

# **Frequently asked questions: An Effective Resolution Regime for Financial Institutions in Hong Kong**

## **Context**

### **Q1. Why is the Government proposing to establish a resolution regime for financial institutions in Hong Kong?**

**A1.** During the global financial crisis, jurisdictions around the world intervened with unprecedented amounts of public money to rescue certain failing financial institutions (FIs).<sup>1</sup> These FIs were considered to be systemically important or “Too-Big-To-Fail” (TBTF); meaning that their entry into normal insolvency proceedings would have had dire consequences for financial stability, the real economy and society in general (for the reasons outlined below in A4). The rescue of these FIs resulted in taxpayers being called upon to subsidise their shareholders and creditors; something which is undesirable including because it weakens market discipline making future failures and crises more likely. Post-crisis a consensus has emerged on the importance of providing robust alternatives by establishing “resolution regimes” which can be used to resolve FIs safely, without severe systemic disruption whilst protecting public funds, restoring market dynamics and limiting moral hazard. This consensus has resulted in the Financial Stability Board (FSB) setting new international standards for resolution regimes, which all FSB member jurisdictions are required to meet.<sup>2</sup>

### **Q2. Why is the Government making these proposals now?**

**A2.** Following the global financial crisis, Group of Twenty leaders tasked the FSB with addressing the TBTF problem. In turn the FSB proposed a series of policies designed to reduce not only the probability of FIs failing but also the impact if they did. Central to these policies are new international standards set out in the FSB’s “Key Attributes of Effective Resolution Regimes for Financial Institutions” (or “Key Attributes”) which

---

<sup>1</sup> An FI is defined as “any entity the principal business of which is the provision of financial services or the conduct of financial activities, including, but not limited to, banks, insurers, securities or investment firms and financial market infrastructure firms” (this definition is drawn from the FSB (August 2013) “Consultative Document: Assessment Methodology for the Key Attributes of Effective Resolution Regimes for Financial Institutions”, [https://www.financialstabilityboard.org/publications/r\\_130828.pdf](https://www.financialstabilityboard.org/publications/r_130828.pdf)).

<sup>2</sup> The FSB was established to coordinate at the international level the work of national financial authorities and international standard setting bodies and to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies.

were finalized in late 2011.<sup>3</sup> As an international finance centre and FSB member jurisdiction, Hong Kong is expected to take the steps necessary to meet these standards and do so, if possible, by an end-2015 deadline set by the FSB.

All FSB member jurisdictions have assessed themselves against the standards set out in the Key Attributes to identify any gaps between what is required and what existing laws provide for. The FSB drew on these assessments to carry out a peer review of resolution regimes.<sup>4</sup> This review found that nearly all member jurisdictions, including Hong Kong, would need to undertake legislative reform in order to fully meet the standards set out in the Key Attributes. In a recent progress report, the FSB noted that some member jurisdictions have subsequently secured, or made considerable progress toward securing, the legislative change needed to fill gaps identified.<sup>5</sup> The Government considers that legislative reform is needed in Hong Kong with a view to implementing the Key Attributes in line with the FSB's end-2015 deadline.

**Q3. How do the new standards for resolution fit with other international reform initiatives being pursued following the global financial crisis?**

**A3.** Some post-crisis reforms focus on reducing the probability that FIs, particularly those that are systemically important, get into difficulties. The enhanced liquidity and capital requirements set for banks under the Basel III framework are an example of such reforms. Complementary reforms, and the standards set under the Key Attributes in particular, seek to reduce the impact in the unlikely event that an FI becomes non-viable, by ensuring that it can be resolved safely.

