

EXECUTIVE SUMMARY¹

Hong Kong SAR has significantly strengthened its crisis management arrangements through a thorough update of the framework for resolution of financial institutions, as recommended by the 2014 Financial Sector Assessment Program. The 2017 Financial Institutions (Resolution) Ordinance (FIRO) creates a resolution regime that is clear, comprehensive in scope, and closely aligned with the Financial Stability Board (FSB) Key Attributes of Effective Resolution Regimes for Financial Institutions. Some aspects of the FIRO, such as the cross-sectoral scope of the regime, are particularly strong. To implement the regime, the Hong Kong Monetary Authority (HKMA)² has established a Resolution Office (RO) with clear operational separation from banking supervision.

Hong Kong SAR needs to maintain momentum and should move quickly to complete the implementation of the FIRO, in particular in the following areas:

- **Resolution planning work should be accelerated for banks beyond domestic systemically important banks (D-SIBs).** A significant amount of work has been done for D-SIBs, but resolution planning for other banks (which account for around half of banking assets) is at an early stage. The HKMA should accelerate the development of proportionate resolution plans for non-D-SIBs which could be systemic in certain circumstances (which the HKMA assesses to include all locally incorporated banks with at least HK\$150 billion in total consolidated assets), and consider how best to cover resolution planning for international bank branches. The HKMA should also further develop plans to test its resolution arrangements (e.g., through regional cross-border simulation exercises).
- **The HKMA should prioritize setting resolvability requirements in areas where Hong Kong SAR D-SIBs are subject to deadlines set at the level of their parent groups (such as requirements for valuation capabilities in resolution).** As a major host jurisdiction for internationally active banks, Hong Kong SAR needs to take account of home-country authority timelines, such as the Bank of England's 2022 target for major banks to be fully resolvable.
- **The HKMA's rules on Loss-Absorbing Capacity (LAC) are clear and consistent with international standards, but timelines for compliance by certain Hong Kong subsidiaries of emerging market G-SIBs may be faster than their group-level TLAC timelines. This will require close cooperation with the relevant home authorities.** For the two D-SIBs that are subsidiaries of Chinese global systemically important banks (G-SIBs), the LAC requirements are expected to come into force earlier than group-level total LAC (TLAC) requirements—the HKMA

¹ This technical note was prepared by Mark Adams (IMF/MCM). The FSAP mission took place in September 2019.

² The MA is a public officer appointed by the Financial Secretary under section 5A of the Exchange Fund Ordinance. The HKMA is the office of the Monetary Authority (MA). This note generally uses HKMA to refer to both, unless otherwise specified.

should continue to actively engage with the relevant home authorities to ensure the timely implementation of local requirements in a coordinated manner.

- **The Financial Services and the Treasury Bureau (FSTB) should develop and publish detailed proposals for the calculation and pace of ex post resolution levies.** For each specific resolution case, the Financial Secretary (FS) may make regulations imposing resolution levies on the industry in order to recoup any public money used but not repaid. The rate of the levies for each case would be prescribed by the Legislative Council (LegCo) on the recommendation of the FS. The FIRO and other existing publications by the authorities include only high-level principles governing the setting of these levies. Clarification of these principles and the calculation methodology in advance would mitigate the risk of delays in legislative approval, particularly during periods of banking sector stress.
- **Other sectoral resolution authorities (the Securities and Futures Commission (SFC) and the Insurance Authority (IA)) should continue to ensure that sufficient staff are allocated to resolution planning.** This is particularly important for Recognized Clearing Houses (RCHs) where the further development of resolution planning expectations and of international standards may result in increased workload. As the RA responsible for a number of major Central Counterparties (CCPs), the SFC should stay at the forefront of global work to strengthen the crisis management framework in this area. For the IA, priorities include developing an integrated framework for use of their pre-existing early intervention powers alongside their powers under the FIRO, and recovery and resolution planning for the largest insurance groups.

The policy framework for liquidity provision by the HKMA has been revised, creating a clear public backstop resolution liquidity facility and removing some previous restrictions on the HKMA's ability to provide effective Emergency Liquidity Assistance (ELA). The HKMA should consider providing further guidance on the information it would expect to carry out its assessment of banks seeking ELA. This should include information to allow assessment and ongoing monitoring of solvency, viability, funding plans, and availability of adequate collateral. The HKMA should also consider working with banks to test its ability to accept non-standard collateral.

The deposit protection regime should be updated to ensure full consistency with the resolution regime. This would also help to ensure that the current high level of depositor confidence is securely underpinned in crisis. A review of certain modalities of the DPS is already planned in 2021; broadening the scope of this review would be an appropriate route to updating the DPS. In particular, the following aspects should be considered:

- To reduce legal challenges in the case of a resolution in which non-deposit creditors take losses, the scope of depositor preference in insolvency should be expanded beyond covered deposits following a review of implementation options, including whether preference should be on a tiered or general basis (see Box 1), and the relative priority of deposits and other preferred claims in insolvency (e.g. tax authority claims).

- The Deposit Protection Board (DPB)'s mandate should be expanded to allow it to contribute to the costs of a resolution that protects covered deposits.
- The target level of the Deposit Protection Scheme (DPS) fund is relatively low and is already intended to be reassessed as part of the 2021 review. The flexibility of annual levies should be increased to allow the fund to be built up, or replenished after use, in a shorter time period.
- The authorities should continue to increase the DPB's integration into interagency crisis coordination arrangements.

