

CLIFFORD CHANCE  
高偉紳律師行  
27TH FLOOR  
JARDINE HOUSE  
ONE CONNAUGHT PLACE  
HONG KONG  
TEL +852 2825 8888  
FAX +852 2825 8800  
INTERCHANGE DX-009005 CENTRAL 1  
www.cliffordchance.com

**By post and  
by email (resolution@fstb.gov.hk)**

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

Our reference: 10-40479565  
Direct Dial: +852 2825 8855  
E-mail: [mark.hyde@cliffordchance.com](mailto:mark.hyde@cliffordchance.com)  
Direct Dial: +852 2825 8992  
E-mail: [mark.shipman@cliffordchance.com](mailto:mark.shipman@cliffordchance.com)  
Direct Dial: +852 2826 2459  
E-mail: [paget.darebryan@cliffordchance.com](mailto:paget.darebryan@cliffordchance.com)  
Direct Dial: +852 2826 3478  
E-mail: [donna.wacker@cliffordchance.com](mailto:donna.wacker@cliffordchance.com)  
Direct Dial: +852 2825 8927  
E-mail: [matt.fairclough@cliffordchance.com](mailto:matt.fairclough@cliffordchance.com)

**FINAL TEXT: 5 April 2014**

Dear Sirs,

## **An Effective Resolution Regime for Financial Institutions in Hong Kong - Comments in response to Consultation Paper**

The Consultation Paper on an Effective Resolution Regime for Financial Institutions in Hong Kong (Consultation Paper) published in January 2014 invited submissions in response.

In collaboration with the Asia Securities Industry and Financial Markets Association (ASIFMA) and the Global Financial Markets Association (GFMA), we submit replies to the specific questions raised in the Consultation Paper, together with comments on related matters: these are based on discussions with a number of financial institution clients, including those listed in the Appendix to this letter who endorse substantially all of the comments we make.

Most financial institution clients have conducted an extensive internal review process in relation to the Consultation Paper; and several have received input from regulatory and resolution specialists in other international financial centres, thereby adding a further dimension to these replies and comments.

HKG-1-1039178-v3

OFFICE-HK

**PARTNERS**

N. BUDHWANI  
C.S.K. CHAN  
P.-J. CHARLTON  
E.Y.L. CHEN  
S.J. COOKE  
E.C. DAVIES  
R.M. DENNY  
F. EDWARDS  
M.W. FAIRCLOUGH  
M. FELDMANN  
B.W. GILCHRIST  
C.D. HASSALL  
C. HENG  
A.E. HO

L. HO  
A.D. HUTCHINS  
M.R. HYDE  
P.K. KILNER  
V. LEE  
A.S.H. LO  
A. MACAULAY  
D.K. MALIK  
K.A. SEETULSINGH  
M.G. SHIPMAN  
C.F.M. TANG  
M.W. TRUMAN  
D. WACKER  
A. WANG

**FOREIGN LEGAL CONSULTANTS**

A.R. KELLY (NEW YORK, USA)  
L.C. BRICKLEY (NEW YORK, USA)  
P.C. DARE BRYAN (ENGLAND AND WALES)  
GAO P.-J. (PRC)  
P.C. GREENWELL (ENGLAND AND WALES)  
T. KOLLAR (NEW YORK, USA)  
M.F. NEWICK (ENGLAND AND WALES)  
W.L. WYSONG (WASHINGTON D.C., USA)  
J. ZONIS (NEW YORK, USA)

**CONSULTANTS**

A.W.Q. CHAN  
B.C.J.B. CHAN  
S.R. CROSSWELL  
L. FANG  
P.S. HUGGARD  
E.R. JOHNSON  
S. LEE  
K.K.C. LEUNG  
T.C.S. LEUNG  
P.S. O'CONNOR  
K.S.H. SANGER  
S.S.S. WONG

We fully support the development of a recovery and resolution framework in Hong Kong to safeguard the stability of the financial system while minimising public costs and economic impact during a crisis. Our existing involvement in relation to resolution planning exercises for the Hong Kong branches and subsidiaries of global financial institutions has highlighted that the existing legal framework would benefit from updating and extension. For example, there is no ability at present for the Hong Kong regulators to quickly approve a change of control or grant new licenses to a 'buyer' of a failing institution, including a 'bridge' institution. This has highlighted the need for Hong Kong to put in place a comprehensive regime to enable it to both resolve local financial institutions and, in appropriate circumstances, facilitate the resolution of branches and subsidiaries of foreign firms, working in conjunction and close cooperation with the relevant 'home' jurisdiction.

The following are 'headline' comments on matters related to the questions raised in the Consultation Paper:

**Consistent support for development of a recovery and resolution framework in Hong Kong** – Our discussions with financial institution clients have been led by partners of this firm practising in various fields of expertise (including capital markets, financial regulation and markets, and insolvency), and the views we have received (whether given 'institutionally' or personally) have been consistent in their support for the development of a recovery and resolution framework in Hong Kong.

**Timetable** – There is concern that the minimum required legislation may not be brought into effect during 2015, even if (as currently envisaged) the second stage of consultation takes place during 2014. Delay in the resolution regime becoming legally effective may well have an adverse effect on Hong Kong's position (and future role) as a leading international financial centre. Accordingly, the FSTB is encouraged to accelerate the development of proposals for Hong Kong's resolution regime and, at the same time, introduce changes to Hong Kong's insolvency laws to support the resolution regime. However, we recognise that from the standpoint of the legislators this may be a tall order – not least because what many regard as very necessary changes to Hong Kong's corporate insolvency laws were first mooted long before the onset of the global financial crisis.

**Hong Kong and Greater China** – Hong Kong's status as a leading international financial centre is heavily dependent on its connections with Greater China. The formulation of Hong Kong's resolution regime without reference to those connections would be regrettable – having regard, in particular, to the onus on China, as an FSB member, to develop its own proposals. At the same time, Hong Kong's resolution regime must be consistent with international standards, and non-Chinese banks and insurers in particular will want to see that compliance with international standards is not sacrificed in the interests of harmonisation

with China. This is an issue that requires detailed attention, separate from the cross-border coordination and information-sharing considered in Chapter 8 of the Consultation Paper.

**Hong Kong and coordination with other leading international financial centres** – Chapter 8 of the Consultation Paper does consider ways in which resolution actions can be coordinated cross-border. Such coordination will be critical to the effectiveness of Hong Kong's resolution regime. Hong Kong's special constitutional status makes it crucially important that this topic is fully addressed and developed as part of Hong Kong's resolution regime.

**Branches and subsidiaries** – Our discussions to date with our foreign financial institution clients highlight that, for each of them, their approach is dictated by whether they are operating in Hong Kong through a branch or a subsidiary. In relation to both branch and subsidiary operations in Hong Kong, there is a clear consensus amongst our relevant financial institution clients that cooperation should mean the 'host' jurisdiction not implementing any regime which could in any way hinder the successful implementation of a 'home' resolution regime. In this regard it is interesting to note that the Bank of England Prudential Regulation Authority (PRA) consultation paper, "*Supervising international banks: the Prudential Regulation Authority's approach to branch supervision*" (PRA Paper), issued in February 2014 after the launch of the Consultation Paper, states that the PRA is proposing to introduce a rule that will require that non European Economic Area firms take all steps within their control to have adequate provision made in resolution plans for their UK branches. A key issue which has therefore emerged for the second stage of the Hong Kong consultation is how the Hong Kong authorities propose to address the not straightforward issue of fully respecting the need for primacy of the home regime whilst at the same time having, of necessity, to reserve for themselves the ability to take action in relation to a failing Hong Kong branch in circumstances where the 'home' jurisdiction authority cannot or will not take the requisite action for whatever reason. Consequently, what will be of paramount importance will be clearly defining the trigger points for such intervention.

**Financial markets and early termination rights** – The Consultation Paper recognises that a stay of early termination rights is likely to be a pillar of the resolution regime, but defers consultation on it. This is a crucial and complex topic and, in our view, the development of a broad approach should be addressed by the FSTB before the second-stage consultation process, with particular reference to cross-border coordination.

**Resolution authority** – Having regard to the speed and clarity of decision-making required in a resolution scenario, we would prefer a single, new resolution authority be established. However, the overall role, and staffing, of a single resolution authority need to be developed in conjunction with the financial institution community.