**Q4. Why are normal insolvency proceedings unsuitable for dealing with FIs that are systemically important or TBTF?**

**A4.** Some FIs provide financial services that are relied upon to a significant degree by large numbers of individuals and companies in going about their daily activities (these financial services can be considered to be “critical financial services”). For example, banks provide services which allow individuals and companies to make and receive

---

<sup>3</sup> FSB (2011) “Key Attributes of Effective Resolution Regimes for Financial Institutions”, [http://www.financialstabilityboard.org/publications/r\\_111104cc.pdf](http://www.financialstabilityboard.org/publications/r_111104cc.pdf)

<sup>4</sup> FSB (April 2013) “Thematic Review on Resolution Regimes: Peer Review Report”, [http://www.financialstabilityboard.org/publications/r\\_130411a.pdf](http://www.financialstabilityboard.org/publications/r_130411a.pdf)

<sup>5</sup> FSB (September 2013) “Progress and Next Steps Towards Ending “Too-Big-To-Fail” (TBTF): Report of the Financial Stability Board to the G-20”, [http://www.financialstabilityboard.org/publications/r\\_130902.pdf](http://www.financialstabilityboard.org/publications/r_130902.pdf)

payments, but if a bank enters liquidation it will typically close for business and the provision of such services will suddenly end. Clearly this could cause hardship for individuals relying on the bank to receive income (including salaries) and to make payments for day-to-day living expenses, because access to their funds and accounts would be blocked.<sup>6</sup> Similarly companies with accounts at that bank would struggle to pay salaries and to purchase or receive payment for goods and services. Where affected parties run into the hundreds of thousands or millions, and taking into account the other types of critical financial services provided, overall consumption, investment and the real economy may suffer.

In addition to the effect that a sudden withdrawal of critical financial services may have, the entry of an FI into liquidation has the potential to cause general financial instability because it creates a risk of contagion to other parts of the financial system. In some cases, the failure of one FI could affect others in a “domino effect”, as it could result in the liquidity and capital positions of other FIs coming under pressure, due to a number of direct and indirect channels of contagion.

Resolution regimes are designed to contain these risks and provide for a series of powers for public authorities to intervene when an FI gets into difficulties to secure continuity for that failing FI’s critical financial services and contain the wider risks posed to financial stability. At the same time, resolution powers are structured in such a way so as to ensure that the costs of failure continue are met by the shareholders and creditors of a failed FI, as would have been the case in liquidation, rather than through reliance on use of public funds.

**Q5. Do the regulatory authorities in Hong Kong already have powers to deal with failing FIs?**

**A5.** In Hong Kong, FIs are regulated by different regulatory authorities depending on the types of activities they perform and their legal status. Under their respective ordinances, each of the regulatory authorities (the Monetary Authority (MA), Securities and Futures Commission (SFC) and Insurance Authority (IA)), can use a set of existing supervisory intervention powers in the event that an FI suffers a serious deterioration in its condition. The Government and the regulators assess, however, that not all of the

---

<sup>6</sup> In many jurisdictions, including Hong Kong, deposit protection schemes provide a measure of protection in such cases by compensating eligible depositors in relation to covered deposits (to a specified limit). See Footnote 12 for further details.

powers now considered to be necessary to carry out resolution to secure the continuity of critical financial services and protect financial stability are currently available. The FSB reached a similar conclusion in the peer review exercise referred to in A2.

**Q6. Hong Kong was not significantly adversely affected by the global financial crisis; so why is a resolution regime needed here?**

**A6.** The recent global financial crisis was felt much less acutely across Asia, as compared with the United States and the European Union, although jurisdictions in the region, including Hong Kong, have had their own crises in the past. Hong Kong experienced a moderate systemic crisis in the mid-1980s, for example, with public money being used to rescue a number of local FIs.<sup>7</sup> The Government therefore considers it prudent to learn from the recent experience of other jurisdictions and to actively improve the resilience of the financial system by establishing a resolution regime, even if it is likely to be called on very infrequently. Without a resolution regime, and in the unlikely event that a systemically important or TBTF FI were to get into difficulties, the authorities would be left with an uncomfortable choice between liquidation, with its negative consequences for financial stability, the economy and wider society, and publicly-funded rescue.

