

# Overview of the Ex-post Public Money Recovery Arrangements under the Financial Institutions (Resolution) Ordinance

By the Resolution Office

## Preface

As a member jurisdiction of the Financial Stability Board (FSB) and an international financial centre, Hong Kong has implemented the international standards in the “Key Attributes of Effective Resolution Regimes for Financial Institutions” published by the FSB and has established a resolution regime, with a view to enhancing the resilience of the financial system and addressing the “too big to fail” phenomenon as observed in the financial crisis that began in 2007. One fundamental objective is to reduce the risks of public funds being used to bail out failed financial institutions (FIs) whose failure has a systemic impact as seen in many other jurisdictions in the financial crisis.

To this end, the resolution funding arrangements under the Hong Kong resolution regime provide an *ex-post* levy mechanism to recover, from the wider financial system, public money paid into the resolution funding account and used in a resolution, but not repaid on completion of the resolution. An *ex-post* levy mechanism is consistent with international standards and is also adopted by resolution regimes in some other jurisdictions.

In its 2018 report on the peer review of Hong Kong, the FSB recommended that authorities in Hong Kong should continue operationalising resolution funding arrangements, including the *ex-post* levy framework, and set out their expectation regarding the imposition of an *ex-post* levy on the industry in order to help underscore the authorities’ intent to recoup public funds.

In light of this recommendation, the Monetary Authority (MA) provides in this article an overview of the resolution levy arrangements in respect of within scope FIs under the MA’s remit as a resolution authority (RA) or a lead resolution authority (LRA).

## Overview

The Financial Institutions (Resolution) Ordinance (Cap. 628) (FIRO)<sup>1</sup>, which came into operation on 7 July 2017, establishes a cross-sectoral resolution regime in Hong Kong and provides that the MA is the RA for banking sector entities<sup>2</sup>, including all authorized institutions (AIs). The MA is also designated as the LRA for all of the existing cross-sectoral groups involving banking sector entities.<sup>3</sup>

While the resolution regime provides a means by which the cost of failure (and of resolution) of a failed institution can be borne by its shareholders and creditors, there may be some cases where the costs of resolution exceed the costs that are actually imposed on shareholders and creditors through the resolution process. Part 12 of the FIRO sets out specific provisions for resolution funding arrangements, including a mechanism for the imposition of an *ex-post* resolution levy on completion of a resolution, to recover any public money<sup>4</sup> that was paid into the resolution funding account and used but not repaid (including interest thereon that has not been paid) in a resolution, from the wider financial system.

Details of a particular resolution levy will be set out in regulations made by the Financial Secretary (FS) in connection with the resolution of a particular entity.<sup>5</sup>

In 2017, the FSB conducted a peer review of Hong Kong covering, among others, the Hong Kong resolution regime, and published its report in 2018. One of the recommendations made in the peer review report was that authorities in Hong Kong should continue operationalising resolution funding mechanisms, including the resolution levy framework to “underscore the authorities’ intent to recoup public funds”<sup>6</sup>

In light of this recommendation, the MA has been considering further how an *ex-post* resolution levy may operate in relation to the within scope FIs under the MA’s remit as an RA or LRA. This article provides an overview of the resolution levy provisions under Part 12 of the FIRO, in relation to the imposition of an *ex-post* resolution levy to recoup any resolution funds (i.e. public money paid into the resolution funding account) that was used, but not repaid, on completion

<sup>1</sup> See: <https://www.elegislation.gov.hk/hk/cap628>.

<sup>2</sup> “Banking sector entity” is defined in section 2 of the FIRO and means any of the following: (a) an authorized institution incorporated in Hong Kong, (b) an authorized institution incorporated outside Hong Kong; (c) a settlement institution, as defined by section 2 of the Payment Systems and Stored Value Facilities Ordinance (Cap. 584), of a designated clearing and settlement system that is not otherwise an authorized institution (excluding a settlement institution that is wholly owned and operated by the Government); (d) a system operator, as defined by section 2 of the Payment Systems and Stored Value Facilities Ordinance (Cap. 584), of a designated clearing and settlement system (excluding a system operator that is wholly owned and operated by the Government); (e) a designated within scope financial institution of which the MA is designated under section 6(1)(a)(iii) of the FIRO as the RA.

