# AN EFFECTIVE RESOLUTION REGIME FOR FINANCIAL INSTITUTIONS IN HONG KONG

# FINANCIAL INSTITUTIONS (RESOLUTION) ORDINANCE (Chapter 628)

# REGULATIONS ON PROTECTED ARRANGEMENTS

# CONSULTATION PAPER

**22 November 2016**

# ABOUT THIS DOCUMENT

1. This consultation paper is published by the Financial Services and the Treasury Bureau of the Government of the Hong Kong Special Administrative Region, in conjunction with the Hong Kong Monetary Authority, the Securities and Futures Commission and the Insurance Authority (for the purposes of this consultation paper, "the authorities").

2. It sets out the authorities' intended approach to the regulations to be made under section 75 of the Financial Institutions (Resolution) Ordinance (Cap. 628) ("FIRO"), which are designed to provide an appropriate degree of protection in resolution for a set of financial arrangements defined collectively as "protected arrangements" under section 74 of the FIRO.

3. After considering the submissions received in response to this consultation paper, the Government intends to further refine its proposals as appropriate, with a view to tabling regulations for negative vetting by the Legislative Council in the first half of 2017.

4. A list of the questions raised in this consultation is set out for ease of reference in Annex A. Interested parties are invited to submit comments on these and any relevant or related matters that may have a significant impact on the proposals in this consultation paper.

5. Comments should be submitted in writing no later than 21 January 2017, by any one of the following means:-

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| By mail to: | Consultation on Protected Arrangements Regulations<br>Financial Services Branch<br>Financial Services and the Treasury Bureau<br>24/F, Central Government Offices<br>2 Tim Mei Avenue, Tamar, Hong Kong |
| By fax to: | +852 2856 0922 |
| By email to: | resolution@fstb.gov.hk |

6. Any person submitting comments on behalf of any organisation is requested to provide details of the organisation they represent.

7. Submissions will be received on the basis that any of the Financial Services and the Treasury Bureau, the Hong Kong Monetary Authority, the Securities and

Futures Commission and the Insurance Authority may freely reproduce and publish them, in whole or in part, in any form; and may use, adapt or develop any proposal put forward without seeking permission from or providing acknowledgement to the party making the proposal.

8. Please note that the names of respondents, their affiliation(s) and the contents of their submissions may be published or reproduced on the Financial Services and the Treasury Bureau's website (or the websites of the Hong Kong Monetary Authority, the Securities and Futures Commission or the Insurance Authority (i.e. the website of the Office of the Commissioner of Insurance)) and may be referred to in other documents published by the authorities. If you do not wish your name, affiliation(s) and/or submissions to be disclosed, please state this clearly when making your submissions.

9. Any personal data submitted will only be used for purposes which are directly related to this consultation. Such data may be transferred to other Government departments/agencies for the same purposes. For access to or correction of personal data contained in your submissions please contact:

   Data Controlling Officer
   Financial Services Branch
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   24/F, Central Government Offices
   2 Tim Mei Avenue, Tamar, Hong Kong

10. Terms adopted in this consultation paper are used in a generic sense to reflect the concepts underpinning the proposals in question, unless the context otherwise provides. When the relevant proposals are implemented in the form of legislation, it is possible that these terms may be modified or replaced in order to better reflect the precise policy intent of the proposals in the law or to aid or address issues relating to the legal interpretation of such terms when used in the law.

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# ABBREVIATIONS

| | |
|---|---|
| AI | Authorized institution |
| BRRD | EU Bank Recovery and Resolution Directive |
| CP | Consultation paper |
| Dodd-Frank Act | Dodd-Frank Wall Street Reform and Consumer Protection Act |
| EU | European Union |
| FI | Financial institution |
| FIRO | Financial Institutions (Resolution) Ordinance |
| FMI | Financial Market Infrastructure |
| FSB | Financial Stability Board |
| LegCo | Legislative Council |
| NCWOL | No creditor worse off than in liquidation |
| PARs | Protected arrangements regulations |
| PPT | Partial property transfer |
| QFC | Qualified financial contract |
| SFST | Secretary for Financial Services and the Treasury |
| TPO | Temporary public ownership |
| UK | United Kingdom |
| US | United States of America |

# INTRODUCTION

1. The Financial Institutions (Resolution) Ordinance (Cap. 628) ("FIRO") was enacted by the Legislative Council ("LegCo") in June 2016.[1] The FIRO provides the legal basis for the establishment of a cross-sectoral resolution regime for financial institutions ("FIs") in Hong Kong and is designed to meet the standards set by the Financial Stability Board ("FSB")'s "Key Attributes of Effective Resolution Regimes for Financial Institutions" ("Key Attributes").[2] The FIRO has not yet come into operation. It will come into force on a date to be appointed by the Secretary for Financial Services and the Treasury ("SFST"). It is considered important that, amongst other matters, the regulations to be made by the SFST as subsidiary legislation under section 75 of the FIRO,[3] the "protected arrangements regulations" ("PARs"), should be put in place and ready to become operational at the same time as the FIRO is brought into operation.

2. The PARs are important because financial market participants rely on a variety of financial arrangements to both mitigate credit risk exposure to counterparties and provide sources of liquidity and financing. In turn, these arrangements are vital to the daily functioning of financial markets. If counterparties do not have legal certainty that such financial arrangements, when entered into with an entity within the scope of the resolution regime under the FIRO ("within scope entity"),[4] will be afforded an appropriate degree of protection in resolution, such that their

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[1] The gazetted version of the FIRO can be found under the following link: http://www.gld.gov.hk/egazette/pdf/20162026/es12016202623.pdf

[2] The Key Attributes were first issued by the FSB in 2011 and subsequently updated in 2014 to incorporate additional guidance elaborating on specific Key Attributes relating to information sharing for resolution purposes and sector-specific guidance setting out how the Key Attributes should be applied to insurers, financial market infrastructures and the protection of client assets in resolution. For reference to the latest version see: http://www.fsb.org/wp-content/uploads/r_141015.pdf

[3] See Annex B for an extract of sections 74 and 75 of the FIRO.

[4] A partial property transfer may be made in respect of a within scope FI, a holding company of a within scope FI, an affiliated operational entity of a within scope FI, a bridge institution, a temporary public ownership ("TPO") company or an asset management vehicle (see definition of "prescribed entity" in section 1 of Schedule 4 to the FIRO). Bail-in may be made in respect of a within scope FI, a holding company of a within scope FI or an affiliated operational entity of a within scope FI (see section 58 of the FIRO and definition of "prescribed entity" under section 1 of Schedule 6 to the FIRO). For simplicity for the purposes of this CP, the terms "within scope entity" or "entity in resolution", depending upon the context, are used to cover these entities collectively notwithstanding that bridge institutions, TPO companies and asset management vehicles are not generally within scope financial institutions or entities in resolution as defined under FIRO. Thus, in short, the protection afforded by the PARs will cover partial transfers involving a bridge institution, a TPO company or an asset management vehicle, as the case may be, and, whilst these entities are not generally within scope entities or entities in resolution as defined in FIRO, they are not referred to separately in the discussion of protected arrangements throughout this consultation paper.

economic purpose is not undermined, then this would likely result in a higher cost of funding for such entities (including through increased capital requirements) as, for example, reliance on set-off and netting could not be assumed; and potentially a reduction in liquidity in the markets. Contagion would also increase. The financial arrangements identified as "protected arrangements" under section 74 of the FIRO are:

(i) clearing and settlement systems arrangements;
(ii) netting arrangements;
(iii) secured arrangements;
(iv) set-off arrangements;
(v) structured finance arrangements; and
(vi) title transfer arrangements.