**Licensing/authorisation issues** – The development of an effective mechanism for the acquiring institution to obtain the appropriate licensing status will be essential in maintaining the continuity of critical functions of the failing FI. This area needs to be addressed in more detail.

**'Bail-in' capital market instruments, and 'prevention rather than cure'** – There is currently a degree of uncertainty or inconsistency as to the 'trigger-point(s)' of bail-in instruments, and the effect of bail-in on those instruments. It seems to us that development of these issues would be useful. A criticism of resolution regimes generally is that regulators' awareness of the poor financial condition of a financial institution tends to lag behind the awareness of market participants. If the holders of bail-in instruments (with their allegedly better awareness) are able to avert formal resolution steps, for reasons of self-interest, this would be an attractive position for all stakeholders.

We, ASIFMA and GFMA are, of course, happy to elaborate on the above points and on the replies to the specific questions.

Yours faithfully,

**Clifford Chance**

## Question 1

*Do you agree that a common framework for resolution through a single regime (albeit with some sector-specific provisions) offers advantages over establishing different regimes for FIs operating in different sectors of the financial system? If not, please explain the advantages of separate regimes and how it can be ensured that these operate together effectively in the resolution of cross-sectoral groups.*

We agree that a common framework for resolution through a single regime is sensible. However, the implementation of the framework must be proportionate to, and cater for, the differing complexity and varying levels of systemic importance of the FIs within its scope.

Whilst the Key Attributes set out by the FSB in its paper "*Key Attributes of Effective Resolution Regimes for Financial Institutions*" (October 2011) constitute an "umbrella" resolution standard, not all Key Attributes are equally relevant for all types of FI. The FSB recognises that the response to a crisis needs to be tailored to the specific nature of an FI's activities, business models and risks, and that the resolution powers set out in the Key Attributes will not all be suitable for all sectors and in all circumstances. Different industries will have different transferability issues in the context of a resolution depending on the products/instruments/assets/liabilities/etc. that will need to be transferred. For example, a FI's business may involve deposits, loans, asset management businesses and securities (equities, debts, derivatives instruments and securitised products), an LC's business may mainly comprise securities products and asset management businesses, and the business of an authorized insurer is likely to primarily involve insurance contracts and investment linked products; long term insurance businesses will also have different considerations from general insurance businesses.

Therefore whilst a common framework for resolution through a single regime supports the universal types of businesses that are common to different FIs, many sector-specific requirements will need to be accommodated. The resolution regime could be structured as a single ordinance with different parts covering different industries, or with specific industries governed by different codes or guidelines (for example, the resolution regime could be structured in a similar way to the anti-money laundering guidelines, where there is a uniform set of requirements applicable to all financial institutions, together with supplementary or sector-specific guidance that is necessary or appropriate for the respective sectors).

The success of a resolution is also dependent on whether the resolution authority is in possession of credible tools and powers to intervene quickly to manage a failing FI. We have considered both the sector-specific and integrated options and we are of the view that a single resolution authority is preferred. In any case the lead resolution authority should have

assessments in place to establish whether the proposed resolution regime will achieve the intended effect of the relevant Key Attributes, and in the absence of practical experience, whether there are potential obstacles hindering effective implementations.

## **Question 2**

***Do you agree that it is appropriate for all LBs to be within the scope of the regime (given it would only be used where a non-viable LB also posed a threat to financial stability)? If not, what other approaches to the setting of the scope of the regime, which ensure that all relevant LBs are covered, should be considered?***

Whilst we support a requirement for recovery and resolution plans, the regime must be implemented in a way that is proportionate to the nature, size, complexity and specific circumstances of each institution.

We can appreciate the argument that it might be convenient to catch all LBs rather than trying to identify which ones would pose systemic risk – it removes doubt.

However, we do not agree that all LBs should be included. We are of the view that the regime should only cover recognized global systemically important financial institutions plus local LBs crossing certain quantitative thresholds.

Key Attribute 1 provides that all FIs whose failure could result in a cessation in the provision of critical financial services or otherwise pose systemic risk should be within the scope of an effective resolution regime. The failure of LBs with only a small operation in Hong Kong (whether or not they have a larger operation overseas) are unlikely to cause critical or systemic issues for Hong Kong. Covering all LBs may therefore be going beyond the original intention of the regime. Accordingly there should be quantitative thresholds which must be met before a LB falls within the scope of the resolution regime. The Consultation Paper recognizes this argument in the context of LCs (see paragraph 140 and on).

## **Question 3**

***Do you agree that it is appropriate for all RLBs and DTCs to be within the scope of the regime (given it would only be used where a non-viable RLB or DTC posed a threat to financial stability)? If not, what other approaches, which would ensure that all relevant RLBs and DTCs are covered, should be considered?***

Our view on the inclusion of RLBs and DTCs is similar to the position we have expressed in relation to LBs in our response to Question 2, but the argument for not including all RLBs and DTCs within the scope of the regime is stronger given their much more restricted scope of activity in Hong Kong (and thus the even smaller likelihood of their failure having an

impact on financial stability in Hong Kong). By definition DTCs are Hong Kong incorporated subsidiaries and so the impact of a DTC's failure on a global basis must be less significant, and their position ring-fenced within the borders of Hong Kong to the extent they only operate in Hong Kong.

In addition, RLBs and DTCs are not covered by the Deposit Protection Scheme (DPS). It can be argued that there is no strong reason for the scope of the resolution regime to be wider than the scope of the DPS.

It might be relevant to catch RLBs and DTCs that are part of a G-SIFI group.

#### **Question 4**

***Do you agree that it would be appropriate to extend the scope of the proposed resolution regime to FMIs which are designated to be overseen by the MA under the CSSO (other than those which are owned and operated by the MA) and those that are recognized as clearing houses under the SFO?***

We agree that (a) FMIs which are designated under the CSSO and (b) recognized clearing houses should be within the scope of the proposed resolution regime. This is in alignment with Key Attribute 1.2.

In particular, we consider that special regard is needed in relation to the resolution regime of FMIs given the critical role they play in our financial markets. This is recognised by the FSB, which published draft guidance on the application of the Key Attributes to non-bank financial institutions (such as FMIs) in August 2013 (Guidance). For example, the continuity of the FMI's functions should be of paramount importance to the resolution authority during the resolution process.

However, we note in paragraph 1 of the Guidance that the resolution regime does not need to cover FMIs that are "owned and operated by central banks". We would encourage the HKMA to clearly identify those FMIs which it is intended would be subject to the resolution regime to be introduced in Hong Kong. Under the CSSO, there are currently six FMIs: (i) Hong Kong dollar Clearing House Automated Transfer System (CHATS), (ii) US dollar CHATS, (iii) Euro CHATS, (iv) Renminbi CHATS, (v) CMU and (vi) Continuous Linked Settlement System.

We understand that the position for the latter two FMIs should be relatively clear. CMU, which is operated by the HKMA, can be exempted from the resolution regime on the basis that it is owned and operated by Hong Kong's central bank. The Continuous Linked Settlement System is a privately owned and operated FMI which should be subject to the resolution regime. However, the position in relation to CHATS is more complex as Hong

Kong Interbank Clearing Limited is partially owned by the Hong Kong Monetary Authority and the Hong Kong Association of Banks. This is further complicated by the fact that the HKMA acts as the clearing bank for HKD CHATS, whereas the clearing bank for each of USD CHATS, EUR CHATS and RMB CHATS is HSBC, SCB and BOCHK respectively. It would therefore be helpful if the HKMA clarified which FMIs designated under the CSSO will be subject to the proposed resolution regime. We would also encourage the HKMA to set out a clear statement of policy for determining which FMIs and CCPs will be within the scope of the proposed resolution regime to avoid any ambiguity in the future, with sufficient clarity on the resolution proposals for all of Hong Kong's FMI so that resolution planning by all financial institutions can address their relationships with all FMIs. Systemically important CCPs should be defined and held to at least the same standards as G-SIFIs, as the failure of a systemically important CCP could have the same or greater consequences than the failure of a G-SIFI.

#### **Question 5**

*Do you agree that it is appropriate to set the scope of the regime to extend to some LCs?*

It is noted in the Consultation Paper there is no individual LC that is likely to pose systemic risk in Hong Kong; however there could be one in the future. We agree that it is appropriate to include some LCs within the scope of the resolution regime, which is consistent with Key Attribute 1. As for LBs (see our response to Question 2), an assessment for inclusion should be carried out based on the size and systemic nature of each LC.