<sup>3</sup> For further information, please see: <https://www.hkma.gov.hk/eng/key-functions/banking/bank-resolution-regime/bank-resolution-framework/lead-resolution-authority/>.

<sup>4</sup> Under section 176 of the FIRO, “public money” means money in an account that is (a) public moneys as defined by section 2 of the Public Finance Ordinance (Cap. 2); or (b) any other money under the control of the Government or a public officer. “Resolution funds” means public money paid into the resolution funding account. “Resolution funding account” means the account into, and out of which, resolution funds and other specified monies may be paid.

<sup>5</sup> See section 181 of the FIRO.

<sup>6</sup> Recommendation 7 on page 50 of the report: <https://www.fsb.org/wp-content/uploads/P280218-1.pdf>. Another aspect of the recommendation is to operationalise resolution funding arrangements by planning options for the design of the funding facility. In this regard, the HKMA has introduced a new Resolution Facility for the provision of liquidity in resolution, under the updated Liquidity Facilities Framework for Banks. See: <https://www.hkma.gov.hk/eng/key-functions/money/liquidity-facility-framework/hong-kong-dollar-liquidity-facility-framework/>.

of a resolution. The content of this article represents the MA's initial views on this subject only, and should not be taken as expressing any fixed policy intent of the MA at this time.

## Supporting orderly resolution and protecting public money

There are four resolution objectives<sup>7</sup> that the RAs<sup>8</sup> must have regard to in performing functions under the FIRO, one of which, subject to the meeting of other resolution objectives, is to seek to contain the costs of resolution and in doing so, protect public money.<sup>9</sup> Core to the powers under the FIRO is a menu of stabilization options<sup>10</sup>, which an RA may apply to resolve a failing within scope FI if the conditions for initiating resolution are met.<sup>11</sup>

In order to support orderly resolution of an AI, resolution planning needs to be undertaken in peacetime to facilitate the effective use of powers in a resolution. This process covers the determination of a feasible and credible preferred resolution strategy and the development of a plan<sup>12</sup>, and the removal of barriers to the effective implementation of the preferred resolution strategy.<sup>13</sup>

A major barrier to resolvability is insufficient loss-absorbing capacity within an FI in resolution. The Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements–Banking Sector) Rules (LAC Rules)<sup>14</sup>, which came into operation on 14 December 2018, represent a significant milestone in addressing this barrier for AIs.

The LAC Rules are designed to ensure that a relevant AI<sup>15</sup> has LAC resources in place such that, should it become non-viable, the MA may resolve the AI and apply stabilization option(s) to it to offset its losses and restore its capital position using the LAC resources of the AI. The recapitalisation of the AI in resolution may, for instance, be achieved through imposing losses on its shareholders and certain creditors by the application of a bail-in stabilization option, thereby reducing the need for the use of public funds to recapitalise the AI.

<sup>7</sup> The resolution objectives are (i) 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; (ii) to seek to protect deposits or insurance policies of a within scope FI to no less an extent than they would be protected under a protective scheme mentioned in Schedule 1 to the FIRO on a winding up of the FI; (iii) to seek to protect client assets of a within scope FI to no less an extent than they would be protected on a winding up of the FI, and (iv) subject to paragraphs (i), (ii), and (iii), to seek to contain the costs of resolution and in so doing protect public money, see section 8(1)(a), (b), (c) and (d) of the FIRO.

<sup>8</sup> The MA, the Securities and Futures Commission and the Insurance Authority as RAs for the within scope FIs under their respective existing regulatory purviews, see section 2 of the FIRO.

<sup>9</sup> See section 8(1)(d) of the FIRO.

<sup>10</sup> The five stabilization options available under the FIRO for resolving an AI are: (i) a transfer of the shares, or the assets, rights or liabilities, of a failing AI to a purchaser; (ii) a transfer of the shares, or the assets, rights or liabilities of a failing AI to a bridge institution; (iii) a transfer of a failing AI's assets, rights or liabilities to an asset management vehicle; (iv) bail-in; and (v) as a last resort, a transfer of the shares of a failing bank to a temporary public ownership company. See Division 1 of Part 5 of, and Schedules 3, 4, 5 and 6 to, the FIRO.