3. The potential for the application of stabilization options, if resolution were initiated under the FIRO, to adversely "disrupt" protected arrangements, by splitting up the inter-linked assets, rights and liabilities under such arrangements, is most likely: (i) where a transfer of some, but not all, of an entity's assets, rights and liabilities is made through a property transfer instrument ("partial property transfer" or "PPT") to a third party;[5] or (ii) on bail-in where liabilities are written down and/or converted without taking into account "linked" assets or rights. Whilst the protections to be afforded in the case of (i) and (ii) are intended to achieve similar effects, there are differences in approach and so this consultation paper ("CP") considers the safeguards for protected arrangements under a PPT and bail-in separately.

4. On the one hand it is recognized that protected arrangements should be afforded an appropriate degree of protection in resolution given their fundamental importance to the operation of financial markets. On the other hand, it is also of critical importance that a resolution authority has sufficient flexibility to act quickly and decisively to achieve orderly resolution and secure continuity of critical financial services. Thus there is a need to balance the scope of protection against the legitimate public interest in not jeopardising the feasibility of resolution.

[5] A third party under a PPT could be: (i) a private sector purchaser; (ii) a bridge institution; or (iii) an asset management vehicle.

5. Taking these factors into account, the proposed scope of the PARs has been developed to be consistent with the following considerations:

   (i) the definition of some classes of protected arrangements (such as arrangements under which the counterparties may set-off or net) could, without some limitation, severely restrict a resolution authority's ability to carry out orderly resolution. For example, if a resolution authority was required to seek to protect those classes of arrangements to their broadest possible extent, in all circumstances, it would be practically impossible to effect a PPT;

   (ii) the definitions of the different classes of protected arrangements must provide sufficient certainty as to what those arrangements are and how they will be protected in order to support confidence, and prevent contagion, amongst market participants; and

   (iii) the consequence and applicable remedial actions to be taken by a resolution authority should be prescribed if the resolution authority has inadvertently not acted in accordance with the PARs. Similar to the protections themselves, the actions to be taken will have to appropriately balance the rights of the affected counterparties and the need to meet the resolution objectives.

6. The approach to the PARs set out in this CP builds on the thinking set out in the authorities' previous two consultation papers and consultation response on "An Effective Resolution Regime for Financial Institutions in Hong Kong"[6] and is intended to be consistent with the standards set by the Key Attributes which, in paragraph 4.1, state that "[t]he legal framework governing set-off rights, contractual netting and collateralisation agreements and the segregation of client assets should be clear, transparent and enforceable during a crisis or resolution of firms, and should not hamper the effective implementation of resolution measures.". In seeking to implement these standards, the authorities have also reviewed the approaches taken in certain other jurisdictions that have adopted, or

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[6] See for reference:

"An Effective Resolution Regime for Financial Institutions in Hong Kong: Consultation Paper", http://www.fstb.gov.hk/fsb/ppr/consult/resolution_e.pdf;

"An Effective Resolution Regime for Financial Institutions in Hong Kong: Second Consultation Paper", http://www.fstb.gov.hk/fsb/ppr/consult/doc/resolutionregime_e.pdf; and

"An Effective Resolution Regime for Financial Institutions in Hong Kong: Consultation Response and Certain Further Issues", http://www.fstb.gov.hk/fsb/ppr/consult/doc/resolutionregime_conclu_e.pdf

are in the process of adopting, resolution regimes designed to be consistent with the Key Attributes. Particular regard has been had to the approach taken in the United Kingdom ("UK"),[7] the United States ("US")[8] and under the European Union ("EU")'s Bank Recovery and Resolution Directive ("BRRD")[9] as well as the approach being developed in Singapore[10]. Of the models considered, the approach set out in this CP largely follows that adopted in the UK and that required under the EU BRRD, which are both considered to largely align with the standards set by the Key Attributes. The authorities prefer an approach whereby there is generally a broad protection for those arrangements that fall within the respective categories of "protected arrangement" with, in some cases, specific "carve-outs" of specified rights and liabilities from the protections, where these are considered necessary to confer an appropriate degree of flexibility on a resolution authority in order to enable orderly resolution.

7. Importantly, even where rights and liabilities are excluded from the protections to be provided for under the PARs, affected pre-resolution shareholders and pre-resolution creditors would still be safeguarded by the "no creditor worse off than in liquidation" ("NCWOL") compensation mechanism under the FIRO. This provides that pre-resolution shareholders and pre-resolution creditors of an entity in resolution should receive no less favourable a treatment than would have been the case in a winding-up.

8. The following sections set out the authorities' proposed approach to the protection of the classes of protected arrangement under the PARs. Section I considers the treatment of the relevant protected arrangements in the context of a PPT whilst section II deals with the relevant protected arrangements in the context of bail-in.

9. This CP seeks feedback on both: (i) the scope and degree of protection for the different classes of protected arrangements, including any necessary "carve-outs"

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7 See The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009 (S.I. 2009/322), http://www.legislation.gov.uk/uksi/2009/322/pdfs/uksi_20090322_en.pdf, as amended by, amongst others, The Banking Act 2009 (Restriction of Partial Property Transfers) (Amendment) Order 2009 (S.I. 2009/1826), http://www.legislation.gov.uk/uksi/2009/1826/pdfs/uksi_20091826_en.pdf; and The Banking Act 2009 (Restrictions of Special Bail-in Provision, etc.) Order 2014 (S.I. 2014/3350), http://www.legislation.gov.uk/uksi/2014/3350/pdfs/uksi_20143350_en.pdf

8 See paragraph 38 and the related Footnotes.

9 See Articles 76 to 80 of the BRRD, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=en

10 See Monetary Authority of Singapore (2016), Consultation paper on "Proposed Legislative Amendments to Enhance the Resolution Regime for Financial Institutions in Singapore", http://www.mas.gov.sg/~/media/MAS/News%20and%20Publications/Consultation%20Papers/Proposed%20Legislative%20Amendments%20to%20Enhance%20Resolution%20Regime%20for%20FIs%20in%20Singapore.pdf

in order not to overly restrict a resolution authority from achieving orderly resolution; and (ii) the consequence and applicable remedial actions to be taken by a resolution authority should it inadvertently not act in accordance with the PARs in effecting a PPT or bail-in.

