO, the MA is the resolution authority for banking sector entities, including, without limitation, all authorized institutions ("**AIs**"). This consultation paper sets out the proposals for the rules that the MA in his capacity as a resolution authority intends to make. In developing these policy proposals, consideration has also been given by the MA in his role as the lead resolution authority for the relevant cross-sectoral groups. The proposals will require an AI and certain of its group companies to adopt appropriate provisions in certain contracts to the effect that the parties to the contract agree to be bound by a temporary stay that may be imposed by the MA under the FIRO on the exercise of termination rights.
- 1.6 This paper is organised as follows: Section 2 of this paper sets out the relevant FIRO provisions and the international context. Section 3 of this paper sets out the proposed scope of the Stay Rules. Section 4 of this paper sets out the operational and implementation matters in relation to the Stay Rules. Section 5 of this paper sets out the next steps intended to be taken in relation to the Stay Rules. The Annex sets out the full list of the consultation questions.

³ Pursuant to section 88 of the FIRO, a qualifying contract is a contract entered into by a qualifying entity (as defined in footnote 4 below) under which the obligations for payment and delivery and for provision of collateral continue to be performed.

⁴ A qualifying entity means a within scope FI or a group company of a within scope FI: see sections 86 and 87 of the FIRO.

⁵ See section 86 of the FIRO.

2 STATUTORY STAY PROVISIONS IN THE RESOLUTION REGIME

- 2.1 The Key Attributes state that, subject to adequate safeguards, entry into resolution and the exercise of any resolution powers should not constitute an event that entitles any counterparties to a contract to exercise contractual acceleration or termination rights, provided the substantive obligations under the contract continue to be performed⁶. Should such rights nevertheless become exercisable, the resolution authority should also have the power to temporarily stay such rights where they arise by reason only of entry into resolution or in connection with the exercise of any resolution powers, subject to certain conditions and safeguards⁷.
- 2.2 In accordance with the Key Attributes described above, the FIRO provides two statutory mechanisms for staying early termination rights that may arise in contracts from the exercise of certain powers under the FIRO, where relevant obligations⁸ continue to be performed. These mechanisms are (i) section 89 of the FIRO, which operates to prevent any “default event provisions”⁹ from being triggered by the exercise of certain powers in the FIRO; and (ii) section 90 of the FIRO, which provides for the resolution authority to impose, by way of an instrument through which a stabilization option is applied (i.e. a “Part 5 instrument”¹⁰), a temporary suspension of the exercise of a termination right.
- 2.3 Section 89 of the FIRO prevents certain measures that may be taken by the resolution authority in resolution or prior to resolution (referred to as a “crisis prevention measure” under the FIRO¹¹), or the occurrence of any events directly linked to the taking of such a measure, from triggering a default event

⁶ Key Attribute 4.2.

⁷ Key Attribute 4.3. See also Appendix I - Annex 5 to the Key Attributes on conditions for a temporary stay.

⁸ See details of the relevant obligations in paragraphs 2.3 and 2.4 respectively

⁹ Defined in section 86 of the FIRO.

¹⁰ A Part 5 instrument is defined in section 2(1) of the FIRO as a securities transfer instrument, a property transfer instrument, or a bail-in instrument.

¹¹ Defined in section 86 of the FIRO. A crisis prevention measure, in relation to a qualifying entity, means the exercise in respect of the entity by a resolution authority of any powers under Part 3, 5 or 13, or Division 2 of Part 4, of the FIRO.

provision in a contract entered into by a qualifying entity where the substantive obligations provided for (including payment and delivery obligations and provision of collateral) continue to be performed. In other words, section 89 of the FIRO operates to override the operation of these contractual triggers as long as the substantive obligations (including payment and delivery obligations and provision of collateral) under the contract continue to be performed, i.e. the stay on default event provision (including termination rights) that may be triggered by a crisis prevention measure as defined under the FIRO is *ongoing*. In this paper, we refer to section 89 of the FIRO as the “**ongoing stay provision**”.

