

The HKMA’s Approach to Resolution Planning (RA-2)

Purpose

This chapter forms part of the Code of Practice (“Code”) issued by the Monetary Authority (“MA”) as a resolution authority in relation to banking sector entities pursuant to section 196 of the Financial Institutions (Resolution) Ordinance (Cap. 628) (“FIRO”). This chapter of the Code is issued pursuant to section 196(1), 2(a)(i) and (3) of the FIRO and provides guidance on the Hong Kong Monetary Authority’s (“HKMA”) approach to resolution planning for authorized institutions (“AIs”).

The development of a feasible and credible resolution strategy is needed to facilitate the effective use of resolution powers in the event of failure of AIs, thereby maintaining the stability of the financial system, including the continued performance of critical financial functions. To facilitate this, resolution planning helps to determine a preferred resolution strategy for an AI and to develop it into an operational plan for a given AI, with the objective of making such strategy feasible and credible to resolve the AI in an orderly manner consistent with the resolution objectives. Broadly speaking, resolution planning for an AI involves: (i) gathering information from the AI; (ii) setting a preferred resolution strategy and developing a resolution plan that operationalises the preferred strategy for the AI; (iii) assessing the AI’s resolvability; and (iv) addressing impediments to resolution.

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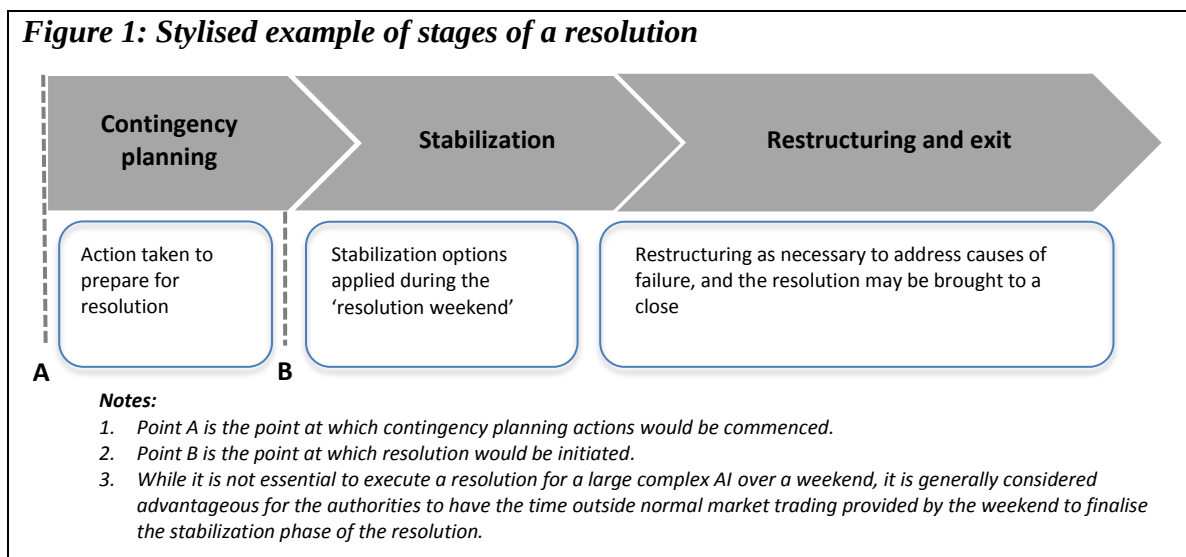
Part 1. Introduction

