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Financial Institutions (Resolution) Ordinance – the derivatives angle

Introduction

Following two rounds of public consultation on proposals to establish a resolution regime for financial institutions ("**FI**"), including financial market infrastructure ("**FMI**"), in Hong Kong[1], the Financial Institutions (Resolution) Ordinance (the "**Ordinance**") was passed by the Legislative Council on 22 June 2016 and gazetted on 30 June 2016. The Ordinance establishes a regime for the orderly resolution of systemically important financial institutions in the banking, insurance, and securities and futures sectors, as well as certain financial market infrastructures. The Monetary Authority ("**HKMA**"), the Insurance Authority ("**IA**") and the Securities and Futures Commission ("**SFC**") will be given powers as resolution authorities, including the power to impose a write off or conversion of capital instruments issued by authorised institutions, the power to resolve a holding company or group company of a within scope entity, and the power to give effect to a resolution action taken by an overseas counterpart. The resolution regime aims to avoid or mitigate the risks posed by the non-viability of a within scope institution to the stability and effective working of Hong Kong's financial system. The resolution regime established under the Ordinance is designed to bring Hong Kong in line with the latest international standards set by the Financial Stability Board ("**FSB**") in its Key Attributes of Effective Resolution Regimes for Financial Institutions (the "**Key Attributes**").

The Ordinance has not come into operation yet - it will commence operation on a date to be appointed by the Secretary for Financial Services and the Treasury pending the Legislative Council's passing of certain of the regulations to be made as subsidiary legislation under the Ordinance.

Changes in the final Ordinance from the bill gazetted in November 2015 are generally speaking not substantial and mainly clarificatory in nature. We will highlight these changes below to the extent that they are relevant to the derivatives market.

The derivatives angle

Given that the resolution authorities are given various tools and powers under the Ordinance, it is necessary to examine whether such resolution tools and

[1] The first public consultation was conducted from January to April 2014 (see our client bulletin on this) and the second public consultation was conducted from January to April 2015.

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powers would have an effect on the efficacy of close-out netting and collateral arrangements, which is key to the functioning of the derivatives market. We will also look at whether the new regime will have an impact on transactions conducted through FMIs and on structured finance transactions.

An overview of the resolution regime

Within scope financial institutions

The Hong Kong resolution regime is a single cross-sectoral resolution regime covering "within scope financial institutions". The HKMA, the IA and the SFC will act as the resolution authority respectively for a banking sector entity, an insurance sector entity and a securities and futures sector entity. Where a failing FI operates across multiple sectors, a lead resolution authority (which may be any one of the HKMA, the IA or the SFC depending on the centre of gravity of the group with respect to the sectors in which it operates) will coordinate resolution.

Within scope financial institutions	
Banking sector entity	> An authorized institution ("**AI**") incorporated in Hong Kong; > An AI incorporated outside Hong Kong; > A *settlement institution* or a *system operator* of a *designated clearing and settlement system* (each as defined in the Payment Systems and Stored Value Facilities Ordinance (Cap. 584) (the "**PSSVFO**")), excluding settlement institutions or system operators wholly owned and operated by the Hong Kong government.
Insurance sector entity	> An authorized insurer that is a global systemically important insurer ("**G-SII**") or belongs to a G-SII group.
Securities and futures sector entity	> A licensed corporation ("**LC**") that is a non-bank non-insurer global systemically important financial institution ("**NBNI G-SIFI**") or belongs to a NBNI G-SIFI group; > A LC that is a branch or subsidiary of an entity in a global systemically important bank ("**G-SIB**") group or a G-SII group; > A recognized clearing house under the Securities and Futures Ordinance (Cap. 571) (the "**SFO**"); > A recognized exchange company under the SFO if the Financial Secretary so designates.

Additional within scope financial institutions may be designated under the Ordinance. References to G-SIBs, G-SIIs and NBNI G-SIFIs are to the global systemically important banks, global systemically important insurers and non-bank non-insurer global systemically important financial institutions as contained in the current list of such entities published by the FSB.