Table 1. Hong Kong SAR: Main Recommendations			
Recommendations	Responsible Authority	Timeframe^{1/}	Priority
Resolution Regime and Resolution Planning			
Maintain flexible interpretation of “Condition 3” which allows application of stabilization options to smaller firms (¶21)	HKMA	Continuous	High
For international D-SIBs, communicate HKMA expectations on resolvability to institutions in advance of home authorities’ implementation timelines. (¶27)	HKMA	Short term	High
Continue active engagement with D-SIB parents’ home authorities on the implementation of Hong Kong’s LAC rules. (¶23)	HKMA	Continuous	High
Accelerate timetable for proportionate resolution plans for non-D-SIBs. (¶28)	HKMA	Medium term	Medium
Adopt detailed methodology for the calculation of ex-post resolution levies. (¶31)	FSTB	Short term	High
Publish detailed timetable for remaining standards required to implement the FIRO. (¶24)	HKMA	Short term	Medium
Ensure sufficient staff allocated to the HKMA RO and to resolution work in other resolution authorities. (¶8,28)	HKMA, SFC, IA	Short term	High
Deposit Protection			
Consider expanding the current prohibition on active bankers joining the Deposit Protection Board to other active market participants. (¶39)	FSTB, DPB	Medium term 2/	Medium
Review DPS fund target and flexibility of levies to ensure the fund size is sufficient even under more pessimistic assumptions and expedite reaching the target level. (¶41, 42)	FSTB, DPB	Medium term 2/	Medium
Expand DPS mandate to include ability to contribute to resolution costs. (¶43)	FSTB, DPB	Medium term 2/	Medium
Introduce depositor preference for all deposits following review and consideration of options for implementation. (¶38)	FSTB	Medium term	High
ELA and Resolution Funding			
Provide further details on how the new contingency and resolution liquidity facilities will operate. (¶34)	HKMA	Short term	High

Table 1. Hong Kong SAR: Main Recommendations (concluded)

Recommendations	Responsible Authority	Timeframe ^{1/}	Priority
Institutional Framework			
Develop and operationalize the proposed inter-agency Crisis Management Framework and clarify division of roles between any new bodies, the Financial Stability Committee (FSC) and the Council of Financial Regulators (CFR). (¶21)	All agencies	Short term	High
Strengthen the role of DPB in the financial safety net's coordination arrangements. (¶40)	All agencies	Short term	High
1/ "Short-term" means within one year; "medium term" means within 3-5 years. 2/ For recommendations related to the DPS, the envisaged timeframe is as part of the planned review of DPS modalities in 2021			

INTRODUCTION

1. This note reviews Hong Kong's financial safety net and crisis management arrangements, including inter-agency crisis management arrangements, the resolution regime for financial institutions, emergency liquidity arrangements, and the depositor protection regime. It is based on analysis of existing legislation and policy, the authorities' detailed responses to a questionnaire, and discussions with the authorities and the private sector during the FSAP mission carried out during September 10–24, 2019. The note refers to international standards, including the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions and the International Association of Deposit Insurers (IADI) Core Principles for Effective Deposit Insurance Systems, but does not constitute a detailed assessment of compliance with these standards.

2. Hong Kong SAR is a major international financial center. Banking system³ assets are more than 800 percent of GDP, with significant exposures to Hong Kong SAR, Mainland China, and other Asian countries. The banking system is dominated by six locally incorporated D-SIBs,⁴ which account for about half of system-wide assets. Five of these are subsidiaries of G-SIB groups, and represent a significant part of these G-SIBs' global businesses. Many other internationally active banks have branches focused on wholesale business in Hong Kong SAR, in aggregate accounting for

³ This note will generally use the term 'bank' to refer to all deposit-taking Authorized Institutions and affiliated group companies, unless otherwise specified.

⁴ The Hong Kong and Shanghai Banking Corporation Limited, Hang Seng Bank Limited, Standard Chartered Bank (Hong Kong) Limited, Bank of China (Hong Kong) Limited, Industrial and Commercial Bank of China (Asia) Limited and Bank of East Asia, Limited.

about a quarter of banking system assets. The HKMA is a member of the Crisis Management Group (CMG) for 12 of the 29 G-SIBs, making it one of the most important host resolution authorities in the world. Hong Kong SAR also has a large insurance sector and its securities markets are among the largest in the world. This note focuses primarily on the banking sector safety net but discusses cross-sectoral arrangements, where appropriate.

3. Significant progress has been made since the 2014 FSAP in strengthening crisis management arrangements, in particular the resolution regime. A cross-sectoral resolution regime has been established under the FIRO, which took effect in July 2017. This provides Hong Kong SAR's resolution authorities (the HKMA for banks, the SFC for securities firms, and certain FMs, and the IA for insurance firms) with legal powers and safeguards related to resolution, which were assessed by an FSB peer review in December 2017 as consistent with the FSB Key Attributes. As noted by the FSB, the FIRO provides a fully cross-sectoral regime that covers all banks (and other categories of deposit-taker), and certain securities firms, insurers, and financial market infrastructures (FMIs). The regime also provides certain resolution powers over group companies of financial institutions (including holding companies and "affiliated operational entities"). Rating agencies assess the resolution regime as credible and effective, and regard the HKMA as having the ability and intent to permit loss absorption by junior creditors, including holders of capital instruments and loss-absorbing capacity instruments, while maintaining continuity of critical financial functions.

4. The HKMA has recently introduced a new Liquidity Facilities Framework. The new framework increases the HKMA's flexibility to provide emergency liquidity assistance and introduces a specific liquidity facility for banks in resolution.

5. Other actions taken by the authorities since the previous FSAP include the introduction of statutory requirements and HKMA policy on recovery planning, reforms to reduce the payout time for covered deposits, a cross-sectoral crisis management simulation exercise conducted in 2017, and a banking sector focused exercise in 2018.

INSTITUTIONAL FRAMEWORK

6. Hong Kong has a well-developed institutional framework for crisis management, which includes five main authorities, as well as other regulatory bodies that play a smaller role. The FS has overall responsibility for maintaining financial stability, supported by the FSTB of the Hong Kong SAR government. The HKMA, the SFC, and the IA are the main regulatory bodies for financial institutions. The DPB is responsible for operation of the deposit protection scheme.