- 1.1 Under the FIRO, resolution authorities in Hong Kong have a set of powers (“resolution powers”) that are designed to mitigate the risks posed by the failure of financial institutions (“FIs”). These resolution powers are designed to be in line with the international standards set by the Financial Stability Board (“FSB”) in its *Key Attributes of Effective Resolution Regimes for Financial Institutions* (“Key Attributes”).
- 1.2 Central to the resolution powers under the FIRO are five **stabilization options**, which a resolution authority may deploy to secure the orderly resolution of a failing FI that is considered systemically important by stabilizing its critical financial functions that are essential to the functioning of the economy.¹ The five stabilization options available under the FIRO with respect to an AI are: (i) transfer of a failing AI or some or all of its business to a purchaser; (ii) transfer of a failing AI or some or all of its business to a bridge institution; (iii) transfer of a failing FI’s assets, rights and liabilities to an asset management vehicle (“AMV”); (iv) bail-in (i.e. a statutory write-off or conversion into equity of certain liabilities of a failing AI, in order to absorb losses and restore its capital position); and as a last resort, (v) transfer of a failing AI to a temporary public ownership (“TPO”) company.²
- 1.3 As shown in Figure 1 below, in applying any of the stabilization options in the event of an AI’s resolution, there are three broad stages of any resolution execution process, as follows:
 - 1.3.1 ‘**Contingency planning**’ - as an AI’s proximity to failure increases, actions are taken by the authorities to establish a state of readiness to be able to resolve the AI in an orderly manner should the need arise. The AI may take recovery actions at this stage to restore its financial strength and viability;
 - 1.3.2 ‘**Stabilization**’ - where there is a need to resolve an AI, the stability and effective working of the financial system of Hong Kong, including the continued provision of critical financial functions, is achieved through the application of stabilization options by the authorities, for example through a **transfer** to a purchaser or bridge institution, and/or through **bail-in**; and
 - 1.3.3 ‘**Restructuring and exit**’ - changes are made to the structure and business model of the whole AI or its constituent parts to address the causes of failure and ensure that the resolved entity is viable and can continue as a going concern, with a view to bringing the resolution process to a close.

¹ Note that the continued performance of critical financial functions is just one aspect of what resolution is intended to achieve. The full set of resolution objectives can be found in section 8 of the FIRO.

² The option of transfer to TPO may only be deployed when (a) the resolution authority has considered all other stabilization options and is satisfied that an orderly resolution of the financial institution is most appropriately achieved by TPO; and (b) the Financial Secretary has approved its use. (See section 68 of the FIRO).

Figure 1: Stylised example of stages of a resolution



- 1.4 To prepare for the effective use of the resolution powers in the event of an AI's resolution, advance resolution planning needs to be undertaken by the HKMA to ensure a resolution can be executed in an orderly manner. To this end, the resolution authority develops a feasible and credible resolution strategy for the AI. This means that an AI needs to be structured in a way that facilitates orderly use of resolution powers by a resolution authority when it fails. This is the purpose of resolution planning, to devise a preferred resolution strategy for an AI and develop it into an operational plan for a given AI, with the objective of making such strategy feasible and credible to resolve the AI in an orderly manner consistent with the resolution objectives. This planning and preparation must be conducted well in advance of an AI experiencing stress and regardless of the AI's current likelihood of, or proximity to, failure.

Part 2. The HKMA's Approach to Resolution Planning

- 2.1 The HKMA's approach to resolution planning for an AI involves four key activities: (i) gathering information from the AI;³ (ii) setting a preferred resolution strategy and developing a resolution plan that operationalises the preferred strategy for the AI;⁴ (iii) assessing the AI's resolvability;⁵ and (iv) addressing impediments to resolution.⁶ This approach, as provided for in the FIRO and illustrated in Figure 2, is designed to be in line with the Key Attributes and international best practice.

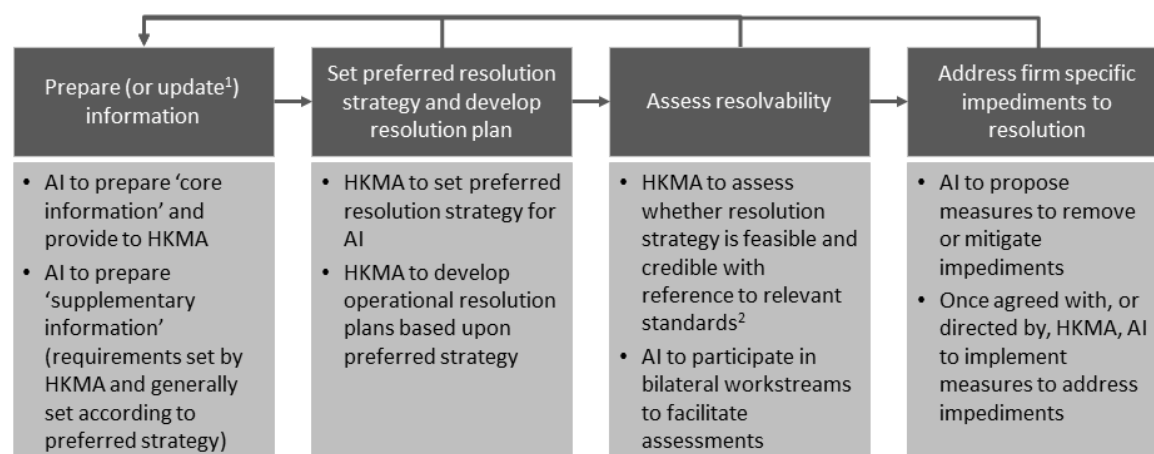
³ See section 158 of the FIRO.