<sup>11</sup> See section 25 of the FIRO.

<sup>12</sup> See section 13 of the FIRO.

<sup>13</sup> See section 14 of the FIRO, and "The HKMA's Approach to Resolution Planning", a chapter in the Code of Practice issued by the MA pursuant to section 196 of the FIRO: [https://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/resolutions/RA-2\\_The\\_HKMA\\_approach\\_to\\_resolution\\_planning.pdf](https://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/resolutions/RA-2_The_HKMA_approach_to_resolution_planning.pdf). For the setting of a preferred resolution strategy, please see Part 4 of that chapter.

<sup>14</sup> See: <https://www.elegislation.gov.hk/hk/cap628B>. This article follows the approach adopted in the LAC Rules of using "loss-absorbing capacity" as a noun and "LAC" as an adjective.

<sup>15</sup> Under the LAC Rules, the MA may classify a Hong Kong incorporated AI, an HK holding company and an HK affiliated operational entity as a resolution entity or material subsidiary, following which the AI or the relevant entity will be subject to the LAC requirements under the LAC Rules.

## Temporary use of public money in a resolution

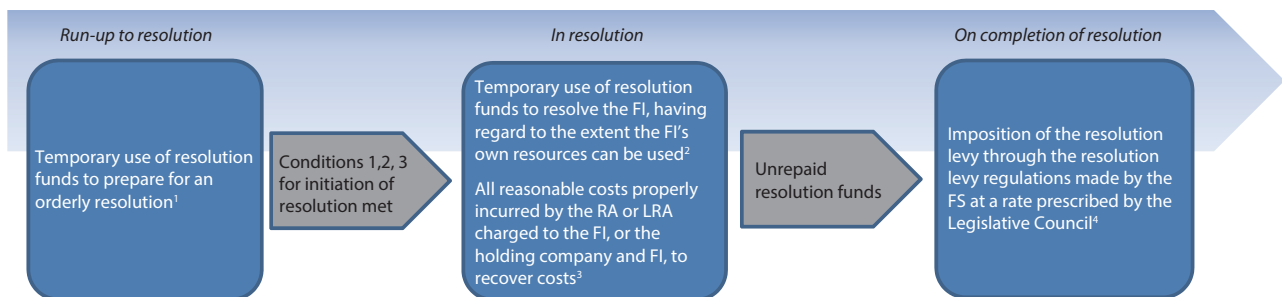
While the implementation of the LAC Rules should help minimise the risks posed to public money in a resolution of an AI to a significant degree, it does not fully eliminate the possibility that the MA may need to consider temporarily extending public money to the resolution funding account in order to support execution of orderly resolution under some circumstances. For example, in some cases it may be that the costs<sup>16</sup> of resolution are in excess of what can be absorbed by the distressed AI or can be borne by its creditors and shareholders, or it could be that the charging<sup>17</sup> of costs incurred in a resolution to the AI may undermine the meeting of resolution objectives.<sup>18</sup> Another example may be the provision, through the Resolution Facility under the HKMA's Liquidity Facilities Framework, of temporary liquidity support

for the purpose of ensuring that an AI which has gone into resolution in Hong Kong has sufficient liquidity to meet its obligations, until such time as the AI is able to transition back to market-based funding.

Even in such circumstances, any temporary use of resolution funds (i.e. public funds in the resolution funding account) would be subject to careful consideration by the RA, as provided for in the FIRO and illustrated in Figure 1. Importantly, before any use of money in the resolution funding account in applying a stabilization option to an AI, the MA as RA must have regard to the extent to which the AI's own resources can be utilised, including the extent to which: (a) liabilities of the AI can be written off or converted to enable it to absorb losses and re-establish its capital position; (b) assets of the AI can be sold; or (c) private sector funding can be obtained by the AI.<sup>19</sup>

**FIGURE 1**

### Stylised example of the temporary use and recovery of resolution funds



#### Notes

1. Section 178(1)(a)(i) of the FIRO.
2. Section 178(3) of the FIRO.
3. Section 177 of the FIRO.
4. Sections 180, 181 and 182 of the FIRO.