7. The FS has overall responsibility for maintaining financial stability and Hong Kong SAR's position as an international financial center, but has only a limited direct role in the resolution regime. Articles 106 to 113 of the Basic Law of the Hong Kong SAR set out, among other things, the responsibilities of the government for public finance and monetary and financial affairs. The FS and Secretary for Financial Services and the Treasury (SFST) exercise the government's

responsibilities for maintaining the stability of the financial system and Hong Kong SAR's status as an international financial center.⁵ The FS is responsible for determining the relevant policy objectives at a macro level and chairs the CFR, while the SFST is responsible for formulating specific policies and overseeing their implementation through the regulatory authorities and other organizations and chairs the FSC. The FS has a limited direct role in the resolution regime, being responsible for approving the application of a “transfer to a temporary public ownership company” stabilization option (as a last resort). Other resolution tools are the responsibility of the relevant sectoral resolution authority (RA). The FS is also responsible for designating and naming a resolution authority for entities that are not automatically within the scope of FIRO, but potentially pose a risk to financial stability—and therefore subject to FIRO resolution planning obligations—and designating a single Lead Resolution Authority (LRA) for cross-sectoral groups.

8. The HKMA is the regulator and RA for banks and has established a dedicated RO that is structurally separated from its Banking Supervision and Monetary Management departments. The RO is headed by a Commissioner who reports directly to the Chief Executive of the HKMA and has a team of dedicated staff, with a target professional headcount of around 20, although actual staffing levels are lower, in part reflecting difficulties in recruitment through either internal staff transfer or external recruitment. It is also supported by dedicated lawyers specializing in resolution. The RO staff are responsible for resolution policy development, undertaking of resolution planning, and build-up of HKMA's institutional capability to execute an actual resolution. The HKMA has published a FIRO Code of Practice,⁶ setting out its operational arrangements as Resolution Authority.

9. The HKMA has established a Crisis Management Framework (CMF) to coordinate its crisis preparedness and management activities across its banking supervision, resolution, and liquidity provision functions. The CMF, established in 2018, describes the roles and responsibilities of individual departments of the HKMA in a crisis, the HKMA's decision-making processes, and the HKMA's preferred approaches to the use of its powers in managing banks experiencing solvency or liquidity stress. As part of the CMF, a standing Crisis Management Coordination Group (CMCG) has been set up, which includes the HKMA's senior management of the resolution, bank supervision, monetary management (responsible for liquidity provision), and legal functions. The CMCG meets regularly in normal times to discuss crisis preparation measures, such as setting preferred resolution strategies. Once an at-risk institution is identified it meets as needed to coordinate analysis and actions across departments.

10. The SFC is the resolution authority for all Recognized Clearing Houses (RCHs), and for systemically important exchanges and securities firms. The SFC's resolution activities to date have focused mainly on development of resolution policy for RCHs, with a small team of staff in its

⁵ See public document at https://www.fso.gov.hk/pdf/fs-sfst_e.pdf.

⁶ https://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/resolutions/RA-1_Operational_Independence_of_the_Monetary_Authority_as_Resolution_Authority.pdf.

Supervision of Markets Division covering recovery and resolution issues. As the home resolution authority for a major CCP, the SFC should ensure that it stays at the forefront of global policy development and planning on CCP resolution. No standalone securities firms have yet been designated as potentially systemic, and therefore within-scope institutions under the FIRO cover only securities subsidiaries of G-SIB and Global Systemically Important Insurer (G-SII) groups, for which the SFC is not the designated LRA. Given the large size of Hong Kong SAR's securities markets, it is helpful that the FIRO includes powers over exchanges. The main equity and futures exchanges⁷ have been designated as potentially systemic, and therefore within scope of the FIRO and subject to the resolution regime, although resolution planning remains at an early stage.

11. The IA, as the RA for G-SII insurers and other potentially systemic insurers, is developing its framework for the use of the FIRO powers. The IA has recently become the lead of the CMG for one G-SII. Although Hong Kong SAR has a well-developed toolkit of crisis management powers for insurers which predates the FIRO, including powers to establish special purpose insurers (a form of bridge institution) to ensure continuity of insurance provision, and for courts to order reductions of insurance liabilities, the IA is developing an integrated framework for the use of the FIRO powers alongside these, as well as recovery and resolution planning for the largest insurance groups.

12. Hong Kong SAR's Deposit Protection Scheme (DPS) is administered by the DPB, an independent statutory body. Investor compensation for customers of failed brokers is provided by the Investor Compensation Company. The authorities have also proposed establishing a general Policyholders Protection Scheme to compensate life and non-life insurance policyholders, which would run alongside existing schemes covering insurance products that are mandatory under the Hong Kong SAR law.⁸

13. Hong Kong SAR is updating its well-established interagency coordination processes to reflect the new resolution regime; it will be important to ensure that this includes all relevant safety net participants and maintains coordination across all aspects of a crisis, not just resolution. Information sharing between authorities is underpinned by bilateral Memoranda of Understanding (MoUs) and legal gateways. The CFR, chaired by the FS, and the FSC, chaired by the SFST, meet regularly to coordinate work on various topics, including crisis preparedness, such as a cross-market crisis simulation exercise commissioned by the CFR in 2017. This exercise was held by the FSTB, involving the main financial regulators in Hong Kong SAR (the HKMA, SFC, IA, and Mandatory Provident Fund Schemes Authority) and the Hong Kong Exchanges and Clearing Limited. It tested the communication and information flow within and among the participants, responses to emergency scenarios, coordination of public communication, and handling of public/media reaction. The exercise highlighted a need to enhance inter-agency coordination in a resolution scenario in light of the commencement of the FIRO, and the authorities intend to establish a new inter-agency crisis management framework to achieve this. Staff welcomes this initiative and underlines that it will

⁷ The Stock Exchange of Hong Kong Limited and the Hong Kong Futures Exchange Limited.

⁸ Policies covering employee work-related injury compensation and motor vehicle third-party claims.

be important to ensure that participants in this framework include all relevant safety net participants (such as the DPB), and that it integrates well with the CMF within the HKMA, which oversees all aspects of the HKMA's responsibilities in a crisis.

14. The FSTB is responsible for Hong Kong SAR's overall crisis management plan, and, in a crisis situation, would activate its Financial Services Branch Coordination Centre (FSBCC) to facilitate communication and information sharing. Each safety net participant has dedicated communications staff for crisis management and communication, with the FSTB responsible for coordinating overall media and public communication. These arrangements are documented in the "Handbook on the Role of the Financial Services Branch in Market Contingency Situations," which is updated and maintained by the FSTB. The FSBCC has been activated on a precautionary basis several times in the last few years, for example, to prepare for possible business continuity disruptions, and the crisis management plan has been updated to reflect lessons learned from these activations (for example, to consider in greater depth options if access to the authorities' premises is unavailable).