2.4 Section 90 of the FIRO allows a resolution authority, subject to the safeguards in section 91 of the FIRO, to impose a temporary suspension of a termination right of a counterparty to a contract if such a right becomes exercisable, so long as the obligations provided for in the contract for payment and delivery and for provision of collateral continue to be performed. The suspension of the exercise of the termination rights may be imposed by the resolution authority through a Part 5 instrument which effects the exercise of a stabilization option, i.e. only when the conditions for triggering a resolution have been met and a resolution is being initiated. The suspension must have a specified duration, which can be up to two business days¹², i.e. the effect of such a suspension is *temporary*. In this paper, we refer to section 90 of the FIRO as the “**temporary stay provision**”.

2.5 In the MA’s view, preventing the triggering of a default event provision (including termination rights) due to the taking of resolution-related actions altogether offers more certainty to ensure the stability and effective working of the financial system. However, it is also important to have the ability to temporarily stay termination rights in resolution should they nevertheless become exercisable. Together, these two statutory stay provisions operate to complement each other in managing early termination risks in resolution. Consistent with the Key Attributes, both provisions are available under the

¹² Section 90(4) of the FIRO provides that a suspension begins when the Part 5 instrument providing for the suspension is first published; and ends at the end of the suspension specified in the Part 5 instrument, being no later than the expiry of the first business day following the day on which the Part 5 instrument is published.

FIRO.

Contractual approach

- 2.6 Where the relevant contracts are governed by non-Hong Kong law, there are uncertainties as to whether a court in a non-Hong Kong jurisdiction would give effect to the temporary stay power over termination rights unless the law of such jurisdiction expressly recognises the MA's resolution action. Further, even if a court in a non-Hong Kong jurisdiction were to give effect to the exercise of the temporary stay power under the FIRO, it could be challenging to effect such recognition in a timely fashion in order to best achieve the resolution objectives in Hong Kong.
- 2.7 Given the openness of Hong Kong's economy and the common use of non-Hong Kong law as the governing law of financial contracts in the Hong Kong banking sector, there is a need to ensure that relevant contracts governed by non-Hong Kong law can be effectively bound by the temporary stay provision in order to achieve the policy objectives and the standards set out in the Key Attributes.
- 2.8 The issue of ensuring cross-border effectiveness of stay powers imposed by local rules or laws is one that is faced by many jurisdictions with FIs which enter into contracts governed by laws of other jurisdictions. This issue has been identified as a common barrier to the orderly resolution of FIs including banks. To this end, the FSB's Principles for Cross-border Effectiveness of Resolution Actions¹³ ("**FSB Principles**") set out the principles in accordance with which this barrier could be addressed. While the FSB Principles emphasise the importance of implementing comprehensive statutory frameworks, the FSB Principles also support contractual approaches to cross-border recognition, which complement and support the statutory frameworks. Specifically in the context of stays of termination rights, the FSB Principles noted a commitment by the FSB members "to act in a concerted manner to promote, by way of regulation or other enforceable measures, the broad adoption of the

¹³ Please refer to FSB, *Principles for Cross-border Effectiveness of Resolution Actions* (3 November, 2015). Accessible at: <http://www.fsb.org/wp-content/uploads/Principles-for-Cross-border-Effectiveness-of-Resolution-Actions.pdf>

contractual approach to cross-border effectiveness of temporary stays of early termination rights in financial contracts". Hong Kong is an FSB member jurisdiction and the MA is fully committed to the adoption of appropriate regulatory measures locally to promote this initiative.

- 2.9 In line with the contractual approach advocated by the FSB, the FRO provides in section 92 that a resolution authority may make rules to ensure that the terms and conditions of a contract entered into by a qualifying entity contain a provision to the effect that the parties to the contract agree to be bound by the temporary stay provision¹⁴. The MA intends to make the Stay Rules pursuant to section 92 of the FRO, and section 3 of this paper sets out the proposed scope of the Stay Rules.