<sup>16</sup> Potential costs include those connected to the preparation or making of a Part 5 instrument in respect of an entity that is likely to be an entity in resolution (e.g. preparatory work leading directly to the application of a stabilization option); or costs that follow as a result of the application of the stabilization option(s) (e.g. conducting the “no creditor worse off than in liquidation” (NCWOL) valuation or the appointment of advisors to support the RA in implementing a resolution).

<sup>17</sup> If the conditions for the initiation of resolution are met and as a result, a stabilization option has been applied to the AI (or to a holding company or an affiliated operational entity of it), the MA as RA may charge to the failed AI (or, if the stabilization option has been applied to its holding company, to both the failed AI and its holding company) all reasonable costs properly incurred by the RA in or in connection with preparing for or implementing the resolution, see section 177 of the FIRO.

<sup>18</sup> See section 177(3) of the FIRO.

<sup>19</sup> See section 178(3) of the FIRO.

## The resolution levy — recouping unrepaid public money

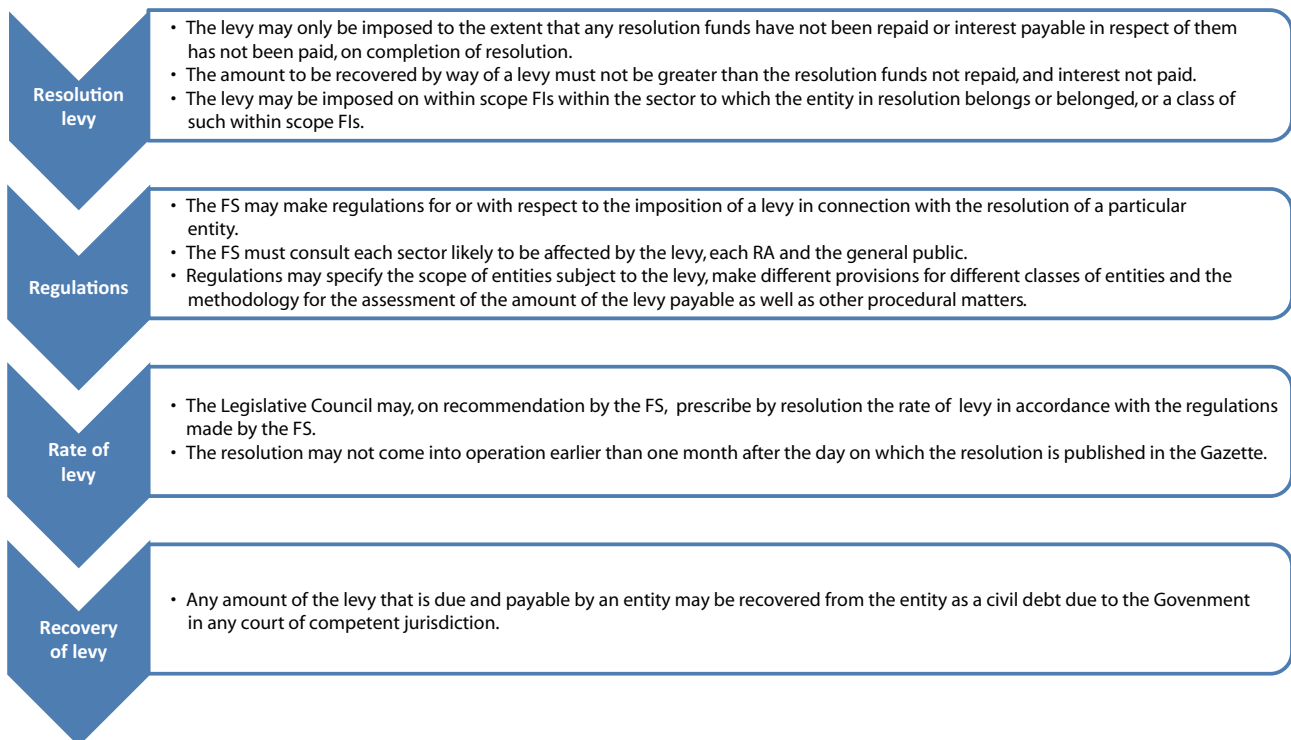
The FIRO provides for the imposition of a resolution levy to recover in full any public money paid into the resolution funding account which was used, but has not yet been repaid, (including any interest thereon which has not yet been paid)<sup>20</sup> on completion of the resolution (see Figure 2). The resolution levy may be imposed on the within scope FIs operating in the same sector to which the entity in resolution belongs or belonged, or a class of such within scope FIs.<sup>21</sup>