EARLY INTERVENTION AND RECOVERY PLANNING

15. HKMA has a broad range of enforcement and early intervention powers under the Banking Ordinance (BO), although it normally aims to resolve issues through agreement. When intervention is required, the initial steps in the escalation process include use of the HKMA's general supervisory power to require remediation, the appointment of an audit firm to report on specific matters, and the introduction of more intensive supervisory engagement. These would typically be accompanied by a downgrading of the bank's CAMEL rating. If capital requirements (including Pillar 2) or liquidity requirements are breached, additional restrictions apply. Where these are unsuccessful in restoring the bank's condition or are inappropriate, the HKMA has powers under section 52 of the BO (such as the appointment of a special manager) and very broad powers of direction. Powers do not have to be applied in a specified order, and the HKMA has in the past applied section 52 powers at an early stage. Other early intervention powers are available under the FIRO for banks that the HKMA assesses as not viable (or likely to become non-viable) and systemic, but whose viability could still be restored through private-sector actions.

16. Recovery planning requirements have been incorporated in primary legislation, through an amendment of the BO in February 2018. This builds on the HKMA's Supervisory Policy Manual module on recovery planning, which was introduced in 2014 and has been subsequently updated and supplemented with further guidance in annual "waves" of recovery planning. Recovery plans are collected from all banks and reviewed by the HKMA annually. Recovery plan requirements include expectations to describe stress scenarios, trigger frameworks, recovery options, and communication plans. Supervisory review of previous recovery plans identified areas for improvement, including the quantification of the impact of recovery options and the testing and validation of the feasibility of recovery options, which the HKMA considers to have been strengthened in the most recent round of recovery plans.

RESOLUTION POWERS AND PLANNING

A. Resolution Powers and Policies

17. The FIRO, which took effect in July 2017, represents significant progress in the Hong Kong SAR's resolution regime. The regime has undergone an FSB peer review in 2017–18, which concluded that FIRO, although its use in resolution has not yet been tested, establishes resolution powers and safeguards that are consistent with those required under the FSB Key Attributes of Effective Resolution Regimes. Each of the major rating agencies regards the regime as effective and that the Hong Kong SAR authorities have the ability and intent to rely on it.

18. The FIRO establishes a fully cross-sectoral resolution regime. There are resolution authorities for banks (HKMA), insurers (IA), RCHs, and exchanges and securities firms (the SFC)). For cross-sectoral financial groups, which include entities that belong to more than one sector subject to FIRO, the FS will designate an LRA. Only the LRA can trigger resolution for any entity in the group, and RAs for other entities within the group are required to take all necessary steps to support the LRA in resolution planning and execution. The HKMA and the IA have been designated as the LRA for all existing cross-sectoral groups that include a banking sector entity and an insurance sector entity respectively. The resolution powers under the regime also apply to holding companies and “affiliated operational entities” that provide services to in-scope entities. The scope of affiliates covered by the regime appears to be sufficiently broad.

19. The powers provided by the FIRO to RAs are closely aligned to the FSB Key Attributes (KA3). Each RA (and LRA), in initiating resolution, may apply any of the following five “stabilization options”:

- transfer of securities or assets, rights, or liabilities to a purchaser;
- transfer of securities or assets, rights, or liabilities to a bridge institution wholly or partially owned by the government;
- transfer of assets, rights, or liabilities to an asset management vehicle (AMV) wholly or partially owned by the government;
- bail-in of liabilities (excluding all deposits, even those above the deposit protection coverage limit); and
- transfer of securities to a temporary public ownership (TPO) company wholly owned by the government

Any transfer of assets, rights or liabilities may be done in whole or in part. Supplementary powers are available to support the execution of resolution, including powers to enforce a temporary stay of contractual counterparties' termination rights, override their ability to treat resolution as a default

event, introduce a selective moratorium (other than on covered deposits and certain other specified liabilities), and require continued performance of essential services.

20. In practice, as many banks in Hong Kong SAR (including five of the six D-SIBs), are part of international groups, the HKMA would, in most cases, need to coordinate with other authorities in a cross-border resolution and therefore should maintain its high level of engagement in global and regional resolution work. In practice, this would mean, in many cases, that the preferred resolution strategy is likely to rely primarily on recapitalization of the Hong Kong SAR bank through a contractual write-down or conversion of Loss Absorbing Capacity (LAC) instruments⁹ held by the group. The FIRO gives RAs discretion to recognize resolution actions (or part of them) taken by non-Hong Kong resolution authorities in Hong Kong SAR law, provided this would not adversely affect Hong Kong SAR's financial stability, disadvantage the Hong Kong SAR creditors or shareholders relative to others, or otherwise deliver outcomes inconsistent with the FIRO resolution objectives. Recognition means that resolution actions would produce substantially the same legal effect in the Hong Kong SAR that they would have produced had they been made and been authorized to be made under the Hong Kong SAR law. RAs may also use their resolution powers (for example, to require the continued provision of essential services) in support of non-Hong Kong resolution actions. As many Hong Kong SAR banks operate in multiple jurisdictions, achieving full recognition of the Hong Kong SAR resolution actions, for example, transferring assets in other jurisdictions, may be legally challenging. For D-SIBs, resolution planning is largely focused on use of the bail-in option (either under the FIRO or through contractual write-down or conversion of LAC instruments), which is less affected by these cross-border issues. In general, staff encourages the HKMA to pursue work on identifying and mitigating these cross-border barriers to resolvability through joint work with other RAs, for example, through its chairmanship of the Executives' Meeting of East Asia-Pacific Central Bank Focused Meeting on Resolution (EMEAP FMR).

21. The HKMA has established a clear framework for assessing whether resolution should be triggered for banks, and should maintain existing flexibility to trigger resolution even for smaller institutions. Triggering resolution under the FIRO requires three conditions to be met, which are in line with the FSB Key Attributes and are summarized below:

- a. **Condition 1** is that the institution has ceased, or is likely to cease, to be viable.
- b. **Condition 2** is that there is no reasonable prospect that private-sector action (outside of resolution) will restore viability within a reasonable period.
- c. **Condition 3** is that non-viability poses risks to the stability and effective working of the financial system of Hong Kong SAR (and resolution will mitigate those risks).

