



# PEOPLE'S REPUBLIC OF CHINA— HONG KONG SPECIAL ADMINISTRATIVE REGION

## FINANCIAL SECTOR ASSESSMENT PROGRAM

July 2014

### CRISIS MANAGEMENT AND BANK RESOLUTION FRAMEWORK—TECHNICAL NOTE

This Technical Note on Crisis Management and Bank Resolution Framework was prepared in the context of the Financial Sector Assessment Program for the People's Republic of China—Hong Kong Special Administrative Region.

The policy of publication of staff reports and other documents by the IMF allows for the deletion of market-sensitive information.

Copies of this report are available to the public from

International Monetary Fund • Publication Services  
PO Box 92780 • Washington, D.C. 20090  
Telephone: (202) 623-7430 • Fax: (202) 623-7201  
E-mail: [publications@imf.org](mailto:publications@imf.org) Web: <http://www.imf.org>  
Price: \$18.00 per printed copy

**International Monetary Fund**  
**Washington, D.C.**



INTERNATIONAL MONETARY FUND

# PEOPLE'S REPUBLIC OF CHINA—HONG KONG SPECIAL ADMINISTRATIVE REGION

FINANCIAL SECTOR ASSESSMENT PROGRAM

June 2014

## TECHNICAL NOTE

CRISIS MANAGEMENT AND BANK RESOLUTION  
FRAMEWORK

Prepared By  
**Monetary and Capital  
Markets Department and  
the Legal Department**

This Technical Note was prepared by IMF staff in the context of the Financial Sector Assessment Program (FSAP) in People's Republic of China—Hong Kong Special Administrative Region (HKSAR). It contains technical analysis and detailed information underpinning the FSAP's findings and recommendations.

# CONTENTS

<b>GLOSSARY</b>	<b>4</b>
<b>EXECUTIVE SUMMARY</b>	<b>5</b>
<b>INTRODUCTION</b>	<b>8</b>
<b>INSTITUTIONAL ARRANGEMENTS</b>	<b>9</b>
A. Domestic Arrangements	9
B. Cross-Border Exchange of Information and Coordination	12
C. Findings and Recommendations	12
<b>PRUDENTIAL SUPERVISION</b>	<b>13</b>
A. Macroprudential Surveillance	13
B. Bank Supervision	13
<b>CRISIS MANAGEMENT</b>	<b>14</b>
A. Emergency Liquidity Assistance	14
B. Capital Support	16
C. Crisis Simulation Exercises	17
D. Findings and Recommendations	17
<b>DEALING WITH PROBLEM BANKS</b>	<b>17</b>
A. Supervisory Intervention	17
B. Recovery and Resolution Plans	19
C. Liquidation	20
D. Findings and Recommendations	21
<b>DEPOSIT PROTECTION SCHEME</b>	<b>23</b>
A. Governance and Mandate	23
B. Membership, Premiums and Scope of Coverage	24
C. Funding	25
D. Payout Procedures	25
E. Findings and Recommendations	26

**BOXES**

- 1. Formal Mechanisms for Domestic Exchange of Information and Coordination \_\_\_\_\_ 11
- 2. Crisis Management During the Global Financial Crisis \_\_\_\_\_ 16

**FIGURE**

- 1. Broad Categories of Resolution Powers Under the Key Attributes \_\_\_\_\_ 21

**TABLE**

- 1. Recommendations on Crisis Management and Bank Resolution \_\_\_\_\_ 7

**ANNEX**

- I. The Key Attributes of Effective Resolution Regimes for Financial Institutions \_\_\_\_\_ 29

## Glossary

AI	Authorized (deposit-taking) Institution
CAR	Capital Adequacy Ratio
CFR	Council of Financial Regulators
CMG	Crisis Management Group
DPB	Deposit Protection Board
DPS	Deposit Protection Scheme
DPSO	Deposit Protection Scheme Ordinance
ELA	Emergency Liquidity Assistance
FS	Financial Secretary
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSBCC	Financial Services Branch Coordination Centre
FSC	Financial Stability Committee
FSTB	Financial Services and the Treasury Bureau
G-SIB	Global Systemically Important Bank
G-SIFI	Global Systemically Important Financial Institution
HKSAR	Hong Kong Special Administrative Region of the People's Republic of China
HKMA	Hong Kong Monetary Authority <sup>1</sup>
IA	Insurance Authority
KA (or Key Attributes)	Key Attributes of Effective Resolution Regimes for Financial Institutions
LOLR	Lender of Last Resort
MA	Monetary Authority
MoU	Memorandum of Understanding
RRPs	Recovery and Resolution Plans
SFC	Securities and Futures Commission
SFST	Secretary for Financial Services and the Treasury

---

<sup>1</sup> In this Note, we use "HKMA" when referring to the whole organization, staff, policies etcetera. "MA" will refer to the Chief Executive of the HKMA and to the powers vested in him. See "Institutional Arrangements" below.