#### **Question 6**

*If so, and in order to capture those LCs which could be critical or systemic, should the scope be set with reference to the regulated activities undertaken by LCs? Are the regulated activities identified in paragraph 144 those that are most relevant? Is there a case for further narrowing the scope through the use of a minimum size threshold?*

We agree with the proposal that regulated activities relating to provision of advisory services (i.e. Type 4 (advising on securities), Type 5 (advising on futures contracts), Type 6 (advising on corporate finance) and Type 11 (advising on OTC derivatives – to be introduced)) are unlikely to pose systemic risks in Hong Kong and may be carved out.

It is suggested in paragraph 144 of the Consultation Paper that it may be more appropriate to set the scope of the resolution regime to extend to those LCs providing certain critical financial services or relevant activities on a material scale only. The Consultation Paper identifies the most relevant activities as: (i) dealing in securities or futures contracts; (ii) asset

management; and (iii) dealing in OTC derivatives or acting as a clearing agent for OTC derivatives. We agree that this is a good starting point to limit/set the scope of the regime.

We also consider that the regime should make specific provision for the resolution of those FIs with holdings of client assets, such that those client assets can be rapidly transferred or returned under the resolution process.

As set out in our response to Question 5, as for LBs (see our response to Question 2), our view is that an assessment for inclusion should be carried out based on the size and systemic nature of each LC. If a minimum size threshold is set for LCs, this would also support the case for a minimum size threshold to be set for authorized institutions.

### **Question 7**

***Do you agree that the scope should extend to LCs which are branches or subsidiaries of G-SIFIs? Do you see a need for the scope to extend to LCs which are part of wider financial services groups, other than G-SIFIs, whether those operate only locally or cross-border?***

In recent times the SFC has only granted licences to locally incorporated entities, and so the number of licensed branches in Hong Kong is limited; although branches of overseas banks continue to be registered with the SFC. We agree that the scope of the regime should extend to LCs which are branches of G-SIFIs, which would be limited in number. This aligns with Key Attribute 1 where the scope of the regime should extend to "branches of foreign firms" as well as to those FIs which are locally-incorporated.

As for the subsidiaries of G-SIFIs, there is justification that the resolution should be extended to them consistent with the FSB's requirement that each local regime enables a host authority to support the orderly resolution of G-SIFIs.

Otherwise, we do not necessarily see a need for the scope to extend to LCs simply because they are part of wider financial services groups, other than G-SIFIs, whether those operate only locally or cross-border.

More thought needs to be given to the various licensing implications arising on the resolution of an LC as, for example, the transfer of substantial shareholdings and/or change of control arising on the resolution of a G-SIFI will trigger licensing issues.

### **Question 8**

***Do you agree that it would be appropriate to extend the scope of the proposed resolution regime to the local operations of insurers designated as G-SIIs and/or IAIGs as well as***

***those insurers which it is assessed could be critical or systemically important locally were they to fail?***

Please see our response to Question 9, which deals more generally with the 'home v host' issue.

If the scope of the regime is extended to local operations of insurers designated as G-SIIs and/or IAIGs as well as systemically important insurers, there is an argument that a consistent standard should be applied to each of the different regulated sectors, namely that the regime should cover authorized institutions, LCs, and authorized insurers that are branches/subsidiaries of a recognized global systemically important entity and also those that could be critical or systemically important locally were they to fail (which local importance should be assessed by reference to a quantitative threshold).

#### **Question 9**

***Do you agree that branches of foreign FIs should be within the scope of the local resolution regime such that the powers made available might be used to: (i) facilitate resolution being undertaken by a home authority; or (ii) support local resolution?***

We agree with the proposal that branches of foreign FIs should be within the scope of the local regime and that relevant powers should be made available to facilitate resolution undertaken by a home authority and, in exceptional cases, carry out local resolution. We set out more detail on this below. This is consistent with the objectives of the Key Attributes and, indeed, it would make no practical sense whatsoever to seek to exclude branches of foreign FIs. The Consultation Paper points out that Singapore and Switzerland have already brought the branches of foreign FIs fully within the scope of their resolution regimes while others are working to implement the necessary changes. It is clearly necessary for Hong Kong as a major financial centre to adopt the same stance as other major jurisdictions, not least for the purposes of effective cooperation.

Our financial institution clients are strongly of the view that, as far as possible, the Hong Kong resolution authority should undertake local resolution of branches, as for subsidiaries, in support of a resolution in the home jurisdiction and in cooperation with the resolution authority in that jurisdiction. The ability for the Hong Kong resolution authority to take independent action to resolve branches of foreign firms in Hong Kong, should, as noted at paragraph 153 of the Consultation Paper, be a fall-back option, to be exercised where the home jurisdiction cannot or will not take action which is necessary, proportionate or appropriate for Hong Kong. This might include, for example, where the home state resolution does not give equal treatment to branch creditors or, as set out in the Consultation Paper, where local action needs to be taken protect financial stability and the public interest locally.

There will need to be detailed guidance issued setting out the circumstances in which the Hong Kong resolution authority would exercise this power, and our global financial institution clients prefer that this explicitly require the resolution authority to consider the potential impact on other jurisdictions that a locally initiated resolution in respect of a Hong Kong branch of a G-SIFI may have.

To ensure that an effective cross-border resolution regime is robust, many complex and technical issues will need to be fully addressed. Resolution involving both 'home' and 'host' jurisdictions requires that both the relevant authorities have a harmonised toolkit of measures which can be exercised promptly with a degree of flexibility.

The success of the necessary cross-border coordination is dependent on the relevant authorities behaving in consistent and predictable ways and therefore a regular disclosure will be key.

Key Attribute 8 requires that home and key host authorities maintain crisis management groups (CMGs) "*with the objective of enhancing the preparedness for, and facilitating the management and resolution of, a cross-border financial crisis affecting the firm*". We would welcome detail on how such CMGs will be established and function in Hong Kong, particularly with regard to cooperation with other regulators outside of Hong Kong.

Our work on resolution planning exercises for FIs in Hong Kong has shown that the existing Hong Kong framework would benefit from updating and extension. Whilst we agree with the statement made at paragraph 155 of the Consultation Paper that existing intervention powers under Section 52 of the Banking Ordinance extend to branches of financial institutions – and also agree that this further supports the argument that branches of FIs should come within a new resolution regime in Hong Kong – we note that the speed of deployment of this provision could be faster and is a potential impediment to effective transfer to a new operating entity. Our view is that amending the Banking Ordinance would not be the best way of addressing the failings of the current limited tool kit available in Hong Kong for dealing with failing financial institutions.

As for applicable insolvency laws, it is worth noting that quite apart from the glaring absence of any statutory corporate rescue procedure, Hong Kong has not enacted the UNCITRAL Model Law on Insolvency designed to facilitate the formal insolvency of a multi-jurisdictional operation. At present, although the Hong Kong court has jurisdiction to wind up an overseas company as an unregistered company if there is a sufficient connection with Hong Kong (and, at its discretion, appoint provisional liquidators at the time of presentation of a winding-up petition), it is not always clear how this jurisdiction will be exercised. The Hong Kong courts have inherent jurisdiction to assist a foreign representative but there is no provision in the Companies Ordinance that expressly authorises a foreign representative to

commence a winding up procedure in Hong Kong. In practice, therefore, that foreign representative will have a choice between commencing an ancillary proceeding in support of the process in the home jurisdiction or alternatively, inviting a local creditor to present a petition.

The net result is that the tools available to Hong Kong should be extended to include a more comprehensive range of measures to support the resolution of a foreign FI.

We comment further on the inadequacies of existing Hong Kong insolvency law in the response to Question 26 below.

### **Question 10**

*Do you see any particular issues that need to be taken into consideration in ensuring that the regime can be deployed effectively in relation to branches of foreign FIs where necessary?*

The issue at the heart of this question is whether foreign FIs should be required to convert their branches into subsidiaries. Our view, consistent with that noted in the Consultation Paper, is that this would not be a proportionate reaction: the reality is that at present FIs operate through branches for very good legal and non-legal reasons. A useful summary of the benefits to a FI of using a branch structure is set out in Box 1 on page 7 of the PRA Paper, issued after the Consultation Paper was launched.

The clear consensus view of our financial institution clients is that Hong Kong should not pursue reforms under which foreign FIs are required to convert branches into subsidiaries.