⁴ See section 13(1) of the FIRO.

⁵ See section 12(1) of the FIRO.

⁶ See section 14 of the FIRO.

Figure 2: Stylised resolution planning approach



Notes:

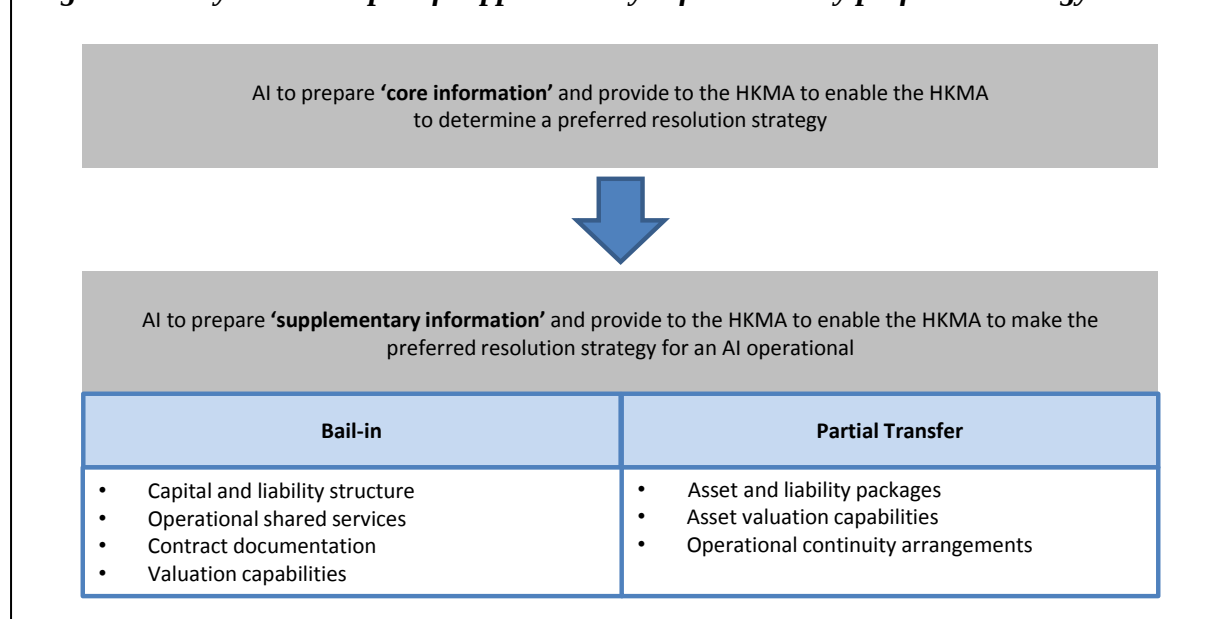
1. Resolution planning is a continuous process and core information should be updated at least every two years.
2. Resolution standards will be defined in relation to matters that have been found to commonly result in impediments to resolution, for example: loss absorbing and recapitalisation capacity; operational services continuity in resolution; termination rights risk in financial contracts; resolution valuations capability; access to payment, settlement and clearing services; liquidity & collateral reporting capability; and post-stabilization restructuring capability.

Part 3. Preparation of Information by AIs

- 3.1 The first step of the HKMA's resolution planning process is to require AIs to submit 'core information'.⁷ This information is intended to assist the HKMA with the development and the setting of a preferred resolution strategy.
- 3.2 For certain AIs, the submission of core information may be followed by the submission of supplementary information to support further development of the preferred resolution strategy, inform the HKMA's resolvability assessments and identify actions for the AI to take to remove any identified impediments to resolvability. This approach allows the HKMA to tailor supplementary information requests to the specific preferred resolution strategy for each AI, thereby applying resolution planning information requirements on a proportionate basis having regard to an AI's nature, scale and complexity of operations. A stylised example of supplementary information collected by preferred strategy is illustrated in Figure 3.
- 3.3 Guidance with respect to the specific core information for resolution planning that AIs will be expected to provide is set out in a chapter of the Code entitled *Resolution Planning – Core Information Requirements* ("CI-1").⁸ The HKMA intends to request core information from AIs in phases, starting with those AIs which are considered to have more significant potential impact on financial stability in Hong Kong.

