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**Subcommittee on Financial Institutions (Resolution) (Protected Arrangements) Regulation and Financial Institutions (Resolution) Ordinance (Commencement) Notice 2017**

**Background brief**

**Purpose**

This paper provides background information on the Financial Institutions (Resolution) Ordinance (Cap. 628) ("FIRO") and the Financial Institutions (Resolution) (Protected Arrangements) Regulation ("PAR") to be made as subsidiary legislation under the Ordinance. It also summarizes the major views and concerns expressed by Members when issues relating to FIRO and PAR were discussed in the Bills Committee on Financial Institutions (Resolution) Bill ("the Bills Committee") and the Panel on Financial Affairs ("FA Panel").

**Background**

2. During the financial crisis which began in 2007/2008, a number of governments around the world intervened to support their largest financial institutions ("FIs"), including by bailing FIs out with public money, in order to allow the financial system to continue to function. This was necessary because of the reliance of individuals, businesses and governments on the services FIs provided and the inadequacy of existing tools for dealing with the failure of a systemically important FI.

3. To reduce the impact of failure of systemically important FIs, the Financial Stability Board<sup>1</sup> has published the "Key Attributes of Effective

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<sup>1</sup> Financial Stability Board ("FSB") was established in April 2009 to coordinate at the international level the work of national financial authorities and international standard-setting bodies and promote the reform of international financial regulations. Hong Kong is a member of FSB.

Resolution Regimes for Financial Institutions" which established new international standards for effective resolution regimes. These new standards require that public authorities be empowered to intervene to resolve FIs which become non-viable and whose failure would pose unacceptable risks to the continuation of critical financial services and wider financial stability. An effective resolution regime should provide alternative means of containing these risks and ensure that the costs of failure and resolution are borne by the failing FIs' shareholders and creditors rather than being met by public funds.

### **Financial Institutions (Resolution) Ordinance**

4. The Legislative Council ("LegCo") enacted FIRO in June 2016 to provide for the legal basis for the establishment of a cross-sector resolution regime for within scope FIs in Hong Kong.<sup>2</sup> Under FIRO, the Hong Kong Monetary Authority ("HKMA"), the Securities and Futures Commission ("SFC") and the Insurance Authority ("IA") are designated as resolution authorities ("RAs") to be vested with a range of powers necessary to effect the orderly resolution of a non-viable systemically important FI for the purpose of maintaining financial stability. FIRO would come into operation on a date to be appointed by the Secretary for Financial Services and the Treasury ("SFST").

#### Initiation of resolution and stabilization options

5. After consulting the Financial Secretary, an RA may initiate the resolution of a within scope FI if it is satisfied that all of the following conditions (i.e. the three conjunctive conditions) are met:-

- (a) the FI has ceased, or is likely to cease, to be viable;
- (b) there is no reasonable prospect that private sector action (outside of resolution) would result in the FI again becoming viable within a reasonable period; and
- (c) the non-viability of the FI poses risks to the stability and effective working of the financial system of Hong Kong, including to the continued performance of critical financial functions, and resolution will avoid or mitigate those risks.

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<sup>2</sup> A within scope financial institution under the Financial Institutions (Resolution) Ordinance (Cap. 628) ("FIRO") refers to an entity in the banking sector, insurance sector, or securities and futures sector.

6. There are five stabilization options that an RA may apply to a within scope FI in resolving such FI. These options are:

- (a) transfer to a purchaser;
- (b) transfer to a bridge institution;
- (c) transfer to an asset management vehicle;
- (d) bail-in; and
- (e) transfer to a temporary public ownership company.

7. To enable resolution to be carried out successfully, RAs will be empowered to devise strategies for securing an orderly resolution for a within scope FI and make resolvability assessment to determine whether there are any impediments to the orderly resolution of the FI, and to require the FI to remove any substantive barrier to its orderly resolution. RAs will also be empowered to gather information from and inspect records or documents of within scope FIs, and carry out investigation on the FIs.