## EXECUTIVE SUMMARY<sup>2</sup>

**The financial sector of HKSAR is large, complex and interconnected with other financial centers, which amplifies the need for an effective framework for crisis management and bank resolution.** The IMF has identified 29 jurisdictions, including HKSAR as having systemically important financial sectors that should be subject to surveillance under the FSAP every five years. Twenty seven out of the twenty nine global systemically important banks (G-SIBs) identified by the Financial Stability Board (FSB) as of November 2013 undertake banking activities in HKSAR. For around a third of these banks, the home authorities have identified the operations in HKSAR as significant to the global group. Consequently, HKSAR plays an important role in supporting international financial stability, and needs an appropriate resolution framework to ensure it can continue to do so effectively and efficiently. Given that several financial institutions—including the local operations of cross-border groups—also play an important role in the local financial system, such a framework is also needed to protect domestic financial stability and to reduce the likelihood that public financial support would be needed to resolve any future failures.

**Overall, the existing institutional framework facilitates communication and coordination domestically, as well as on a cross-border basis.** Information sharing and coordination among domestic regulatory authorities and with the Government is undertaken through a variety of formal mechanisms, which are supported by sound legal bases for the exchange of confidential information. Outside of the formal arrangements, ad hoc coordination is common. With respect to the supervision and resolution of banks, the Hong Kong Monetary Authority (HKMA) engages in coordination and exchange of information with its foreign counterparts, and has demonstrated a cooperative approach to cross-border bank resolution in recent cases.

**There are complementary structures in place for macro- and microprudential supervision that contribute to the prevention and identification of problems in banks.** Market-wide or bank-intrinsic risk issues will be identified by macroprudential surveillance and bank supervision in the HKMA, or by other financial sector regulatory bodies. The HKMA uses early warning indicators, such as the bank capital trigger ratio, to facilitate timely supervisory action.

**For systemic crisis management, the authorities have means and procedures under which they can provide emergency liquidity or capital support to banks in exceptional cases, supported by resources from the Exchange Fund.** The HKMA's lender-of-last-resort policy is transparent and in line with best international practices, such as limiting emergency liquidity assistance (ELA) to solvent banks and to circumstances where the failure to provide liquidity may result in a systemic threat to the stability of the exchange rate or the stability and integrity of the monetary and financial systems of HKSAR. The terms and conditions for capital support, which is provided in practice with

<sup>2</sup> This Technical Note was prepared by Dinah Knight (Legal Department) and Göran Lind (External Consultant for the Monetary and Capital Markets Department).

the Financial Secretary's (FS) approval, are not formally established or publicly disclosed. Regular crisis simulation exercises are carried out to test preparedness.

**The resolution regime needs significant strengthening and the authorities are encouraged to continue ongoing efforts to establish a comprehensive resolution regime.** While powers to restore viability or to protect the assets of, a problem bank are broadly appropriate, there is at present no comprehensive resolution framework in place. Good international practices suggest that a resolution framework should empower an administrative resolution authority to override the rights of shareholders and creditors in order to secure the continued operation of some or all of a non-viable institution's business with a view to ensuring continuity of critical financial services and protecting financial stability. Adapting international practices to local circumstances could present some challenges. For example, the Hong Kong Government plays an active role in financial stability, which reflects the constitutional framework; however, good practice suggests that a resolution authority should have operational independence from government in carrying out this role. In addition, a resolution authority, which needs to have the capacity to act promptly and decisively, could face obstacles in a legal system bound by rigorous procedures. Finally, in line with international good practice, the ready resources of the Exchange Fund should not limit the imperative to ensure the private sector bears an appropriate share of any costs.

