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**Subcommittee on Financial Institutions (Resolution) (Contractual
Recognition of Suspension of Termination Rights – Banking Sector) Rules**

Background brief

Purpose

This paper provides background information on the Financial Institutions (Resolution) (Contractual Recognition of Suspension of Termination Rights – Banking Sector) Rules ("the Rules"). It also summarizes the major views and concerns expressed by members of the Panel on Financial Affairs ("FA Panel") when the Panel was consulted on the relevant legislative proposals at the meeting on 1 March 2021.

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 them 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 tools at that time for dealing with the failure of systemically important FIs.

Financial Institutions (Resolution) Ordinance

3. The Legislative Council ("LegCo") enacted the Financial Institutions (Resolution) Ordinance (Cap. 628) ("FIRO") in June 2016 to provide for the legal basis for the establishment of a cross-sectoral resolution regime for within

scope FIs¹ in Hong Kong. Under FIRO, the Monetary Authority ("MA") (i.e. the Hong Kong Monetary Authority ("HKMA")), the Securities and Futures Commission and the Insurance Authority 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, including applying five stabilization options² by making one or more Part 5 instruments.³

4. FIRO came into operation on 7 July 2017.⁴

The necessity of making rules on contractual stays on termination rights in financial contracts for the banking sector

5. According to the Administration, in a resolution where one or more stabilization options are applied by an RA to a non-viable within scope FI, it is important that the contractual counterparties to the FI cannot terminate and close out their positions solely as a result of the FI's entry into resolution. Disorderly termination of contracts on a mass scale could frustrate resolution actions taken with respect to a non-viable within scope FI, thus causing significant contagion effects to the financial markets and posing wider risks to the stability and effective working of the financial system.

¹ Within scope financial institutions ("FIs") under the Financial Institutions (Resolution) Ordinance (Cap. 628) ("FIRO") include all authorized institutions ("AIs"), certain financial market infrastructures, certain licensed corporations, certain authorized insurers, certain settlement institutions and system operators of designated clearing and settlement systems, and recognized clearing houses. The scope of FIRO also extends to holding companies and affiliated operational entities of within scope FIs.

² The five stabilization options include four transfer stabilization options (whereby some or all of the assets, rights or liabilities of, or securities issued by, a within scope FI, are transferred to: (a) a purchaser; (b) a bridge institution; (c) an asset management vehicle; and/or (d) (as a last resort) a temporary public ownership company) and the bail-in stabilization option (whereby certain liabilities issued by the within scope FI are written down or converted into equity so as to reduce the issuer's debt, thereby absorbing losses and recapitalizing the within scope FI).

³ A Part 5 instrument means a securities transfer instrument, a property transfer instrument or a bail-in instrument.

⁴ The Financial Institutions (Resolution) Ordinance (Commencement) Notice 2017 appointed 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) commence.

6. Should a termination right of a counterparty to a qualifying contract⁵ become exercisable, section 90(2) of the FIRO empowers an RA to temporarily suspend, for up to two business days, the termination right of a counterparty (other than a counterparty that is a financial market infrastructure⁶) to a qualifying contract, by way of provision in a Part 5 instrument.

7. Notwithstanding the above, where the relevant contracts are governed by non-Hong Kong law, there are uncertainties as to whether a court in a non-Hong Kong jurisdiction would give effect to a suspension of termination rights imposed by an RA under section 90(2) of FIRO unless the law of such jurisdiction expressly recognizes the RA's action.

8. Further, even if a court in a non-Hong Kong jurisdiction were to give effect to the suspension imposed under FIRO, it could be challenging to effect such recognition in a timely fashion in order to best achieve the resolution objectives in Hong Kong. To address the issue of ensuring cross-border effectiveness of a suspension of termination rights imposed under local rules or laws with respect to contracts governed by laws of other jurisdictions, the Financial Stability Board ("FSB")⁷ has set out certain principles in its "Principles for Cross-border Effectiveness of Resolution Actions" ("the FSB Principles")⁸. The FSB Principles support, amongst others, contractual approaches to giving effect to cross-border resolution actions, which complement and support statutory frameworks.

9. Section 92 of FIRO provides that an RA may make rules to require that the terms and conditions of a contract entered into by a qualifying entity contain a provision to the effect that the parties to the contract agree to be bound by any suspension of termination rights in relation to the contract imposed under section 90(2) of FIRO. In this connection, HKMA has formulated the relevant rules for the banking sector ("the proposed Rules") and conducted a two-month public consultation on the proposed Rules on 22 January 2020. The consultation conclusion was released on 31 December 2020.