#### Safeguards

8. Pre-resolution creditors or pre-resolution shareholders treated less favourably in resolution than they would have been on a hypothetical winding up will be eligible for compensation (i.e. "no creditor worse off than in liquidation" ("NCWOL") compensation). Pre-resolution shareholders, pre-resolution creditors and the RA that has initiated resolution can make applications to the Resolution Compensation Tribunal ("RCT") for a review of a decision of an independent valuer on the valuation and the compensation amount. RCT is empowered to confirm or vary the decision or set it aside and substitute a fresh decision for it, or remit the matter back to the independent valuer.

### **Financial Institutions (Resolution) (Protected Arrangements) Regulation and Financial Institutions (Resolution) Ordinance (Commencement) Notice 2017**

#### Financial Institutions (Resolution) (Protected Arrangements) Regulation

9. Financial market participants rely on a variety of financial arrangements to both mitigate credit risk exposure to counterparties and provide sources of

liquidity and financing. In turn, these arrangements are vital to the daily functioning of financial markets. Therefore it is important to provide legal certainty that such financial arrangements will be protected when an entity is under resolution and that the economic purpose of the arrangements is not undermined. The financial arrangements identified as protected arrangements under section 74 of FIRO are:

- (a) clearing and settlement systems arrangements;
- (b) netting arrangements;
- (c) secured arrangements;
- (d) set-off arrangements;
- (e) structured finance arrangements; and
- (f) title transfer arrangements.

10. Actions taken by an RA to effect a stabilization option could "split up" the assets, rights or liabilities constituting protected arrangements, thus adversely affecting the economic effect of such arrangements. The "split up" is likely to arise: (a) when an RA makes a partial property transfer ("PPT") to transfer some, but not all, of an entity's assets, rights or liabilities to a third party; or (b) on bail-in where liabilities are written down and/or converted without taking into account linked assets or rights entitled to be set off or netted under arrangements that are documented or otherwise evidenced in writing.

11. Section 75 of FIRO provides that SFST may, for safeguarding the economic effect of a protected arrangement in connection with the making of a regulated Part 5 instrument, make regulations (i.e. PAR) prescribing requirements to be complied with by an RA. A regulated Part 5 instrument, as provided in section 74 of FIRO, means a Part 5 instrument<sup>3</sup> that: (a) results in a PPT being effected; or (b) contains a bail-in provision. The Financial Services and the Treasury Bureau ("FSTB"), HKMA, SFC and IA jointly conducted a two-month public consultation in November 2016 to gauge views on the proposals for PAR. According to the Government, the approach to PAR is largely modelled on that adopted by the United Kingdom ("UK") and that

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<sup>3</sup> Part 5 instrument means any of the following instruments made under Part 5 of the Financial Institutions (resolution) Ordinance ("FIRO") —

- (a) a securities transfer instrument;
- (b) a property transfer instrument;
- (c) a bail-in instrument.

required by the European Union's Bank Recovery and Resolution Directive ("BRRD"), and respondents generally agreed with the approach proposed in the consultation paper. The consultation conclusion was issued on 6 April 2017.

12. The main provisions of PAR are set out in paragraph 19 of the LegCo Brief dated 10 May 2017 issued by FSTB, HKMA, SFC and the Office of the Commissioner of Insurance, and paragraphs 5 and 6 of the Legal Service Division Report on Subsidiary Legislation gazette on 12 May 2017 (LC Paper No. LS67/16-17). PAR will come into operation on 7 July 2017. PAR sets out how an RA should treat each type of "protected arrangement" in resolution. It also identifies some limited and clearly specified exclusions of rights and liabilities from the scope of certain protected arrangements. According to the Government, these exclusions are to provide flexibility for an RA to achieve orderly resolution (e.g. to be able to transfer certain critical liabilities such as deposits quickly and decisively in order to secure continuity of access for depositors). PAR further establishes the consequences should an RA inadvertently act in a manner inconsistent with the objectives of PAR.