**The deposit protection scheme (DPS) is transparent, and trusted; however, steps should be taken to enhance efficiency of pay-outs and to ensure the scheme's sustainability.** The DPS was introduced in 2006 and has never been triggered. The DPS is pre-funded but the size of the target fund and the premium levels, in particular surcharges to replenish the fund after a payout, should be reviewed to ensure that the private sector assumes appropriate responsibility for costs associated with problem banks, and there is no undue reliance on the fiscal back-stop provided by the Exchange Fund. To further enhance the effectiveness of the scheme, the authorities could consider broadening the functions of the Hong Kong Deposit Protection Board (DPB) to include financing the transfer of protected deposits to a healthy institution or bridge bank, on a least-cost basis (i.e., when such financing carries lower costs than direct payouts to depositors). In order to make swifter pay-outs, the DPB should also consider changing the present rule of covering deposits on a net basis (as opposed to gross) and developing new payment channels. In addition, to provide timely notification to the DPB of bank distress, the identified early warning indicators should be formalized with the HKMA.

**Table 1. Recommendations on Crisis Management and Bank Resolution****Powers to Deal with Problem Banks**

- Continue efforts to develop a comprehensive resolution regime, in line with emerging international good practices.

**DPS**

- In connection with developing the resolution framework, consider broadening the functions of the DPB to include financing the transfer of protected deposits to a healthy institution or bridge bank, on a least-cost basis (i.e., when such financing carries lower costs than direct payouts to depositors).
- Review the modalities (target size; normal premium level; surcharge premiums for replenishment) for ensuring that DPS Fund has the appropriate resources without undue reliance on the Exchange Fund.
- Continue to seek ways for speedier payouts, including: (i) changing the netting rule for calculation of payouts to a gross rule and (ii) developing new payment channels.
- Formalize the identified early warning indicators for the HKMA to notify the DPB of bank distress.



## INTRODUCTION

**1. The Hong Kong financial sector is large, complex and interconnected with other financial centers.** HKSAR has around 200 authorized deposit-taking institutions (AIs), the majority of which are subsidiaries or branches of international financial groups. Twenty seven out of the twenty nine G-SIBs undertake banking activities in HKSAR, and the HKMA is a member of nine Crisis Management Groups (CMGs) organized by the home authorities of the G-SIBs. Concentration in the banking sector is significant, with the top four banks (all of which are subsidiaries of G-SIBs) holding almost 50 percent of banking sector assets. While banks dominate the financial system (with total assets of 705 percent of GDP at end-2013), the securities and insurance sectors are also important. For example, as of end-2012, the net asset value of unit trust, mutual and pension funds represented 505 percent of GDP, while gross premiums of the insurance sector amounted to 13 percent of GDP. In line with the banking sector, there is significant participation by foreign-owned entities in the securities and insurance sectors. HKSAR adopts a universal banking model, where banks conduct market intermediary and insurance underwriting directly through the bank or through bank subsidiaries and affiliates. Overall, the financial system has remained relatively stable over the past couple of decades. In the few instances of distress, the issues largely stemmed from problems faced by parent institutions abroad and the implications for domestic financial stability were limited.

**2. Given the relative stability of the Hong Kong financial sector, there has been little urgency to develop a comprehensive crisis management and resolution framework in line with emerging international good practices.** Indeed, there is no comprehensive resolution framework in place for banks or other types of financial institutions. Such a framework would provide designated public authorities with the powers necessary to stabilize some or all of a non-viable institution's business (including powers to override certain rights of shareholders and creditors) with a view to securing continuity in provision of critical financial services and protecting financial stability. That said, the authorities recognize the jurisdiction's role and responsibilities as a systemically important financial center, and are active and engaged members of the FSB, the Basel Committee on Banking Supervision, and other international fora that set global standards for the regulation and supervision of financial institutions and markets. The authorities plan to launch the first stage of public consultation<sup>3</sup> on a proposal for a cross-sectoral resolution framework, covering a range of systemically important financial institutions (including financial market infrastructures) in line with the FSB's Key Attributes of Effective Resolution Regimes for Financial Institutions (Key Attributes or KAs).<sup>4</sup> Following a second round of public consultation (expected later in 2014), draft legislation is expected to be introduced to the Legislative Council for consideration during 2015.<sup>5</sup>

<sup>3</sup> The authorities issued the first stage public consultation on January 7, 2014, which occurred during the finalization of this Note but outside of the assessment period.

<sup>4</sup> FSB, "Key Attributes of Effective Resolution Regimes for Financial Institutions" (October 2011) [www.financialstabilityboard.org/publications/r\\_111104cc.pdf](http://www.financialstabilityboard.org/publications/r_111104cc.pdf). A summary is presented in Annex I.