Please also see our response to Question 9, in particular the need to ensure that resolution actions in Hong Kong in respect of branches of FIs are, as far as possible, undertaken by the Hong Kong resolution authority in support of a resolution in the home jurisdiction and in cooperation with the resolution authority in that jurisdiction, or, in exceptional cases, to carry out a local resolution where the home jurisdiction cannot or will not take action which is necessary, proportionate or appropriate for Hong Kong.

### **Question 11**

*Do you agree that extending the scope of the proposed resolution regime to cover locally-incorporated holding companies is appropriate such that the powers available might be used where, and to the extent, appropriate to support resolution of one or more FIs?*

We agree that the proposed resolution regime should cover locally incorporated holding companies where it has been assessed that it is more appropriate to resolve at the "single

point of entry" i.e. to resolve locally incorporated holding companies in 'home' jurisdictions. As pointed out in the Consultation Paper, the effective resolution of some Hong Kong FIs depends on the possibility to carry out resolution at the level of their holding companies hence it is sensible for the regime to be extended to those holding companies. The proposal also aligns with the approach taken in the EU, UK, US and Singapore.

Some of our financial institution clients thought that whether it would be appropriate for a firm to establish a locally incorporated holding company should be aligned to the normal business strategy or agreed resolution strategy of that firm, rather than being a requirement imposed for the purposes of resolution.

## **Question 12**

***Do you have any initial views on whether it is appropriate to extend the scope of the regime to affiliated operational entities to help ensure that they can continue to provide critical services to any FIs which are being resolved?***

As a matter of practical reality, a number of FIs rely on affiliated operational entities, perhaps in a different jurisdiction, for key services such as IT. The Consultation Paper suggests that, in the absence of appropriate provision in the resolution regime, there may be a need for FIs to make changes to the way in which they are structured and operate in order to reduce their day-to-day reliance on such affiliated operational entities. In reality FIs may incur significant cost by adjusting their reliance on affiliates, which may not be economically sensible when the initial decision to engage affiliated operations was often driven by the desire to achieve cost savings.

Some of our financial institution clients strongly believe that an extension of the regime to affiliated operating entities is not the only or most appropriate answer, as this could be disruptive if the operational unit services entities across jurisdictions. It should also be noted that some regulators and global FIs are moving toward setting up shared-service entities specifically to improve resolvability. We believe it is more important to look at how these operational entities (including shared-service entities) are structured, by exploring the extent to which critical services from affiliated operational entities could be continued in, through and after resolution (for example, by ensuring that such contracts are 'resolution remote' and that payments are up to date), rather than simply focusing on reducing reliance on these entities, given that this could conflict fundamentally with the aim behind building a shared-service entity structure in the first place.

We agree that further analysis is needed to determine the extent to which individual FIs actually place reliance on affiliated operational entities in Hong Kong, before determining which (or both) of the two proposed approaches outlined in the Consultation Paper should be

adopted. In the case of foreign FIs, it may be that the Hong Kong resolution authority can, through discussions in the CMGs, ensure that they are comfortable with the arrangements made in the home jurisdictions.

### **Question 13**

***Do you agree that the conditions proposed for initiating resolution are appropriate in that they will support the use of the regime in relevant circumstances?***

We agree that the regulatory assessment based on the first non-viability condition and second financial stability condition is sensible.

The "threshold conditions" cover possible causes of a FI's failure other than inadequate capital, and include the FI's inability to meet conditions set for its authorisation or its licensed activities. The assessment for resolution initiation effectively checks if there exists a reasonable prospect that the threshold conditions will be met by the FI over a reasonable timeframe, and, if not, whether the failing FI will affect the general stability and effective working of the financial system.

The conditions appear to be appropriate and promote the objective of providing a resolution regime only as a last resort, where there is a threat to the continuity of critical financial services and financial stability. The concept of the threshold applying also to authorisation or licensing conditions is also consistent with the approach taken in the EU legislation. However, the factors relevant to assessing the conditions, in particular the first non-viability condition, need to be refined and elaborated on (as noted in the Consultation Paper) as well as applied in a consistent and transparent manner. The concern is that if creditors fear the resolution authority initiating a resolution of a FI this could, of itself, accelerate a collapse of that FI.

Further, the effectiveness of the resolution process relies upon the ability of the resolution authority to conduct a rapid assessment of the situation, particularly in relation to possible viable private sector options. Where the FI is assessed as non-viable and the second financial stability test is met such that the FI is resolvable, should the FI have the ability to propose a private sector remedy or intervention in order to assist a full and proper assessment of the available alternatives to resolution?

Please also see our response to Question 9. We note the need to ensure that resolution actions in Hong Kong in respect of branches and subsidiaries of FIs are, as far as possible, undertaken by the Hong Kong resolution authority in support of a resolution in the 'home' jurisdiction and in cooperation with the resolution authority in that jurisdiction, or, in the case of branches, in exceptional cases to carry out a local resolution where the home jurisdiction

cannot or will not take action which is necessary, proportionate or appropriate for Hong Kong. Some of our financial institution clients thought that this philosophy should be reflected in the conditions to, or objectives for, resolution action being taken.

#### **Question 14**

*In particular, do you agree that it is appropriate that the first condition recognises that non-viability could arise on financial and non-financial grounds (noting that resolution could occur only if the second financial stability condition is also met)?*

We agree that it is right to recognise there may be instances of non-viability by reason of non-financial grounds. Please also see our response to Question 13.

Where the relevant non-financial ground is a breach of regulation, if the second financial stability condition is also met, any resulting resolution should refrain from shielding any party whose behaviour was found to have caused the breach.

The resolution authority may be the frontline supervisor provided that there are arrangements in place to ensure the separation between the resolution and the supervisory functions. The key is to ensure there is no interference with the usual regulatory process or the resolution process, and avenues exist for the FI to appeal against the decision to resolve the FI.

#### **Question 15**

*Are the objectives which it is proposed should be set for resolution suitable to guide the delivery of the desired outcomes?*

We recognize that the proposed objectives aim to align with the expressed intentions of the Key Attributes, and we appreciate the Hong Kong government's efforts in ensuring that Hong Kong's resolution regime places it on a level playing field with other major markets.

Whilst the objectives proposed in this first phase Consultation Paper are high level aspirational ones which appear to provide suitable guidance, until we are aware of the outcomes set in the second phase of consultation we simply cannot confirm that these objectives are sufficient to achieve such outcomes.

Key Attribute 2.3 provides that the resolution authority should be required, as part of either its statutory objectives or functions, to consider the potential impact of its resolution actions on financial stability in other jurisdictions. We note the statements at paragraphs 186 and 331 of the Consultation Paper that this is being considered further. The preference amongst our financial institution clients was for this to be added as a further objective for the resolution authority.

Please also see our response to Question 9. We note the need to ensure that resolution actions in Hong Kong in respect of branches and subsidiaries of FIs are, as far as possible, undertaken by the Hong Kong resolution authority in support of a resolution in the home jurisdiction and in cooperation with the resolution authority in that jurisdiction, or, in the case of branches, in exceptional cases to carry out a local resolution where the home jurisdiction cannot or will not take action which is necessary, proportionate or appropriate for Hong Kong. Some of our financial institution clients thought that this philosophy should be reflected in the conditions to, or objectives for, resolution action being taken.

### **Question 16**

*Do you agree that, in line with their existing statutory responsibilities and supervisory intervention powers, the MA, SFC and IA should be appointed to act as resolution authorities for the FIs under their respective purviews?*

In the interests of prompt and efficient resolution action, it is crucial that the responsibility for determining whether an institution is failing, or likely to fail, be allocated to a competent authority. The authority (whether a single regulator or multiple authorities) should have the appropriate skills, expertise, resources and powers to implement resolution.

The authority must also be equipped to conduct resolution assessments on the basis of a proportionality test (based upon the both the size (applying a quantitative threshold test) and systemic nature of the relevant FI) to determine whether a FI comes within the scope of the regime.

Regardless of whether there is a single resolution authority or multiple resolution authorities, there should be an ability for an FI to appeal a decision to resolve the FI. See also our response to Question 14.