# SECTION I: SAFEGUARDS IN A PARTIAL PROPERTY TRANSFER

## CLEARING AND SETTLEMENT SYSTEMS ARRANGEMENTS

Definition

10. Under section 74 of the FIRO a clearing and settlement systems arrangement is defined as "an arrangement governed by the rules and directions relating to participation in the clearing and settlement of transactions within a financial market infrastructure" ("FMI"). Such arrangements can relate to settlement finality, payment and delivery obligations, transfer orders or processes to be observed on the default of a participant in an FMI.

Rationale for protection

11. FMIs provide clearing and settlement services that are relied on by market participants and are critical to the daily functioning of financial markets. Without an appropriate degree of protection for such arrangements in resolution, including providing certainty around settlement finality, significant systemic risk could arise through contagion as counterparties to FMIs could face uncertainty about the exposures they face.

Proposed level of protection

12. Given the importance to financial stability of both predictability and continuity in the clearing and settlement of transactions within an FMI, the authorities' proposed approach is that the PARs will restrict a resolution authority from transferring some but not all of the property, rights or liabilities of an entity in resolution under a PPT in a way that will disrupt the operation of a clearing and settlement systems arrangement. Such arrangements will be defined as those relating to FMIs that are a designated clearing and settlement system under the Payment Systems and Stored Value Facilities Ordinance (Cap. 584) or a clearing house recognized under the Securities and Futures Ordinance (Cap. 571)), given the importance of those systems and clearing houses to the stability and effective working of the financial system in Hong Kong.

Consequences of a PPT which disrupts a clearing and settlement systems arrangement

13. In the case of any inadvertent action by a resolution authority under a PPT which

disrupts a clearing and settlement systems arrangement (such as where the action taken by a resolution authority transfers some but not all of an entity in resolution's property, rights or liabilities that are constituent parts of a clearing and settlement systems arrangement) the intention is for the PARs to provide that the PPT is void to the extent that it splits property, rights and liabilities that are part of the arrangement.

14. The authorities consider that the approach to protecting clearing and settlement systems arrangements under the PARs, as described above, is broadly consistent with that adopted in the UK, as well as under the EU BRRD.[11]

| **Q1.** | **Do you agree with the proposed approach to protecting clearing and settlement systems arrangements in a PPT under the PARs?** |
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## SECURED ARRANGEMENTS

Definition

15. A "secured arrangement" is defined under section 74 of the FIRO as "an arrangement under which a person acquires, by way of security, an actual or contingent interest in the property of another". In simpler terms, it is an interest a creditor has in an asset, or assets, belonging to the debtor, and over which the creditor has recourse in the event of the debtor defaulting. Secured arrangements can be over specified assets (e.g. a fixed charge), or over a changing pool of assets (i.e. a floating charge).

Rationale for protection

16. Secured arrangements may play an important role both as a financing source (e.g. secured lending) as well as a credit risk mitigation technique. As such, participants in secured arrangements need to be sure that in resolution an asset of the entity in resolution over which a creditor has security will not be transferred to a third party under a PPT without the corresponding liability to, and the benefit of the security in favour of, the creditor also being transferred (and vice versa).

[11] See section 7 of The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009 (S.I. 2009/322) as amended by, amongst others, The Banking Act 2009 (Restriction of Partial Property Transfers) (Amendment) Order 2009 (S.I. 2009/1826); and Article 80 of the BRRD. See Footnotes 7 and 9 respectively for reference.

Proposed level of protection

17. Given the above rationale, the authorities' proposed approach is that the PARs will provide that a resolution authority, in effecting a PPT, should not transfer any constituent part of a secured arrangement without all other corresponding constituent parts. So, the property or rights against which a liability is secured may not be transferred unless the liability and the benefit of the security are also transferred. Additionally, the benefit of the security may not be transferred unless the liability which is secured is also transferred (and vice versa). It is further proposed that provision be made in the PARs such that only "legitimate" secured arrangements, i.e. those not made in contravention of any other legal or regulatory requirement,[12] will benefit from the protection.

18. It is the policy intent that secured arrangements should include those arrangements where security is by means of either a fixed or a floating charge provided that the rights or assets to which the security is attached, or would be attached on an enforcement event, are clearly identified or identifiable in accordance with the terms of the secured arrangement. This approach is similar to that adopted in the UK[13] as well as the framework established under the EU BRRD[14]. Any incentive that the proposed approach might create in terms of encouraging the proliferation of floating charges should be mitigated by resolution planning and resolvability assessment where such charges might be identified as an impediment to orderly resolution and at least in the case of authorized institutions there are legislative restrictions on their ability to create charges over their assets (under section 119A of the Banking Ordinance (Cap. 155)).

19. It is further proposed that where foreign property (i.e. property that is not governed by the laws of Hong Kong[15]) forms part of a secured arrangement then,

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[12] See for example Section 119A(2) of the Banking Ordinance (Cap. 155) which provides that an authorized institution incorporated in Hong Kong must not, except with the approval of the Monetary Authority, by whatever means create any charge over its assets if, inter alia, the aggregate value of all charges existing over its total assets is 5% or more of the value of those total assets.

[13] See Section 5(1) of The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009 (S.I. 2009/322), as amended by, amongst others, The Banking Act 2009 (Restriction of Partial Property Transfers) (Amendment) Order 2009 (S.I. 2009/1826). See Footnote 7 for reference.

[14] See Article 76(2)(a) and Article 78 of the BRRD (See Footnote 9 for reference) and Article 2 of the Commission Delegated Regulation of 18.03.2016 on classes of arrangements to be protected in a partial property transfer under Article 76 of Directive 2014/59/EU of the European Parliament and of the Council, http://ec.europa.eu/finance/bank/docs/crisis-management/160318-delegated-regulation_en.pdf

[15] As defined in section 2(1) of the FIRO, non-Hong Kong property "means any property in respect of which any issue arising in any proceedings would have to be determined (in accordance with the

if a resolution authority is unable to transfer that foreign property, notwithstanding the provision made in section 13 of Schedule 4 to the FIRO,[16] e.g. because of some restriction or prohibition under the law governing the property, a resolution authority would not be prevented, by the protections afforded under the PARs, from transferring the remainder of the constituent parts of the secured arrangement. Absent such provision, a resolution authority could be severely restricted in effecting an orderly PPT. This approach is similar to that adopted in the UK.

