

Establishing an effective resolution regime for financial institutions in Hong Kong

by the Banking Policy Department

As discussed in an earlier issue of the HKMA Quarterly Bulletin¹, the Financial Stability Board (FSB) issued a set of Key Attributes of Effective Resolution Regimes for Financial Institutions (Key Attributes)² in 2011 which were designed to make the orderly resolution of financial institutions both feasible and credible, and thereby address the “too big to fail” phenomenon observed in the global financial crisis that began in 2007. The Key Attributes, which were reissued in 2014, are now the international standard for resolution regimes worldwide and it is incumbent upon all FSB member jurisdictions, including Hong Kong, to adopt them with a view to enhancing the resilience of the financial system and Hong Kong’s role as an international financial centre. Recently, a Financial Institutions (Resolution) Bill (FIRB) was introduced into the Legislative Council³ in Hong Kong for this purpose. This article provides an overview of some of the key proposals in FIRB and explains how they relate to the Key Attributes.

What is resolution and what does it seek to achieve?

Resolution is an administrative process by which operationally independent resolution authorities can intervene, using the powers available under the resolution regime, to manage the failure of a financial institution in circumstances where such failure could have adverse systemic consequences. Resolution differs from existing insolvency procedures in that it is designed to preserve continuity of critical financial functions and avoid their abrupt termination whilst still imposing the costs of failure on shareholders and creditors of a financial institution.

Each resolution authority in Hong Kong⁴, in performing its functions, will be obliged to have regard to the resolution objectives specified in FIRB. These are:

- (a) to promote, and seek to maintain, the stability and effective working of the financial system of Hong Kong, including the continued performance of critical financial functions;
- (b) to seek to protect deposits or insurance policies of a within-scope financial institution to no less an extent than they would be protected on a winding-up of the financial institution;

¹ See “New international standards on effective resolution regimes for financial institutions”, feature article, HKMA Quarterly Bulletin, September 2013. The article describes the standards for effective resolution regimes drawn up by the Financial Stability Board.

² See “Key Attributes of Effective Resolution Regimes for Financial Institutions”, Financial Stability Board, reissued in October 2014.

³ See “Financial Institutions (Resolution) Bill”, Legislative Council website: <http://www.legco.gov.hk/yr15-16/english/bc/bc05/general/bc05.htm>

⁴ It is proposed that the Hong Kong Monetary Authority (HKMA), the Insurance Authority (IA) and the Securities and Futures Commission (SFC) would be designated as resolution authorities in Hong Kong for those institutions within the scope of the resolution regime which fall within their respective purviews. See section under “Role of the resolution authorities in Hong Kong” for further details on the authorities’ respective responsibilities.

- (c) to seek to protect client assets of a within-scope financial institution to no less an extent than they would be protected on a winding-up of the financial institution; and
- (d) subject to (a), (b) and (c), to seek to contain the costs of resolution and, in doing so, protect public money.

In deciding whether to initiate resolution, the resolution authority may also take into account the potential effect of the decision on any other entities within the same group as the failing financial institution and on the stability and effective working of the financial system of any other jurisdiction.

These objectives reflect those set out in paragraph 2.3 of the Key Attributes, whilst at the same time introducing some degree of priority for the objects of maintaining financial stability and protecting certain stakeholders who would be afforded a measure of protection on insolvency in any event.

Scope

According to the Key Attributes, any financial institution that “could be systemically significant or critical if it fails”⁵ should be within the scope of an effective resolution regime. In the context of Hong Kong, this has resulted in the bringing into scope of: all authorized institutions (licensed banks, restricted licence banks and deposit-taking companies) under the Banking Ordinance; licensed corporations under the Securities and Futures Ordinance that are designated by the FSB as non-bank non-insurance global systemically important financial institutions (NBNI G-SIFs) or are subsidiaries or branches of G-SIFs⁶; authorized insurers under the Insurance Companies Ordinance that are global systemically important insurers (G-SIIs), or are subsidiaries or branches of G-SIIs operating in Hong Kong; settlement institutions and system operators of all clearing and settlement systems designated by the Monetary Authority under the Payment Systems and Stored Value Facilities Ordinance⁷ or recognized as clearing houses under the Securities and Futures Ordinance; and any recognized exchange companies (e.g. stock exchanges) that are considered systemically important domestically and are specifically designated by the Financial Secretary (upon the recommendation of the SFC) as falling within the scope of the regime.

⁵ Key Attributes paragraph 1.1.

⁶ G-SIFs include financial institutions on the lists periodically published by the FSB of global systemically important banks (G-SIBs) and global systemically important insurers (G-SIIs) as well as NBNI G-SIFs (the methodology for which is still under development and so none are designated yet).