The amount of money that may be recovered by way of a resolution levy must not be greater than the sum of any resolution funds not repaid, and interest thereon not paid.<sup>22</sup>

Pursuant to the FIRO, the FS may make resolution levy regulations to set out specific details relating to the imposition of a resolution levy in connection with the resolution of a particular entity.<sup>23</sup> As the resolution levy is an *ex-post* recovery mechanism, the resolution levy regulations would only be made on completion of a resolution on a case specific basis.<sup>24</sup> Before making any resolution levy regulations, the FS must consult each sector likely to be affected by the resolution levy, each RA, and the general public.<sup>25</sup>

**FIGURE 2**

### Stylised example of the development of a resolution levy



<sup>20</sup> Interest, by reference to the prevailing market rates, may be charged to the resolution funding account on the outstanding principal amount of resolution funds until repaid, see section 178(8) of the FIRO.

<sup>21</sup> See section 180(3) of the FIRO, which also sets out specific provisions applicable to an entity in resolution that is a financial market infrastructure or a recognized exchange company.

<sup>22</sup> See section 180(2) of the FIRO.

<sup>23</sup> See section 181(1) of the FIRO.

<sup>24</sup> See section 180(1) of the FIRO.

<sup>25</sup> See section 181(4) of the FIRO.

Once the resolution levy regulations have been made, the Legislative Council may, on the recommendation of the FS, by resolution prescribe the rate of the resolution levy in accordance with the resolution levy regulations.<sup>26</sup> The resolution levy regulations would be able to take into account the particular circumstances of each resolution and set the parameters for the development of the resolution levy and levy rate in a proportionate manner, which may include:

- (i) Scope of the resolution levy: The resolution levy regulations may specify the entities or classes of entities by which the resolution levy is payable, and can make different provisions for different classes of entities, or for different entities within the same class of entity.<sup>27</sup> This approach recognises that entities determined to be subject to a particular resolution levy may not be static from year to year, and allows flexibility to specify the class or classes of within scope FIs that fall within the scope of a particular resolution levy depending on the class to which an entity in resolution belongs or belonged. This could cater for the possibility that a within scope FI may move into (or out of) a class of entity that is subject to a resolution levy after the resolution took place (e.g. due to changes in business mix, restructuring, or mergers and acquisitions etc.). Similarly, there is flexibility for the resolution levy regulations to make different provision according to when an FI by which a resolution levy is payable became, or ceased to be, a within scope FI.<sup>28</sup>
- (ii) Matters related to the methodology for calibrating the resolution levy: Pursuant to the FIRO, the resolution levy regulations may set out the methodology for assessing the amount of resolution levy payable by a particular entity or class of entity, including the factors on

which the methodology relies. Such factors may include, but are not limited to: (i) the size or quantum of the activities of the entity (or of any group company of the entity); (ii) the risks posed by the non-viability of the entity (or of any group company of the entity) to the stability and effective working of the Hong Kong financial system based on any factors<sup>29</sup> that the FS considers to be relevant; and (iii) the extent to which the entity (or any group company of the entity) has benefitted, or would likely benefit, from the orderly resolution of the entity resolved.<sup>30</sup>

- (iii) Procedural matters in relation to the payment of the resolution levy: To support the efficient imposition and operation of a resolution levy, the resolution levy regulations may specify procedural or administrative matters in relation to the imposition and operation of the resolution levy. The resolution levy regulations may prescribe the manner (e.g. whether by instalments or a single levy repayment) and timing (e.g. time period for payment of the levy such as the length of time for which the levy will be imposed or the amount of time between each instalment) of payment in respect of the resolution levy.<sup>31</sup> Other matters that may be prescribed in the resolution levy regulations include circumstances in which, and the period for which, payment of a levy may be temporarily deferred for an entity or group of entities for a defined period, after which payment of the levy would resume.<sup>32</sup> The resolution levy regulations may also prescribe any other matter relating to the resolution levy or obligations of the entities liable to pay it<sup>33</sup>, for example, the nomination by each entity of a contact point to facilitate communication with the RA in connection with the payment of the levy.