Consequences of a PPT which disrupts a secured arrangement

20. If the constituent parts of a secured arrangement were to inadvertently be split in implementing a PPT the intention is for the PARs to provide that an affected party may notify the resolution authority of this, such that the affected party's position might be rectified by the resolution authority restoring the constituent parts of the secured arrangement through a supplemental transfer to a transferee or reverse transfer to the transferor as appropriate.[17]

21. In terms of timeframe, it is proposed to provide under the PARs that the affected party must notify the relevant resolution authority within 60 days of the PPT taking effect and then provide the resolution authority with 60 days from receipt of such notification to identify whether the PPT has indeed resulted in the constituent parts of a secured arrangement being split in a manner inconsistent with the PARs and, if so, to effect the necessary supplemental or reverse transfer as appropriate. This latter period of 60 days may be extended by one further period of 60 days if the relevant resolution authority considers the matters raised in the affected party's notice to be so complex that it is not reasonably practicable to take action within the first period of 60 days. The proposed successive 60 day periods are in line with the approach taken in the UK.[18]

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rules of private international law) by reference to non-Hong Kong law" with non-Hong Kong law defined as the law of a jurisdiction other than Hong Kong.

[16] Section 13(2) of Schedule 4 to the FIRO, inter alia, requires the transferee and transferor to "take any necessary steps to ensure that the transfer [of property not subject to the laws of Hong Kong] is effective [under the governing law of the property]".

[17] Supplemental and reverse property transfers are provided for respectively under Part 2 and Part 3 of Schedule 4 to the FIRO.

[18] See section 12 of The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009(S.I. 2009/322), as amended by, amongst others, The Banking Act 2009 (Restriction of Partial Property Transfers) (Amendment) Order 2009 (S.I. 2009/1826). See Footnote 7 for reference.

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| **Q2.** | **Do you agree with the proposed approach to defining and protecting secured arrangements in a PPT under the PARs?** |

## STRUCTURED FINANCE ARRANGEMENTS

Definition

22. A structured finance arrangement is defined under section 74 of the FIRO as "an arrangement under which a person creates and issues an instrument under which some or all of the return or amount due (or both the return and the amount due) or the method of settlement is determined by reference to the price, value or other parameters, or changes in the price, value or other parameters, of financial assets or the occurrence or non-occurrence of a specified event…". The authorities' intention is primarily to capture securitisation vehicles. Such structured finance arrangements include asset-backed securities and asset-backed commercial paper (including residential and commercial mortgage backed-securities); collateralised debt obligations and covered bonds. To be clear, it is not the policy intention that the definition of structured finance arrangement extends to unsecured structured products e.g. instruments issued by an FI with embedded derivatives.

Rationale for protection

23. Structured finance arrangements provide a means of refinancing and allowing risk diversification for financial market participants through the transfer of credit risk to other market participants. If the constituent parts of a structured finance arrangement could be disrupted as a result of a PPT, damage could be caused to the structured finance market as participants would be uncertain as to the efficacy of any structured finance arrangements they enter into with a within scope entity.

Proposed level of protection

24. Recognising this risk, the authorities propose that a resolution authority, in effecting a PPT, be restricted by the PARs from transferring some, but not all, of the property, rights and liabilities which are, or form part of, a structured finance arrangement. This will include the underlying assets, liabilities under the instruments issued, the security arrangements and the contractual relationships under derivative transactions or liquidity facilities required for maintaining the flow of payments under the liabilities.

25. It is further proposed that where foreign property (i.e. property that is not governed by the laws of Hong Kong) forms part of a structured finance arrangement then, if a resolution authority is unable to transfer that foreign property, notwithstanding the provision made in section 13 of Schedule 4 to the FIRO,[19] e.g. because of some restriction or prohibition under the governing law of the property, the resolution authority would not be prevented from transferring the remainder of the constituent parts of the structured finance arrangement by the protections afforded under the PARs. Absent such provision, a resolution authority could be severely restricted in effecting an orderly PPT.

26. Additionally, it is intended to provide a "carve-out" from the protection for any deposits which form part of a structured finance arrangement. This would allow a resolution authority to transfer the critical financial function of deposit-taking without the need to have regard to the role, if any, those deposits may play in a structured finance arrangement (e.g. a guaranteed investment contract account that is linked to the structured finance arrangement). This approach balances the need to protect such arrangements with the public interest in securing orderly resolution by allowing for a prompt and decisive transfer of deposits.

Consequences of a PPT which disrupts a structured finance arrangement

27. It is proposed to provide in the PARs that, in the event of a PPT resulting in the assets, rights and liabilities constituting a structured finance arrangement being inadvertently treated inconsistently with the protection described above, an affected party may notify the resolution authority of this, such that the relevant resolution authority might consider and determine whether the PPT has resulted in the structured finance arrangement being treated inconsistently with the PARs and, if so, take steps to restore the position as appropriate through the exercise of supplemental or reverse transfer powers. The purpose of the supplemental or reverse transfer is to restore the affected party to the position they would have been in had the PPT not disrupted the structured finance arrangement e.g. by restoring its constituent parts.

28. In terms of timeframe, it is proposed to provide under the PARs that the affected party must notify the relevant resolution authority within 60 days of the PPT coming into effect and then the resolution authority would have 60 days from receipt of the notification, subject to extension of a further 60 days in certain

[19] See Footnote 16.

circumstances,[20] to identify whether the PPT has disrupted the arrangement and, if so, to effect the necessary supplemental or reverse transfer as appropriate.

29. The authorities consider the overall approach to protecting structured finance arrangements under the PARs, as described above, to be broadly consistent with the approach adopted in the UK and under the EU's BRRD.[21]

| **Q3.** | **Do you agree with the proposed approach to protecting structured finance arrangements in a PPT under the PARs?** |
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## SET-OFF, NETTING AND TITLE TRANSFER ARRANGEMENTS

Definition

30. Under section 74 of the FIRO set-off arrangement "means an arrangement under which 2 or more debts, claims or obligations can be set off against each other"; netting arrangement "means an arrangement under which a number of claims or obligations can be converted into a net claim or obligation"; and title transfer arrangement "means an arrangement under which a person transfers assets to another person on terms providing for the other person to transfer assets if specified obligations are discharged and includes - (a) a repurchase or reverse repurchase transaction; and (b) a stock borrowing or lending arrangement.".

Rationale for protection

31. Set-off and netting have similar economic effects and are commonly used in financial markets to allow counterparties to reduce their exposure to each other (as the net exposure each counterparty faces is likely to be smaller, and in many cases, much smaller – than the gross exposure). Therefore, in order to avoid destabilising these markets and increasing contagion risk and financing costs, it is considered necessary to give the participants in arrangements that allow counterparties to set-off or net their exposures, such as set-off, netting and title transfer arrangements, legal clarity about how they will be treated under a PPT. However, a very wide definition of set-off, netting and title transfer arrangements

[20] See paragraph 21 for an explanation of those circumstances.

[21] See section 6 of The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009 (S.I. 2009/322), as amended by, amongst others, The Banking Act 2009 (Restriction of Partial Property Transfers) (Amendment) Order 2009 (S.I. 2009/1826); and Article 79 of the BRRD. See Footnotes 7 and 9 for reference.

for this purpose may effectively jeopardise a resolution authority's ability to effect a PPT promptly and decisively thus impairing the efficacy of the property transfer powers under the FIRO.