⁷ Save for those wholly-owned and operated by the Government.

In view of the dependencies which a financial institution may have on other entities within its group, the scope of the proposed powers also extends to holding companies and affiliated operational entities of financial institutions, with a view to delivering orderly resolution of the financial institutions themselves. Branches of foreign financial institutions operating in Hong Kong are also included in line with the way in which scope is set for each sector. This is in line with the standards set by the Key Attributes.⁸

In addition, with a view to accommodating any future changes in the potential risks posed by different types of financial institution, it is proposed that the Financial Secretary should have a “residual” designation power. This power could be used to subsequently bring any financial institution not initially covered by the regime within its scope, if it should become apparent in future that systemic disruption could result were such an institution to become non-viable. This designation power may apply to any financial institution (whether regulated or not) that could be systemically significant or critical on failure.

Role of the resolution authorities in Hong Kong

Under the Key Attributes, each jurisdiction should have one or more resolution authorities responsible for exercising the resolution powers.⁹ Furthermore, where different resolution authorities are in charge of resolving entities within the same group within a single jurisdiction, a “lead” authority should be identified for coordinating the resolution.¹⁰

In Hong Kong, a “sectoral model” has been preferred in FIRB under which each of the sectoral financial regulators, namely the HKMA, SFC and IA, would be designated as the resolution authority for those within-scope financial institutions which are under their respective existing regulatory purviews. Generally, unless a lead resolution authority has been designated (see next paragraph), each resolution authority will have the responsibility and authority to decide whether to initiate the resolution of a within-scope financial institution under its purview as well as how to apply the necessary powers to effect an orderly resolution. However, a resolution authority must consult the Financial Secretary before initiating any resolution.

Under the “sectoral model”, there is a need to identify a single resolution authority to lead the coordination and implementation of (and indeed the advance planning for) any resolution of a cross-sectoral group.¹¹ To this end, it is proposed in FIRB that the Financial Secretary should designate a lead resolution authority for relevant cross-sector financial groups once the legislation comes into force, based on an assessment of the relative systemic importance of the within-scope financial institutions within each such group.

⁸ Key Attributes paragraph 1.1.

⁹ Key Attributes paragraph 2.1.

¹⁰ Key Attributes paragraph 2.2.

¹¹ Whilst resolution tools are applied to legal entities within a group, there may be cases where orderly resolution is best achieved by adopting a group resolution strategy requiring coordinated resolution of entities within that group in accordance with that strategy.

Conditions for initiating resolution

Under FIRB, a resolution authority must be satisfied that three conjunctive conditions have been met before it may initiate resolution of a within-scope financial institution. The first condition is that the resolution authority is satisfied the financial institution has ceased, or is likely to cease, to be viable. The second is that there is no reasonable prospect that private sector action (outside of resolution) would result in the financial institution becoming viable again within a reasonable period. The third is that the resolution authority is satisfied that (a) 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 (b) resolution will avoid or mitigate those risks.

This broadly reflects paragraph 3.1 of the Key Attributes which provides for resolution to be initiated “when a firm is no longer viable or likely to be no longer viable, and has no reasonable prospect of becoming so. The resolution regime should provide for timely and early entry into resolution before a firm is balance-sheet insolvent and before all equity has been fully wiped out.”

Stabilization options

The Key Attributes set out a range of resolution powers which the FSB considers necessary for an effective resolution regime. Central to these powers are the menu of “stabilization options”.¹² These are the main tools for the resolution authority to secure orderly resolution of a failing financial institution that is considered systemic or critical, by stabilizing the key parts of its business that are essential to the functioning of the economy. The five stabilization options proposed under FIRB are:

1. Transfer of a failing financial institution, or some or all of its business, to a purchaser: Where there is a willing and credible purchaser for the failing financial institution’s business, this option is obviously desirable as the responsibility for continuing the business would remain in the private sector and intervention by resolution authorities may be more limited. This option may be easier to realise for smaller financial institutions than for those which are large or complex;
2. Transfer of a failing financial institution, or some or all of its business, to a bridge institution: A bridge institution is an institution wholly or partially owned by the Government and created for the purpose of receiving a transfer from a failing financial institution in order to stabilize and operate all or part of the institution’s business on a temporary basis. This option is intended for cases where the resolution authority assesses that there is a realistic prospect of concluding an onward sale on suitable terms in the reasonably foreseeable future but where such sale cannot be arranged immediately;

¹² Key Attributes paragraphs 3.3, 3.4, 3.5 and 3.6.