¹⁴ Section 92(1) of the FRO states:
"For ensuring the effective implementation of section 90, a resolution authority may make rules that impose a requirement on a qualifying entity to ensure that the terms and conditions of a contract entered into by it contain a provision to the effect that the parties to the contract agree to be bound by any suspension of termination rights in relation to the contract imposed under section 90(2)."

3 SCOPE OF THE STAY RULES

- 3.1 While the temporary stay power under section 90 of the FIRO may be exercised by the MA on contracts entered into by qualifying entities under his purview upon meeting certain conditions, the MA considers it a proportionate approach to propose a narrower range of contracts as well as entities to fall within the scope of the Stay Rules. This approach recognises that if the scope of the Stay Rules were to be crafted as wide as the scope of the statutory power, the cost of compliance would seem disproportionate to the benefit afforded by such a wide scope.
- 3.2 The MA proposes that a contract with all of the following features would fall within the scope of the Stay Rules as a **within scope contract**:
- (i) a contract entered into by any of the **covered entities** as described in paragraph 3.4 below;
 - (ii) a contract that is a **covered financial contract**, as described in paragraph 3.14 below;
 - (iii) a contract that is governed by non-Hong Kong law;
 - (iv) a contract that contains a termination right; and
 - (v) a contract where the counterparty is not a financial market infrastructure (including a central counterparty).
- 3.3 The following sub-sections discuss in further detail the considerations and the rationale for each of the above features of a within scope contract.

Entities to be covered by the Stay Rules

- 3.4 The MA proposes that the Stay Rules would apply to any of the following entities (collectively referred to in this consultation paper as “**covered entities**”):
- (i) a Hong Kong incorporated AI;
 - (ii) a Hong Kong incorporated holding company of a Hong Kong incorporated AI;
- and

(iii) a group company of a Hong Kong incorporated AI, but only to the extent that the covered financial contracts entered into by the group company contain obligations that are guaranteed or otherwise supported by the AI or the Hong Kong incorporated holding company of the AI.

- 3.5 The focus of covered entities on Hong Kong incorporated AIs and Hong Kong incorporated holding companies of the AIs has been informed by prevailing international resolution planning practices, including the approaches to developing a resolution strategy, and takes into account the design and specificities of the local resolution regime, including the circumstances under which a temporary stay may be imposed by the MA.
- 3.6 On the development of resolution strategies and plans, the FSB published guidance on developing effective resolution strategies in July 2013¹⁵. It sets out the common considerations for the development of resolution strategies. Under the stylised approaches to resolution strategies described in the guidance, the presumptive point(s) of entry, namely the point(s) to which resolution powers are expected to be directly applied under any given resolution strategies, is typically a legal entity, be it (i) a top parent or holding company; (ii) an intermediate holding company; or (iii) an operating subsidiary at a regional or local level. In practice, it has also been observed that resolution planning by authorities to date has largely been conducted on the premise that the point(s) of entry would be at an entity level.¹⁶
- 3.7 The presumptive point of entry under the preferred resolution strategy is considered a relevant factor in the scoping of covered entities under the Stay Rules. This is because by operation of the temporary stay provision, the imposition of a temporary stay by a resolution authority would take place by way of provision in a Part 5 instrument, a legal instrument that gives effect to the application of a stabilization option (among other things). In other words,

¹⁵ See FSB, Recovery and Resolution Planning for Systemically Important Financial Institutions: Guidance on Developing Effective Resolution Strategies, https://www.fsb.org/wp-content/uploads/r_130716b.pdf

¹⁶ As an example, in the context of discussing resolution strategies and plans for banks including global systemically important banks (“G-SIBs”), the term ‘resolution entity’ is commonly used by authorities and the FSB to refer to the entity to which resolution tools will be applied in accordance with the resolution strategy.

the circumstances in which powers under a temporary stay provision may become exercisable would necessarily be concurrent with the application of stabilization options by a resolution authority in Hong Kong.