#### Financial Institutions (Resolution) Ordinance (Commencement) Notice 2017

13. FIRO (Commencement) Notice 2017 was made by SFST, pursuant to section 1(2) of FIRO, to appoint 7 July 2017 as the date on which all provisions of FIRO (except for Part 8 (sections 144 to 148), section 192 and Division 10 of Part 15 (sections 228 to 232))<sup>4</sup> will commence.

#### **Major views and concerns expressed by Members**

14. The Government briefed FA Panel on the proposed commencement of FIRO and PAR at the meeting on 18 April 2017. The major views and concerns expressed by the Bills Committee on issues relating to the stabilization options under the resolution regime, and those expressed by FA Panel on PAR are summarized in the ensuing paragraphs.

#### Financial Institutions (Resolution) (Protected Arrangements) Regulation

15. Noting that the proposed approach to PAR was largely modelled on that adopted by the UK and that required by BRRD, Panel members enquired about the resolution actions taken by RAs in the UK and member states of the

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<sup>4</sup> For details of the uncommenced provisions of FIRO, see paragraph 18 and footnotes 10 to 12 of the Legislative Council Brief dated 10 May 2017.

European Union ("EU") so far, and the impact of such actions on the relevant stakeholders.

16. HKMA advised that so far there had been limited number of bank failure cases in the EU countries which required the use of resolution tools after the passage of BRRD. PPT, subject to the protected arrangements provisions set out in BRRD, had been effected by the RA in Portugal in resolving a failing bank. A bridge bank was then established to which certain "good" assets and liabilities of the failing bank had been transferred with the remainder left in a residual "bad" bank.

17. Panel members enquired if there were other pieces of subsidiary legislation to be made under FIRO besides PAR for the commencement of the Ordinance, and sought information on how issues relating to conflict of law, in particular that related to the legal concept of "universal succession", would be dealt with by PAR.

18. The Government pointed out the importance to have PAR in place and ready to become operational at the same time as FIRO commenced operation so as to provide legal certainty for treatment of protected arrangements. The Government would continue to work on other rules and regulations to be made under FIRO (e.g. on loss-absorbing capacity requirements, contractual recognition requirements, etc.). As regards the conflict of law issues, HKMA explained that under PAR, where an RA was unable to transfer foreign property under, for example, a secured arrangement because the transfer of that foreign property was restricted by the property's governing law (e.g. as a result of a decision of a foreign court), the inability to transfer that foreign property with the other constituent parts of the protected arrangement would not be treated as an action that was inconsistent with the objectives of PAR. This issue highlighted the importance of effective *ex ante* cross-border resolution planning to avoid such potential challenges in the event of resolution being initiated. In order to ensure that cross-border FIs were resolvable and cross-border resolution strategies were feasible and credible, RAs in Hong Kong would work together with foreign RAs to identify and remove significant impediments to an orderly cross-border resolution in the conduct of cross-border resolution planning.

19. In relation to a structured finance arrangement, some Panel members asked why RAs would be restricted under the proposed PAR from transferring some, but not all, of the property, rights and liabilities, which were or form part of the arrangement.

20. HKMA explained that structured finance arrangements, defined under PAR as securitizations, provided a means of refinancing and allowing risk diversification for financial market participants through the transfer of credit risk to other market participants by, for example, issuing securities to the market that would usually be secured against a pool of underlying assets. If the constituent parts of a structured finance arrangement could be disrupted as a result of a PPT of only some but not all of a failed FI's assets, rights and liabilities that were part of such an arrangement, the functioning of the arrangement could be significantly affected and damage could be caused to the structured finance market because participants would be uncertain as to the efficacy of any structured finance arrangements they entered into in which a within scope FI played a material role. That said, RAs would have the discretion to determine whether a structured finance arrangement would need to be transferred at all in meeting the resolution objectives. Moreover, any deposits which formed part of a structured finance arrangement would be carved out from the protection so that an RA could transfer the critical financial function of deposit-taking without the need to take into account the role of those deposits in a structured finance arrangement. This would secure continuity of the critical financial function, including continued access to deposits for depositors.

#### Stabilization options

21. The Bills Committee sought clarification as to whether the stabilization options (e.g. bail-in, temporary public ownership, mandatory reduction of capital, suspension of payment obligations, etc.) would deprive private property rights, which Article 105 of the Basic Law ("BL 105") sought to protect.