⁷ The HKMA may require the submission of information pursuant to section 158 of the FIRO.

⁸ http://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/resolution/CI-1_Resolution_Planning_Core_Information_Requirements.pdf.

Figure 3: Stylised example of supplementary information by preferred strategy

Part 4. Setting the Preferred Resolution Strategy

- 4.1 The HKMA intends to set a preferred resolution strategy for each AI⁹ that may likely require the exercise of resolution powers under the FIRO upon failure.¹⁰ The HKMA's preferred resolution strategy will reflect an optimal and proportionate approach to the resolution of the AI in a manner that meets the resolution objectives. The preferred resolution strategy will form the basis for subsequent resolution planning work for the AI and underpins any measures that the AI may need to take to remove or mitigate the effect of any significant impediments to orderly resolution and in order to be considered resolvable by the HKMA.
- 4.2 Setting the preferred strategy involves identifying the entity (or entities) that would be subject to the application of resolution powers, and determining which stabilization options would be applied. The MA may apply one or a combination of stabilization options to stabilize an AI upon initiating resolution. For example, a preferred resolution strategy for an AI may involve a bail-in or a partial transfer of some of the AI's business. For an AI that is part of a cross-border group however, the preferred group resolution strategy may not always require the direct application of stabilization options under the FIRO in Hong Kong (see Part 7).
- 4.3 The setting of a preferred resolution strategy by the HKMA will depend upon factors specific to an AI. This includes consideration of, among other things, the AI's legal entity structure; the nature of business conducted by the AI; the scale of the AI's business; the nature of any operational dependencies on intra-group entities and third parties; and the nature of the AI's funding arrangements. For example, understanding whether an AI's group operates a distributed business model (whereby legal entities

⁹ See section 13(1) of the FIRO.

¹⁰ The preferred resolution strategy will inevitably only be "presumptive", given that there may be circumstances where resolution in practice is to deviate from a planned strategy. The MA will only be able to make a definitive determination of which resolution powers to use in the event of an AI's failure and in light of the particular causes of the failure and prevailing market conditions.

operate largely independently) or a highly integrated business model, may influence the determination of whether the group could be more effectively resolved by applying resolution powers to more than one entity in the group or to a single entity. In the latter case, for the majority of G-SIBs with a bail-in resolution strategy, the top parent or holding company is the single point of entry.

- 4.4 A transfer of the securities (e.g. shares) issued by a failing AI to a private sector purchaser¹¹ tends to be considered to carry lower execution risk from a resolution transaction perspective, as it avoids any splitting up of the business of an AI and may therefore involve less risk to public funds. However, there may not be a private sector purchaser who is willing or able to receive the transfer of the shares of a failing AI, as this would entail absorbing the associated losses which may have caused the AI's failure.
- 4.5 For large and complex AIs, HKMA's preferred resolution strategy would typically involve use of the bail-in stabilization option. This is because the size and complexity of such AIs could make it difficult for a swift separation and transfer of critical financial functions over a resolution weekend. However, for smaller AIs (i.e. AIs with simpler business models and fewer business lines), a preferred resolution strategy based on partial transfer of business, e.g. deposit liabilities backed by good quality assets, may be considered feasible and credible.

Preferred Resolution Strategy Involving Partial Transfer

- 4.6 A partial transfer resolution strategy involves the transfer of part of an AI's business to a private sector purchaser¹², or temporarily to a bridge institution¹³, with a view to enabling continuity of access for the AI's customers to the critical financial functions performed by the AI. The feasibility of such a transfer depends on there being a credible purchaser who is willing and ready to take on some of the business of the failing AI. Whether or not such a purchaser would be available at the requisite time would depend on, among other things, the prevailing market circumstances at the time, the size of the business proposed to be transferred relative to the size of the purchaser's business, and cause of the AI's failure. In order to prepare for a situation where no such purchaser would be immediately available, resolution planning involving a partial transfer strategy would therefore generally consider both a potential transfer to a purchaser and a transfer to a bridge institution. In respect of a transfer to a bridge institution, resolution planning would also need to consider the authorization of a bridge institution, or the change of contract documentation (e.g. operational service agreements) to which the AI is a party, and how continuity in payment or security settlement services, whether direct membership or via third party affiliates, would be maintained.
- 4.7 However, a transfer to a bridge institution is only intended to be a temporary arrangement, acting as a 'bridge' to facilitate an onward sale (e.g. via a transfer to a purchaser or portfolio sales). Hence a transfer to a bridge institution may not be

¹¹ See section 39(1) of the FIRO.