For banks, the Chief Executive of the HKMA is responsible for deciding whether these conditions are met, and the RO is responsible for coordinating the decision process through the CMCG. The work

⁹ Including capital instruments.

supporting assessment of Condition 1 is carried out by the Banking Supervision Department (BSD), and of Conditions 2 and 3 by the RO, with inputs from the BSD and the Monetary Management Department. The HKMA should ensure it does not adopt an overly restrictive interpretation of Condition 3, which would prevent the use of FIRO powers to enable the transfer of the deposit book of even small banks. Such a transfer requires use of FIRO powers, as it is not possible without the depositors' consent under Hong Kong SAR law (outside the resolution regime).

22. The FIRO provides for compensation arrangements for creditors and protection of netting and setoff rights, which are consistent with international standards. Given Hong Kong's position as an international financial center, it is essential that creditors and counterparties have confidence in the protection of property rights under the FIRO, and discussions with private sector stakeholders confirmed that this is the case. The authorities are planning further work on operationalizing the compensation arrangements under the FIRO (i.e. "no creditor worse off than in liquidation"), including appointing a panel of valuation advisors and publishing further policy guidance on information requirements for banks to enable a sound valuation.

23. The HKMA has published requirements on loss-absorbing capacity for the banking sector, which took effect from December 2018, and seeks to maintain a level playing field between all locally incorporated systemic banks in implementation; staff encourages the HKMA to maintain active engagement with G-SIB home authorities on their implementation. The LAC Rules prescribe minimum LAC requirements for both resolution entities (i.e., where the preferred resolution strategy contemplates the application of resolution powers under the FIRO to the entity) and material subsidiaries (particularly of banking groups not headquartered in Hong Kong SAR).¹⁰ All D-SIBs have been identified by the HKMA as either resolution entities or material subsidiaries subject to LAC requirements. For resolution entities, LAC requirements will be set as the sum of a Capital Component Ratio (by default, equal to their minimum total capital requirements) and a Resolution Component Ratio (by default, equal to the Capital Component Ratio). These default levels can be adjusted if the HKMA considers it prudent. For material subsidiaries, the default internal LAC requirement is set at the lower end of the scale envisaged in the FSB TLAC term sheet (75 percent of the requirement that would be set if it was a resolution entity) but can be increased to 90 percent. The implementation timetable for the LAC rules includes three major milestones:

- a. From July 1, 2019, D-SIBs that are part of non-Chinese G-SIB groups must meet local LAC requirements, which are in line with the minimum FSB TLAC requirements.
- b. From January 1, 2022 (at the earliest), all D-SIBs will be required to meet institution-specific LAC requirements.

¹⁰ An entity in a resolution group may be classified by the HKMA as a material subsidiary if it contributes more than 5 percent of the risk-weighted assets, operating income, or unweighted assets of the resolution group, or is material to the provision of critical financial functions

- c. Other locally incorporated banks with more than HK\$300 billion in assets will be subject to institution-specific LAC requirements, but not before January 1, 2023.

For the two Hong Kong SAR D-SIBs that are subsidiaries of Emerging Market G-SIBs, this implies they may be subject to the HKMA's internal LAC requirements earlier than the application of the FSB TLAC requirements by the Mainland Chinese authorities to their parent groups from 2025. Staff encourages the HKMA to continue active engagement with, in particular, the Mainland Chinese authorities, to ensure a clear, common understanding of the required timeline for internal LAC issuance by the Hong Kong SAR subsidiaries of Chinese G-SIBs.

24. Staff welcomes the HKMA's plans to issue additional rules and guidance under the FIRO, and to continue to be active in international resolution policy development. Planned topics for further work include operational continuity in resolution, resolution valuation, liquidity in resolution, stay of early termination of contracts, and access to financial market infrastructure in resolution. The HKMA publishes a high-level overview of its policy-making plans in its annual report, but a more detailed public timetable could enable industry to plan their work on resolvability more efficiently and ensure the HKMA is committed to achieving its planned timings. As the resolution authority for a major international financial center, the HKMA's active participation in the FSB and regional resolution policy development groups is important to ensure feasible resolution approaches are adopted for international banks.

B. Resolution Planning

25. The HKMA has conducted a significant amount of work on resolvability assessment and resolution planning for D-SIBs. Resolution planning work had commenced prior to the enactment of the FIRO and has involved extensive participation in CMGs and engagement with D-SIBs on priority actions to improve resolvability. This approach has been effective in delivering a number of significant changes to D-SIB structures to enhance resolvability, such as the creation of a Hong Kong SAR holding company to replace a chain of overseas holding companies, the establishment of a Hong Kong SAR service company, and inclusion of "resolution proof" terms in service contracts.

26. Following the implementation of the FIRO, the HKMA's approach to resolution planning for banks has been formalized and documented in the FIRO code of practice chapters on resolution planning.¹¹ The approach involves four stages of activities:

- a. The HKMA requests core resolution planning information from a bank.
- b. On the basis of this information, the HKMA determines the preferred resolution strategy (identifying which entities would be subject to which resolution powers) and begins to

¹¹ RA-2 "The HKMA's Approach to Resolution Planning" and CI-1 "Resolution Planning—Core Information Requirements."

develop a more detailed operational resolution plan. For large banks, the preferred resolution strategy will typically be bail-in (either using resolution powers under the FIRO or contractual write-down or conversion of LAC instruments).

- c. The HKMA then assesses the feasibility and credibility of the proposed resolution strategy and identifies impediments to its execution.
- d. The HKMA then works with the bank to remove or mitigate these impediments.

The HKMA has broad powers to direct a bank to take actions to remove or mitigate significant impediments to resolution if it is not satisfied with the proposed actions at stage d. The HKMA's decision can be reviewed by a tribunal (the Resolvability Review Tribunal established under the FIRO). The bank and its officers are subject to criminal sanction if they fail to comply with the HKMA's direction. However, the HKMA has not yet found it necessary to apply these formal powers of direction, having achieved its objectives through iterative discussions with banks.