Proposed level of protection

32. The protection under the PARs for the right to set-off and to net under set-off, netting and title transfer arrangements should be based on similar principles given their similar economic consequences. The authorities' proposed approach is to restrict a resolution authority under the PARs from splitting the rights and liabilities that may be set off or netted under written contractual set-off, netting or title transfer arrangements, to which the entity in resolution is a party; but with specific exclusions where the ability to transfer certain rights or liabilities that might otherwise be constituent parts of a set-off, netting or title transfer arrangement could be crucial for a resolution authority in meeting the resolution objectives. This approach will exclude rights solely arising by operation of law such as the set-off of all mutual debits and credits under insolvency rules in a winding-up. The intention is for the protection to ensure certainty where assets, rights and liabilities are linked to each other by virtue of bona fide financial arrangements (e.g. International Swaps and Derivatives Association master agreements, Global Master Repurchase Agreements, Global Master Securities Lending Agreements) that are critical to the effective functioning of financial markets and not to protect "catch-all" or "sweeper" provisions that provide for any and all rights and liabilities between the parties to be set-off or netted. This approach has the benefit of providing a broad scope of protection for established contractual arrangements entered into with the express intent of allowing the rights and liabilities arising under those arrangements to be set-off or netted whilst not unnecessarily restricting a resolution authority's ability to effect a PPT in a manner consistent with the resolution objectives.

33. The exclusions, mentioned in paragraph 32 above, that have been identified are rights or liabilities which relate to:

(i) deposits: a transfer of deposits is likely to be a key objective of a PPT, in order to minimise disruption for customers and the banking system. There is, therefore, a clear benefit in permitting a resolution authority to transfer a deposit book without being obliged to transfer all other assets, rights and liabilities relating to the depositors. It is proposed that this exclusion would apply to all deposits (i.e. it would not be linked solely to those deposits protected by the Deposit Protection

Scheme). This exclusion ensures that a resolution authority is not restricted from achieving the transfer of a deposit book by the possible existence of a contractually agreed set-off or netting arrangement that explicitly included deposit liabilities. This differs slightly to the approach taken in the UK where the authorities understand that only deposits that are within scope of the deposit protection scheme are excluded from the protection. The authorities were minded to adopt this wider exclusion under the PARs having considered the importance of achieving continuity of a deposit business given the potential contagion risks of not doing so;

(ii) subordinated debt: not excluding rights and liabilities relating to subordinated debt from the protection of the PARs could artificially increase its ranking in the creditor hierarchy, compared with other subordinated liabilities, where a subordinated debt instrument is part of a set-off, netting or title transfer arrangement which also includes more senior instruments. This could prevent a resolution authority from imposing losses on holders of subordinated debt instruments consistent with the creditor hierarchy;

(iii) transferable securities: the exclusion of rights and liabilities relating to transferable securities is designed to ensure that a resolution authority is not restricted from, for example, leaving the obligation to make payment in respect of senior unsecured bonds behind in the residual issuing entity where the resolution strategy requires the transfer of assets owed by a bondholder in order to secure continuity of critical financial functions. However, this exclusion would not operate to exclude transferable securities from protection where they are sold or lent under a documented title transfer or stock lending agreement which provides for set-off or netting of transactions upon termination;

(iv) "operating" rights and liabilities: rights or liabilities that are not related to "financial activity" carried out by an entity in resolution can nonetheless be critical to the ability of a transferee under a PPT to continue to perform the critical financial functions transferred to it. It is therefore imperative that a resolution authority is not restricted, by the existence of contractual set-off or netting, from transferring these rights or liabilities. An example might be a lease of real property or an IT outsourcing agreement. A resolution authority might need to transfer the lease or contract to another FI taking on part of the entity in

resolution's business but leave behind or transfer to a third FI a lending business where there is a loan to the landlord or to the outsourcing provider. In such circumstances it is necessary to ensure that any creation of any written contractual set-off or netting between obligations owed by the entity in resolution under the lease or outsourcing contract against the obligations of the landlord or outsourcing provider under the loan, cannot operate to prevent a resolution authority effecting a PPT; and

(v) an award of damages or a claim under an indemnity relating to the undertaking of "financial activity": a resolution authority should not be restricted from transferring rights and liabilities relating to the performance of critical financial functions by the existence of any related award for damages. It is perhaps less likely that such an award would be covered by a contractual set-off, netting or title-transfer arrangement. However, given the difficulty for a resolution authority to find a willing transferee if rights and liabilities could only be transferred with any related claim or award of damages or claim under an indemnity, it could jeopardise the efficient use of a PPT if the possibility is not excluded from the protection of the PARs.

34. It is further proposed that where foreign property (i.e. property that is not governed by the laws of Hong Kong) forms part of a set-off, netting or title transfer arrangement then, if a resolution authority is unable to transfer that foreign property, notwithstanding the provision made in section 13 of Schedule 4 to the FIRO,[22] e.g. because of some restriction or prohibition under the law governing the property, the resolution authority would not be prevented from transferring the remainder of the constituent parts of the set-off, netting or title transfer arrangement by the protections afforded under the PARs. Absent such provision, a resolution authority could be severely hindered from effecting a PPT even where there is a single contract or transaction governed by a law other than that of Hong Kong that is entitled to be set-off or netted under a set-off, netting or title transfer arrangement.

35. In addition, it is intended that any set-off or netting rights under a written contract which includes a clause permitting a non-defaulting counterparty to make no (or limited) payments to the defaulting party (even if the defaulting party is a net creditor) should not be protected under the PARs. This would mean that the

[22] See Footnote 16.

property, rights and liabilities under such an arrangement would not have to be transferred, or left behind, together.

36. The approach set out above is similar in principle to that adopted in the UK where there is broad protection for set-off and netting under set-off, netting and title transfer arrangements with specified rights and liabilities being "carved out" from that broad protection.[23] One material difference is that the proposed protection in Hong Kong would apply only to set-off and netting rights (under set-off, netting and title transfer arrangements) that have been created by written contractual agreement, to the intent that the rights and liabilities have a nexus or link inter se and are clearly specified.

37. Focussing the protection under the PARs on set-off and netting rights agreed by written contract is considered necessary as to afford broader protection for rights of set-off, which could arise by operation of law in respect of *all* mutual debits and credits under insolvency, would disproportionately constrain the use of resolution tools and go well beyond what is necessary to ensure financial market participants have certainty with respect to the credit risk mitigation and funding arrangements on which they, and the wider funding market, rely.

Other approaches considered

38. An alternative approach to providing for broad protection with carve-outs would be to list a narrower group of rights and liabilities for protection in resolution. This type of approach has been adopted in the US where the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") imposes a requirement on the Federal Deposit Insurance Corporation, when making a transfer of assets or liabilities of a covered financial company,[24] to transfer either all or none of the qualified financial contracts ("QFC")[25] between the covered financial company and any person or affiliate of that person.[26] Such an approach

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23 See section 3 of The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009 (S.I. 2009/322), as amended by, amongst others, The Banking Act 2009 (Restriction of Partial Property Transfers) (Amendment) Order 2009 (S.I. 2009/1826). See Footnote 7 for reference.