- 3.8 While all AIs are within the scope of the resolution regime and may be subject to the application of stabilization options under the FIRO by the MA as the resolution authority upon meeting certain conditions, local application of stabilization options directly on an AI that is incorporated outside of Hong Kong may be more complex in practice. For instance, as non-Hong Kong incorporated AIs are not subject to regulatory capital requirements in Hong Kong, stabilization options which seek to recapitalise an AI in resolution may not be directly applicable to a non-Hong Kong incorporated AI, or at least not in the same manner compared to a Hong Kong incorporated AI.
- 3.9 In light of the above considerations, the MA believes a proportionate approach would be to focus the scoping of the Stay Rules on Hong Kong incorporated AIs and their Hong Kong incorporated holding companies.
- 3.10 Hong Kong incorporated affiliated operational entities (“AOEs”) are not proposed to be scoped in as covered entities under the Stay Rules (unless their obligations are guaranteed or otherwise supported by a Hong Kong incorporated AI or a Hong Kong incorporated holding company of such an AI¹⁷), although they may be subject to the direct application of stabilization options under the FIRO. This is considered a proportionate approach, given that the nature of an AOE’s operation should mean that it would unlikely be entering into significant volumes of financial contracts that fall within the scope of the Stay Rules.
- 3.11 In addition to scoping in the relevant contracts entered into by Hong Kong incorporated AIs and their Hong Kong incorporated holding companies, the MA also proposes scoping in the relevant contracts entered into by group companies of a Hong Kong incorporated AI, but only to the extent that the covered financial contracts entered into by the group companies contain obligations guaranteed or otherwise supported by the AI or its Hong Kong incorporated holding company. This proposal is designed to address

¹⁷ For details see paragraph 3.11 below.

termination risks that may impact Hong Kong incorporated AIs and their Hong Kong incorporated holding companies, the deterioration of whose financial conditions could potentially pose significant risks to the stability and effective working of the financial system of Hong Kong.

3.12 Where an AI's group company is incorporated in (or operates in) other jurisdictions, it may also be subject to the regulatory measures on contractual stays in those jurisdictions. However, it should be noted that this does not absolve the group company from compliance with the Stay Rules in Hong Kong. This is because the regulatory measures in each jurisdiction relate to resolution actions taken by the local resolution authority, just as the Stay Rules in Hong Kong are aimed at ensuring the effective enforcement of actions taken under the Hong Kong resolution regime.

Q1. Do you have any views on the scope of the covered entities to be subject to the Stay Rules?

Types of contracts to be covered by the Stay Rules

3.13 Regarding the types of contracts to be subject to the Stay rules, the MA proposes to limit the scope to only certain financial contracts, despite the applicability of the temporary stay power under the FIRO not being limited to financial contracts. This approach is in line with the FSB's commitment to prevent large-scale early termination of financial contracts¹⁸ and is in the interest of maintaining a level-playing field internationally¹⁹. It is proposed that a defined list of financial contracts that are considered to be most at risk of termination on a mass scale in resolution and therefore most likely to have repercussions on the stability and effective working of the financial system would be subject to the Stay Rules ("**covered financial contracts**").

¹⁸ See paragraph 2.8, and also Annex 2 of the FSB 2018 Resolution Report: "Keeping the pressure up", which lists temporary stays on early termination rights in financial contracts as one of its key priorities.

¹⁹ A number of jurisdictions limit their regulatory measures on contractual stays to financial contracts only, including Japan, Italy, Singapore, Switzerland, UK and US.