The resolution regime also covers holding companies of a within scope financial institution (notwithstanding the fact that the holding company may be an unregulated entity) so resolution powers may be used on holding companies if an orderly resolution of the within scope financial institution can be more effectively achieved by resolving the holding company. Affiliated operational entities (i.e. service companies) of a within scope financial institution are also covered by the resolution regime to help ensure that they can continue to provide critical services to any FIs subject to resolution.

Stabilisation options

The following five stabilisation options are provided in the Ordinance. The resolution authority can apply the below stabilisation options individually, in combination or sequentially.

- *Transfer of the failing FI, or some or all of its business, to a commercial purchaser*: This involves the compulsory transfer of all or parts of the business of a failing FI to a commercial purchaser. In order to implement this, the resolution authority has the power to determine which parts of the business are to be transferred and whether to effect the transfer through a transfer of shares in or assets and liabilities of the failing FI to the acquirer, and to carry out the above without the need to obtain consent from shareholders or other affected parties.

- *Transfer of some or all of a failing FI's business to a bridge institution*: The primary purpose of this option is to allow the resolution authority to temporarily transfer all or part of the failing FI's business to a bridge institution in circumstances where the resolution authority assesses that a commercial purchaser might ultimately be found for the business of the failing FI, but where this cannot be arranged immediately. This option involves a compulsory transfer of business, as a temporary arrangement, to a bridge institution.

- *Transfer to an asset management vehicle* ("**AMV**"): if it is considered that liquidation of a substantial portfolio of assets of the failing FI may have a materially adverse effect of the financial markets, then the resolution authority can use an AMV as an alternative to liquidation. The resolution authority can transfer assets of the failing FI or a bridge institution to the AMV whose role will be to manage the assets transferred to it with a view to maximising their value through eventual sale or orderly wind down. Shareholders and creditors of the failed FI may receive an equity stake in the AMV so that the risks associated with such assets remain with them.

- *Statutory bail-in*: resolution authorities are given power under the Ordinance to write down shareholders and certain unsecured creditors in a way that generally respects the hierarchy of claims in liquidation, and to effect a debt-for-equity swap on certain unsecured creditors.

- *Taking a failing FI into temporary public ownership* ("**TPO**"): very much a last resort option as it involves the use of public funds (and requires approval by the Financial Secretary), this option involves a transfer of the failing FI to temporary public ownership.

Excluded liabilities for the purpose of bail-in

The Ordinance provides that the bail-in power may not be exercised in respect of any "excluded liability", the list of which includes (i) secured liabilities (but only to the extent that they are secured), (ii) liabilities arising from participation in designated clearing and settlement systems and owed to such systems or to the operators of, or participants in, such systems, and (iii) liabilities arising from participation in the services provided by a recognized clearing house and owed to the clearing house or to its clearing participants. A resolution authority can add any liability or class of liability to the list of excluded liabilities in order to ensure that resolution objectives will be met.

Secured liability exclusion: a secured liability is an excluded liability only to the extent that it is secured and any excess liability above the value of the security is eligible for bail-in. In the context of derivative transactions documented under a master agreement (e.g. the ISDA Master Agreement) with credit support, the excess net exposure above the value of the collateral will be subject to bail-in. Such "excess net exposure" will practically speaking only be able to be determined after the master agreement has been closed out and valued according to its terms. It is less than clear how the close out valuation process under the ISDA Master Agreement will interact with the statutory valuation prior to the application of a stabilisation option as required under the Ordinance[2].

Designated clearing and settlement systems and recognized clearing houses: The reference to "clearing and settlement systems" has been amended in the final Ordinance to refer to "designated clearing and settlement systems". It is now clear that the term only refers to systems designated under the PSSVFO, rather than to be given its natural meaning.

Liabilities arising from participation in the services provided by a recognized clearing house have also been added to the list of excluded liabilities in the final Ordinance. It is now clear that liabilities owed by or to Hong Kong CCPs which are recognized clearing houses under the SFO will not be subject to bail in. However in the case of overseas CCPs that are not recognized clearing houses under the SFO, liabilities owed by such CCPs to its clearing members or by the clearing members to such CCPs will not have the benefit of exclusion from bail in, unless the relevant liabilities fall under another limb of the definition of excluded liabilities (such as secured liabilities).