<sup>5</sup> FSB member jurisdictions have committed to introduce resolution regimes consistent with the KAs by end of 2015.

**3. Against this background, the Technical Note aims to examine the existing framework for crisis management and bank resolution in five key areas.** First, this Note analyzes the institutional arrangements for crisis management and bank resolution, including domestic and cross-border arrangements for information sharing and coordination. Second, the Note—at a high level—examines the measures the authorities take towards crisis prevention through macro- and microprudential supervision. These areas will be assessed more concretely in other work streams that are also part of the FSAP. Third, the Note examines tools specifically designed for crisis management, namely ELA and capital support. Next, the Note assesses the powers available to deal with problem banks. Finally, the Note evaluates the DPS. While this Note is focused on issues relating to the resolution of banks, many of the issues are also relevant for other types of financial institutions, which are also expected to be covered by the proposed resolution framework.

## INSTITUTIONAL ARRANGEMENTS

### A. Domestic Arrangements

**4. The Hong Kong Government plays an active role in financial and monetary stability.** Under the constitutional framework, the Government is responsible for providing an appropriate economic and legal environment for the maintenance of the status of HKSAR as an international financial center and for formulating monetary and financial policies, safeguarding the free operation of financial business and financial markets, and regulating and supervising them in accordance with the law.<sup>6</sup> The FS is the designated official who, on behalf of the Government, is responsible for determining the monetary policy objective and the structure of the monetary system, exercising control over the Exchange Fund,<sup>7</sup> as well as for determining macro-level policy objectives for the financial system, HKSAR's status as an international financial center, and the public finances. The Secretary for Financial Services and the Treasury (SFST) presides over the Financial Services and the Treasury Bureau (FSTB) and is responsible for formulating specific policy objectives with respect to the financial system, HKSAR's status as an international financial center and the public finances and for overseeing their implementation through the regulatory authorities or other bodies. The FS and SFST are accountable to the Chief Executive in discharging their responsibilities.<sup>8</sup> On some matters related to implementation of financial sector policies, the Chief Executive, acting after consultation with the Executive Council, retains discretion to exercise authority, as further discussed below in the context of dealing with problem banks.

<sup>6</sup> Articles 109 and 110 of the Basic Law of HKSAR.

<sup>7</sup> HKSAR conducts monetary policy through a currency board system. As such, the monetary base is backed 100 percent by foreign exchange reserves held through the Exchange Fund.

<sup>8</sup> For more detail on the division of labor between the FS and the SFST, see "Responsibilities of the Financial Secretary and the Secretary for Financial Services and the Treasury" available at: <http://www.fso.gov.hk/eng/links.htm>.

**5. In key policy areas, primary responsibilities for implementing the Government's monetary and financial policies have been delegated to regulatory authorities.**<sup>9</sup> The banking, securities and insurance industries are primarily regulated by three financial regulators, namely for banking<sup>10</sup>—the Monetary Authority (MA);<sup>11</sup> for securities and futures—the Securities and Futures Commission (SFC); and for insurance—the Insurance Authority (IA). Each of these regulators is tasked with functions and objectives that extend to the promotion and maintenance of financial stability.<sup>12</sup> In addition, under the Exchange Fund Ordinance, the FS has substantially delegated his powers for the use and management of the Exchange Fund to the MA. The Exchange Fund can be deployed primarily for matters affecting, either directly or indirectly, the exchange value of the currency. In addition to this primary purpose, the FS or the MA may use the Exchange Fund to maintain the stability and integrity of the domestic monetary and financial systems.<sup>13</sup> In this capacity, the MA serves as the lender of last resort (LOLR) for the banking sector.

**6. The Hong Kong authorities have adopted a multi-pronged approach to ensure information exchange and coordination among the regulatory authorities and with the Government.** Given that the authorities have adopted a universal banking model, coordination and information exchange is particularly important, both during normal times and times of market stress. The regulatory authorities have broad powers under their respective ordinances to share non-public information among themselves, and with the Government, where the statutory criteria are met. In the case of the HKMA, such sharing of information is permitted (*inter alia*) where it will enable or assist the recipient to perform its functions, and the disclosure is not contrary to the interests of depositors or potential depositors or the public interest.<sup>14</sup> Information sharing and coordination is facilitated through a variety of formal mechanisms (Box 1). Under these formal arrangements, each agency remains independently responsible for discharging its statutory duties. Outside of the formal arrangements, *ad hoc* communication and coordination among the regulatory authorities and with the Government is common.