### **Integrated regulator**

One of the challenges that will be faced by a single standalone regulator is that it will not have the same level of familiarity as those sectoral regulators that are already supervising FIs under their existing purviews. The obvious challenges with a newly formed resolution authority are resourcing it and ensuring it is close enough to the FIs to understand when they cease to be viable and their systemic importance. One way to close the gap is perhaps having the respective regulatory supervisors provide support to the resolution authority, for example, through secondments or job rotation.

The benefit of having a single regulator is that a more consistent approach in facilitating the resolution regime can be promoted and potential supervisory conflict can be addressed more effectively.

The Consultation Paper recognizes that the concentration of responsibility gained from the benefit of economies of scale may be offset by the cost of maintaining an agency whose services are only used rarely. Whilst we still think having a single integrated authority is beneficial and is the preferred option, we look forward to having more clarity around how a single authority would operate in practice and how its interrelationship with other sector-specific regulators would be managed.

### **Multiple regulators**

The resolution authority may be one (or more) of the sector-specific supervisors provided that there are arrangements in place to ensure the separation between the resolution and the supervisory functions with a view to managing potential conflicts of interests properly.

We are concerned that the underlying regulatory intent of sectoral regulators may affect the way the resolution regime is conducted. For example, if the regulator has to decide the 'no longer viable' test they may leave it too late, and then over react in resolution as an overly defensive measure, or they may decide to react too early for the wrong reasons.

In the event that multiple resolution authorities are the preferred option, then there will need to be clarity around how the lead resolution authority is designated and its interrelationship with the other resolution authorities. For example, in a banking group with a corporate finance business, a securities business and an asset management business, perhaps operating through different Hong Kong incorporated subsidiaries, there would be a question as to which resolution authority is best suited to be designated as the lead resolution authority; in turn, this probably depends on the relative size and importance of the banking business versus, for example, the securities business.

There may still be a need for the establishment of a specialist agency to coordinate resolution of FIs which operate within financial services groups operating across multiple sectors.

### **Question 17**

***Do you have any views on how a resolution option allowing compulsory transfer of all or part of a failing FI's business could most effectively be structured and used?***

It may seem intuitive that the process for a complete transfer (i.e. transferring the shares in a failing institution to an acquiring institution) would be easier to complete than a partial transfer; but we acknowledge in some cases it might be more expedient to sell specific assets than the full company.

There should be safeguards in place in relation to partial transfers e.g. protection of netting and the preservation of the NCWOL standard. Where the resolution authority decides that a

partial transfer of assets/business operations from a failing institution to an acquiring institution is the appropriate measure, the resolution authority should follow clear guidelines in separating those assets and liabilities to be transferred, ensuring that no important asset or liability is left behind.

As is the case with the exercise of all of the other resolution powers, where the FI is part of a wider group incorporated outside Hong Kong, the resolution authority's compulsory transfer powers should generally be exercised in cooperation with the home regulator. See our response to Question 9 for further detail.

The Consultation Paper seems focused on feasibility in the context of FIs, citing examples relating to the transfer of deposits, but there will be additional considerations relating to the transfer of other assets/liabilities (see also our comments in response to Question 1).

As stated in paragraph 216 of the Consultation Paper, the regime will need to allow for the regulator to carry out the transfer (whether a complete or partial transfer) without the consent of other parties (for example by replacing the need for consent with a notice requirement) and without the need to comply with all other applicable regulatory procedural requirements (e.g. affiliation issues, substantial shareholder reporting/approval requirements, disclosure of interest, takeover issues, etc.). We query whether there should be a grace period applicable before the acquiring institution need to comply with the relevant regulatory requirements resulting from the acquisition.

Licensing/authorisation issues are also important considerations in a transfer e.g. transferring substantial shareholding in Hong Kong subsidiaries will have licensing/change of control implications. Without the appropriate licensing status, the acquiring institution will not be able to effectively carry out the operations transferred from the failing FI, which defeats the purpose of the resolution regime being to maintain continuity of critical functions.

Certain business operations may not be as easily transferable as cash deposits. For example, for FIs holding client securities (equities, debts, derivatives, securitised products, etc.) as nominee or custodian (which could be located offshore with contracts subject to foreign law), the transfer of such securities may not be as easy as the transfer of cash deposits (the example given in paragraph 213 of the Consultation Paper is that the transfer of deposits could be done over the course of a weekend).

We also query whether the transfer of failing FI businesses should be impacted by the Transfer of Business (Protection of Creditors) Ordinance or should this Ordinance be disapplied?

## Question 18

*Do you have any views on how a resolution option allowing compulsory transfer of part of a failing FI's business to a bridge institution could most effectively be structured and used?*

In our response to Question 17, we identified issues arising from the partial transfer of a failing FI's business. In our response to this Question 18, we consider issues surrounding bridge institutions.

Consideration will need to be given as to the personnel managing the bridge institution as it will in turn control the failing FI. The bridge institution will require managers with appropriate skills and experience in order to continue to operate the business of the failing FI in the interim.

We have the following questions in relation to bridge institutions:

- Will the bridge institution be set up beforehand in case of future failure? What are the cost considerations? Our view is that it will not be justifiable for FIs to establish a bridge institution ahead of time.
- Will the FIs covered by the regime need to develop a plan to effect their own compulsory transfer in case of a failure? The view of several of our financial institution clients is that this should only be necessary if it forms part of the resolution strategy for the firm.
- Will the bridge institution need to obtain relevant regulatory status (e.g. licenses and approvals) so as to effect the transfer? Would this be done beforehand or at the relevant time? How would this be expedited (e.g. over a weekend)?
- How will be the transfer of employee and service providers be managed to ensure continuance of operations?

We foresee issues with the need to obtain waivers and consents, as well as ensuring continued compliance with regulatory procedural requirements (and in this regard also see our response to Question 17).

As is the case with the exercise of all of the other resolution powers, and as similarly noted in our response to Question 17, where the FI is part of a wider group incorporated outside Hong Kong, the resolution authority's powers to transfer part of a business to a bridge institution should generally be exercised in cooperation with the home regulator. See also our response to Question 9.

## Question 19

### *Do you have any views on the factors which should be taken into account in drawing up proposals for the provision of a bail-in option for the resolution regime in Hong Kong?*

We support the inclusion of a statutory bail-in option which aligns with the Key Attributes. For many of our financial institution clients, bail-in is the preferred resolution tool of choice. The terms of any bail-in option proposed must be consistent with the international standards for determining gone concern loss absorbing capital (GLAC) which the FSB is to put in place, and the Hong Kong regulators are encouraged to look to the provisions set out in the EU Resolution and Recovery Directive (which should be formally adopted by the European Union later this year).

We also agree that the regime should generally respect the hierarchy of claims on liquidation (using the NCWOL standard, which is discussed in our response to Question 27) and treat creditors fairly, and that protection of certain categories of stakeholders will be important (e.g. certain short-term interbank liabilities, trade creditors, settlement system and central counterparty and employee liabilities). In order for statutory bail-in to be effective, it is essential that clear guidance is given as to the point at which it may, or will, be exercised.

Our financial institution clients provided us with various factors which they thought should be considered in drawing up the proposals for the bail-in option:

- (a) Clarity on the liabilities that could be 'bailed in' so as to give ex ante clarity to creditors.
- (b) Flexibility for qualifying liabilities to be issued to holders within the group which the FI is part of or externally.
- (c) Bail-in should have a broad scope, with specific and stated exclusions only.
- (d) The regulation authority should have the ability to exclude specific classes of creditors from bail-in in order to avoid contagion or to maintain financial stability, but there should be strict controls on the use of such exclusion powers.
- (e) Any requirement for a FI to have a certain level of GLAC should be calculated on the basis of the risk weighted assets held by that FI, and not its total liabilities.
- (f) The minimum level of GLAC should be specifically determined for each FI, and should form part of its proposed and agreed resolution strategy, including where that GLAC is held within the group structure.

- (g) Sufficient time should be given to FIs to ensure compliance with the requirement to maintain GLAC.
- (h) FIs will need to develop the capability to support the speedy valuation of assets in order to calculate the capital need on resolution.
- (i) FIs and lenders of last resort will need to ensure that there is a plan for ensuring that liquidity continues to be provided to a FI in resolution, so that creditor claims can be met as they fall due.
- (j) Each FI will need the capability to produce, both in the course of ordinary business and on demand, a relatively accurate representation of the liabilities that could be bailed-in under the regime.
- (k) As noted in paragraph 237 of the Consultation Paper, each FI and the resolution authority will need to come up with a plan, within a reasonable time frame, to ensure the longer-term viability of that FI post- resolution. A bail-in would restore solvency, but will not necessarily in itself create a viable institution going forward.
- (l) A mechanism for 'down-streaming' the capital provided by a bail-in to recapitalise subsidiary entities would be useful for most large FIs in order ensure that the application of the bail-in tool does not result in the arbitrary splitting up of the ownership structure of an FI, except where this in line with the objectives of the resolution regime.
- (m) It is important that the resolution authority has both enough flexibility and safeguards to enable use of the bail-in without causing undue financial instability.