⁵ A qualifying contract is a contract entered into by a within scope FI or a group company of a within scope FI (each a "qualifying entity" under FIRO) under which the obligations for payment and delivery and for provision of collateral continue to be performed.

⁶ A financial market infrastructure is a multilateral system among participating financial institutions used for clearing, settling or recording payments, securities, derivatives or other financial transactions and includes any payment system, central securities depository, securities settlement system, central counterparty and trade repository.

⁷ The Financial Stability Board is an international body that monitors and makes recommendations about the global financial system.

⁸ Principles for Cross-border Effectiveness of Resolution Actions, November 2015.

Financial Institutions (Resolution) (Contractual Recognition of Suspension of Termination Rights –Banking Sector) Rules

10. The Rules are made by MA under section 92 of FIRO. The Rules seek to require that entities subject to the Rules (i.e. covered entities⁹) must ensure that certain contracts contain a provision to the effect that the parties will be bound by any suspension of termination rights in relation to those contracts imposed by MA as an RA under section 90(2) of FIRO.

11. The details of the Rules are set out in paragraph 7 of the LegCo Brief (File Ref: B&M/2/1/29/4/4C (2021) Pt.4) issued by the Financial Services and the Treasury Bureau and HKMA in June 2021, and in paragraphs 12 and 13 of the report of the Legal Services Division of the LegCo Secretariat (LC Paper No. LS86/20-21).

12. The Rules were gazetted on 25 June 2021, tabled at LegCo on 7 July 2021 for negative vetting, and will come into operation on 27 August 2021.

Major views and concerns expressed by members of the Panel on Financial Affairs

13. FA Panel was briefed by the Administration and HKMA on the relevant legislative proposals at the meeting on 1 March 2021. The major views expressed by Panel members are summarized in the ensuing paragraphs.

Feedback of the consultation conducted by the Hong Kong Monetary Authority

14. Noting that HKMA had conducted a public consultation on the proposed Rules from January to March 2020, members asked if views from respondents had been taken into account in finalizing the legislative proposals, and whether there were technical comments which the Administration had not taken on board. They also sought information on the percentage of covered contracts among the total number of financial contracts entered into by authorized institutions¹⁰ ("AIs") in Hong Kong.

⁹ A covered entity is an authorized institution incorporated in Hong Kong ("HKAI"), a Hong Kong holding company (being a holding company incorporated in Hong Kong of an HKAI) or a related company of an HKAI.

¹⁰ Under the Banking Ordinance (Cap. 155), an AI means a bank, a restricted licence bank or a deposit-taking company.

15. The Administration advised that HKMA received in the public consultation concerned 14 submissions which gave comments or sought clarifications on some technical aspects of the proposed Rules. Moreover, HKMA conducted an industry consultation on the draft text of the proposed Rules from December 2020 to January 2021. Respondents provided technical comments on the draft text of the proposed Rules and indicated areas where further guidance was required from MA. Having considered the views received, HKMA had made appropriate refinements to the legislative proposals. For example, the minimum duration of the initial period for compliance with the proposed Rules had been lengthened from 18 months to 24 months, "other foreign banks" had been removed from the types of counterparties covered by the 24-month initial period, and the definition of "excluded counterparties" had been extended to cover central banks and governments. HKMA added that the responses received during industry engagement indicated that the majority of the financial contracts entered into by AIs in Hong Kong were governed by non-Hong Kong law.

Implementation of the proposed Rules

16. Some members were concerned about how an RA could effectively suspend termination rights of the counterparties to financial contracts entered into by covered entities, in particular when the relevant contracts were governed by non-Hong Kong law. Members also enquired about the possible consequences on an AI if it did not comply with the proposed Rules, what actions would be taken by MA, and whether enforcement actions for non-compliance with the proposed Rules by a cross-border AI would be taken by MA or an overseas RA.

17. The Administration explained that FIRO allowed an RA to temporarily suspend the termination right of a counterparty to a qualifying contract entered into by a within scope FI and its group companies. However, where the relevant contracts were governed by non-Hong Kong law, there were uncertainties as to whether a court in a non-Hong Kong jurisdiction would give effect to a suspension of termination rights imposed by an RA. To address the cross-border risks to orderly resolution arising from the early termination of financial contracts governed by non-Hong Kong law, the proposed Rules required covered entities to include an appropriate provision in their non-Hong Kong law governed financial contracts to the effect that the parties to the contracts agreed to be bound by a temporary suspension of termination rights that might be imposed by MA as an RA under FIRO. The proposed Rules were in line with the contractual approach to giving effect to cross-border resolution actions advocated by FSB which had been broadly adopted by FSB members by way of regulations or other enforceable measures.