27. The current status of resolution planning varies significantly across banks, and is most advanced for D-SIBs; the HKMA should ensure timelines for further work are consistent with those set by the home authorities for the D-SIBs' parent groups. The HKMA has identified and communicated the preferred resolution strategies to all six D-SIBs, conducted resolvability assessments, and is working on the removal of institution-specific impediments. A monthly resolution planning progress report is prepared for the HKMA's internal management, and periodic bilateral meetings are held with individual local senior executives who are accountable for resolution planning in each D-SIB.

28. Staff is of the view that the HKMA should consider allocating additional staff and other resources to accelerate the resolution planning timetable for other potentially systemic institutions. For six locally incorporated banks, other than D-SIBs, with more than HK\$300 billion in total consolidated assets, the information collection stage began in 2020. The aim is to develop a preferred resolution strategy and conduct resolvability assessments for these banks by end-2021. For five further locally incorporated banks with more than HK\$150 billion in total consolidated assets, the information collection stage has not begun. Collectively, these banks are a material part of the banking system, accounting for 16 percent of total deposits. Resolution planning for these banks should reflect their less-complex nature in keeping with the principle of proportionality.

29. Branches of overseas banks are fully subject to FIRO powers and the proportionate application of resolution policies standards, but institution-specific resolution planning for branches is not undertaken, other than through CMGs; the HKMA should develop plans to test the adequacy of these arrangements. Given the large size of many foreign branches in Hong Kong and the significant overseas assets of many Hong Kong SAR banks, it is particularly important for the authorities to be confident that they have effective crisis management arrangements for branches. Staff see benefits in the authorities exploring further resolution planning for branches, and validating the effectiveness of cross-border arrangements with international peers, for example through regional cross-border simulation exercises.

Table 2. Hong Kong SAR: Summary of Resolution Planning Status for Hong Kong SAR Banks¹

Category of bank	Share of system deposits	Status of resolution planning
D-SIB	61 percent	<ul style="list-style-type: none"> • Substantial amount of work done on resolution planning. • Ongoing need for international coordination (especially given the UK's commitment for major banks to be fully resolvable by 2022).
Locally incorporated (>HK\$300 billion in total consolidated assets)	11 percent	<ul style="list-style-type: none"> • Identified in HKMA LAC policy as "likely to pose a risk to the stability and effective working of the financial system" in failure. • Collection of resolution information to begin in 2020.
Locally incorporated (>HK\$150 billion and <HK\$300 billion in total consolidated assets)	5 percent	<ul style="list-style-type: none"> • Identified in HKMA LAC policy as "likely to pose a risk to the stability and effective working of the financial system" in failure. • Collection of resolution information to begin in due course, at a date to be determined by HKMA.
Locally incorporated (other)	2 percent	<ul style="list-style-type: none"> • Subject to proportionate resolution standards. • Resolution planning work for individual banks not currently undertaken but could be accelerated in certain circumstances.
Branches	21 percent	<ul style="list-style-type: none"> • Subject to proportionate resolution standards. • Resolution planning work for individual banks not currently undertaken but could be accelerated in certain circumstances. • Institution specific resolution planning only through CMGs/colleges.

¹ In addition to the above, the HKMA leads or participates in institution-specific, cross-border resolution planning with the relevant home and host authorities through CMGs and colleges as appropriate.

RESOLUTION FUNDING AND EMERGENCY LIQUIDITY ASSISTANCE

30. The FIRO sets out resolution funding arrangements at a high level. FIRO provisions cover the definition of a resolution funding account; sources of money that may be made available to the resolution funding account, including public money; purposes for which money in the resolution account may be used by an RA or the FS; recovery of costs incurred by an RA; and power to impose an ex post resolution levy. There is no pre-funded resolution fund—a specific resolution funding account would be set up for each institution under resolution, with potential sources of funds including the Exchange Fund or other public money. Resolution funds may be used for a broad range of purposes connected with resolution, including provision of guarantees and indemnities, loans, and provision of capital.

31. The HKMA has set out its high-level thinking on ex post resolution levies on the banking sector in a Quarterly Bulletin article; this should be further developed into a detailed methodology for the calculation and pace of ex post resolution levies. Under the FIRO, for each specific resolution case, the FS may make regulations, subject to the approval of LegCo, imposing resolution levies on the relevant sector of the financial industry in order to recoup public money used but not repaid. In each case the LegCo may, on the recommendation of the FS, by resolution prescribe the rate of a resolution levy in accordance with these regulations. Given that resolution cases are likely to occur at times of general stress for the banking system, this could be highly controversial at the time. To mitigate this risk, the FSTB should adopt in advance the principles on the basis of which it would set levies. For financial market infrastructures, this may require additional preliminary work, given that the FIRO allows for more complex levy arrangements, which can include levies on the FMI's participants and their clients.

32. ELA in Hong Kong SAR is provided from the Exchange Fund. The Exchange Fund Ordinance provides legal authority to the FS to use the Exchange Fund to maintain the stability and integrity of the monetary and financial systems of the Hong Kong SAR, provided its primary purpose of affecting, either directly or indirectly, the exchange value of the Hong Kong dollar (HKD) is respected.¹² In past crises, this authority has been used for a range of purposes, including guarantees, nationalization, and provision of capital and loans. The HKMA is responsible for decision making on the use of the Exchange Fund under a delegation of authority from the FS.¹³

33. The HKMA has recently published a revised Liquidity Facilities Framework, which includes both a Contingent Term Facility (CTF) for distressed but viable banks, and a Resolution Facility for liquidity support to banks in resolution. The framework supersedes the

¹² See sections 3(1) and 3(1A) of the Exchange Fund Ordinance.

¹³ See exchange of letters between the FS and the MA here: <https://www.hkma.gov.hk/eng/news-and-media/press-releases/2003/06/20030627-4/>.