## **Question 20**

***Do you agree that there is a case for including a temporary public ownership (TPO) option in the proposed regime?***

Our financial institution clients had mixed views on the inclusion of the TPO option under the resolution regime. Of particular concern was the risk of the moral hazard created, and that it was not beneficial for either the public or the market to have the perception that taxpayers could be required to bail out financial institutions in the future. We note that the EU regime does include a TPO tool.

If Hong Kong decides to go ahead with the inclusion of a TPO option, the triggering threshold needs to be carefully calibrated to ensure that its use really is limited to being the "last of the last resorts", where no other resolution mechanism can sufficiently meet the

resolution objectives. Our financial institution clients look forward to seeing further detail as to how the TPO arrangements would work, including as to who would assume day-to-day control of an FI subject to TPO.

#### **Question 21**

***Do you have any views on when it would be appropriate to make temporary use of an asset management vehicle (AMV) in order to manage the residual parts of an FI in resolution?***

In the circumstances where rapid liquidation of certain residue components of a failing FIs could adversely affect the stability of the financial market, a separate asset management vehicle should be established to manage such businesses of the FI being resolved. This should be done with a view to maximizing the value of such businesses, and to ensure that the sale of assets or the winding-up of the businesses can be carried out in an orderly manner over an appropriate timeframe.

#### **Question 22**

***Do you have any views on how best to provide for a stay of early termination rights where these might otherwise be exercisable on the grounds of an FI entering resolution or as a result of the use of certain resolution options?***

As a preliminary observation, we emphasise that Hong Kong needs to carefully consider the cross-border implications of any proposed resolution regime given Hong Kong's position as one of the key global financial centres (with 28 of the 29 global systemically important financial institutions having operations locally). The introduction of a stay of early termination rights under Hong Kong's proposed resolution regime will have major implications for market participants and we would encourage the regulators to assess whether the proposals to be put forward in Hong Kong are aligned with and equivalent to those rules which are being introduced in other comparable global financial centres. It is our view that any substantive difference between Hong Kong's resolution regime with those of comparable jurisdictions may adversely affect Hong Kong's desire to maintain itself as a key global financial centre.

We note that there is considerable momentum in various jurisdictions globally for introducing a temporary stay of early termination rights in order to manage a "race for the exit" during the resolution process for an FI. In principle, we are supportive of a temporary stay of early termination rights provided that this is subject to the strict conditions provided for in Key Attribute 4.3, as described in paragraph 252 of the Consultation Paper.

In particular, we note the condition that a temporary stay of early termination rights could only be used "*where the authorities are required to transfer all of the eligible contracts with*

*a particular counterparty to a new entity and would not be permitted to select for transfer individual contracts with the same counterparty and subject to the same netting agreement".* On the one hand, we consider that this is an important condition to prevent "cherry picking" which could be detrimental to any netting analysis conducted in relation to such eligible contracts. However, it should be noted that this condition may also restrict the flexibility of the resolution authority in restructuring the failing FI's business (for example, where the failing FI's operations were partially transferred to another FI and the remainder to a bridge entity (as was the case for Dunfermline Building Society in March 2009)).

Furthermore, we consider that a number of cross-border issues will arise from a temporary stay of early termination rights, particularly around (a) whether such a stay would be recognised by the laws of other relevant jurisdictions, (b) differences in time zones and public holidays and (c) the impact on existing netting opinions that FIs rely on for regulatory capital purposes. In particular, we would encourage the regulators to provide clarity on how a stay of early termination rights under the Hong Kong resolution regime will be accepted and enforced in another jurisdiction, and how cross default provisions would be disapplied (so that resolution of the parent entity does not trigger termination by counterparties of an operating subsidiary). We expect that, for cross-border issues like this, there will need to be significant dialogue and cooperation among regulators of different jurisdictions in order to achieve a suitable outcome from a resolution process. In relation to cross-border cooperation, please see our response to Question 32 below.

### **Question 23**

***Do you have any views on how best to provide the supervisory or resolution authorities with powers to require that FIs remove substantial barriers to resolution?***

According to the FSB's thematic report, only some jurisdictions have the ability to require changes to the structures of FIs solely to improve resolvability. Our view is that how the power should be provided for in Hong Kong should very much depend upon the assessment of the types of barriers which exist to resolution, and we look forward to seeing further information as to what these are. It should be noted that it may not be possible to remove some barriers completely, and that some barriers might arise because of differences between the nature of the resolution regime in place in the 'home' state of the FI and that in Hong Kong.

In addition, whether there are any barriers to resolution for a FI, and how (or if) they should be removed (or minimized), should be determined by the resolution authority on a case by case basis, as part of the 'resolvability assessment' process for each FI. If the correct resolution strategy is chosen for a FI, which should be aligned to its structure and business operating model, then a FI may not need to make changes to its legal or operating structure.

To the extent that FIs may need to make changes to their legal or operating structures, or their businesses, the resolution authority will need to be careful about prescribing such changes and should consider carefully whether the changes will lead to other undesired outcomes or burdensome cost consequences which may have a negative impact on the viability of the FI. Please also see our response to Question 12.

There is a divergence of views amongst our financial institution clients as to the degree of powers which the resolution authority should have. Whilst the majority accept the need for such powers, others note that other jurisdictions have provided incentives for doing so (rather than sanctions for not doing so). Others think that such powers would be better placed with the supervisory authority that deals with the FI in the normal course of business, rather than with the resolution authority.

Whatever powers are to be given to the resolution authority, we strongly support the suggestion at paragraph 259 of the Consultation Paper that FIs should be given sufficient time to consider changes proposed by the resolution authority arising out of a 'resolvability assessment'. The FI should be afforded an opportunity to suggest alternative ways of achieving the same end, as well as an ability to demonstrate why the recommendations are not necessary.

#### **Question 24**

***Is the proposed approach to ensuring that third parties cannot act to pre-empt the resolution of a non-viable FI (including by means of a petition to initiate a winding-up) appropriate?***

This question touches upon the interesting inter-relationship with existing insolvency laws. It is being suggested that nobody should be able to petition for the winding up of an FI without first giving notice to the resolution authority. A period of up to 14 days may then be given for the resolution authority to decide how it wishes to act.

In the absence of any effective corporate rescue regime in Hong Kong for companies, never mind FIs, liquidation is always going to be a last resort. With this in mind, we question if the proposed mechanism is necessary. If, on the one hand, a creditor is genuinely in a position to present a winding up petition then something must be badly awry and the resolution regime should presumably kick-in immediately. On the other hand, if, as is sometimes the case, the proposed petition is frivolous or vexatious, then existing insolvency laws and procedures should ensure that the petition is dismissed at an early stage.

## Question 25

***Do you have any views on how provision might be made to ensure that the residual part of an FI could be called on to temporarily support a transfer of business to another FI or bridge institution (in the manner described in paragraph 266)?***

We agree with the concept that the residual part of an FI could be called on to temporarily support a transfer of business to another FI or bridge institution, which aligns with the position taken in other major jurisdictions including the UK and US. As many FIs centralise their middle office and back office functions (particularly in relation to information technology), it is highly likely that the transferee of a part of a failing FI will be unable to operate effectively without appropriate support from the residual part of the failing FI.

We expect that cross-border cooperation between regulators will be key to ensuring that the residual part of an FI will remain available to offer temporary support to any FI or bridge institution to which part of the business has been transferred. As we explain in our response to Question 32 below, cross-border cooperation between regulators must be addressed and established early on as the regulators will be under considerable time pressure once an FI fails. We are unclear on how this form of cooperation will be achieved by the HK regulators for all FIs (both G-SIFIs and otherwise) in Hong Kong, and look forward to additional clarity being provided in the second phase consultation.