**Proposals**

**Q7. Which FIs will the resolution regime apply to?**

**A7.** The Key Attributes say that any FI “which could be systemically significant or critical if it fails” should be within the scope of an effective resolution regime. It is proposed, therefore, that the regime in Hong Kong should apply to all authorized institutions (AIs) and certain financial market infrastructures (FMIs),<sup>8</sup> licensed corporations (LCs) and insurers based on an assessment of the risks that could be posed to the continuity of critical financial services and financial stability by the entry of FIs

---

<sup>7</sup> Between 1983 and 1986, three banks were taken over by the Government temporarily and financial assistance was provided to facilitate private takeovers of four others. In 1987, following the global stock market crash, very substantial defaults by futures brokers led to a rescue of the Hong Kong futures market and clearing house with use of both public and private funds.

<sup>8</sup> An FMI is defined as a “multilateral system among participating institutions, including the operator of the system, used for the purposes of clearing, settling or recording payments, securities, derivatives, or other financial transactions”. This definition is drawn from the Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organization of Securities Commissions (IOSCO) “Principles for Financial Market Infrastructures” published in April 2012, <http://www.bis.org/publ/cpss101a.pdf>

in these sectors into liquidation. Whilst the primary concern may be the risks posed locally, the Government also considers that fully implementing the Key Attributes may imply that the scope of the local regime should extend to those FIs in Hong Kong that are part of financial services groups operating cross-border and which could be critical or systemic in other jurisdictions.

In line with practice in a series of jurisdictions, it is proposed that the regime would apply to all AIs and that an assessment would be made if any got into difficulties on whether the risks posed justify use of the regime as an alternative to liquidation. Setting scope so it extends to all banks is an approach widely adopted elsewhere because whilst it is apparent that some large banks are likely to be critical and systemic in all eventualities, the risks posed by medium- and small-sized banks are somewhat state contingent. This is because the failure of even a relatively small bank can pose systemic risk through contagion in stressed conditions when confidence in the banking system is low.

It is proposed that the scope of the regime should also extend to FMIs designated under the Clearing and Settlement Systems Ordinance and clearing houses recognized under the Securities and Futures Ordinance in light of their critical role in supporting payments, clearing and settlement in the Hong Kong markets. This accords with guidance on implementation of the Key Attributes which clarifies that “[t]he presumption is that all FMIs are systemically important or critical, at least in the jurisdictions where they are located”.<sup>9</sup>

Additionally it is proposed that the scope of the regime should extend to certain LCs and insurers in line with an assessment of the risks they would pose on failure, including where they are part of wider financial services groups which could themselves pose risks cross-border.

#### **Q8. When will the authorities use the resolution regime?**

**A8.** Resolution will be a last resort. It is proposed that the regime will be used where an FI, which is assessed to no longer meet the minimum regulatory requirements to which it is subject, has exhausted all potential recovery options and its non-viability

---

<sup>9</sup> FSB (August 2013) “Application of the Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions, Consultative Document”, [https://www.financialstabilityboard.org/publications/r\\_130812a.pdf](https://www.financialstabilityboard.org/publications/r_130812a.pdf)

poses a threat to continuity of critical financial services and financial stability (meaning that its entry into liquidation would be unsuitable for the reasons outlined in A4).

To secure orderly resolution the resolution authority will need to be able to intervene promptly, and ahead of the triggers normally set for insolvency, to maintain confidence in the financial system and prevent unnecessary value destruction. As considered below in A16, it may also be appropriate to set conditions allowing for the resolution authority in Hong Kong to support the resolution of FIs that are part of wider cross-border financial groups which a home authority intends to resolve.<sup>10</sup>

### **Q9. What will be the objectives of resolution?**

**A9.** It is proposed that in deciding whether and how to carry out resolution, the resolution authority will be guided by three resolution objectives. These require that resolution of an FI should seek to: (i) secure continuity of critical financial services, and payment, clearing and settlement functions, as well as the stability and effective functioning of the financial system ; (ii) afford an appropriate degree of protection to depositors, investors with client assets<sup>11</sup> and insurance policyholders; and (iii) subject to pursuing these first two objectives, to contain the costs of resolution and, in so doing, protect public funds. The first objective recognises the importance of ensuring that critical financial services are not suddenly withdrawn as well as of containing the potential for contagion. The second objective recognises that resolution should provide outcomes for depositors, investors and insurance policyholders that are at least equal to those already afforded to them when FIs enter liquidation (including under protection schemes covering deposits, client assets and insurance contracts<sup>12</sup>). The third objective recognises that subject to securing these first two objectives, any steps which can be taken to reduce the costs of resolution will benefit all parties who may be otherwise called on upon to meet them.