3.14 The covered financial contracts proposed to be subject to the Stay Rules are²⁰:

- A. securities contracts, including: (i) contracts for the purchase, sale or loan of a security, a group or index of securities; (ii) options on a security or group or index of securities; (iii) repurchase or reverse repurchase transactions on any such security, group or index;
- B. commodities contracts, including: (i) contracts for the purchase, sale or loan of a commodity or group or index of commodities for future delivery; (ii) options on a commodity or group or index of commodities; (iii) repurchase or reverse repurchase transactions on any such commodity, group or index;
- C. futures and forwards contracts, including contracts for the purchase, sale or transfer of a commodity or property of any other description, service, right or interest for a specified price at a future date;
- D. swap agreements, including: (i) swaps and options relating to interest rates; spot or other foreign exchange agreements; currency; an equity index or equity; a debt index or debt; commodity indexes or commodities; weather; emissions or inflation; (ii) total return, credit spread or credit swaps; (iii) any agreements or transactions that are similar to an agreement referred to in point (i) or (ii) which are the subject of recurrent dealing in the swaps or derivatives markets; and
- E. master agreements for any of the contracts or agreements referred to in points (A) to (D) above.

3.15 Regarding covered financial contracts entered into by group companies of a Hong Kong incorporated AI, as noted in paragraph 3.4, they are subject to the Stay Rules only to the extent that the contracts contain obligations that are guaranteed or otherwise supported by the Hong Kong incorporated AI or its Hong Kong incorporated holding company. In other words, covered financial contracts that are entered into by group companies of a Hong Kong incorporated AI but do not contain any obligations that are guaranteed or

²⁰ A similar list of financial contracts was originally considered in Annex III of the *Second Consultation Paper on An Effective Resolution Regime for Financial Institutions in Hong Kong* (21 January 2015), jointly published by the Financial Services and the Treasury Bureau, the HKMA, the Securities and Futures Commission and the Insurance Authority. The list mentioned above has been refined in formulating the proposals below based on international developments, with reference to the approaches taken or proposed to be taken in key jurisdictions including the European Banking Union, UK, US and Singapore.

otherwise supported by the AI or its Hong Kong incorporated holding company are not proposed to be included in the scope of the Stay Rules.

Q2. Do you have any views on the scope of the covered financial contracts to be subject to the Stay Rules? Should other types of contracts also be included in your view?

Rights to be bound by the Stay Rules

3.16 For consistency, the definition of termination rights under section 86 of the FIRO (as specified in paragraph 1.4 above) is proposed to be adopted in the Stay Rules. Adopting the same definition as section 86 of the FIRO will avoid any discrepancies in the scope of rights bound by the Stay Rules and those subject to section 90 of the FIRO. This will ensure that the same rights may be bound by the temporary stay provision for both Hong Kong law governed covered financial contracts and non-Hong Kong law governed covered financial contracts.

3.17 Furthermore, it should be noted that by operation of the temporary stay provision under the FIRO, only contracts where the obligations for payment and delivery and for provision of collateral continue to be performed²¹ will be bound by a resolution authority's imposition of a suspension of termination rights.

Counterparties to be excluded from the Stay Rules

3.18 In line with the exceptions under the temporary stay provision, the Stay Rules will exclude counterparties that are financial market infrastructures, including central counterparties.

3.19 In addition, the MA has considered whether to exclude from the Stay Rules any within scope contracts with a counterparty that is a central bank. In the interest of encouraging a level-playing field, the MA proposes not to exclude

²¹ Under section 90(2) of the FIRO, only qualifying contracts (under which the obligations for payment and delivery and for provision of collateral continue to be performed) may be subject to a temporary stay.

financial contracts with central banks as counterparties from the scope of the Stay Rules. The MA will consider industry feedback, if any, and also keep in view any future developments on an international level before finalising his position in this regard.

Q3. Do you have any views on the counterparties proposed to be excluded from the Stay Rules?