<sup>9</sup> The DPS Ordinance established the DPB, which has a pay-box mandate and no regulatory or resolution functions. A more detailed discussion of the DPB follows later in this Note.

<sup>10</sup> In addition to “banking business”, the MA’s functions include taking all reasonable steps to ensure that any business carried on by an AI is carried on (*inter alia*) with integrity, prudence and competence. The MA is the “frontline” regulator of AIs’ securities business.

<sup>11</sup> The MA is a public officer appointed by the FS under Section 5A of the Exchange Fund Ordinance. The HKMA is the office of the MA.

<sup>12</sup> For example, under the Banking Ordinance, the principal function of the MA is to “promote the general stability and effective working of the banking system.” Section 7 of the Banking Ordinance.

<sup>13</sup> Section 3(1A) of the Exchange Fund Ordinance. For more detail on the division of labor between the FS and the MA with respect to monetary and financial affairs see HKMA Press release, 27 June 2003: “Functions and Responsibilities in Monetary and Financial Affairs: Exchange of Letters between the Financial Secretary and the Monetary Authority” available at <http://www.hkma.gov.hk/eng/key-information/press-releases/2003/20030627-4.shtml>.

<sup>14</sup> Section 120(5)(f)(ii) of the Banking Ordinance; See also, Section 120(5)(fa) of the Banking Ordinance.

**Box 1. Formal Mechanisms for Domestic Exchange of Information and Coordination**

**The following forums (in addition to a multitude of working groups and joint committees) provide for communication both in times of market stability and market stress:**

- The **Council of Financial Regulators (CFR)** serves as a platform to review regulatory and supervisory issues with cross-sectoral implications with the aim to minimize gaps or duplication in the regulation and supervision of financial institutions. The CFR is chaired by the FS and consists of the SFST, the MA, the Chief Executive Officer of the SFC, the IA and the Managing Director of the Mandatory Provident Fund Schemes Authority. The CFR meets on a quarterly basis.
- The **Financial Stability Committee (FSC)** monitors the functioning of the financial system and deliberates on issues with possible cross market and systemic implications. The FSC is chaired by the SFST and comprises the MA, the Chief Executive Officer of the SFC and the IA. The FSC meets on a monthly basis and provides regular reports to the FS. Where regulatory action is needed, the FSC refers matters to the CFR.
- The **Financial Services Branch Coordination Centre (FSBCC)**, which is operated on demand by the FSTB, facilitates communication in circumstances of high market volatility, or if a contingency event occurs in any segment of the financial sector. Under such circumstances, the regulatory authorities apprise the FSBCC of planned courses of action to ensure the front-line regulators' actions and media responses are consistent with each other and that the flow of information between regulators is unobstructed. The FSBCC has broad reach since it can facilitate the sharing of pertinent information with segments of the Government that under normal circumstances would not be involved in financial sector matters. The FSBCC has been activated on several occasions in recent years, including with respect to the failure of Lehman Brothers.
- **MoUs** support bilateral information exchange and coordination between regulatory authorities. For example, the MA has entered into comprehensive MoUs with his two principal counterparts—the SFC and IA.<sup>15</sup> Under the MoUs, the parties agree to identify dedicated points-of-contact for coordinating interactions; commit to hold regular meetings to discuss matters of mutual interest relating to the performance of their regulatory and supervisory functions; and commit to information-sharing on specified trigger events, such as violations of regulatory requirements.
- Each of the regulatory authorities have **Legal Powers and Obligations** that provide for consultations with, or notifications or reports to, the FS or the Chief Executive acting after consultation with the Executive Council on various matters. For example, the MA must notify the FS of any contravention by an AI of the minimum requirements for capital adequacy or liquidity and consult with the FS before taking any supervisory interventions under Section 52 of the Banking Ordinance.

<sup>15</sup> Certain of the MoUs entered into by the MA, including those with the SFC and the IA are available at: <http://www.hkma.gov.hk/eng/key-functions/banking-stability/banking-policy-and-supervision/supervisory-co-operation.shtml>

## B. Cross-Border Exchange of Information and Coordination

**7. The HKMA engages in coordination and exchange of information with its foreign counterparts.** The HKMA has clear powers to share non-public information that will assist a foreign supervisory authority in performing its functions, if (inter alia) the disclosure is in the interests of depositors or potential depositors or the public interest. To enhance the exchange of supervisory information and cooperation, the HKMA has also entered into MoUs or similar formal arrangements with more than 20 foreign authorities. These arrangements provide a framework to:

- Share and exchange supervisory information related to AIs operating in the jurisdictions of both signatories;
- Hold regular meetings and have informal contacts;
- Consult each other on planned cross-border establishments or investments by an AI; and
- Keep shared information confidential, when needed.