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[2] Section 35 of the Ordinance.

Protected arrangements

It is recognised that certain financial arrangements ("protected arrangements") may be undermined by resolution actions (particularly partial property transfers and bail-ins). In order to safeguard the economic effect of a protected arrangement, the Ordinance empowers the Secretary for Financial Services and the Treasury to make regulations prescribing the requirements to be complied with in applying the partial property transfer or the bail-in stabilisation option. The Ordinance provides that any partial property transfers should not result in a separation of the constituent parts of the protected arrangement; any bail-in should only apply to the net amount of a liability under a protected arrangement. This should ensure that the close-out netting provisions in the ISDA Master Agreement will be respected and only the net amount may be bailed-in. The regulations should also specify the remedial action if any partial property transfer or bail-in is effected in breach of these rules.

We await the draft regulations in relation to protected arrangements although we agree with the derivative industry's concerns that, for legal certainty reasons, any remedy with respect to netting and set-off arrangements should be self-executing. More clarity would be welcomed on the types of liabilities which may be subject to bail-in. If bail-in applies only to liabilities created after the Ordinance commences operation, then in the context of derivatives transactions documented under master agreements, a practical issue may arise as the bailing-in of the net amount may mean that existing transactions entered into prior to the commencement date and included in the same netting set will be affected.

Protected arrangements
> clearing and settlement systems arrangements
> netting arrangements;
> secured arrangements;
> set-off arrangements;
> structured finance arrangements; and
> title transfer arrangements.

Temporary stays on early termination rights

The ability of resolution authorities to carry out an orderly resolution may be compromised if counterparties to the failing FI had an unfettered right to trigger contractual early termination, acceleration or other close-out rights. The Ordinance therefore provides that the entry into of resolution and the exercise of any resolution powers should not trigger contractual set-off rights or constitute an event that entitles any counterparty of the failing FI to exercise contractual acceleration or early termination rights, provided that the substantive obligations under the contract continue to be performed.

Resolution authorities in Hong Kong are given a power to temporarily stay termination rights of counterparties to contracts (both financial and non-financial) with an FI in resolution or related group companies, provided that certain conditions are met. The stay is effective from the publication of the notice of resolution until midnight in Hong Kong on the business day following the publication: a short window allowing the resolution authorities to determine what form resolution should take. We set out below how the stay is meant to work conceptually and the conditions that have to be fulfilled before the stay applies.

- The stay only applies to early termination rights that arise for reasons of entry into resolution; the substantive obligations under the contract must continue to be performed;
- The early termination rights of the counterparty are preserved against the failing FI in the case of any default occurring before, during or after the period of stay that is not related to the entry into of resolution; e.g. a failure to make payment or to deliver or return collateral on a due date occurring during the period of stay;
- The counterparty can exercise the right to close out immediately on expiry of the stay (if the conditions for contractual termination exist) or before expiry of the stay if the counterparty receives notice from the resolution authority that the rights and liabilities covered by the relevant contracts will not be transferred to another entity; and
- After the period of stay, early termination rights can be exercised for those contracts that are not transferred to a sound third party (e.g. a commercial purchaser or a bridge institution).

Suspension of obligations

The Ordinance also empowers the resolution authorities to suspend the obligations to make a payment or delivery under a contract to which a FI or a holding company of an FI within the scope of the regime or a subsidiary of the FI is a party. The suspension is temporary: beginning at the time when the suspension notice is first published until no later than midnight in Hong Kong on the business day following the publication. During the suspension period, no creditor may enforce any security given by the relevant FI, holding company or subsidiary without the written consent of the resolution authority.