4 OPERATIONAL AND IMPLEMENTATION MATTERS

Operation of the Stay Rules

- 4.1 It is proposed that once in force, the Stay Rules would operate to expressly prohibit (i) the entry into new obligations under a within scope contract and (ii) any material amendments to any obligations under an existing within scope contract, unless the contract contains the appropriate contractual provisions in a legally enforceable manner, to the effect that the parties to the contract agree to be contractually bound by a temporary stay that may be imposed by the MA.
- 4.2 It is not proposed for the Stay Rules to have retrospective effect. In other words, existing obligations under a within scope contract that are already in place prior to the coming into force of the Stay Rules (“**pre-existing contract**”) may continue under its existing terms and conditions.
- 4.3 However, upon the expiry of a pre-existing contract that is within the scope of the Stay Rules, the contract may only be extended if the terms and conditions of the contract contain the appropriate provisions to the effect that the parties to the contract agree to be bound by a temporary stay imposed by the MA. If a counterparty refuses to accept terms and conditions to such an effect, the pre-existing contract may not be extended.
- 4.4 While a pre-existing contract may continue under its existing terms and conditions, it is proposed that the Stay Rules will prohibit any material amendment of a pre-existing contract that is within the scope of the Stay Rules. This prohibition is designed to prevent an AI from using a pre-existing contract to avoid compliance with the Stay Rules, for example, by materially altering the nature of an existing obligation or effectively creating a new obligation using a pre-existing contract with an existing counterparty. Accordingly, any amendments that may constitute a material alteration of an existing obligation, such as any amendments to a key commercial element in the pre-existing contract including a reference rate, underlying asset, payment date or mechanism, or a maturity date will be considered material. On the other hand, changes of a minor or administrative nature (such as addresses for

notices) would not be considered material.

Q4. Do you have any questions or comments on the above operational matters in relation to the Stay Rules?

Q5. Do you have any views on the proposed approach to 'material amendment'?

Implementation timetable

4.5 In the interest of maintaining a level playing field for the banking sector, all covered entities will be subject to the same implementation timetable. However, recognising that the requirements may not be met immediately as this will involve discussions with the relevant counterparties, and in view of the experiences of other jurisdictions that have implemented regulatory measures on contractual stays, the MA believes that it would be preferable to phase in the implementation of the Stay Rules by counterparty types. The proposed transitional timetable is as follows:

- (i) for counterparties that are AIs, other foreign banks, and entities that are part of a G-SIB group, 18 months from the date of the coming into force of the Stay Rules; and
- (ii) for all other counterparties (for the avoidance of doubt, including central banks and except for excluded counterparties mentioned in paragraph 3.18 above), 30 months from the date of the coming into force of the Stay Rules.

4.6 The longer transitional timetable proposed for counterparties other than AIs, other foreign banks, and entities that are part of a G-SIB group is primarily due to the consideration that non-bank counterparties may, on the whole, be less familiar with the policy rationale for and the requirements under the Stay Rules, and may hence require more time of the covered entities subject to the Stay Rules to negotiate the necessary amendments to the relevant contracts in order to comply with the Stay Rules.

Q6. Do you agree with phasing in the implementation of the Stay Rules by counterparty types?

Expectations on AIs' internal capabilities to support resolvability

- 4.7 To support resolvability, an AI will need to make sure it has adequate internal system capabilities to maintain detailed record of relevant financial contracts entered into (or guaranteed or otherwise supported), as well as to catalog and present information on relevant contracts in a flexible and timely manner.
- 4.8 Given the importance of these capabilities for contingency planning²² as well as ensuring effective application of temporary stay in a resolution, the lack of sufficient capabilities of an AI in this regard may constitute a significant impediment to orderly resolution in the opinion of the MA. Under section 14 of the FIRO, if the MA is of the opinion that significant impediments exist to the orderly resolution of the AI in accordance with its resolution plan (developed to support the preferred resolution strategy), then the MA may direct the AI to take actions that are considered reasonably required to remove or mitigate the effect of any significant impediments to orderly resolution.²³
- 4.9 It is important to note that these capabilities will need to be established well in advance of any foreseeable resolution and be embedded in the AI's business-as-usual trade processes. Such capabilities would also facilitate an AI in demonstrating its compliance with the Stay Rules and its resolvability status more broadly.