**8. The HKMA is also a member of the CMGs of nine G-SIBs with significant operations in HKSAR.** At present, the main task of these CMGs is to discuss and oversee the development of recovery and resolution plans (RRPs) for each banking group in accordance with the principles laid out in the KAs. As discussed further below, the HKMA has demonstrated a cooperative approach to cross-border bank resolution with respect to recent cases.

## C. Findings and Recommendations

**9. Overall, the institutional arrangements contribute to efficient and effective communication and coordination domestically, as well as on a cross-border basis.** There are clear mandates and divisions of labor for the relevant domestic authorities. In addition, there are explicit coordination mechanisms and solid legal bases for the exchange of confidential information, both with respect to domestic and cross-border arrangements. These features are likely to facilitate policy communication and decision-making among key stakeholders and the effective use of tools to manage crises and problem banks. As discussed below, as work on the integrated resolution framework progresses, certain of the legal powers and obligations of the MA (and potentially other regulatory authorities) in relation to the Government warrant further review, given that emerging international good practice—as set forth in the KAs—calls for resolution authorities to have operational independence with respect to that role.

## PRUDENTIAL SUPERVISION

### A. Macroprudential Surveillance

**10. The HKMA has established a Macroprudential Surveillance Committee, chaired by the MA, and has set up a framework for macroprudential analysis.** The aim is to identify risks to the banking system and AIs in particular. The Financial Stability Surveillance Division conducts focused macroprudential risk analyses and shares the results of the analyses with the microprudential supervisors to facilitate their monitoring of individual banks. In addition, the Banking Supervision Department also conducts macroprudential analyses on various issues. The macroprudential analyses themselves may lead to the use of various macroprudential tools to stop or reverse potentially dangerous developments. As an example, since October 2009, the HKMA has introduced six rounds of macroprudential countercyclical measures on property mortgage lending to strengthen the resilience of banks in HKSAR to the risk of property market downturn and the ability of mortgage borrowers to cope with the potential impact of interest rate rises in future. This included the application of more stringent loan-to-value caps for more risky property mortgage loans, such as those related to higher-value residential properties, non self-use properties, as well as commercial and industrial properties. As another example, macroprudential monitoring has influenced HKMA microprudential supervisors to request banks to ensure the robustness of their exposures to vulnerable markets abroad.

### B. Bank Supervision

**11. The HKMA has the objectives and means to ascertain that AIs comply with regulations and generally operate in a safe and sound manner.** Supervision is risk-based and conducted in a forward-looking manner. The surveillance of banks takes on various forms, including onsite inspections, offsite monitoring, and other contacts with banks or other parties. To complement the regular supervisory cycle, the supervisors make use of forward-looking indicators of bank risks. For instance, HKMA supervisors analyze data reporting from the banks with the aim of spotting excessive loan growth or changes in the funding structure. HKMA supervisors also review Management Information Packages from individual banks. Prioritization of supervision reflects the assessed risk profile of individual institutions. There are also thematic supervisory reviews of specific risk areas, for instance those identified by the HKMA's macroprudential analyses.

**12. In order to enhance the proactive stance of supervision, the HKMA has set an additional requirement on bank capital.** In addition to the Pillar 2 capital add-on, the HKMA requires each AI to observe a non-statutory trigger ratio of capital above the minimum capital adequacy ratio (CAR). This ratio is specific to each individual bank and determined taking into account its risk profile. The HKMA also conducts regular stress tests of AIs to assess the vulnerability of the bank capital to shocks. Should capital prove vulnerable, or decline towards the trigger level, the HKMA will enter into discussions with the AI management or its shareholders.

