On 7 January 2014 the Financial Services and Treasury Bureau of the Hong Kong Government (FSTB), in conjunction with the Hong Kong Monetary Authority (HKMA), Securities and Futures Commission (SFC) and the Insurance Authority (IA), issued a first stage consultation regarding the introduction of a resolution regime for financial institutions in Hong Kong (the “Consultation”). The Consultation initiates a discussion as to the regulatory structure and principles that would be required to establish an effective resolution regime for financial institutions in Hong Kong. The HKMA proposals are modelled on the key attributes set out by the Financial Stability Board (FSB) in October 2011 (“Key Attributes”), and identify how the existing regulatory regime in Hong Kong requires augmentation to cope with the failure of a systemically important financial institution.

Many of the proposals made in the Consultation are to be elaborated on in a further consultation due to be carried out later this year, but the Consultation is an informative catalyst for discussion around the implementation of a resolution regime in Hong Kong. The deadline for responding to the Consultation is 6 April 2014.

The Key Attributes

As demonstrated by the recent global financial crisis, the failure of financial institutions previously considered ‘too big to fail’ can have a ruinous impact on the financial stability of the economies around the world. As financial institutions that were vital to the life blood of many economies fell into difficulties, governments were forced to plough substantial amounts of tax payers’ money to rescue those institutions in order to safeguard financial services identified as critical to their economies, and avoid the calamitous consequences that would have resulted from those institutions entering insolvency. This was, and remains, controversial. In the aftermath of the financial crisis, there is accord among governments that regimes should be introduced which can be used to resolve the failure of a major financial institution in such a way that safeguards against disruption to the provision of financial services, limits moral hazard in the operation of financial institutions and reduces – so far as possible – the need for public funds to be used to bail out struggling financial institutions.

The Consultation looks to establish a resolution regime in Hong Kong which satisfies the standards set by the FSB.

Scope and coverage of the proposed regime

The proposed scope of the resolution regime is broad, encompassing the following categories of financial institutions (and in some instances the holding companies and operational affiliates of those entities):

- All types of Authorised Institutions, being financial institutions subject to the oversight of the MA, including licensed banks, restricted licensed banks and deposit-taking companies.
- SFC-licensed corporations which exceed a minimum size threshold, which is to be established, or where the licensed corporation is a branch or a subsidiary of a globally systemically important financial institution.
- Insurers, being any local operations of globally systemically important or internationally active insurance groups having a presence in Hong Kong, and any insurer whose failure would cause systemic risk to Hong Kong.
- Financial market infrastructures that are subject to the oversight of the HKMA, and all recognised clearing houses under the Securities and Futures Ordinance.
Branches of overseas financial institutions operating in Hong Kong and holding companies may also be subject to a Hong Kong resolution regime, which is likely to require a co-ordinated approach to resolution between the authorities in Hong Kong, and those in the home state. Issues in respect of international co-operation and coordination will be considered in the second stage consultation.

The purposes of the resolution regime is, in part, to insulate the Hong Kong economy from the systemic risk that is inherent in the failure of an institution which fulfils functions critical to the economy. Accordingly, it will only be necessary for a resolution regime to be instigated where a financial institution which provides critical economic functions is likely to fail, or only in relation to those aspects of the financial institution that are critical to the economy. Those financial institutions that are not identified as critical will remain amenable to the corporate insolvency regime.

**Authority v Authorities**

The introduction of a resolution regime requires an authority to oversee that process (“Resolution Authority”). Financial institutions in Hong Kong may be subject to the jurisdictions of the HKMA, the SFC or the IA. The Consultation proposes a sector-specific approach so that each of the regulatory bodies acts as a Resolution Authority in relation to financial institutions already subject to their authority.

The Consultation notes that financial institutions whose failure would be most likely to pose a systemic risk to the Hong Kong economy, are financial services groups which operate across multiple sectors of the financial industry. On the failure of such a group, the jurisdiction of each regulatory body would be engaged. If the sector-specific approach is implemented, it is proposed that a Lead Resolution Authority be appointed to, principally, oversee and co-ordinate the resolution of a financial group which is subject to the powers of multiple regulatory bodies in Hong Kong. The second stage consultation will set out more detailed proposals as to how best provide for the appointment of a Lead Resolution Authority.

**What’s on the menu: the resolution powers**

The Consultation proposes a regime which has within it a number of resolution options, namely:

- Compulsory transfer to another financial institution
- Compulsory transfer to a bridge institution
- Statutory bail-in (whereby the shareholder stakes and liabilities to certain unsecured creditors are written down with the effect of recapitalising the financial institution)
- Temporary public ownership

The majority of these options have been tested by regulatory authorities in the recent financial crisis, but the option to effect a statutory bail-in is relatively untested. Notwithstanding, this is a conceptually attractive option and the HKMA intends to maintain a watch on international developments in this regard, and to set out proposals of bail-in powers in the second stage consultation.

In addition to setting out broad resolution options, the Consultation makes limited provision for the non-critical functions provided by an institution that has been resolved by partial compulsory transfer. Operations of a financial institution that are not identified as critical will normally be resolved through the liquidation process, but it may be appropriate for some business lines to be managed by an asset management vehicle where the liquidation process is considered to be unduly value destructive.