24 A covered financial company means a financial company, which covers a broad range of US-incorporated entities including bank holding companies, in respect of which a determination has been made by the Secretary of the Treasury to commence Title II resolution proceedings. See Sec. 201(a)(8) of the Dodd-Frank Act, https://www.sec.gov/about/laws/wallstreetreform-cpa.pdf

25 A qualified financial contract is defined under Sec. 210(c)(8)(D) of the Dodd-Frank Act and, at a high level, includes securities contracts, commodity contracts, forward contracts, repurchase agreements and swap agreements, (including the claims in respect of, property securing or any other credit enhancement under such a contract). See Footnote 24 for reference.

26 See Sec. 210(c)(9)(A) of the Dodd-Frank Act. See Footnote 24 for reference.

offers the benefit that all QFCs are required to be kept together in resolution (be that at a transferee or a residual entity), thus respecting set-off or netting with a counterparty to these QFCs. It also provides clarity on the population of contracts that would not receive any form of protection (i.e. those not meeting the definition of QFC). However, this approach presents the difficulty of identifying adequately and sufficiently precisely in advance all of the contracts that should benefit from the protection. To manage the risks related to an excessively narrow definition, i.e. precluding contracts which are important to funding markets (e.g. bespoke agreements or contracts with non-standard terms), and which should therefore benefit from an appropriate degree of protection in resolution, this approach would require continual monitoring and updating of the regulations to ensure that all relevant contracts were captured by the protection.

39. Another approach adopting a narrower focus would be to build upon that used in the EU by linking protection only to set-off and netting arrangements that are recognised for risk-mitigation purposes under applicable prudential rules, such as those relating to the calculation of regulatory capital. Again the authorities are concerned that this might be too narrow a protection as counterparties that are not themselves subject to regulatory capital requirements (e.g. non-bank lenders or broker dealers) still rely on entering into arrangements which entitle them to set-off and net with within scope entities and so ensuring confidence in their set-off and netting arrangements in a resolution is important from the perspective of minimising contagion.

40. Taking into account the pros and cons of the different approaches, the authorities propose to adopt a model similar to that in operation in the UK, but focused on set-off and netting rights, under set-off, netting and title transfer arrangements, that are agreed by written contract.

41. This approach is considered to address the twin objectives of the regulations which are to provide: (i) confidence for financial market participants that critical risk mitigation and funding techniques will be protected with certainty and predictability; and (ii) an appropriate degree of flexibility for a resolution authority to split parts of an entity in resolution's balance sheet, particularly those relating to the provision of critical financial services (e.g. deposits), so that these can be transferred to, and continued with minimal disruption by, an acquirer.

Consequences of a PPT which disrupts set-off or netting rights under a set-off, netting or title transfer arrangement

42. In the case of any inadvertent splitting of the rights and liabilities otherwise subject to a protected set-off, netting or title transfer arrangement, it is proposed that the affected counterparty should be permitted to continue to set-off or net any amount it owes to the entity in resolution, under the relevant arrangement, to reduce its exposure as originally envisioned under the relevant arrangement.

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| **Q4.** | **Do you agree with the proposed approach to protecting rights to set-off or net under set-off, netting and title transfer arrangements in a PPT under the PARs?** |

# SECTION II: SAFEGUARDS IN BAIL-IN

43. The FIRO establishes a number of protections for counterparties in bail-in, particularly by defining a list of "excluded liabilities" which cannot be subject to bail-in.[27] This definition captures, amongst others, "liabilities arising from participation in designated clearing and settlement systems and owed to such systems or to the operators of, or participants in, such systems" (section 2(r) of Schedule 5 of the FIRO), "liabilities arising from participation in the services provided by a recognized clearing house and owed to the clearing house or to its clearing participants" (section 2(s) of Schedule 5 of the FIRO) and "any liability, so far as it is secured" (section 2(l) of Schedule 5 of the FIRO). However, the authorities are of the view that despite these protections, rights to set-off and net under set-off, netting and title transfer arrangements could potentially be disrupted in bail-in absent additional protections.

## SET-OFF, NETTING AND TITLE TRANSFER ARRANGEMENTS

44. As discussed above in the context of a PPT, there is a need to provide a degree of certainty as to how set-off, netting and title transfer arrangements will be treated in resolution, given the reliance placed on such arrangements by participants in financial markets to mitigate risk.

45. A number of responses submitted during the earlier consultation process on the establishment of the local resolution regime placed importance on a resolution authority being required to close out derivative transactions to create a net liability before that liability may be subject to bail-in. As explained in the authorities' Consultation Response of 9 October 2015,[28] it is proposed that a safeguard be included in the PARs providing that a resolution authority should only make bail-in provision in respect of the "net" amount that the entity in resolution and its counterparty are entitled by contract to set-off or net under set-off, netting or title transfer arrangements. However, in order not to unduly restrict a resolution authority from exercising the bail-in stabilization option effectively, it will be necessary to exclude from this safeguard:

    (i) liabilities arising from any capital instrument issued by the entity in resolution: capital instruments should, consistent with their position in

[27] Section 58(4) of the FIRO provides that a power to make a bail-in provision (i.e. applying the bail-in stabilization option) may not be exercised in respect of any excluded liability, which includes, amongst others, any liability listed in section 2 of Schedule 5 to the FIRO.

[28] See Footnote 6 for reference.

the creditor hierarchy, absorb losses before other liabilities be that in normal insolvency proceedings or in resolution. If a counterparty were able to claim that a capital instrument should benefit from any set-off or netting, then this could alter the position of the capital instrument in the creditor hierarchy and potentially result in preferential treatment for the holder of that capital instrument, when compared with holders of equally ranking instruments;

(ii) liabilities arising from subordinated debt issued by the entity in resolution: after capital instruments have absorbed loss then, consistent with the creditor hierarchy, subordinated debt must absorb loss before losses can be imposed on senior unsecured creditors. Without excluding subordinated debt from the protection given to set-off, netting and title transfer arrangements, there is a risk that where subordinated debt forms part of such an arrangement which also includes other senior unsecured liabilities then the subordinated instrument's position in the creditor hierarchy could be "inflated", thus potentially affording it a greater protection than other equally ranking instruments and posing a risk of valid NCWOL claims;

(iii) liabilities arising from an unsecured debt instrument that is a transferable security issued by the entity in resolution: if an entity in resolution's capital instruments and subordinated debt are insufficient to absorb losses and recapitalise it, a resolution authority would then have to turn to senior unsecured liabilities, and in particular senior unsecured debt instruments such as bonds, to achieve recapitalisation. A resolution authority must therefore be able to apply bail-in powers to such liabilities promptly in order to achieve orderly resolution which in turn means that such instruments must be excluded from protected arrangement status where they otherwise form part of a set-off, netting or title transfer arrangement;

(iv) unsecured liabilities arising from any instrument or contract which –

- at the date it was issued, had a maturity period of twelve months or more; and
- is not a derivative contract, financial contract or qualifying master agreement.[29]

[29] See Annex C for the proposed definitions of derivative, financial contract and qualifying master agreement for the purposes of the PARs. These proposed definitions apply wherever these terms arise in this CP.