HKMA's published policy on the provision of emergency liquidity to banks, last revised in 2009. The CTF can be used at the HKMA's discretion, subject to the HKMA considering that the bank's liquidity stress could damage systemic stability. The term and pricing of any lending is set on a case-by-case basis. Only HKD loans are envisaged (although legal authority under the Exchange Fund Ordinance would allow foreign currency lending, if necessary). The CTF removes a number of restrictions in the HKMA's 2009 policy, in particular a cap of HK\$25 billion on lending to any one bank, which could have limited the ability of lending under the policy to provide adequate liquidity support in a crisis. The CTF does, though, make reference to the guiding principles of the 2009 policy and although lending decisions are delegated to the HKMA, they may consult with the FS.

34. The HKMA should, in the view of staff, consider providing further guidance on its assessment for banks seeking to access the CTF and the information it would need to carry this out, and working with banks to test its ability to accept non-standard collateral. This should include information to allow assessment and ongoing monitoring of solvency, viability, funding plans, and availability of adequate collateral. Lending under the CTF is expected to always be collateralized, with a wider pool of eligible collateral than the HKMA's business-as-usual facilities which includes mortgage loans. Valuation and risk-management of non-standard collateral would be supported by specialists from the BSD, but both the HKMA and the banks would benefit from further ex ante strengthening, operationalization and testing of these processes.

35. The Resolution Facility sets out how Hong Kong SAR will provide a public sector backstop liquidity funding mechanism in resolution which is consistent with the FSB's Guiding Principles on Temporary Funding.¹⁴ It is similar to the CTF, with the difference that it is available only where resolution has been initiated under the FIRO and any losses for the HKMA can be recovered through resolution funding levies under the FIRO.

DEPOSITOR PROTECTION

36. The funding structure of banks in Hong Kong SAR is deposit focused, making a credible deposit protection regime particularly important to maintain stable bank funding. Deposits from nonbanks account for 56 percent of total banking system funding and deposits from banks for another 24 percent. Negotiable debt instruments and negotiable certificates of deposit account for 6 percent and other liabilities (including capital and reserves) for 14 percent. Hong Kong SAR applies the option under the Basel LCR framework to reduce the outflow rate on stable retail deposits from 5 percent to 3 percent in jurisdictions that have an effective, pre-funded deposit insurance scheme.

37. Membership of the DPS is mandatory for all banks and a high percentage of depositors are fully covered, although the prevalence of large deposits in the Hong Kong SAR

¹⁴ <https://www.fsb.org/wp-content/uploads/Guiding-principles-on-the-temporary-funding-needed-to-support-the-orderly-resolution-of-a-global-systemically-important-bank-%E2%80%99CG-SIB%E2%80%99D.pdf>

means that the share of bank funding covered is relatively low. A review of the modalities of the DPS fund is planned for 2021. The DPS covers up to HK\$500,000 per depositor.¹⁵ Foreign currency deposits (which account for about half of total deposits) are covered, but payout would be in HKD. Around 90 percent of depositors are fully covered by the deposit protection limit, which is in line with international peers. However, only about 20 percent of the total value of deposits with scheme members is covered (compared, for example, to 61 percent in the European Union, or approximately 40 percent in the United Kingdom, another global financial center¹⁶). During the global financial crisis, a temporary blanket deposit guarantee was provided, which expired at the end of 2010. The DPB maintains a high level of depositor awareness of the scheme through publicity and outreach work, which it measures through regular surveys. The 2018 survey found that 78 percent of the public were aware of the DPS, which is in line with recent years.

38. The authorities should expand the scope of depositor preference to ensure the treatment of creditors in resolution and in insolvency is consistent. Currently, protected deposits up to HK\$500,000 (or the DPB as a subrogated creditor) are treated as preferential creditors in an insolvency, with the amount of any deposit over this limit treated as an ordinary, unsecured claim. However, under the FIRO, all deposits (irrespective of amount) falling within the definition of “protected deposit” under the Deposit Protection Scheme Ordinance (DPSO) are excluded from bail-in. This means that losses for other categories of unsecured creditors are likely to be higher in a bail-in, and the authorities may be liable to pay compensation under the NCWO provisions of the FIRO. Conversely, market expectations (as reflected in, for example, rating agency rationales for their deposit ratings) are that large deposits would not be exposed to loss in a bank failure—depositor confidence could be undermined if a bank insolvency occurs in which large depositors unexpectedly take losses. These risks can be mitigated by expanding the scope of depositor preference in insolvency—Box 1 discusses options for doing so. Changes to depositor preference should follow a review of implementation options, including whether preference should be on a tiered or general basis (see Box 1), and the relative priority of deposits and other preferred claims in insolvency (e.g. tax authority claims).

39. The DPB has established guidelines for managing conflicts of interest, including through excluding active bankers from its membership, but should consider expanding these. The DPB is institutionally independent but draws on seconded staff and other administrative support from the HKMA. It is a statutory body with a Board, which currently comprises nine members—two ex officio (representing the SFST and the HKMA) with the remainder appointed by the FS. Active bankers are not eligible to be Board members, but it includes other active professionals (including investment managers and insolvency practitioners) who could have conflicts of interest with aspects of the DPB’s work; for example, the sharing of information on distressed banks by the HKMA or

¹⁵ Excluding term deposits of more than five years, structured deposits, deposits at non-Hong Kong offices, and certain other categories of deposit specified in Schedule 1 of the Deposit Protection Scheme Ordinance.

¹⁶ EU figure based on European Commission data; UK figure is an IMF staff estimate based on Bank of England and European Banking Authority data.

managing the DPB's position as a creditor in a potential insolvency. The DPB has established guidelines for declaring and managing potential conflicts of interest. However, this has sometimes required Board members to recuse themselves from significant parts of the DPB's work (for example, on improving payout speed). Staff recommends that the authorities review the current prohibition on active bankers joining the Board to consider excluding other active market participants; The DPB has access to external expertise through non-Board members (for example, on its investment committee); any remaining concerns of loss of expertise could be addressed by appointing suitable advisory panels (for example, on portfolio management or of insolvency practitioners).