**13. The identification of weaknesses will allow the HKMA to take prompt progressive supervisory actions that are commensurate with the situation.** There are safeguards to ensure timely and adequate implementation of remedial measures. Findings allow supervisors to request further information from banks, or to take remedial action. Also, in cases where no actual violation of law or regulations has yet occurred, the HKMA is still expected to act and not to wait for an adverse trend to develop into a formal violation. In practice, banks will normally adhere to “informal” requests from the HKMA supervisors to prevent an escalation that results in formal enforcement. If timely and adequate remedial action is not forthcoming, the MA may opt to use his powers under the Banking Ordinance (See “Dealing with Problem Banks” below). For deficiencies identified by the HKMA from its onsite examination of an AI, the AI must send a Management Letter to the HKMA normally within 30 days of receiving a notification of required or recommended measures. In this letter, the AI will outline how it intends to meet the requirement and present a time schedule. The Banking Supervision Department will monitor the implementation of the actions taken through offsite surveillance and onsite examinations. If necessary, external auditors will be used to verify the effectiveness of the measures implemented by the bank.

**14. Information-sharing on bank problems (potential or current) within the HKMA is frequent.** There are weekly meetings with the HKMA management, where incidents are expected to be reported. These include all cases where there is a proposal to require an AI to provide further information to the HKMA or to take some other action. There are also regular meetings of the senior executives, chaired by the Chief Executive of the HKMA, where general banking or individual AIs’ developments are analyzed and discussed. Where necessary, ad hoc meetings will also be arranged to discuss issues on bank problems and, where appropriate, escalate to the senior management of the HKMA promptly. As noted above, whenever the information is relevant for other domestic authorities or foreign authorities, in particular in crisis situations, there are established and frequently used channels for external communication.

## CRISIS MANAGEMENT

### A. Emergency Liquidity Assistance

**15. The HKMA has published a policy for the granting of ELA to banks.**<sup>16</sup> Resources for ELA would be drawn from the Exchange Fund. According to the policy, ELA may be granted subject to a number of conditions, including, among other things:

- The situation constitutes a systemic threat to the stability of the monetary and financial systems or to the stability of the exchange rate;

<sup>16</sup> “Policy Statement on the Role of the Hong Kong Monetary Authority as Lender of Last Resort” issued by the HKMA (March 2009) available at: <http://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2009/loir.doc>

- The problem bank is solvent. This is defined as reporting a CAR level of at least 6 percent after making any necessary loan loss provisions;
- There is no prima facie evidence that the management of the problem bank is not fit and proper, or that the problem of the bank is due to fraud;
- The problem bank has sought other reasonably available sources of funding and its shareholder controllers have made all reasonable efforts to provide liquidity and/or capital support to the problem bank before seeking the ELA;
- The bank is able to present eligible collateral. These include, among other things, HKSAR Government debt securities in the form of Exchange Fund Bills and Notes, and other eligible debt securities denominated in Hong Kong dollar or acceptable foreign currencies, eligible residential mortgage portfolio, deposits in other creditworthy AIs, or investment grade securities denominated in foreign currencies; and
- The provision of ELA will normally be conditioned on remedial measures, for example, that the bank dispose of certain assets.

**16. The role of the HKMA Banking Supervision Department in the event of an ELA application is outlined in internal documents.** Among other things, the Department shall submit a report on the situation with recommendations on whether to grant ELA. Banking supervisors must also visit the premises of the AI concerned to physically verify the existence of some of its assets, such as residential mortgages and securities.

**17. ELA may be provided for a period of a maximum 30 days, with a possible 30 days extension.** The LOLR policy states that ELA is not intended for purposes other than short-term liquidity support. The HKMA will charge an appropriate interest rate, to be decided in each specific case. However, the rate will not be set so high that the aim of rescuing the bank is endangered.

**18. The amount of ELA that may be provided to a bank is limited.** For banks with CARs of 6 percent, ELA is limited to 100 percent of the bank's own capital base. This increases to up to 200 percent for a bank with a CAR in excess of its statutory minimum. However, there is an absolute limit of HK\$25 billion to a single bank. The HKMA may also provide ELA in foreign currencies if needed. For example, the HKMA has entered into a swap agreement with the People's Bank of China such that renminbi funding may be obtained for lending to banks if needed.

**19. AIs incorporated outside of HKSAR face significantly higher hurdles to obtaining ELA.** The LOLR policy generally applies to the provision of liquidity to locally incorporated AIs whose failure might have systemic implications. ELA would only be provided to branches of foreign banks operating in HKSAR to (i) swap Hong Kong dollars for U.S. dollars held by the branch if no suitable counterparty could be found in the market, or (ii) provide urgently required bridging finance on a secured basis, pending receipt by the branch of funds from head office and on the basis of assurances from the home supervisor that such funds would be forthcoming. As a preventive



measure, the HKMA may require branches of foreign banks to maintain a specified level of liquidity locally.