3. Transfer of a failing financial institution's assets and liabilities to an asset management vehicle:
An asset management vehicle is a company wholly or partially owned by the Government and created for the purpose of receiving assets and liabilities from a failing financial institution, with a view to eventual sale or orderly wind-down and with the potential for greater value maximisation by avoiding an immediate "fire sale";
4. Statutory bail-in: Bail-in is a statutory write-off or conversion into equity of the liabilities of the failing financial institution, in order to absorb losses and restore its capital position. Bail-in must generally be carried out having regard to the creditor hierarchy in a winding-up. However, certain liabilities are proposed to be excluded from bail-in under FIRB, including deposits, and others may be excluded on a case-by-case basis, where certain conditions are met; and
5. Taking a failing financial institution into temporary public ownership: Temporary public ownership (TPO) is the last resort measure which, under FIRB, can only be deployed when (a) the resolution authority has considered all other stabilization options and is satisfied that an orderly resolution of the financial institution is most appropriately achieved by TPO; and (b) the Financial Secretary has approved its use.

All of the stabilization options can be exercised individually, in combination or sequentially, to some or all parts of the business of a financial institution. This gives the resolution authority flexibility to tailor its approach to stabilizing a failing financial institution, depending on the profile of the institution and the prevailing circumstances.

Preparatory powers

The Key Attributes also set requirements in relation to the planning required for resolution in order to facilitate the effective use of resolution powers, in both the cross-border and domestic contexts.¹³ This recognizes that the resolution of large and complex financial institutions is unlikely to be feasible or credible without detailed advance planning. Whilst the responsibility for developing resolution plans for within-scope financial institutions rests with the resolution authority, the financial institutions themselves will be required to provide information to the resolution authority to facilitate the planning process. To enable a resolution authority to undertake the necessary planning activities, it is proposed that a range of "preparatory" powers be made available through FIRB which are exercisable in advance of resolution. These include powers to gather information.

Resolvability assessment is another area where a resolution authority will need to gather information from financial institutions, in order to consider whether and to what extent it will be able to effect resolution in a given case in an orderly manner that fulfils the resolution objectives. If any significant barriers to resolution are identified during the resolvability assessment process, FIRB provides that the resolution authority may direct the financial institution or its holding company to take action to remove such barriers (e.g. by making structural or operational changes). This reflects the provision in paragraph 10.5 of the Key Attributes. However, given the potentially intrusive nature of this power, it is provided in FIRB that the financial institution will be allowed a reasonable period to make representations concerning any such direction to the resolution authority. Furthermore, as an additional safeguard, the establishment of a dedicated avenue of appeal for a financial institution to a new "Resolvability Review Tribunal" is proposed.

¹³ Key Attributes Section 11.

In the run-up to any potential resolution, the resolution authority will likely need to take preparatory steps or actions to ensure that resolution can be carried out in an orderly manner. Where the resolution authority is satisfied that the financial institution has ceased, or is likely to cease, to be viable, and that resolution will avoid or mitigate the systemic risks otherwise posed by the non-viability of the institution, FIRB provides the resolution authority with the power to issue directions to the institution or its directors, or senior management, in relation to its affairs, business and property as the resolution authority deems fit. It is also proposed that the regime empower the resolution authority, in similar circumstances, to remove directors and senior management of a financial institution, as well as those of a holding company of a financial institution, on a case-by-case basis where the resolution authority is of the opinion that such removal will assist in meeting the resolution objectives.

Safeguards

In line with the Key Attributes¹⁴, a number of safeguards have been built into the proposed regime in FIRB to protect the rights of those affected by resolution. These safeguards also serve to reduce uncertainty for creditors in relation to the way that they would be treated in resolution.

One of the key safeguards underpinning the resolution regime is that of “no creditor worse off than in liquidation” (NCWOL). This establishes the proposition that the shareholders and creditors of a financial institution in resolution should be entitled to compensation if they do not receive at a minimum in resolution, what they would have received in a liquidation of the institution under the applicable insolvency regime. The valuation underpinning the NCWOL safeguard would be undertaken by an independent valuer, appointed once resolution was initiated. The central assumptions for the NCWOL assessment are set out in FIRB¹⁵, and further assumptions (together with a prescribed claims process) will be set out in rules (following consultation) in due course.

As a further safeguard to strengthen the credibility of the NCWOL compensation mechanism, FIRB provides for the establishment of a new “Resolution Compensation Tribunal”, specifically for the purpose of hearing appeals against the NCWOL assessment of an independent valuer.

The regime in FIRB also provides for the protection of certain financial arrangements where, on the application of stabilization options, any separation of the constituent parts of those arrangements might undermine their overall economic effect. These financial arrangements include: secured arrangements; set-off and netting arrangements; title transfer arrangements; structured finance arrangements; and clearing and settlement systems arrangements. The technical details of these protections, including scope of coverage and remedies for any inadvertent breach, will be set out in rules (following consultation) in due course.