While much remains to be discussed and decided, we note that the Consultation does not raise for discussion the extent to which a Resolution Authority could be empowered to investigate the causes of failure in respect of financial institutions that are made subject to the resolution regime.

As a result of deficiencies that have been identified in the current regulatory regimes, the Consultation identifies a number of powers that Resolution Authorities will require to execute resolutions of financial institutions. These powers would permit Resolution Authorities to override certain aspects of Hong Kong securities laws and third party rights to take control of, manage and dispose of the financial institution, as opposed to simply its assets. In particular, the Consultation goes on to propose that the resolution regime should include the ability to impose a temporary stay on the exercise of early termination rights, to avoid an orderly resolution process being undermined and further detail in this respect is to be provided in the second stage consultation.
Significantly, the Consultation observes that the range of resolution options may not be effective in cases where financial institutions are structured in such a way as to create barriers to the implementation of a resolution regime. In this regard, the Consultation proposes that powers be introduced which compel a financial institution to make structural and operational changes to its business so that it is amenable to the options in the resolution regime.

**Interaction with the corporate insolvency regime**

A reason for the implementation of the resolution regime has been the realisation that liquidation procedures alone are not suitable to manage a wind-down of systemically important financial institutions. However, where a (or part of a) financial institution which is not critical to the economy, fails, that institution (or part thereof) will remain amenable to the corporate insolvency regime.

Where resolution is by partial transfer, the Consultation does not make proposals as to the residual parts of the financial institution but leaves the question open for the relevant regulatory bodies. In contrast, the resolution regimes of the US and the UK require that the residual parts of the financial institution provide ongoing support to the transferee-entity to ensure that essential services remain available to the transferred business. The FSTB intends to consider the requirement for similar support to be included within the resolution regime in Hong Kong.

Significantly, the Consultation acknowledges that it is desirable for the liquidation process to provide for the disposal of deposits and client assets, as this may result in customers and client enjoying uninterrupted access to their funds. While deposits are protected to a limited extend under the Depositor Protection Scheme, the corporate insolvency regime does not currently permit a transfer of deposits or client assets out of liquidation, and reforms in this area have been considered as being of lower priority than implementing an effective resolution regime. The FSTB has invited views as to whether reforms in this area should be regarded as higher priority.

**Safeguards**

The Resolution Authorities will have far-reaching powers to act quickly on the failure of a critical financial institution. The use of these powers within a short space of time may have adverse consequences for a number of stakeholders in a financial institution. Recognising this, the Consultation proposes certain safeguards to give market participants, shareholders and creditors a better understanding as to how the failure and resolution of a financial institution may effect them. We outline some key proposals in this regard below.

**FLEXIBILITY OF PARI PASSU**

A principle underpinning the proposals of the Consultation is that no creditor should be worse off in a resolution regime than would be the case in a liquidation, and it is intended that the Resolution Authorities should exercise their powers in a way which accords with the priority of creditors applicable on insolvency. However, this principle is tempered by the need for there to be some flexibility to depart from the *pari passu* principle where a better outcome may be achieved for all creditors as a result.

**COMPENSATION**

While the intention of the resolution regime is not to place shareholders and unsecured creditors in a worse position than had the financial institution been liquidated, this may in fact be the outcome of a resolution process. To cater for this scenario, the Consultation proposes that these parties have rights to compensation where they do not receive the minimum that was expected had there been a liquidation. How this compensation process will be managed, and particularly how value will be assessed, are aspects that will be discussed in the second stage of consultation.

**PROTECTING CLIENT ASSETS**

The Consultation recognises that for an institution to be successfully resolved it is necessary to ensure that clients have, as far as possible, uninterrupted access to their assets on the failure of a financial institution. Part of this requirement is ensuring the protection of client assets. While the Consultation recognises this, it is not proposed that any changes be made to the existing regime at this stage.

**Still to come.....**

A number of issues raised by the Consultation are to be developed further in a second stage consultation which is due to be carried out later this year. It is
anticipated that this further consultation will add some colour to the picture sketched by the Consultation. Issues that have been set down for consideration at the second stage consultation concern both the structure of the proposed regime, and the substantive rights and powers required to ensure the regime introduced satisfies the Key Attributes. Outstanding questions include:

- how best the resolution regime introduced in Hong Kong will safeguard the provision of essential services to a financial institution from affiliated operational entities;
- the extent to which robust co-ordination arrangements can be established between the exiting regulatory bodies and a Lead Resolution Authority to efficiently manage the resolution of financial institutions with cross-sector operations;
- in establishing the range of resolution options, the terms which should govern a statutory bail-in and the option of temporary public ownership;
- to ensure the success of any resolution option, the extent to which it is necessary for Resolution Authorities to override third party contractual rights, including termination rights in order to prevent a proposed resolution being undermined by enforcement action by creditors;
- how resolution will work alongside or override existing regulations, i.e., securities regulations and the corporate insolvency regime; and significantly
- how the costs of resolution should be funded. The question of costs is not addressed in detail in the Consultation, but is held over for further consideration.

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