---

<sup>10</sup> A home jurisdiction is where the operations of a financial firm or, in the case of a G-SIFI, its global operations, are supervised on a consolidated basis.

<sup>11</sup> In other words, a client of an intermediary who has monies, securities and financial instruments entrusted to or held by the intermediary on behalf of the client.

<sup>12</sup> Under the Deposit Protection Scheme Ordinance (Cap. 581), covered depositors are protected, in the event that a licensed bank fails, up to a limit currently set at HKD500,000 per depositor per scheme member. The Investor Compensation Fund (ICF) exists to provide compensation to qualifying investors who sustain a loss in relation to specified securities or futures contracts or related assets as a result of a default by an intermediary up to a limit of HKD150,000 per investor. There are presently two insolvency funds for non-life statutory insurance policies covering motor vehicle third party claims and employees' work-related injuries. The Government recently set out its proposals for establishing a Policyholders' Protection Fund (PPF) and the associated legislative process is underway.

**Q10. Who will be responsible for using the resolution regime?**

**A10.** It is proposed that each of the regulators, the MA, SFC and IA, be designated as resolution authority responsible for exercising the resolution powers available under the regime in relation to the FIs they regulate. Discharging a resolution function is consistent with the existing mandates of the regulators given these reflect a need to seek to secure a measure of protection for certain parties (depositors, investors and insurance policyholders) as well as the stability and effective working of parts, or all, of the financial system. Furthermore, the powers to be made available under the regime can be seen as filling gaps identified in each regulator’s existing supervisory intervention powers; leaving them better placed to contain the risks posed should any individual FI become non-viable.

As noted in the consultation paper, the proposed approach implies a need for a lead resolution authority to co-ordinate resolution where a failing FI operates across multiple sectors of the local financial system. Further details on how best to provide for this type of arrangement will be set out in a second stage consultation in 2014 (if a decision is taken to designate the sectoral regulators as resolution authorities).

**Q11. What resolution powers will be included under the proposals?**

**A11.** In order for the resolution regime to deal effectively with different types of FIs which become non-viable under differing circumstances, the Key Attributes say that it is necessary to provide a menu of resolution options which allow a resolution authority to step in and take speedy decisive action to stabilize, and restructure, an entire FI or key parts of its business. These options would allow for continuity of the critical financial services provided by an FI to be secured in resolution through:

- (i) the compulsory transfer of ownership of a failing FI, or of some or all of its business, to another FI willing and able to make such an acquisition, or in cases where this cannot be achieved immediately, through temporary use of a “bridge institution” controlled by the authorities; or
- (ii) an officially-mandated creditor-financed recapitalization or bail-in that restores the viability of a failing FI.

The options described under (i) are ones which have long been available in a handful of jurisdictions (most notably the US) and were used successfully before and during the recent crisis; whilst bail-in has been developed more recently to better ensure that

resolution of the largest and most complex FIs is possible. In line with the new standards, and reforms being undertaken in other key financial centres, it is proposed that the resolution regime in Hong Kong should provide for the full menu of resolution options set out in the Key Attributes. The consultation paper also considers the merits of ensuring that, as a last resort, it is possible to take a failing FI into temporary public ownership. It proposes that, on balance, this should be possible but only as a last resort where the threat to financial stability is severe and where it is assessed that the other resolution options cannot be used to safely resolve an FI.

**Q12. What protections will be provided for depositors, investors and policyholders under the resolution regime?**

**A12.** Resolution is likely to better protect a broad set of stakeholders, including depositors, investors and policyholders, as compared with liquidation since it implies that some or all of the business of a failing FI's subject to the regime will be stabilised, restructured and continued. As such resolution should deliver an outcome where some or all depositors and investors with client assets at a failing FI have close to uninterrupted access to their accounts, funds and assets. (As noted in A4 such access would be suspended (or in some cases, be delayed) in liquidation). Similarly, resolution may secure continuity of cover for some or all insurance policyholders.