22. The Government explained that BL 105 did not prohibit lawful deprivation of property per se and protected the right to compensation for lawful deprivation of property. The second paragraph of BL105 further provided that such compensation should correspond to the real value of the property concerned at the time. The Government supplemented that section 33(3) of FIRO provided for payment of "real value consideration" to the person whose property was transferred when resolution was initiated. This provision stated that consideration that was fair and reasonable in the circumstances was due to the transferor in respect of any transfer under a Part 5 instrument (e.g. to the FI in a property transfer, or to the FI's shareholders in a share transfer). In addition, section 102 provided that pre-resolution creditors and pre-resolution shareholders were eligible for payment of NCWOL compensation where, as a result of the resolution of the FI, they had received, were receiving or were likely to receive less favourable treatment than would have been the case had the winding-up of the entity commenced immediately before its resolution was

initiated. The Government considered that NCWOL compensation would provide fair compensation to the above-mentioned parties. Moreover, there was an appeal mechanism to RCT available to those aggrieved by any decision made by the independent valuer who undertook the NCWOL compensation calculation.

#### Stamp duty exemption for Part 5 instruments

23. The Bills Committee enquired whether securities transfer instruments issued by an RA would be subject to stamp duty under the Stamp Duty Ordinance (Cap. 117) ("SDO"). Bills Committee members were of the view that there should be *ex ante* certainty on the stamp duty exemption for securities transfer instruments which would facilitate smooth conduct of resolution, especially since a stamp duty exemption might incentivize a private sector acquirer to consider acquiring part or all of the business of the failing or failed FI to facilitate a swift transaction. They stressed that stamp duty exemption for the instruments would be justified on the ground that the transfers in resolution were to protect the financial stability of Hong Kong.

24. The Government advised that while such instruments would be subject to stamp duty, the policy intention was to grant exemption to the Part 5 instruments on a case-by-case basis recognizing that the relevant stamp duty consequence arose not out of a normal commercial transaction but as a result of the exercise of a stabilization option in protecting financial stability and integrity of the financial system of Hong Kong. The approach to implement this policy was to rely on an existing mechanism under section 52 of SDO whereby the Chief Executive might exempt or remit any stamp duty after taking into account the circumstances of the case and the transfers involved. That said, the Government agreed to look into how the stamp duty exemption policy would be effected in the context of the resolution legislative framework by developing appropriate amendments to the enacted Ordinance in a separate legislative exercise in the future.

#### **Latest development**

25. At the House Committee meeting on 19 May 2017, Members agreed that a subcommittee should be formed to examine the FIRO (Commencement) Notice 2017 and PAR.



**Relevant papers**

26. A list of relevant papers is in the **Appendix**.

Council Business Division 1  
Legislative Council Secretariat  
1 June 2017

## List of relevant papers

Date	Event	Paper/minutes of meeting
22 June 2016	The Legislative Council passed the Financial Institutions (Resolution) Bill	<a href="#">Hansard</a> <a href="#">The Bill passed</a> <a href="#">Report of the Bills Committee</a> (LC Paper No. CB(1)1032/15-16)
22 November 2016 and 6 April 2017	Consultation paper and the consultation conclusion on protected arrangements regulations jointly issued by the authorities	<a href="#">Consultation paper</a> <a href="#">Consultation conclusion</a>
18 April 2017	Meeting of the FA Panel	<a href="#">Administration's paper</a> (LC Paper No. CB(1)777/16-17(05)) <a href="#">Background brief</a> (LC Paper No. CB(1)777/16-17(06))
17 May 2017	The Financial Institutions (Resolution) (Protected Arrangements) Regulation and the Financial Institutions (Resolution) Ordinance (Commencement) Notice 2017 gazetted on 12 May 2017 were introduced into LegCo	<a href="#">Legislative Council Brief</a> (dated 10 May 2017) <a href="#">Legal Service Division Report</a> (LC Paper No. LS67/16-17)