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Client Briefing

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HONG KONG RESOLUTION REGIME: STAY RULES AND TERMS TO BE INCLUDED IN CERTAIN BANK GROUP CONTRACTS

Summary:

The Hong Kong Monetary Authority (**HKMA**) is taking a practical approach to its proposals for bank groups to include contractual stay/suspension provisions to buttress Hong Kong's resolution regime.

The proposals are limited in scope.

Bank groups will nonetheless need to implement new internal processes in order to comply with the rules.

The rules do not apply to existing contracts, although they will apply where an existing contract is subject to material amendment.

On 31 December 2020, the HKMA issued its consultation conclusions on the 'Rules on Contractual Stays on Termination Rights in Financial Contracts for Authorized Institutions' (**Rules**) under the Financial Institutions (Resolution) Ordinance, Cap. 628 (**FIRO**). The original consultation paper was issued on 22 January 2020.

The Rules will require certain entities to include certain contractual stay/suspension terms in specified contracts.

One of the main reasons behind the Rules is to ensure that the HKMA is able to exercise a 'stay' over the specified contracts, including where those contracts are governed by non-Hong Kong laws.

1. Legislative background

The Rules will be made under section 92 FIRO, which authorises the HKMA to make rules to ensure that terms and conditions of a contract with an authorized institution (**AI**) or its group company contain terms to the effect that the contracting parties agree to be bound by any suspension of termination rights in relation to the contract imposed under section 90(2).

In order for a contract to fall within the ambit of section 90, the contract's obligations for payment, delivery and provision of collateral must continue to be performed (so that the contract is a 'qualifying contract' under section 88).

Section 90(2) permits the HKMA to suspend for a specified period the 'termination right' (defined under section 86 FIRO to include set-off and other rights) of a counterparty to the contract, other than a counterparty that is 'financial market infrastructure' (as defined in FIRO). Section 90(4) requires the suspension to be short term in nature, meaning it must end no later than the expiry of the first business day following the date on which the relevant suspension instrument is published (although there appears to be no restriction on issuing multiple suspension instruments). After the suspension period, section 91(2) generally permits the counterparty to terminate other than where the termination right arises by reason of, or is directly linked to, a 'crisis prevention measure', being the exercise by the HKMA of its powers under certain specified provisions of FIRO. There are other particular rules where the contract has been transferred to another entity.

In addition to the above section 90 rights (**Temporary Stay Rights**), section 89 FIRO contains **Ongoing Stay Rights** which prevent a 'crisis prevention measure', or an event directly linked to a crisis prevention measure, of itself from triggering an event of default under contracts with the bank or a member of its group, where the substantive obligations provided for in the contract continue to be performed.

2. Consultation Paper and Consultation Conclusions

Although the legislation gives the HKMA rights to make wide-ranging contractual stay rules, the HKMA intends to limit the type of contracts to which the Rules will apply. A description of the expected scope and effect of the Rules is set out below.

What contacts will the Rules apply to?

The Rules apply to a **within scope contract**, being a contract which satisfies all of the following five tests:

(1) The contract is entered into by a **covered entity**, being:

(a) A Hong Kong incorporated AI;

(b) A Hong Kong incorporated holding company of a Hong Kong incorporated AI; and

(c) A group company of a Hong Kong incorporated AI (but note the limited scope, below, of the 'covered financial contracts' for group companies);

(2) The contract is a **covered financial contract**, being:

(a) In respect of the Hong Kong incorporated AI (or Hong Kong incorporated holding company of a Hong Kong incorporated AI):

(i) *Securities contracts*
(including purchases, sales, loans, options, repos over securities or a group or index of securities, whether cash settled or physically settled and irrespective of whether or not transferrable);

(ii) *Commodities contracts*
(including purchases, sales, loans, options and repos over commodities or a group or index of commodities);

(iii) *Currency contracts*
(contracts for the purchase, sale or delivery of any currency);

(iv) *Derivative contracts*
(including forwards contracts, futures contracts, options contracts and swap agreements);

(v) *Master or other agreements, in so far as they relate to a contract referred to in (i) to (iv) above*
(including standalone guarantees, security or credit enhancements); or

(vi) *Contracts of a similar nature to the contracts referred to in (i) to (v) above*
(this limb is intended to future-proof for the evolution of financial contracts).

(b) In respect of a group company of a Hong Kong incorporated AI:

A contract or agreement of the type referred to in (a)(i) to (a)(vi) above that is guaranteed or otherwise supported by the AI or the Hong Kong incorporated holding company of the AI;

(3) The contract is governed by non-Hong Kong law;

(4) The contract contains a termination right (defined under section 86 FIRO to include set-off and other rights) that is exercisable by the counterparty; and

(5) The counterparty is not ‘financial market infrastructure’ or a central bank or government.

The HKMA may exempt a covered entity from complying with the Rules in respect of one or more within scope contracts (or classes of contracts).

How will the Rules operate?

(1) The Rules will prohibit the entry into new obligations under a within scope contract, or material amendments to obligations under an existing within scope contract, unless the contract contains the appropriate contractual terms required under the Rules.

(2) The Rules will not apply to existing contracts (meaning that there is no need to repaper existing contracts - provided those existing contracts are not subject to material amendment).

(3) The HKMA has clarified that changes of a minor or administrative nature, such as change of address, would not be considered a material amendment.

Other points

(1) It is expected that primary legislation will be amended so that the Rules may require contractual provisions to be included both for the Temporary Stay Rights and also for the Ongoing Stay Rights.

(2) The HKMA has stressed that an AI must have adequate internal system capabilities to maintain detailed records of relevant financial contracts and to catalogue and present information on those contracts in a flexible and timely manner. The lack of such capabilities may constitute a significant impediment to orderly resolution, leading to the HKMA giving a direction under section 14 FIRO.

(3) The HKMA intends to use its information gathering power under section 158 FIRO to request periodic reporting from Hong Kong incorporated AIs and their Hong Kong incorporated holding companies to monitor compliance with the Rules. More details on periodic reporting are contained in paragraph 4 of the Consultation Paper.

(4) The HKMA may require a covered entity to propose and implement a rectification plan should it fail to comply with the Rules after the expiry of the transitional periods referred to below.

(5) The HKMA may extend the transitional period for a covered entity in respect of specified covered financial contracts if the HKMA is satisfied that it is prudent to do so.

(6) If and when a particular case warrants such action, the HKMA may, in the course of bilateral resolution planning work between the HKMA and an AI, require sight of legal opinions to evidence enforceability of the relevant contractual provisions required under the Rules.

Timing

(1) The HKMA proposes to introduce the Rules to the Legislative Council for negative vetting in the 2021 Legislative Session.

(2) The HKMA intends to consult on and issue a final FIRO Code of Practice chapter to provide guidance on operational aspects of the Rules, which would be issued around the time the Rules come into operation.

(3) The current proposed timetable is:

(a) Phase 1: for a within scope contract where the only counterparties (ignoring any excluded counterparties) are (a) AIs; and/or (b) financial institutions (other than AIs) that are, or are part of, global systemically important banks (**G-SIBs**) on the commencement date of the Rules, 24 months from the date of the commencement of the Rules; and

(b) Phase 2: for all other within scope contracts, 30 months from the date of the commencement of the Rules.

Draft Rules

The HKMA has made available draft Rules at **https://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/resolution/Consultation_draft_AI_Stay_Rules.pdf**.

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