Hong Kong Institute of
Certified Public Accountants
香港會計師公會

By email (resolution@hkma.gov.hk)

20 March 2020

Our Ref.: C/RIF, M125306

Resolution Office
Hong Kong Monetary Authority
55th Floor
Two International Finance Centre
8 Finance Street, Central
Hong Kong

Dear Sirs,

Re: Consultation on Contractual Stays

Thank you for inviting views from the Hong Kong Institute of CPAs on the consultation paper on proposed rules to be made under the Financial Institutions (Resolution) Ordinance (Cap. 628) on contractual stays on termination rights in financial contracts for authorized institutions.

The Institute's Restructuring and Insolvency Faculty Executive Committee has considered the proposals and its views are contained in the **Appendix**.

Should you have any questions on this submission, please feel free to contact me at the Institute on 2287 7084 or at <peter@hkicpa.org.hk>.

Yours faithfully,

Peter Tisman
Director, Advocacy & Practice Development

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Encl.

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Appendix

Consultation Paper on Rules on Contractual Stays on Termination Rights in Financial Contracts for Authorized Institutions

Comments from the Restructuring and Insolvency Faculty Executive Committee of the Hong Kong Institute of CPAs

Scope of the Stay Rules

Q1 - Do you have any views on the scope of the covered entities to be subject to the Stay Rules?

Members of the Hong Kong Institute of CPAs' Restructuring and Insolvency Faculty Executive Committee ("RIFEC") appreciate that there may be complexities involved in seeking to extend the Stay Rules to branches of non-Hong Kong ("HK") authorized institutions ("AIs"), because, for example, they are not subject to regulatory capital requirements in HK. For this reason, the Hong Kong Monetary Authority ("MA") is proposing that the Stay Rules would apply only to HK-incorporated AIs, their HK incorporated holding companies and designated group companies, as indicated in paragraph 3.4 of the consultation paper ("CP"). We also understand that, where there are issues with overseas AIs' resolution plans, the MA may request them to convert their branches into locally-incorporated subsidiaries, or to set up another local legal entity, which could then be subject to the Stay Rules.

However, given that for historical reasons many international banks operate in HK via branches, this could leave much of the market not covered by the Stay Rules. Therefore, if any of these AIs goes into resolution, termination rights in relevant contracts entered into by these entities could be exercised immediately by their contractual counterparties, affecting the ability of the MA to co-operate with the resolution authority in the AI's home jurisdiction and, potentially, increasing the level of uncertainty and risks to the stability of the financial market in HK. Further, if they are counterparties to a HK-incorporated AI under a resolution exercise and are not bound by the Stay Rules, the effectiveness of the Stay Rules would also be seriously compromised.

We would suggest that the MA needs to provide more information about how it will deal with non-HK incorporated AIs in resolution, and the possible impact of not being able to apply the Stay Rules to them.

Q2 – Do you have any views on the scope of the covered financial contracts to be subject to the Stay Rules? Should other types of contracts also be included in your view?

We agree with the inclusion of those covered financial contracts proposed to be subject to the Stay Rules. However, we also note that, in the Second Consultation Paper on an Effective Resolution Regime for Financial Institutions in Hong Kong, issued on 21 January 2015 ("2015 CP"), it was proposed that inter-bank borrowing agreements, where the term of the borrowing is three months or less, also be included in the scope of the covered financial contracts. We would like to clarify why such agreements are no longer included.

We also suggest that consideration be given to including commercial paper and short-term loan agreements, given that the termination of these types of agreements, if held in sufficient quantities, could play a part in the collapse of a financial institution ("FI"), as we understand that they did in the case of Lehman Brothers.

In addition, in 2015 CP the question was asked whether a temporary stay on early termination rights should apply solely to financial contracts or whether broader provision should be made? (Question 20). In the Consultation Response issued on 9 October 2015, it was stated:

"*Furthermore, a considerable number of respondents were of the view that broader provision should be made such that the resolution authority may also apply a temporary stay to non-financial contracts where such contracts contain early termination rights and are critical to the operational continuity of the FI in resolution.*

The authorities concur that, although financial contracts will likely be the most sensitive to the exercise of early termination rights, there are other contracts of particular importance to the ongoing business of an FI (for instance in some cases leases of branch premises) which may well contain default provisions that could be triggered by matters related to resolution. The authorities have consequently determined that, in order to avoid precipitating any disorderly termination of contracts that could undermine resolution action, the scope of the temporary stay should be extended to <u>all</u> contracts whose early termination could hinder the ability of the resolution authority to achieve the resolution objectives. Accordingly, both financial and non-financial contracts will be within the scope of the temporary stay (and will be equally subject to the relevant safeguards)."