In a scenario where an entity in resolution's losses are of a scale that bail-in of all capital, subordinated debt and senior unsecured debt instruments is not sufficient to stabilise it, this exclusion is designed to allow a resolution authority to bail-in any term, unsecured liability that is not a derivative contract, financial contract or qualifying master agreement. Without the exclusion from the protection, term liabilities that could represent a source of loss-absorbing capacity (for example, bilateral loan agreements that do not fall within the definition of an unsecured debt instrument) may be prevented from being effectively subject to loss despite their characteristics and ranking in the creditor hierarchy being similar to senior unsecured debt instruments;

(v) unsecured liabilities owed to another member of the same group as the entity in resolution which do not arise from a derivative contract, financial contract or qualifying master agreement: this exclusion is designed to limit any restriction on a resolution authority from imposing losses on entities in the same group as the entity in resolution;

(vi) deposits which are not excluded from bail-in pursuant to section 2(b) of Schedule 5 to the FIRO: section 2(b) of Schedule 5 to the FIRO excludes from bail-in "liabilities representing protected deposits". The definition of protected deposits in the FIRO draws on the definition used in the Deposit Protection Scheme Ordinance (Cap. 581). However, as other deposits do not fall within the definition of protected deposits (e.g. certificates of deposit) and rank pari passu with other senior debt instruments, a resolution authority would need to be able to subject them to bail-in in the same manner as other equally ranking liabilities in order to mitigate the risk of successful NCWOL compensation claims; and

(vii) liabilities which relate to a claim for damages or an award of damages or a claim under an indemnity: such claims are not critical to the continuity of critical financial functions or the effective working of the financial system in Hong Kong and, as such, it is not considered that there is an argument from the point of view of securing systemic stability for conferring any protection under the PARs on such liabilities.

46. These exclusions from the proposed protection under the PARs mean that where any of the rights and liabilities identified under (i) to (vii) above are a constituent part of a set-off, netting or title transfer arrangement then a resolution authority could subject the liability to bail-in on a "gross" basis (i.e. without the need to

convert it into a net liability). This is in order to facilitate a resolution authority's prompt and decisive application of the bail-in stabilization option to those liabilities most likely to be subject to write-down under this power, with less likelihood of triggering further instability or contagion.

47. For other liabilities not identified in (i) to (vii) above that are entitled to be set-off or netted under written contractual set-off, netting or title transfer arrangements, the intention is for the PARs to provide that a resolution authority may only make bail-in provision as follows:

    (i) where the liability relates to a derivative contract, financial contract or qualifying master agreement the resolution authority must convert the liability into a net debt, claim or obligation in accordance with the terms of the arrangement or through the making of bail-in provision;[30] or

    (ii) where the liability relates to any other type of contract, the resolution authority must convert the liability, or treat the liability as if it had been converted, into a net debt, claim or obligation either in accordance with the terms of the arrangement or through the making of bail-in provision.

    Once a net debt, claim or obligation had been ascertained it could then be bailed-in by the resolution authority, provided that it was not an "excluded liability" as defined under Schedule 5 to the FIRO (e.g. so far as it was secured).

48. It is considered that the approach outlined above strikes an appropriate balance between providing adequate protection in bail-in for set-off and netting rights under set-off, netting and title transfer arrangements, while ensuring that a bail-in can be executed effectively.

<u>Consequences of a bail-in that disrupts set-off or netting rights under a set-off, netting or title transfer arrangement</u>

49. In the case of any inadvertent bail-in of a liability that is part of a protected set-off, netting or title transfer arrangement by a resolution authority on a "gross" basis when the bail-in should rather be on a net basis in accordance with the PARs, the intention is that the affected counterparty will be empowered by the PARs to notify the relevant resolution authority of the same and the resolution authority

[30] Section 58(3)(c) of the FIRO provides that bail-in provision includes: "a provision that an instrument under which the financial institution has a liability is to have effect as if a specified right had been exercised under it".

will determine whether this is in fact the case and, if so, assess and determine the appropriate measures to be taken to restore the affected party's position. Such measures may take the form of a payment to the affected party in order to put them in the position they would have been had the bail-in been effected on a net basis.

50. In terms of timeframe, it is proposed to provide under the PARs that an affected party must notify the relevant resolution authority within 60 days of any bail-in instrument taking effect and then the resolution authority would have 120 days from receipt of said notification, subject to an extension of a further 120 days in certain circumstances,[31] to determine whether the facts are accurate and, if so, to assess and determine the appropriate measures to be taken in order to put the affected party in the position they would have been had the bail-in been effected on a net basis.

51. The overall approach to the protection of set-off and netting rights under set-off, netting and title transfer arrangements in a bail-in is designed to be broadly consistent with the approach adopted in the UK.[32]

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| **Q5.** | **Do you agree with the proposed approach under the PARs to protecting rights to set-off or net under certain set-off, netting and title transfer arrangements in bail-in?** |
| **Q6.** | **Do you agree with the proposed definition for the terms "derivative contract", "financial contract" and "qualifying master agreement" as set out in Annex C and used in paragraphs 45(iv), 45(v) and 47(i)?** |

[31] See paragraph 21 for an explanation of those circumstances.

[32] See sections 4 to 8 of The Banking Act 2009 (Restriction of Special Bail-in Provision, etc.) Order 2014. See Footnote 7 for reference.

# INFORMATION REQUIREMENTS

52. In order to be able to effectively observe the safeguards to be provided under the PARs, within scope entities will need the appropriate information and reporting capabilities to promptly and accurately identify the constituent parts of any protected arrangements to which they are a counterparty and, within that, those rights and liabilities that are protected or excluded from protection under the PARs. This could include having management information systems capable of identifying sufficiently swiftly to facilitate orderly resolution:

    (i) secured arrangements entered into by the entity in resolution including the relevant liabilities and the assets against which they are secured and the underlying documentation which creates the security;

    (ii) contractually agreed set-off, netting and title transfer arrangements entered into by the entity in resolution, including the identification of the rights and liabilities which are entitled to be set-off/netted under each contract; the terms triggering the entitlement to set-off or net; the mechanism for calculating any net settlement amount etc.; and

    (iii) the entity in resolution's relationships with, including exposures to and liabilities arising from participation in, a clearing and settlement systems arrangement, including whether arising as a result of direct or indirect participation in a designated clearing and settlement system or recognized clearing house.