<sup>26</sup> See section 182 of the FIRO.

<sup>27</sup> See section 181(2)(a) and (b) of the FIRO.

<sup>28</sup> See section 181(3) of the FIRO.

<sup>29</sup> Such factors may include the entity's financial condition; market share; substitutability; stability and variety of sources of funding; structural complexity and resolvability; and interconnectedness within the sector or across sectors, see section 181(2)(c)(ii) of the FIRO.

<sup>30</sup> See section 181(2)(c)(iii) of the FIRO.

<sup>31</sup> See section 181(2)(d) of the FIRO.

<sup>32</sup> See section 181(2)(e) of the FIRO.

<sup>33</sup> See section 181(2)(f) of the FIRO.



## Cross-sectoral groups

Under the FIRO, a resolution levy can be imposed on the within scope FIs within the same sector to which an entity in resolution belongs or belonged. In the case of a resolution of an FI within a cross-sectoral group, however, the benefits of the resolution would be enjoyed not only by entities in the sector to which the resolved entity belongs or belonged, but also by entities in each other sector represented by the cross-sectoral group. The FIRO, therefore, specifically provides that, in setting out the methodology for the assessment of the amount of resolution levy payable by an entity, the methodology may take into account the extent to which such entity or any group company of such entity, has benefitted or would likely benefit from the orderly resolution.<sup>34</sup> In assessing the extent to which an entity has benefitted or would likely benefit from an orderly resolution, the relevant factors to be taken into account would be broadly similar to those in the paragraphs above on the methodology for calibrating the resolution levy in connection with the resolution of a particular entity. Additional considerations in the case of developing resolution levy regulations in connection with the resolution of an FI in a cross-sectoral group may include:

- (i) Relative systemic importance: A cross-sectoral group could have greater systemic importance in one sector than another if, for example, the cross-sectoral group's within scope FI(s) in that sector are larger in size relative to the market as a whole, more interconnected vis-à-vis other FIs in one or more markets, or if it provides functions in that sector critical to the stability and effective

working of the Hong Kong financial system.

Consideration may also be given to the principal business conducted by the cross-sectoral group (e.g. the primary business "footprint" of the cross-sectoral group).

- (ii) Nature and functions of a cross-sectoral group: In the resolution of more than one FI of different sectors within a cross-sectoral group, a resolution levy may be imposed on each of the relevant sectors. For example, where both an AI and a securities and futures sector entity<sup>35</sup> are resolved as part of a cross-sectoral group resolution, then a resolution levy would be considered in relation to the banking sector as well as the securities and futures sector.<sup>36</sup>
- (iii) Any additional considerations/information: This may include other considerations or information that could help inform the extent to which other within scope FIs and their group companies within the same sectors as those to which the resolved FIs in the cross-sectoral group belong or belonged, have benefitted or would likely benefit from the resolution.

## Looking ahead

The MA stands ready, in his capacity as the RA for banking sector entities and the LRA for the designated cross-sectoral groups involving banking sector entities, to provide the FS with any support or information that may be needed in making the resolution levy regulations, if and when such a case arises.

<sup>34</sup> See section 181(2)(c)(iii) of the FIRO.

<sup>35</sup> "Securities and futures sector entity" is defined in section 2 of the FIRO and means any of the following: (a) a licensed corporation that is a non-bank non-insurer global systemically important FI; (b) a licensed corporation that is a branch or subsidiary of, or a subsidiary of a holding company of, a global systemically important bank or a global systemically important insurer; (c) a recognized clearing house; (d) a designated within scope FI of which the Securities and Futures Commission is designated under section 6(1)(a)(ii) of the FIRO as the RA; and (e) a recognized exchange company that is designated under section 6(1)(b) of the FIRO as a within scope FI.

<sup>36</sup> "Securities and futures sector" is defined in section 2 of the FIRO and means the sector comprised of securities and futures sector entities.