We are curious why it is no longer proposed that any non-financial contracts be included within the scope of temporary stay. There could be some essential non-financial services, without which an AI could not continue to operate (e.g. utility-type services). Therefore, we would suggest that the Stay Rules be extended to other contracts whose early termination could limit the resolution authority's ability to achieve the resolution objectives.

Q3 – Do you have any views on the counterparties proposed to be excluded from the Stay Rules?

While we note that financial market infrastructures will be exempted from compliance with the Stay Rules, in accordance with section 90 of the Financial Institutions (Resolution) Ordinance (Cap. 628). However, at the same time, we believe that the exclusion of central counterparties, such as clearing houses, will create an imbalance between private FIs and these central counterparties. In particular, we are concerned whether the Stay Rules can be implemented effectively when the termination right of a private FI is suspended while such right may be exercised immediately by the central counterparty in the course of a resolution.

<u>Operational and Implementation Matters</u>

Q4 – Do you have any questions or comments on the above operational matters in relation to the Stay Rules?

We understand the aim of the MA's proposal in paragraph 4.1 of the CP to prevent AIs from circumventing the Stay Rules. However, a material revision in contractual obligations could be made for genuine commercial reasons. The proposed prohibition may constitute an unwarranted restraint on an AI's flexibility to negotiate amended terms in the course of their normal business. Under the circumstances, we suggest that the proposed prohibition be more narrowly defined, to cover only those amendments aimed primarily at avoiding compliance with the Stay Rules, which could include, e.g. an amendment to extend the existing maturity date of the contract for a long period, unless the parties include a provision to agree to be bound by a temporary stay imposed by the MA, with effect from a certain date.

Q5 – Do you have any views on the proposal approach to 'material amendment'?

Please see our response to Q4.

Furthermore, the example of what would not be regarded as a "material" amendment, given in paragraph 4.4 of the CP (i.e. addresses for notices), suggests that nothing more than simple

mechanical alterations would be permitted. This seems to be taking quite an extreme view of what should be considered to be "material". We suggest that further clarification is needed on this point to avoid any potential disputes in the future.

Q6 – Do you agree with phasing in the implementation of the Stay Rules by counterparty types?

In view of the current volatile financial markets and difficult economic environment, the Stay Rules should be implemented as soon as possible to prepare for any potential financial crisis. Further, as the risks in dealing with bank counterparties or non-bank counterparties are the same, in principle, there should not be any gap of the implementation timetable for the two categories. However, we accept that non-bank counterparties are generally be less familiar with the policy rationale for and the requirements under the Stay Rules and, therefore, some additional implementation time may be required for them.

For the above reasons, we suggest that the implementation timeline for non-bank counterparties could be shortened to, for example, 24 months from the date of the coming into force of the Stay Rules, or even earlier if the implementation timeline for bank counterparties is also shortened. We would also point out that central banks, which, as proposed in paragraph 3.19 of the CP, will be included as counterparties, should not be unfamiliar with the policy rationale for and the requirements under the Stay Rules. In principle, therefore they should be included within the category of bank counterparties.

Q7 – Do you have any views on the expectations on AIs' internal capabilities to support resolvability and the effective application of temporary stay in a resolution?

This is matter for AIs to comment on, although some RIFEC members who are more familiar with the operation of AIs observed that a balance needs to be found between requiring AIs to provide sufficient information to enable the MA to assess resolvability, and not requiring AIs to have to report excessive detail.

Q8 – Do you have any views on the periodic reporting and information requests in relation to the Stay Rules?

Other than pre-existing contracts, it may not be very clear what would be covered in category (a), i.e. covered financial contracts that are assessed to be out of the scope of the Stay Rules, given that, by definition, "covered financial contracts" should be those falling within the scope of the Rules.

Next Steps

Q9 – Do you have any views on potentially extending the coverage of the Stay Rules so that relevant contracts may be bound by the ongoing stay provision, in addition to the temporary stay provision?

We believe that the coverage should be extended to the ongoing stay provision as soon as practicable. This removes any doubt whether the provision should apply only to Hong Kong law governed contracts and not to non-Hong Kong law governed contracts, under a resolution exercise to be undertaken by the MA. Furthermore, the coverage should also apply to non-financial contracts.

Hong Kong Institute of CPAs
20 March 2020