## Question 26

***Do you attach any priority to pursuing reforms designed to ensure that the claims of protected parties (particularly those of depositors and investors) can be transferred out of liquidation proceedings, alongside those reforms being pursued to establish an effective resolution regime?***

The Consultation Paper notes that in the event an FI is failing but does not provide critical financial services and does not pose risk to financial stability, the FI could be dealt with under existing corporate insolvency proceedings. However, the "Lehman experience" amply demonstrated that even in those jurisdictions with far more developed corporate insolvency rescue regimes than Hong Kong, such as the UK, there were ample deficiencies, for example in addressing the return of custody assets and the release of shares held through nominee vehicles. Meanwhile in Hong Kong, whilst there have been a series of consultation papers in relation to proposed reforms of Hong Kong's corporate insolvency laws dating back to the early 1990's, our understanding is that there is no immediate legislative intent to amend corporate insolvency laws. Whilst we are in no doubt that this deficiency should be addressed, we do not envisage that whole scale amendments to substantive insolvency law at the same time as instituting a financial institution resolution regime is feasible.

## **Question 27**

***Do you agree that a compensation mechanism is a necessary safeguard to ensure that shareholders and creditors are no worse off under resolution than they would have been in liquidation? Do you have any views on the factors which should be taken into account in designing such a compensation mechanism?***

We fully support the inclusion of NCWOL safeguard, and expect that as it is designed to create fundamental fairness for creditors, it will give potentially affected parties considerable comfort as the regime is developed. We await the more concrete proposals to be provided at the second stage of the consultation.

In practice we note that it is often a far from straight forward task to determine at the outset of a liquidation what recovery relevant creditors are likely to make, and this would be even more difficult and time consuming for complex FIs. The mechanism will need therefore to apply an appropriate and transparent valuation methodology. How tangible values can be effectively applied on the comparators following the compensation assessment would be another challenge.

A big question is how the compensation mechanism can be funded, and we look forward to seeing further detail on this. Please see also our response to Question 31.

## **Question 28**

***Do you consider that any adjustments are needed to the existing framework for protecting client assets for the purposes of resolution?***

We agree that the aim of the resolution regime should be to ensure client assets held directly or indirectly by an FI entering resolution are returned to the clients quickly, or transferred to an acquiring FI or bridge institution, in order to limit interruption to access to the assets. At this stage, we do not consider that any adjustments are needed to the existing framework for protecting client assets for the purposes of resolution.

One of the lessons from the Lehman bankruptcy is the need to have in place international cooperation for client assets. In IOSCO's "*Recommendations Regarding the Protection of Client Assets – Final Report*" (January 2014), IOSCO identified two possible scenarios that may contribute to regulatory challenges in protecting clients assets: (i) a client knowingly or unknowingly waiving or modifying the degree of protection applicable to client assets or otherwise opted out of the application of the client asset protection regime (where permitted by law); and (ii) where an intermediary has placed or deposited assets in a foreign jurisdiction.

The Hong Kong regulators may need to consider whether they have adequate tools to monitor an intermediary's compliance with the domestic client asset protection rules. In particular, we would encourage the Hong Kong regulators to consider whether there is sufficient market education and awareness in relation to client asset protection under the laws of Hong Kong. Even if the existing framework for protecting client assets is considered to be sufficient, this will be of little assistance if clients have (both knowingly and unknowingly) consented to the disapplication of such rules.

### **Question 29**

***What types of “financial arrangements” do you consider as important to protect in resolution? Why is it important that those arrangements be protected?***

We agree that it is highly important for "financial arrangements" to be clearly defined and to be protected in a resolution process. The category of financial arrangements identified under paragraph 291 of the Consultation Paper is consistent with the approach taken in the resolution regimes proposed in other jurisdictions and are types of financial arrangements which we believe are important to safeguard. In the absence of protections for such financial arrangements, it is likely that higher funding costs and regulatory capital requirements will be imposed on FIs due to the lack of certainty in relation to the ability of market participants to manage their exposure to FI counterparties.

One of the issues which the Consultation Paper comments on, and which we would like to draw attention to, is the balance between the need to undertake resolution action swiftly and the need to safeguard financial arrangements (as described in paragraph 293 of the Consultation Paper). In this regard, we find it helpful to draw on the UK experience with Dunfermline Building Society in March 2009, which involved a complex resolution resulting in the business being split into three parts: (a) the part acquired by Nationwide, (b) the bridge entity and (c) the original failed entity. In this example, the resolution authority was placed under significant time pressure to identify the financial arrangements which needed to be protected whilst attempting to arrange the transfer of part of the business to Nationwide. We would encourage the Hong Kong regulators to consider how financial arrangements in a failing FI would be identified and protected in a timely manner during a resolution process.

Furthermore, it is important for the Hong Kong regulators to consider the cross-border implications arising from the protection of financial arrangements (such as conflicts of law issues) that are not addressed in this Consultation Paper. We highlight that the case of Dunfermline Building Society involved a primarily domestic institution. Where the failing institution is an international institution with financial arrangements spanning several jurisdictions, it will be important for regulators to identify these financial arrangements prior to any resolution process in order to avoid the need to do this within an extremely limited

time frame in the event of a crisis. We further note that the rules in relation to financial arrangements in other jurisdictions, such as the EU, are still in development, particularly in relation to derivatives and centrally cleared transactions. In practice, we consider that prior dialogue and coordination between regulators from different jurisdictions will be key to ensuring the prompt implementation of a resolution process for an international institution.

### **Question 30**

***Do you agree that, in order to ensure resolution can be effected as swiftly as needed, there should be protection from civil liability for: (a) officers, employees and agents of the resolution authority, and (b) directors and officers of FIs acting in compliance with the instructions of the resolution authority, limited to cases where these parties are acting in good faith?***

In respect of (a), whilst we support the notion that the resolution authority should be protected from frivolous law suits and its employees and agents need to be able to perform their functions in good faith without fear of personal liability, we believe such protection should be limited, such that the rights of creditors and third parties are not unduly restricted. Whilst paragraph 298 of the Consultation Paper notes that the SFC and MA currently enjoy immunity under the BO and SFO, we note that their decisions can be the subject of an appeal. There needs to be a process applicable to the resolution regime (whether it be judicial review or an appeal process) to ensure that there is no manifest abuse of process or unnecessary or unfair derogation of a party's rights.

We agree that in respect of (b) there should be protection from civil liability for directors and officers of FIs acting in compliance with the instructions of the resolution authority. However this protection should also extend to (i) all employees of the FI, not just "directors and officers"; (ii) directors, officers and employees of FIs who are acting in compliance with the instructions of the home resolution authority to give effect to any agreed Group resolution plan; and (iii) foreign staff acting in compliance with the instructions issued by the local resolution authority.

Furthermore, where the directors, officers and employees of the FI in resolution are acting under the direction of the resolution authority, immunity from liability should not also require that they act in 'good faith' as it will be difficult to determine what 'good faith' may mean and also the directors and others at the FI may have very little discretion as to how they carry out the requirements of the resolution authority. We therefore recommend removing the requirement that 'directors and officers of FIs' must be acting 'in good faith' in order to benefit from the immunity from civil liability.

A key issue is ascertaining who will be in the best position to determine whether, in the case of (a) or (b), the relevant person acted "in good faith", and what recourse is available when there is a disagreement with that decision.

### **Question 31**

***What provisions should be made under the regime to fund resolution, with a view to ensuring that any call on public funds is no more than temporary?***

The primary aim of the resolution regime is that significant costs of failure are imposed on shareholders and creditors. However the NCWOL safeguard clearly limits the losses that can be absorbed and could leave potential unfunded resolution costs. Some of our financial institution clients feel strongly that the resolution fund should not be used for recapitalisation purposes but only for NCWOL compensation claims and other administrative expenses. We note that given increased capital levels, upcoming GLAC requirements and a broad scope of bail-in, our view is that there are likely to be significant levels of loss absorbency available whilst still respecting the NCWOL principle. This is a critical element in the reduction of reliance on resolution funds and to support the global progress made in addressing 'too-big-to-fail'.

The FSB noted in its "*Thematic Review on Resolution Regimes - Peer Review Report*" (April 2013) that most jurisdictions "*rely on privately funded protection funds to finance resolution actions, but it is not clear whether such arrangements are adequate or appropriate in scale or scope*". The Consultation Paper already notes that the existing Deposit Protection Scheme, Insurance Compensation Fund and the planned Policyholders' Protection Fund in Hong Kong will be insufficient for a meaningful resolution of a FI.