¹² See section 39(2) of the FIRO.

¹³ See section 42(2) of the FIRO.

considered a preferable resolution strategy if an onward sale is not foreseeable within a reasonable timeframe in the HKMA's opinion.

Preferred Resolution Strategy Involving Bail-In

- 4.8 Bail-in¹⁴ is designed to recapitalise a failing AI by imposing losses on its shareholders and creditors, thereby stabilizing the AI as a going concern and ensuring continuity of access for its customers to the AI's critical financial functions. The stabilization phase of bail-in allows time for an orderly restructuring or wind down of all or part of the failing AI's business in order to address the cause(s) of failure and restore its longer-term viability.
- 4.9 Bail-in of a failing AI's liabilities under the FIRO is expected to take one of two approaches: either (i) through the use of the bail-in stabilization option to write-down the failing AI's liabilities or convert the liabilities into the equity of the AI¹⁵, or (ii) via transfer to a bridge institution ("bridge bail-in")¹⁶. In a bridge bail-in, the liabilities to be exposed to bail-in would be left behind in the failing AI, while those critical financial functions requiring continuity are transferred to the bridge institution. In contrast, where the bail-in stabilization option is applied directly to a failing AI, liabilities of the AI are written down or converted into the equity of the AI itself.
- 4.10 Resolution planning for strategies involving bail-in would therefore need to take into account of the operational differences under these two approaches to bail-in. In the case of a bridge bail-in, resolution planning would need to cover considerations in relation to the authorization of a bridge institution, similar to the case of a transfer to bridge institution as noted above.
- 4.11 For any preferred resolution strategy involving bail-in of an AI, it is expected that resolution planning will consider, among other things, whether the AI has sufficient loss-absorbing capacity in place to absorb losses and recapitalise the AI so that it is solvent and viable.

Part 5. Assessing Resolvability

- 5.1 The preferred resolution strategy for an AI provides the basis for the HKMA's assessment of resolvability. In line with the Key Attributes, the intention is for the HKMA's resolvability assessment to consider both the feasibility and the credibility of a preferred strategy¹⁷:

5.1.1 For a strategy to be **feasible**, a resolution authority should be able to implement the resolution strategy effectively in a timely manner. In considering whether a resolution strategy is feasible, the HKMA expects to work with the AI to

¹⁴ See section 58(1) of the FIRO.

¹⁵ See section 58(3) of the FIRO.

¹⁶ See section 58(5)(c)(iv) of the FIRO in respect of converting liabilities into securities issued by a bridge institution.

¹⁷ Paragraph 1 of I-Annex 3 to the Key Attributes states that a systemically important financial institution ("SIFI") is resolvable if it is feasible and credible that resolution authorities can resolve the SIFI in a way that protects systemically important functions without severe systemic disruption and without exposing taxpayers to loss.

identify matters that could prevent the preferred resolution strategy from being effectively implemented in a timely manner; and

5.1.2 In considering whether a resolution strategy is **credible**, the HKMA expects to assess the implications of resolving an AI and appraise whether executing the preferred strategy would avoid or mitigate the risks posed by the AI's failure to the stability and effective working of the financial system of Hong Kong, including to the continued performance of critical financial functions.