Box 1. Different Forms of Deposit Preference

When deposit preference is established, depositors are given a more senior (or higher) claim than other unsecured creditors of the bank over the liquidation proceeds of a failed bank's assets. This means that depositors must be paid in full before other unsecured creditors can collect on their claims. Three ways of broadly stipulating deposit preferences are set out below:

- **Insured deposit preference** which gives preference to deposits covered by the deposit insurance scheme—those eligible and below the deposit insurance limit—and the scheme through subrogation (in cases where it has paid out insured depositors in a resolution or liquidation). It ranks all other ordinary, senior (non-subordinated) unsecured creditors (e.g., bondholders, interbank deposits), including uninsured deposits, equally (or "pari passu") thereafter.
- **Tiered deposit preference** (with two tiers) gives preference to insured deposits (and the scheme through subrogation) over uninsured eligible deposits (deposits eligible for insurance coverage but above the limit), and prefers both over other senior unsecured, general creditors.
- **General deposit preference** gives preference to all deposit liabilities of a deposit-taking institution, regardless of eligibility and coverage of deposit insurance, over other senior unsecured creditors. The scheme is subrogated for insured deposits and, thus, bears losses to the same degree (pari passu) as all deposits.

Without	Insured	Tiered	General
i. All deposits (and the DPS subrogated for insured deposits) and other senior creditors rank equally	i. Insured deposits (with DPS subrogated)	i. Insured deposits (with DPS subrogated)	i. All deposits (with DPS subrogated for insured deposits)
	ii. Other senior unsecured (including uninsured depositors and bondholders)	ii. Eligible deposits, over insurance limit	
		iii. Other senior unsecured	ii. Other senior unsecured

Note: A higher position within each column and darker shading, indicates a more senior claim.

Relative Advantages and Disadvantages	Insured	General	Tiered
• Enhance depositor confidence and reduce contagion		++	+
• Facilitate a resolution in which all deposits are protected		++	+
• Reduce the costs of bank failures to the DPS and/or state	+		+
• Protect payment system and economic activity		++	+
• Maximize market discipline for wholesale creditors	+	+	+

40. The authorities have strengthened information sharing and cooperation between the HKMA and the DPB, and should continue to increase the integration of the DPB into crisis management arrangements. The HKMA has entered into an MOU with the DPB to support information sharing and coordination of actions, and established an early-warning system for notifying the DPB of distressed banks. The DPB also participated in the HKMA's 2018 banking crisis simulation exercise. This should be built on and made routine, with the DPB's participation in crisis management planning reflected in the membership and terms of reference of the planned new inter-agency crisis management framework. This would further improve compliance with IADI Core Principle 6 on the deposit insurer's role in contingency planning and crisis management, which requires that the deposit insurer (regardless of its mandate) is a member of any institutional framework related to system-wide crisis preparedness and management.

41. The DPB has a small pre-fund and relatively low caps on banking industry levies, mitigated by established backstop funding arrangements with the Exchange Fund. The DPB's target fund size is 0.25 percent of eligible deposits, which is low relative to most peers; for example, the United States targets 2 percent, EU jurisdictions 0.8 percent plus resolution funds of 0.7 percent, and Malaysia targets 0.6-0.9 percent. Although the DPB has never made a payout since it was established in 2006, the target size has also not been reached due to deposit growth and the low rate of annual contributions specified in the DPSO. This low rate would also mean rebuilding the fund after a payout would potentially take a long time. The DPB does have a well-established backstop borrowing facility with the Exchange Fund, which is capped at HK\$120 billion (~5 percent of eligible deposits), which would be its primary source of liquidity to fund a payout and helps to underpin confidence in the adequacy of the DPB's funding arrangements.

42. Given the importance of deposit funding to Hong Kong's banking system, the authorities should, as part of the 2021 review, reassess the size of the fund to ensure it is sufficient even on more pessimistic assumptions, and make annual levies more flexible to allow a faster build-up. Although the combination of the preferred creditor status of covered deposits and the relatively small share of deposits that are covered would promote high recovery rates for the DPB in insolvency, simulations of the appropriate fund size are sensitive to input assumptions (in particular, on asset recovery rates and financing costs during the insolvency process). The authorities should ensure the fund size is sufficient, even allowing for more pessimistic assumptions on these key variables. A larger pre-fund that is more aligned with peers could also help underpin the existing high level of depositor confidence, which is reflected in Hong Kong's application of the lower level of retail deposit outflows in the LCR calculation, which the Basel Committee on Banking Supervision permits for jurisdictions with pre-funded deposit guarantee schemes. Annual levies should also be made more flexible, allowing the DPB to set levies to achieve its funding target within a specified time period (for example, five years), subject to limits based on the impact of levies on bank capital or profitability.

43. The DPB mandate should be expanded to allow it to contribute to the costs of bank resolution. Currently, the DPB cannot contribute to resolution costs, and can only provide funding for compensation payments directly to depositors. The Hong Kong SAR law (outside resolution

regime) would not permit the transfer in bulk of the deposit book of a failed bank to a new institution without the depositors' consent. As noted above, the resolution regime under the FIRO includes deposit protection as an objective and can permit the transfer of the deposit books, even of small banks, provided that the HKMA assesses that this is justified to protect the stability and effective working of the financial system. This provides an alternative means of achieving the DPB's objectives, and it should be possible for the DPB to contribute to the costs of doing so, provided that this is no more than the cost it would have incurred in an insolvency. The DPB's contributions to the cost of a crisis will be more significant if the size of the DPS fund is adjusted. These changes would improve consistency with IADI Core Principles, in particular Core Principle 2, Essential Criterion 4, on deposit insurers' powers to transfer deposits, and Core Principle 9, Essential Criterion 8 on deposit insurers' ability to use funds for resolutions other than liquidation.

44. The DPB has undertaken a considerable amount of work to increase payout speed, with the target timeframe reduced from six weeks to seven days following a payout being triggered. This work has included moving to paying out depositors claims on a gross basis (rather than after netting of loans from the failed bank), improving the provision of early warnings from the HKMA, issuing guidelines on information that banks need to be able to submit to the DPB in the event of a payout, and enhancing the DPB's IT systems. Assurance of these arrangements is provided by the DPB review of banks' readiness to meet the information submission requirements and regular simulation testing by the DPB with Scheme members. Work is ongoing to further improve payout speed by enabling use of electronic payment channels, which is intended to be complete in 2021.