Periodic reporting and information requests in relation to the Stay Rules

- 4.10 The MA, as a resolution authority, has a broad information gathering power

²² Contingency planning refers to the stage at which actions are taken by the authorities to establish a state of readiness to be able to resolve an AI in an orderly manner, as the AI's proximity to failure increases. See paragraph 1.3 in the FIRO Code of Practice chapter published by the MA, RA-2.

²³ The FIRO also provides AIs with a specific safeguard concerning a resolution authority's power to direct removal of impediments to orderly resolution. See section 15, section 17 and Part 7 of the FIRO as well as Part 6 of the FIRO Code of Practice Chapter published by the MA, RA-2 for details.

under section 158 of the FIRO. To assist the MA's work in monitoring compliance and implementation of the Stay Rules, the MA intends to request periodic reporting from Hong Kong incorporated AIs and their Hong Kong incorporated holding companies in relation to their compliance with the Stay Rules under section 158 of the FIRO²⁴. This will enable the MA to monitor the extent to which requirements are being met and, in the case of any within scope contracts that do not contain the required contractual provisions, keep track of the steps being taken to ensure compliance where required under the Stay Rules.

- 4.11 In addition, under section 158 of the FIRO, the MA may request further details on specific cases in the course of the bilateral resolution planning work programme between the MA and an AI on an ad-hoc basis. For example, where the AI experiences compliance difficulties with particular contracts or counterparties, the MA may request the details of those trades and counterparties with a view to working with the AI to remove impediments to resolvability in this regard.
- 4.12 In the course of the bilateral resolution planning work programme between the MA and an AI, the MA may also request sight of legal opinions as evidence of enforceability, if and when a particular case warrants, for example, to obtain assurance from the AI on the legal enforceability of the contractual provisions, or to assist contingency planning. However, the MA does not intend to routinely perform due diligence on the legal enforceability or the effectiveness of the contractual provisions for effecting suspension of termination rights, as the onus is on the AI to ensure its compliance with the Stay Rules.
- 4.13 As for the periodic reporting in relation to the Stay Rules mentioned in paragraph 4.10, an AI and, where applicable, its holding company are expected to have a clear understanding of the contracts entered into by (as well as those entered into by their group companies and are guaranteed or otherwise supported by) them, including the status of compliance with the Stay Rules on an aggregate basis at an entity level, for each of the covered entities in the AI's group. At a minimum, the AI should be capable of readily producing periodic snapshots for the covered entities within its group under the following broad

²⁴ Any failure to comply with section 158 of the FIRO is an offence under section 159 of the FIRO.

categories: (a) covered financial contracts of Hong Kong incorporated AIs and their Hong Kong incorporated holding companies that are assessed to be out of the scope of the Stay Rules (including, for the avoidance of doubt, pre-existing covered financial contracts); (b) compliant within scope contracts; and (c) non-compliant within scope contracts (for the avoidance of doubt, not including pre-existing covered financial contracts).

- 4.14 In order to have an overall understanding of early termination risks in relation to covered financial contracts, the MA considers it important to capture category (a) in the above paragraph for periodic reporting purposes despite the contracts under that category not falling within the proposed scope of the Stay Rules. This is in recognition of the fact that the Stay Rules, even when fully implemented and complied with by an AI, may not (and are not designed to) fully eliminate the risk of disorderly early termination of financial contracts. The MA considers it important for the AI to have an overall understanding of the early termination risks that may arise in a wider range of financial contracts not covered by the Stay Rules and the implications of such risks for a resolution.
- 4.15 The MA envisages the periodic reporting on compliance and implementation to be conducted on an aggregate basis at an entity level, for each of the covered entities subject to the Stay Rules. For each of the three broad categories of contracts described in paragraph 4.13, an AI is expected to possess sufficient data and reporting capabilities to report status flexibly at an entity level (i.e. at the level of the AI, the Hong Kong incorporated holding company, as well as any other group companies that are subject to the Stay Rules), according to the key features of the contracts. Such key features of the contracts may include, but are not limited to, governing law, covered financial contract type, details of the termination right provisions (e.g. details of the termination rights and triggers), counterparty type, counterparty jurisdiction of incorporation, mark-to-market value and notional amounts by number of trades and agreements.
- 4.16 In future, the MA will consider the merits of developing reporting templates to facilitate the monitoring of compliance with the Stay Rules and requiring submission of the templates by Hong Kong incorporated AIs and their Hong Kong incorporated holding companies on a periodic basis. In line with usual

practice, to the extent that reporting templates are to be developed, the MA will consult the industry on the templates before they are finalised.