18. As for the handling of non-compliance, the Administration pointed out that if an AI failed to comply with the requirement of including an appropriate provision in their non-Hong Kong law governed financial contracts and, in the opinion of MA, this posed a significant impediment to an orderly resolution of the AI, MA might serve a written notice on the AI pursuant to section 14 of FIRO requiring it to take any measures that were in the opinion of MA reasonably required to remove the impediment. Under section 16 of FIRO, an AI which failed without reasonable excuse to comply with the written notice committed an offence. Section 16 of FIRO provided for a fine of \$2,000,000 and imprisonment for five years. HKMA added that while the power under section 14 of FIRO might be exercised if MA was of the opinion that significant impediments existed to orderly resolution, HKMA worked closely with individual AIs on resolution planning with a view to identifying and removing any impediments to AIs' resolvability. The maximum penalty under the proposed Rules would be a fine of \$5,000 and imprisonment for six months.

Compensation mechanism of the resolution regime

19. Some members enquired if creditors and shareholders of an FI under resolution would receive more favourable treatment under the resolution regime than they would have received in a hypothetical winding up.

20. HKMA advised that pre-resolution creditors and pre-resolution shareholders of the FI were eligible for payment of compensation in accordance with the "no creditor worse off than in liquidation" safeguard under the regime if as a result of the resolution of the FI, those pre-resolution creditors and pre-resolution shareholders had received, were receiving or were likely to receive less favourable treatment than would have been the case had winding-up of the FI commenced immediately before its resolution was initiated.

Latest development

21. At the House Committee meeting on 2 July 2021, Members agreed to form a subcommittee to study the Rules.

Relevant papers

22. A list of relevant papers is in **Appendix**.

List of relevant papers

Date	Event	Paper/minutes of meeting
22 June 2016	The Legislative Council ("LegCo") passed the Financial Institutions (Resolution) Bill	Hansard The Bill passed Report of the Bills Committee (LC Paper No. CB(1)1032/15-16)
22 November 2016 and 6 April 2017	Consultation paper and consultation conclusion on protected arrangements regulations jointly issued by the authorities	Consultation paper Consultation conclusion
18 April 2017	The Panel on Financial Affairs ("FA Panel") was briefed by the Administration on the Commencement Notice and Protected Arrangements Regulation for the Financial Institutions (Resolution) Ordinance	Administration's paper (LC Paper No. CB(1)777/16-17(05)) Minutes (paragraphs 29-41) (LC Paper No. CB(1)1344/16-17)
17 May 2017	The Financial Institutions (Resolution) (Protected Arrangements) Regulation and Financial Institutions (Resolution) Ordinance (Commencement) Notice 2017 were tabled at the LegCo	The Regulation and the Notice Report of the Subcommittee (LC Paper No. CB(1)1205/16-17)

Date	Event	Paper/minutes of meeting
17 January 2018 and 25 July 2018	Consultation paper and consultation conclusion on rules for loss-absorbing capacity requirements for authorized institutions under Financial Institutions (Resolution) Ordinance issued by the Hong Kong Monetary Authority	Consultation paper Consultation conclusion
3 April 2018	FA Panel was briefed by the Administration on the legislative proposals on loss-absorbing capacity requirements under the Financial Institutions (Resolution) Ordinance (Cap. 628)("FIRO")	Administration's paper (LC Paper No. CB(1)724/17-18(06)) Background brief (LC Paper No. CB(1)724/17-18(07)) Minutes (paragraphs 45-48) (LC Paper No. CB(1)1178/17-18)
24 October 2018	The Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements – Banking Sector) Rules were tabled at the LegCo	The Rules Report of the Subcommittee (LC Paper No. CB(1)265/18-19)
January-March 2020	The Hong Kong Monetary Authority conducted a public consultation regarding rules on contractual stays on termination rights in financial contracts for authorized institutions	Consultation paper Consultation conclusion

Date	Event	Paper/minutes of meeting
1 March 2021	FA Panel was briefed by the Administration on the Rules on contractual stays on termination rights in financial contracts for banks under FIRO	Administration's paper (LC Paper No. CB(1)604/20-21(08)) Minutes (LC Paper No. CB(1)883/20-21)
7 July 2021	The Financial Institutions (Resolution) (Contractual Recognition of Suspension of Termination Rights – Banking Sector) Rules gazetted on 25 June 2021 were tabled at the LegCo	The Rules Legislative Council Brief (File Ref: B&M/2/1/29/4/4C (2021) Pt.4) Legal Service Division Report (LC Paper No. LS86/20-21)