¹⁴ Key Attributes Section 5.

¹⁵ For example, in the valuation of the treatment of shareholders and creditors in a hypothetical liquidation, the independent valuer must: (i) disregard any stabilization option(s) applied to the financial institution; (ii) adhere to the winding-up creditor hierarchy; and (iii) disregard any public financial support provided to the financial institution.

Cross-border resolution

One of the key lessons learned from the global financial crisis is that a coordinated and cooperative approach to the resolution of a cross-border financial institution has the potential to better protect financial stability across both home and host jurisdictions. To this end and with a view to enhancing the certainty of the effect of cross-border resolution actions, the Key Attributes require jurisdictions to provide for transparent and expedited processes to enable resolution measures taken by a foreign resolution authority to have cross-border effect, provided that domestic creditors are treated equitably in the foreign resolution proceedings.¹⁶

As a major international financial centre¹⁷, it is essential that the resolution regime in Hong Kong provides an effective framework for cross-border resolution that is, and is seen to be, supportive of coordinated, cooperative approaches to the resolution of systemically important cross-border financial institutions. If the Hong Kong authorities were unable to support an orderly cross-border resolution, this could result in overseas authorities requiring financial institutions to take, or indeed the financial institutions themselves pre-emptively taking, actions to reduce exposures to and dependencies upon their Hong Kong operations in order to improve the resolvability of the wider group. This could have a negative commercial impact and result in the gradual transfer of business to other jurisdictions in the region which have more developed resolution frameworks.

Consistent with the FSB Principles for Cross-border Effectiveness of Resolution Actions¹⁸, FIRB therefore contains provisions enabling the resolution authority to give effect to foreign resolution actions by “recognition” and/or “support” measures.

Under the statutory “recognition” framework part or all of a foreign resolution action may be recognized by a resolution authority, such that the action will produce substantially the same legal effect in Hong Kong that it would have produced had it been made, and been authorized to be made, under the laws of Hong Kong. While certain conditions would have to be met before a resolution authority in Hong Kong may recognize a foreign resolution action¹⁹, the granting of recognition is not dependent on the meeting of the conditions for initiating local resolution (as outlined in the section under “Conditions for initiating resolution”), or the exercise of resolution powers locally.

In addition to “recognizing” foreign resolution actions, a resolution authority may also exercise its own powers under the regime in FIRB in respect of within-scope financial institutions to “support” foreign resolution actions, provided that the conditions for initiating resolution are also met locally.

Conclusion

This article provides an overview of the main proposals in FIRB for implementing an effective resolution regime in Hong Kong, which is designed to meet the standards in the Key Attributes. The proposals for the local regime, once implemented, will provide the authorities with tools to further strengthen the resilience of the financial system in Hong Kong in the face of any future shocks or stress events.

Managing the orderly failure of a major financial institution will always be a challenging task, where swift action by the authorities (usually over a weekend) would be necessary in order to limit contagion to the financial system and the economy more broadly. As highlighted in this article, advance planning is an important component in making the orderly resolution of financial institutions feasible and credible.

¹⁶ Key Attributes paragraph 7.5.

¹⁷ As of December 2015, 29 out of the 30 G-SIBs designated by the FSB and 8 of the 9 G-SILs designated by the FSB have operations in Hong Kong.

¹⁸ “Principles for Cross-border Effectiveness of Resolution Actions”, Financial Stability Board, November 2015.

¹⁹ For example, the resolution authority must be of the opinion that recognition: (i) would not have an adverse effect on financial stability in Hong Kong; (ii) would deliver outcomes that are consistent with the resolution objectives; and (iii) would not disadvantage shareholders or creditors (or both) in Hong Kong relative to their counterparts outside Hong Kong.

Internationally, the FSB continues to develop guidance and standards on various aspects of resolution in order to promote and facilitate the full implementation of the Key Attributes. For example, a key element of minimising the risks to public funds is ensuring that financial institutions have adequate loss-absorbing capacity, in the appropriate locations within their groups, to enable bail-in. To this end, the FSB recently finalised a new standard on the Total Loss-Absorbing Capacity (TLAC) of G-SIBs.²⁰ Separately, the FSB has also issued a set of guiding principles to promote the cross-border effectiveness of resolution actions.²¹

Against this moving backdrop, it is expected that further measures to make the local regime fully operable will be developed alongside the legislative proposals set out in FIRB, in the form of rules, regulations and a Code of Practice as appropriate. The authorities in Hong Kong will continue to monitor international developments, and are committed to continued engagement with stakeholders in the development of the proposed resolution regime.

²⁰ See "Total Loss-Absorbing Capacity Principles and Term Sheet", Financial Stability Board, November 2015.

²¹ See Footnote 18.