According to the FSB's Peer Review Report, most jurisdictions intend to recoup financial assistance by the sale of FIs and assets acquired in the course of resolution actions and to replenish deposit insurance funds through industry contributions. Key Attribute 6.3 provides that, in addition to privately-financed deposit insurance or resolution funds, a funding mechanism for ex-post recovery from the industry of the costs of providing temporary financing to facilitate the resolution of a FI is recommended. Some of our financial institution clients noted that the costs of any pre-funding, whether through levies or otherwise, would be passed on indirectly to users of the financial system, and therefore to retail and other customers. Concerns were also raised about the potential for this creating competitive disadvantages between institutions within a sector, across sectors and when compared to other financial centres.

Our view is that further analysis is required as to whether pre or ex-post levies, or a combination of both, on FIs in Hong Kong is appropriate. Temporary public financial support

will remain an important component of resolution funding arrangements for SIFIs, but the key is to identify good practices to mitigate moral hazard risks under the temporary public approach.

### **Question 32**

***Do you agree that it is important that the resolution regime in Hong Kong supports, and is seen to support, cooperative and coordinated approaches to the resolution of cross-border groups given Hong Kong's status as a major financial centre playing host to a significant number of global financial services groups?***

We believe that it is important for Hong Kong to support cooperative and coordinated approaches to the resolution of cross-border groups, particularly given that Hong Kong hosts a significant number of FIs which are subsidiaries or branches of foreign firms. The cooperation between the Hong Kong resolution authority and the resolution authority of other major markets including the EU and US, as well as other APAC countries, is a prerequisite for resolution in a cross-border context.

As a major financial centre Hong Kong is unique in its role as the gateway to China. Over the years there has been a rise in the importance of local Chinese banks in Hong Kong. China is an FSB member and its, as yet unpublished, approach to resolution will impact the operations of the PRC banks and other FIs operating in Hong Kong. It will be very important for the Hong Kong and PRC regimes to be harmonised (whilst also being consistent with international standards) for effective resolution of any cross-border groups involving Hong Kong and the PRC.

In reality, home and host resolution authorities may have diverging views on the best resolution process (e.g. as to the priority given to the competing requirements). The ambiguities and questions arising in a cross-border context cannot be resolved easily and pose tough challenges to the resolution authorities making recovery and resolution plans.

We support the principles set down in Key Attribute 7 (*Legal framework conditions for cross-border cooperation*), 8 (*Crisis Management Groups*) and 9 (*Institution-specific cross-border cooperation agreements*) in relation to the topic of cross-border cooperation between home and host jurisdictions. In particular, we highlight the emphasis placed on pre-planning between the resolution authorities of the home and host jurisdictions, as well as the need for comprehensive information sharing between regulators.

Furthermore, we draw attention to paragraph 4.1(v) of Annex I to the Key Attributes, which provides that a home resolution authority should "*coordinate a resolution of the firm as a whole, with the aim of maintaining financial stability, and protecting depositors, insurance*

*policy holders, and retail investors in all relevant jurisdictions", and paragraph 5.1(iii), which provides that a host resolution authority should not "pre-empt resolution actions by home authorities while reserving the right to act on their own initiative if necessary to achieve domestic stability in the absence of effective action by the home authority".*

As part of the second consultation paper, we would encourage the Hong Kong regulators to provide clarity on the implementation of institution-specific cross-border cooperation agreements and Hong Kong's approach to cooperation with resolution authorities of other jurisdictions.

We note that the recent PRA Paper explores these issues in greater detail. While the subject matter of the PRA Paper is still subject to market discussion, we set out two observations below.

Firstly, even though subsidiaries of international financial institutions are fully capitalised entities that are legally separate from their head office, the PRA considers that a host jurisdiction should, for the purposes of resolution planning, consider the resolvability of the subsidiary (i.e. the linkage between the subsidiary and the head office and how the subsidiary fits into the group's recovery and resolution plan). We would suggest that ensuring the inclusion of the resolvability of the Hong Kong subsidiary as part of the overall group resolution plan for international FIs will be important for a successful resolution regime for Hong Kong.

Secondly, in relation to branches of international financial institutions, the host jurisdiction should assess the resolution regime of the international bank's home jurisdiction to establish whether (i) the home regulators accept responsibility for the resolution of the local branch and (ii) the home resolution regime can be considered equivalent to the local resolution regime. In this regard, we note that the PRA will base its analysis on the International Monetary Fund's Financial Sector Assessment Programme reviews and the Financial Stability Board peer reviews.

From the observations above, we consider that it is important for resolution authorities (whether in the capacity as a home jurisdiction or a host jurisdiction) to cooperate with and evaluate the resolution regimes of other jurisdictions to determine whether an equivalent level of regulation has been implemented. Where equivalence can be determined, it is submitted that both the home and host jurisdictions should strive to minimise any potential differences and/or overlap between their resolution regimes to avoid creating uncertainty or conflict during a resolution process.

### Question 33

***Do you agree that the model outlined in paragraphs 331 to 333 to support and give effect to resolution actions being carried out by a foreign home resolution authority would be effective in supporting coordinated approaches to resolution where it is in the interests of Hong Kong to do so?***

We understand from Key Attribute 7.1 that one of the most important conditions for the effective resolution of G-SIFI is that national regulators will need to act collectively under a coordinated approach during a crisis. Key Attribute 8 also requires home and host authorities of G-SIFIs to maintain CMGs to facilitate the planning and management of a cross-border firm. However, the standardised toolkit – the Key Attributes – which the FSB members are to follow does not fully address the cross-border issues arising from the resolution of a FI with foreign counterparties.

More guidance and clarity is needed around how "discretionary national action" for Hong Kong would be applied in practice. We also encourage the regulators to consider including powers for the resolution authority to recognize and give effect to foreign resolution actions in Hong Kong.

As noted throughout our responses, our financial institution clients are strongly of the view that, as far as possible, the Hong Kong resolution authority should undertake resolution of branches or subsidiaries of G-SIFIs in support of a resolution in the home jurisdiction and in cooperation with the resolution authority in that jurisdiction. They accept that the Hong Kong resolution authority should have the ability, in exceptional cases, to carry out a local resolution where the home jurisdiction cannot or will not take action which is necessary, proportionate or appropriate for Hong Kong.

### Question 34

***Do you consider the powers proposed regarding information sharing strike an appropriate balance in terms of facilitating information sharing for resolution in both a domestic and cross-border context whilst also ensuring that all reasonable steps are taken to preserve confidentiality?***

We consider the powers proposed to ensure sufficient information is provided to relevant domestic and foreign authorities, whilst at the same time protecting the confidentiality of that information, are consistent with the objectives of the Key Attributes. Confidentiality and security protections are critically important and are essential preconditions for resolving global banks.

However, any additional investment in information resources by the FIs should be achieved in a reasonable and proportionate manner and the regime should not impose significant costs and compliance burdens on the FIs.

We agree that cross-border cooperation and the ability for resolution authorities to exchange information is crucial to the development of effective cross-border resolution plans. We also agree that cooperation and information exchange (subject to confidentiality safeguards such as the exclusion of information from "freedom of information" access) amongst financial supervisors and regulators are essential for effective oversight, and that weaknesses in international cooperation and information exchange can undermine the efforts of regulatory and supervisory authorities to ensure laws and regulations are followed

We support the proposal for each jurisdiction to establish clear legal gateways to enable national authorities to disclose information to other authorities where such exchange is necessary and subject to adequate confidentiality safeguards. However, the use of cross-border protocols/MOUs and reciprocal arrangements can sometimes hinder the rapid action required for a successful resolution so more flexible solutions need to be considered (for example, an arrangement whereby a FI is permitted to share any confidential information it has given to overseas regulators with the Hong Kong resolution authority at its own discretion without the need to get permission of the overseas regulator). Furthermore, we consider that, in most circumstances, the home regulator should be the lead resolution authority and a host authority should not take any actions unless agreed with the home regulator. Any sharing of information in relation to the resolution plan for an FI should be done between home and host regulator.

We also support the proposal to exclude the application of any freedom of information legislation to information in the hands of the resolution authority, as well as the proposal to limit the access of confidential information to those officials, employees and agents of the recipient authority who require the information to perform their resolution function.

## Appendix

Barclays

Citi

J.P. Morgan

UBS AG