Q7. Do you have any views on the expectations on AIs' internal capabilities to support resolvability and the effective application of temporary stay in a resolution?

Q8. Do you have any views on the periodic reporting and information requests in relation to the Stay Rules?

5 NEXT STEPS

- 5.1 The MA will consider submissions in response to this consultation and refine the proposals as appropriate. The current intention is to introduce the Stay Rules into the Legislative Council for negative vetting in the 2020/2021 Legislative Session.
- 5.2 The MA intends to engage closely with relevant stakeholders, including market participants, industry associations and professional firms, in the process of developing the Stay Rules. In particular, the MA understands that there have been significant industry efforts to provide a coordinated response to mitigate the risks of early termination of certain financial contracts in resolution through standardised industry documentation, including the ISDA 2015 Universal Resolution Stay Protocol (**ISDA UP**) and Country Annexes, and the ISDA Resolution Stay Jurisdictional Modular Protocol (**ISDA JMP**) and Jurisdictional Modules. The International Swaps and Derivatives Association, Inc. (**ISDA**) published a Hong Kong Country Annex to the ISDA UP in December 2017.
- 5.3 In support of these industry efforts, the MA intends to liaise with ISDA closely with a view to putting in place an ISDA Jurisdictional Module for Hong Kong in due course, which should assist the entities subject to the Stay Rules and their counterparties to comply with the Stay Rules in a consistent and efficient manner.
- 5.4 Over the course of developing the policy proposals set out in this paper, the MA has also been considering whether there may be merit to requiring inclusion of contractual provisions to give effect to not only the temporary stay provision, but also the ongoing stay provision, subject to appropriate amendments being made to the empowering provision in section 92 of the FIRO. Covering both temporary stay and ongoing stay provisions would enable Hong Kong law governed contracts and non-Hong Kong law governed contracts to be more equally bound by the full set of statutory stay provisions under the FIRO, which could contribute to a level-playing field for the banking sector as well as their counterparties at both domestic and international levels. This approach also seems more fully in line with the approach taken in a

number of jurisdictions²⁵. The MA welcomes feedback from respondents on this matter, although it should be noted that this does not form part of the proposals for the Stay Rules to be made within the timing envisaged under paragraph 5.1.

Q9. Do you have any views on potentially extending the coverage of the Stay Rules so that relevant contracts may be bound by the ongoing stay provision, in addition to the temporary stay provision?

²⁵ Examples of jurisdictions that have required or proposed contractual clauses to cover their temporary stay provision as well as ongoing stay provision include the UK and Singapore.

ANNEX: CONSULTATION QUESTIONS

Q1. Do you have any views on the scope of the covered entities to be subject to the Stay Rules?

Q2. Do you have any views on the scope of the covered financial contracts to be subject to the Stay Rules? Should other types of contacts also be included in your view?

Q3. Do you have any views on the counterparties proposed to be excluded from the Stay Rules?

Q4. Do you have any questions or comments on the above operational matters in relation to the Stay Rules?

Q5. Do you have any views on the proposed approach to 'material amendment'?

Q6. Do you agree with phasing in the implementation of the Stay Rules by counterparty types?

Q7. Do you have any views on the expectations on AIs' internal capabilities to support resolvability and the effective application of temporary stay in a resolution?

Q8. Do you have any views on the periodic reporting and information requests in relation to the Stay Rules?

Q9. Do you have any views on potentially extending the coverage of the Stay Rules so that relevant contracts may be bound by the ongoing stay provision, in addition to the temporary stay provision?