53. As the resolution authorities develop their resolution planning requirements, further thought will be given to the precise form of the information and reporting capabilities which will need to be maintained. However, within scope entities will be expected to be able to produce the information required by resolution authorities sufficiently promptly and accurately in order for a resolution authority to be able to execute an orderly resolution over a short period of time such as a "resolution weekend".

# ANNEX A – CONSULTATION QUESTIONS

Q1. Do you agree with the proposed approach to protecting clearing and settlement systems arrangements in a PPT under the PARs?

Q2. Do you agree with the proposed approach to defining and protecting secured arrangements in a PPT under the PARs?

Q3. Do you agree with the proposed approach to protecting structured finance arrangements in a PPT under the PARs?

Q4. Do you agree with the proposed approach to protecting rights to set-off or net under set-off, netting and title transfer arrangements in a PPT under the PARs?

Q5. Do you agree with the proposed approach under the PARs to protecting rights to set-off or net under certain set-off, netting and title transfer arrangements in bail-in?

Q6. Do you agree with the proposed definition for the terms “derivative contract”, “financial contract” and “qualifying master agreement” as set out in Annex C and used in paragraphs 45(iv), 45(v) and 47(i)?

# ANNEX B –EXTRACT OF SECTIONS 74 AND 75 OF THE FIRO

## 74. Interpretation

In this Subdivision—

***arrangement*** includes an arrangement that—

(a) is formed wholly or partly by one or more contracts or trusts;

(b) arises under, or is wholly or partly governed by, a non-Hong Kong law;

(c) arises, wholly or partly, automatically as a matter of law;

(d) involves any number of parties; or

(e) operates partly by reference to another arrangement between parties;

***clearing and settlement systems arrangement*** means an arrangement governed by the rules and directions relating to participation in the clearing and settlement of transactions within a financial market infrastructure;

***netting arrangement*** means an arrangement under which a number of claims or obligations can be converted into a net claim or obligation;

***partial property transfer*** means a transfer by a property transfer instrument of some, but not all, of the assets, rights and liabilities of the transferor;

***protected arrangement*** means a clearing and settlement systems arrangement, a netting arrangement, a secured arrangement, a set-off arrangement, a structured finance arrangement or a title transfer arrangement;

***regulated Part 5 instrument*** means a Part 5 instrument that—

(a) results in a partial property transfer being effected; or

(b) contains a bail-in provision;

***secured arrangement*** means an arrangement under which a person acquires, by way of security, an actual or contingent interest in the property of another;

***set-off arrangement*** means an arrangement under which 2 or more debts, claims or obligations can be set off against each other;

***structured finance arrangement*** means an arrangement under which a person creates and issues an instrument under which some or all of the return or amount due (or both the return and the amount due) or the method of settlement

is determined by reference to the price, value or other parameters, or changes in the price, value or other parameters, of financial assets or the occurrence or non-occurrence of a specified event and includes—

(a) asset-backed securities;

(b) securitizations;

(c) asset-backed commercial paper;

(d) residential and commercial mortgage-backed securities;

(e) collateralized debt obligations; and

(f) covered bonds;

***title transfer arrangement*** means an arrangement under which a person transfers assets to another person on terms providing for the other person to transfer assets if specified obligations are discharged and includes—

(a) a repurchase or reverse repurchase transaction; and

(b) a stock borrowing or lending arrangement.

**75. Regulations relating to protected arrangements**

(1) The Secretary for Financial Services and the Treasury may, for safeguarding the economic effect of a protected arrangement in connection with the making of a regulated Part 5 instrument, make regulations—

(a) prescribing requirements to be complied with by a resolution authority in making a regulated Part 5 instrument; or

(b) for connected purposes.

(2) Without limiting subsection (1), regulations made under that subsection may—

(a) impose conditions on the exercise of a power to make a regulated Part 5 instrument;

(b) require a regulated Part 5 instrument to include a specified provision, or a provision to a specified effect, relating to protected arrangements;

(c) provide for rights, assets, liabilities, claims or other matters to be classified not according to how they are described by the relevant parties but according to how they are treated, or intended to be treated, in commercial practice;

(d) require a resolution authority, in making a regulated Part 5 instrument that results in a partial property transfer being effected, to seek to ensure that

the instrument does not have the effect of adversely affecting a party (other than the transferor) to a protected arrangement by separating or otherwise affecting the constituent parts of the arrangement;

(e) require a resolution authority, in making a regulated Part 5 instrument that contains a bail-in provision, to seek to ensure that the instrument does not have the effect of cancelling, modifying or changing the form of a liability covered by a protected arrangement in an amount in excess of the net debt, claim or obligation under the arrangement;

(f) specify remedial action to be taken by a resolution authority, or provide for other consequences to arise, if a regulated Part 5 instrument has an effect mentioned in paragraph (d) or (e); or

(g) make provision for determining the scope of coverage of a protected arrangement, taking into account the effect on the ability of a resolution authority to achieve the orderly resolution of an entity.

(3) Regulations made under subsection (1) may—

(a) apply to protected arrangements generally or only to protected arrangements of a specified class;

(b) specify principles related to protected arrangements to which a resolution authority must have regard in making a regulated Part 5 instrument; or

(c) contain any incidental, supplementary, consequential, transitional or savings provisions that may be necessary or expedient in consequence of the regulations.

# ANNEX C – PROPOSED DEFINITIONS

**Derivative contract**— means an agreement the purpose or effect of which is to obtain a profit or avoid a loss by reference to the value or price of, or any fluctuations in the value or price of, property of any description or an index or other factor designated for that purpose in the agreement.

**Financial Contract** means any or any combination of the following (other than a derivative contract) —

(a) a securities contract, including:

(i) a contract for the purchase, sale or loan of a security, a group or index of securities;

(ii) an option on a security or group or index of securities;

(iii) repurchase or reverse repurchase transactions on any such security, group or index;

(b) a commodities contract of a financial nature, including:

(i) a contract for the purchase, sale, transfer or loan of a commodity, a group of commodities or an index of commodities for future delivery;

(ii) a swap or option on a commodity, a group of commodities or an index of commodities;

(iii) a repurchase or reverse repurchase transaction on any such commodity, group or index;

(c) a futures contract, including a contract (other than a commodities contract) for the purchase, sale or transfer of property of any description under which delivery is to be made at a future date and at a price agreed when the contract is made.

(d) swap agreements, including:

(i) swaps and options relating to interest rates; spot or other foreign exchange agreements; currency; an equity index or equity; a debt index or debt; commodity indexes or commodities; weather; emissions or inflation;

(ii) total return, credit spread or credit swaps;

(iii) any agreements or transactions that are similar to an agreement referred to in point (i) or (ii) which are the subject of recurrent dealing in the swaps or derivatives markets;

**Qualifying master agreement** means a master agreement in so far as it relates to—

(a) a derivative contract;

(b) a financial contract, or

(c) a contract for the sale, purchase or delivery of the currency of Hong Kong or any other country, territory or monetary union.