Furthermore, the second objective proposed for resolution (see A9) implies that the resolution authority is required to seek outcomes for these stakeholders that are at least equal to those that they would have received under in liquidation including given any statutory protections already provided for.

**Q13. What protections will the resolution regime offer to other creditors?**

**A13.** As securing orderly resolution requires that action be taken quickly and decisively, resolution regimes inevitably empower resolution authorities to act in a manner that can affect contractual and property rights as well as the payment that shareholders and creditors receive in resolution. This creates a clear need for checks and balances, both to safeguard the position of those affected by resolution as well as to reduce, to the extent possible, uncertainty about the outcomes that resolution will deliver.

It is noted that resolution may be less value-destructive than liquidation because some or all of a failing FI's activities are continued; indeed in some cases all parties may be better off under resolution than would have been the case in liquidation. Even so, the consultation paper includes a series of safeguards which are relevant to all creditors including that in using the regime, the resolution authority should seek to impose losses in a manner that broadly respects the creditor hierarchy that would apply in liquidation.



This implies that, as in liquidation, losses would fall on shareholders initially and that no losses would be imposed on senior debt holders until subordinated debt (including all regulatory capital instruments) has been written-off. Furthermore that any preferences provided for in liquidation should be upheld and that secured creditors should retain the benefit of their security.

It is also proposed, in line with the Key Attributes and practice elsewhere, that a mechanism to compensate creditors for any losses they might suffer over-and-above those they might have sustained in liquidation, should be provided. This is known as a “no creditor worse off than in liquidation” safeguard and how best to implement this proposal will be given further consideration and additional detail will be set out in the second stage consultation in 2014.

**Q14. How will resolution be funded?**

**A14.** An important motivation for establishing a resolution regime is that it should support the orderly resolution of FIs in a manner which protects public funds. This implies that as in liquidation, the costs of an FI’s failure should be borne by its shareholders and its various creditors (broadly in line with the established creditor hierarchy). As noted in A13, under the regime shareholders and creditors will be required to contribute to the costs of resolution up to the point they would have done so in liquidation. In the unlikely event that the costs of resolution exceed this amount, the Key Attributes say that they should be met by the wider financial system rather than by public funds (by establishing either a resolution fund and/or mechanism for ex post levies). The consultation paper outlines these funding options and this aspect of the regime will be further considered ahead of the second stage consultation.

**Q15. What is the importance of the resolution regime in relation to cross-border FIs?**

**A15.** As demonstrated during the financial crisis, the orderly resolution of systemically important cross-border FIs in a manner which protects financial stability across the various jurisdictions affected poses a significant challenge. Many jurisdictions lacked resolution regimes with the scope or powers needed to resolve large and complex FIs and too little time had been spent considering whether and how home and key host authorities could coordinate and cooperate in deploying their respective powers to stabilize the constituent parts of a cross-border group.<sup>13</sup> When cross-border FIs got into difficulties, public authorities in home jurisdictions found themselves rescuing the

---

<sup>13</sup> A home jurisdiction is where the operations of a financial firm or, in the case of a G-SIFI, its global operations, are supervised on a consolidated basis. A host jurisdiction is one where a cross-border FI has a presence either as a locally-incorporated subsidiary or as a branch.

entire global group (via costly bailouts with public funds); or acted to stabilise only the local operations, regardless of the effect on financial stability in host jurisdictions. The Key Attributes seek to provide for better outcomes if a cross-border FI becomes non-viable, including by ensuring that all home and key host jurisdictions adopt consistent resolution regimes and by securing enhanced coordination and cooperation in their deployment. It is important that, Hong Kong, as a major international finance centre which hosts the operations of a large number of systemically important cross-border FIs,<sup>14</sup> secures the necessary powers to support cross-border resolution.