Such powers are not applicable to an “excluded obligation”, which includes “an obligation of a financial institution in relation to its participation, whether directly or indirectly, in financial market infrastructure”, and “an obligation in relation to a security interest that a financial market infrastructure has in relation to any asset of a financial institution that has been pledged or provided as collateral or as cover for margin by a financial institution”. This would exclude payment and delivery obligations by CCPs to clearing members and by clearing members to CCPs, whether such CCPs and clearing members are Hong Kong-incorporated or overseas-incorporated.

Notice of intention to present winding up petition to resolution authority

To preserve the ability of resolution authorities to carry out an orderly resolution, the Ordinance provides that any person intending to petition for the winding-up of an FI or a holding company of an FI within the scope of the regime must notify the resolution authorities in writing of his intention before presenting the petition to the Court of First Instance. The resolution authority is then given seven calendar days to decide whether to initiate resolution. If the resolution authority decides not to initiate resolution, the petitioner then has another 14 calendar days to file the winding up petition with the Court of First Instance.

Cross border resolution actions

The resolution powers are given to the local resolution authorities under the local resolution regime. When a resolution is cross-border in nature, uncertainty remains as to whether a foreign jurisdiction will recognise the Hong Kong resolution (and vice versa). Consistent with the "Principles for Cross-border Effectiveness of Resolution Actions" published by the FSB in November 2015 (the "**FSB Principles**"), the Ordinance provides for a statutory framework and also a contractual approach to give cross-border effect to resolution actions.

Statutory framework

The statutory framework in the Ordinance provides for (i) a recognition process and (ii) supportive measures to give effect to foreign resolution actions. Recognition gives effect to measures adopted by the foreign home authority in accordance with Hong Kong law; while supportive measures involve the taking of resolution measures by the relevant resolution authorities in Hong Kong to support the resolution action taken by the foreign resolution authority. The Ordinance provides that the resolution authority can make a "recognition instrument" recognising the resolution action taken in a foreign jurisdiction, irrespective of whether the non-Hong Kong FI or non-Hong Kong group company is a within scope financial institution under the Hong Kong regime. Despite industry advocacy for an immediate and automatic recognition of cross-border resolution measures (provided that certain specified safeguards are satisfied) to give legal certainty, the recognition process in the Hong Kong regime is not automatic. In particular, the resolution authority has to first consult the Financial Secretary before making a recognition instrument, and the resolution authority must not make a recognition instrument if it is of the opinion that recognition would have an adverse effect on the financial stability in Hong Kong or would disadvantage Hong Kong creditors or shareholders.

Contractual approach

In order to give cross-border effect to foreign resolution actions, the Ordinance has introduced requirements for contractual recognition of stays on early termination rights and the exercise of bail-in powers. As the FSB explained in the FSB Principles, contractual approaches to the cross-border recognition of resolution actions are useful as an interim recognition measure while statutory frameworks are being developed; they also support the efficacy of the statutory frameworks once they are in place. Details of the requirements for contractual recognition will however only be available in rules to be made by the resolution authority.

With respect to bail-in, we expect that under the Hong Kong regime, contractual recognition requirements will only apply to non-Hong Kong law agreements creating any relevant liability entered into by a within scope financial institution. As mentioned above, secured liability (but only to the extent of the security) is an excluded liability for the purposes of bail-in. In the context of derivatives transactions with constant fluctuations of the net exposure and the amount of collateral under the master agreement, a requirement to include contractual recognition provisions for the “excess” net exposure may mean that a large number of derivative master agreements will have to be amended. It remains to be seen how the resolution authorities will implement such requirement in the detailed rules although we hope that the Hong Kong authorities will take heed of the challenges faced by the European market when implementing the contractual recognition requirements for bail in under the Bank Recovery and Resolution Directive of the European Union.

Resolution of FMIs

It appears that some of the issues raised in the FSB’s Key Attributes for resolution of FMIs have yet to be addressed in the Ordinance. The Ordinance has also failed to include amendments to the SFO and the PSSVFO to make it clear that settlement finality under those laws prevail over any resolution action. It is hoped that these will be taken into account in any subsidiary legislation or detailed regulations to be published under the Ordinance.

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