- 5.2 To be considered resolvable, an AI must be organised and operate in a way that would not impede the execution of resolution powers. Based on international experience from the global financial crisis, FIs can often be organised or operate in such a way that aspects of their legal, financial and operational structure may frustrate efforts to carry out an orderly resolution. Resolution planning that has been conducted to date by the HKMA and by FSB member authorities has resulted in the identification of a number of common pre-conditions for resolution strategies to be feasible. These pre-conditions have been compiled by the FSB in its Report to the G20 on progress in resolution: *Removing Remaining Obstacles to Resolvability*.¹⁸
- 5.3 In conducting a resolvability assessment of an AI, the HKMA intends to take into consideration, among others, the following attributes of the AI: (1) loss absorbing and recapitalisation capacity (external and internal); (2) operational services continuity in resolution; (3) early termination risk in financial contracts in resolution; (4) resolution valuations systems capability; (5) continuity of access to payment, settlement and clearing services in resolution; (6) liquidity and collateral reporting capability; and (7) post-stabilization restructuring capability.
- 5.4 As the resolution planning process for local AIs evolves, the HKMA may develop additional Hong Kong specific resolution standards which AIs will be expected to meet in order to be considered resolvable in respect of the AI's preferred resolution strategy set by the HKMA.
- 5.5 Assessments of feasibility are dependent upon input from the AI. The HKMA intends to organise resolvability assessments according to the resolution standards applicable to an AI's preferred resolution strategy and such assessments may be conducted through bilateral workstreams that may be established between the HKMA and the AI. The bilateral workstreams will allow assessments to be tailored to individual AI and also facilitate efficient interaction between the HKMA and relevant staff from the AI. Other domestic and overseas authorities may be engaged as appropriate to support assessments and to facilitate a coordinated approach among relevant authorities to resolution planning and removal of any identified impediments to the AI's resolvability.

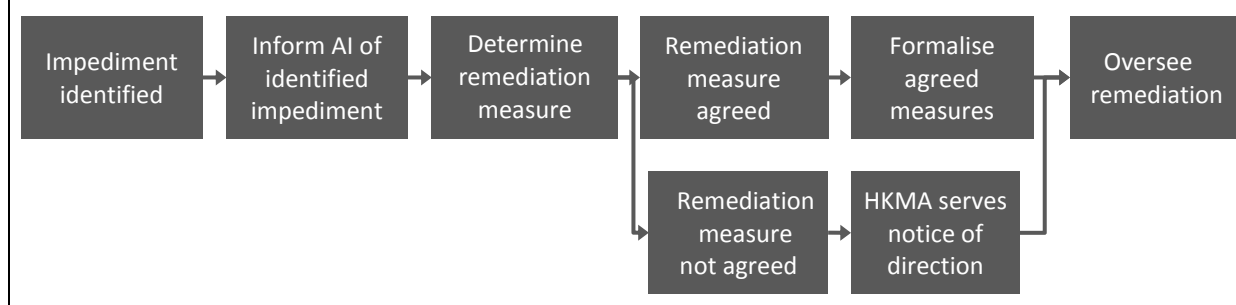
Part 6. Addressing Impediments to Resolvability

- 6.1 As noted in Part 5, if an AI-specific impediment to resolvability is identified by the HKMA, the AI would generally be expected to propose measures to address the

¹⁸ See: <http://www.fsb.org/wp-content/uploads/Report-to-the-G20-on-progress-in-Resolution-for-publication-final.pdf>.

impediment within a set timeframe following notification by the HKMA. The intention is that if measures proposed by the AI are acceptable to the HKMA, the AI will be notified and the HKMA will oversee and monitor the remediation by the AI to ensure that actions taken are in line with the agreed measures and timeframes. AIs will be expected to provide regular progress reports to the HKMA on the implementation of any agreed measures to address impediments. The stylised process for addressing impediments to resolvability is shown in Figure 4.

Figure 4: Stylised process for addressing impediments to resolvability



6.2 However, there may be cases where the measures proposed by the AI to address an impediment are deemed to be insufficient by the HKMA, and alternative, mutually agreeable measures cannot be found. Under section 14 of the FIRO, if the MA is of the opinion that significant impediments exist to the orderly resolution of the AI in accordance with its resolution plan (and the preferred resolution strategy), then the MA as the resolution authority may direct it to take any measures in relation to its structure (including group structure), operations (including intra-group dependencies), assets, rights or liabilities that are considered reasonably required to remove or mitigate the effect of, those impediments.¹⁹

6.3 The FIRO also provides AIs with a specific safeguard concerning a resolution authority's power to direct removal of impediments to orderly resolution. An AI may make representations to the HKMA about the direction and the HKMA must consider and respond to those representations. If the notice is subsequently confirmed by the HKMA and the AI or its holding company is aggrieved by the decision, then the AI may apply for a review of the decision by the Resolvability Review Tribunal.²⁰ The Resolvability Review Tribunal reviews the resolution authority's decisions in private (section 114(1) of the FIRO).