**Q16. How might the resolution regime in Hong Kong support orderly resolution of a cross-border FI?**

**A16.** The Key Attributes reflect that a coordinated and cooperative approach to resolution of cross-border FIs has the potential to better protect financial stability and public funds across home and host jurisdictions. Work being carried out internationally to identify and agree approaches to the resolution of global systemically important banks, in particular, indicates that in a number of cases the most effective way of stabilising and securing continuity of their critical financial services could be a group-wide resolution carried out by the home jurisdiction (and supported by key host jurisdictions), for example. Such an approach could have the added benefit of reducing incentives for home and host jurisdictions to pre-emptively require that cross-border FIs make costly changes otherwise needed to insulate operations in each jurisdiction from shocks elsewhere in the group and to ensure that they can be independently resolved.

On these grounds, the consultation paper suggests that it may be appropriate to allow for use of the resolution regime in relation to the Hong Kong operations of a cross-border FI to recognise and give effect to resolution by a home resolution authority, conditional on an assessment that the outcomes delivered are consistent with the objectives set for resolution in Hong Kong and do not disadvantage local creditors. Where these conditions are not met, the resolution authority in Hong Kong would retain the flexibility to use the powers available under the local regime to carry out resolution of local entities independently.

---

<sup>14</sup> The FSB is conducting work with sectoral standard setters to identify global systemically important financial institutions. For the banking sector, 28 out of 29 global systemically important banks identified have operations in Hong Kong. For the insurance sector, 8 out of 9 global systemically important insurers have operations in Hong Kong. See FSB (November 2013) “2013 update of groups of global systemically important banks (G-SIBs)”, [http://www.financialstabilityboard.org/publications/r\\_131111.pdf](http://www.financialstabilityboard.org/publications/r_131111.pdf) and FSB (July 2013) “Global systemically important insurers (G-SIIs) and the policy measures that will apply to them”, [http://www.financialstabilityboard.org/publications/r\\_130718.pdf](http://www.financialstabilityboard.org/publications/r_130718.pdf)

**Q17. How do the proposals for Hong Kong compare with reforms being undertaken in other FSB jurisdictions?**

**A17.** The FSB expects all member jurisdictions to undertake the necessary legislative reform to provide for an effective resolution regime meeting the standards set out in the Key Attributes by end-2015. The FSB has concluded that substantive progress is being made in implementing the Key Attributes across a number of member jurisdictions, including Australia, Germany, France, Japan, Netherlands, Spain, Switzerland, the United Kingdom (UK) and the United States (US).<sup>15</sup> It was also noted that the EU's Recovery and Resolution Directive, which will likely be finalised in early 2014, will be an important step towards implementation of the Key Attributes in EU Member countries (including the six which are also members of the FSB). The proposals for implementation of the Key Attributes in Hong Kong are informed by the approach taken across other FSB member jurisdictions adapted for local circumstances.

**Next steps**

**Q18. What will follow from this initial consultation?**

**A18.** This first stage public consultation will run until 6 April 2014. Following consideration of submissions received, it is anticipated that a second stage public consultation will follow in 2014. Subject to the results of these consultation exercises, and in order to meet the implementation deadline set by the FSB, legislative proposals would need to be introduced into the Legislative Committee during 2015.

**Q19. How can I submit my views on the proposals set out in this consultation?**

**A19.** The Government welcomes written comments on the concepts and proposals set out in this consultation paper, on or before 6 April 2014 through any of the following means:

Mail: Resolution Regime Consultation  
Financial Services Branch  
Financial Services and the Treasury Bureau  
24/F, Central Government Offices  
2 Tim Mei Avenue, Tamar, Hong Kong

Fax: +852 2856 0922

Email: resolution@fstb.gov.hk

---

<sup>15</sup> FSB (September 2013) "Progress and Next Steps Towards Ending "Too-Big-To-Fail" (TBTF): Report of the Financial Stability Board to the G-20", [http://www.financialstabilityboard.org/publications/r\\_130902.pdf](http://www.financialstabilityboard.org/publications/r_130902.pdf)