Part 7. Cross-Border Resolution Planning Considerations

7.1 In respect of resolution planning for an AI that is part of a cross-border group, the HKMA recognises the importance of close consultation and cooperation with the AI's home resolution authority. For an AI that is part of a cross-border group, the HKMA

¹⁹ Section 14(2) and 14(3) of the FIRO.

²⁰ Section 17 of the FIRO. The period specified under section 17(1) of the FIRO is the period of 30 days beginning on the date on which a notice under section 15(3) or 15(4) was served on the FI in relation to the decision mentioned in section 17(1) (section 17(3) of the FIRO).

intends to develop a preferred resolution strategy that has been devised on a group-wide basis in consultation with the home resolution authority (and if applicable, with the group's Crisis Management Group, for AIs that are part of groups that are designated as global systemically important banks ("G-SIBs")). If, however, the group resolution strategy were determined by the HKMA to be inconsistent with the resolution objectives under the FIRO, the HKMA would consider whether it would be necessary to pursue an alternative or independent strategy as the preferred resolution strategy for the AI.

- 7.2 For an AI that is part of a cross-border group, it may not always be necessary for stabilization options to be applied directly to entities in Hong Kong to secure an orderly resolution in the event of group failure. The resolution strategies for certain cross-border banking groups are based on a "single point of entry" approach, which involves the application of resolution powers at the top parent or holding company level by a single resolution authority, typically in the jurisdiction responsible for the global consolidated supervision of the group. A "single point of entry" strategy entails the passing of an AI's losses up to an overseas parent entity that would in turn be resolved by the home resolution authority in that entity's jurisdiction were it to fail.
- 7.3 In such cases, provided the HKMA is satisfied that the group resolution strategy is consistent with the FIRO's resolution objectives, resolution planning may involve the HKMA preparing for measures to recognize resolution actions at the group level, taken by a resolution authority outside Hong Kong (section 187 of the FIRO). Regardless of the type of the preferred resolution strategy pursued, the HKMA expects to cooperate closely with relevant home and host resolution authorities of cross-border groups to enhance preparedness for resolution.
- 7.4 As the resolution authority for AIs, the MA, in considering whether to adopt a coordinated cross-border resolution strategy as the preferred strategy for an AI that is part of a cross-border group, expects to assess, among other things, whether: (i) such a strategy is consistent with the resolution objectives established in the FIRO; (ii) it would be both feasible and credible in Hong Kong; (iii) it would impact the group's operations in Hong Kong; and finally, (iv) the potential impact it may have on depositors, creditors and financial stability in Hong Kong. In this regard, AIs will be expected to ensure that core information provided to the HKMA includes the relevant information about the AI relative to its wider group. The HKMA may also conduct resolvability assessments for these AIs and if local impediments to the group resolution strategy are identified, it is expected that these impediments will be discussed with the relevant overseas authorities (and if applicable, with the group's Crisis Management Group, for AIs that are part of groups that are designated as G-SIBs) and the AI will need to take the necessary action to address these impediments (see Part 6).
- 7.5 As mentioned in Part 6, the MA has powers to direct AIs to take measures locally to remove impediments to the group-wide resolution strategy. In the case of resolution planning for cross-border groups with an AI in Hong Kong, generally speaking the HKMA does not expect to exercise the powers to require that AI to take action other than to remove impediments that have been identified to the group wide preferred resolution strategy and agreed with relevant home and host authorities. Only if the HKMA had come to the view that such a group wide strategy would not effectively

deliver the resolution objectives under the FIRO in Hong Kong, would the HKMA require that AI to remove impediments according to an independent resolution strategy led by the HKMA.

Part 8. Engagement with AIs in the Resolution Planning Process

- 8.1 The HKMA expects to engage with AIs as appropriate throughout the resolution planning process as described in earlier in the document. AIs will be expected to engage in a structured and collaborative work programme with the HKMA to advance the work towards becoming more resolvable. To this end, AIs will be expected to ensure that they have the necessary governance and organisational arrangements in place to support the HKMA's resolution planning process. This is consistent with I-Annex-4 of the Key Attributes, whereby firms are "required to have in place robust governance structures and sufficient resources to support....the resolution planning process".²¹ Accordingly, the expectation will be for each AI to identify a member of its Hong Kong executive management team that is accountable for resolution planning; ensure adequate staffing and access to appropriate expertise; and establish the mandate and mechanics to work collaboratively with the HKMA to advance resolution planning.

²¹ See paragraphs 1.18-21 of I-Annex-4 to the Key Attributes.