**20. If the conditions for granting ELA in accordance with the HKMA policy statement are not met, the MA has sufficient discretion to provide ELA as he sees fit to maintain the stability and integrity of the monetary and financial system, although in practice he would likely consult with the FS on such decisions.** This discretion would include extending ELA in excess of the limits outlined above if necessary.

## B. Capital Support

**21. In addition to liquidity support, the Exchange Fund may also be used to provide capital support to a problem bank.** The terms and conditions for such support are not formally established or publicly disclosed as is the case for ELA. The Exchange Fund has been used for this purpose in the past. For example, during 1983–86, seven local banks got into difficulties, including the third largest local bank at the time, Overseas Trust Bank. In light of an assessment of the systemic implications of their failure given the prevailing circumstances, the banks were rescued using the Exchange Fund. Three banks (one of the banks was a subsidiary of another) were taken over by the Government through the passing of acquisition ordinances by the Legislative Council. Financial assistance (e.g., in the form of guarantee of assets, liquidity support etc.) was provided to facilitate the takeover of the other four banks by private sector entities. In recent years, a capital support facility was temporarily made available during the Global Financial Crisis along with other crisis measures, although it was never drawn (Box 2).

### Box 2. Crisis Management During the Global Financial Crisis

**Between 2008-10, the HKSAR authorities adopted a range of tools, backed by the resources of the Exchange Fund, to restore public confidence and ensure the normal operation of the local banking system.** Other than the liquidity measures, these tools were not drawn upon.

- **Liquidity Measures.** The HKMA's normal discount window operations were expanded to accept a wider range of collateral, increase the tenor of loans, and reduce the interest rate. Two new discretionary facilities were also offered: (i) foreign exchange swaps, and (ii) term repos (up to three months). The discount window extension was terminated in March 2009, but the two discretionary measures have been incorporated into the ongoing monetary operations framework so that the HKMA can provide liquidity assistance to individual banks on a case-by-case basis if needed.
- **Blanket Deposit Guarantee.** To guard against external shocks and reduce the risk of depositor runs, the Government introduced a general guarantee of customer deposits held with all AIs in HKSAR up to 100 percent of their value following the principles of the DPS. The Blanket Deposit Guarantee expired at the end of 2010.
- **Capital Support.** A Contingent Bank Capital Facility was announced to provide comfort that additional capital would be available to locally incorporated licensed banks should it be needed. The Capital Facility expired at the end of 2010.

## C. Crisis Simulation Exercises

**22. In order to test preparedness, the authorities conduct regular crisis simulation exercises.** The FSTB organizes bi-annual, cross-market exercises, applying stress scenarios affecting several financial market sectors. The latest exercise took place in December 2012, was overseen by the FS, and involved the HKMA, DPB, the Mandatory Provident Fund Schemes Authority (MPFA), IA, SFC and Hong Kong Stock Exchange. In addition, the HKMA conducts its own simulation exercises annually, testing contingency scenarios such as liquidity contingencies. The HKMA has developed a “Contingency Plan for Handling a Banking Crisis”, containing various relevant internal documents. The latest internal HKMA exercise took place in March 2012. Finally, the DPB conducts its own separate exercises in order to test its preparedness to make swift pay-outs to depositors.

## D. Findings and Recommendations

**23. The HKMA possesses a comprehensive framework for preventing problems in banks and to address any actual problems swiftly and adequately.** Various channels are used to identify both increasing general and intrinsic risks. Early warning indicators are used to identify and address adverse developments swiftly. For instance, violations of the “trigger capital ratio” must be immediately reported by a bank to the HKMA, which will require the bank to take appropriate action.

**24. The framework for identifying problem bank situations is generally sound.** Potential risk factors are identified and presented swiftly in appropriate HKMA internal (and, when relevant, also external) committees for consideration. The deliberations have often led to further actions, such as communications with the supervised institutions. In a few cases of significant bank problems, remedial measures have been implemented such as appointing a Manager of a bank, as further described below.

**25. The LOLR policy—being transparent and setting clear conditions limiting the use of liquidity support—generally follows international “best practice.”** Hence it mitigates potential moral hazard.

## DEALING WITH PROBLEM BANKS

### A. Supervisory Intervention

**26. The MA’s powers to intervene in a problem bank are concentrated in Section 52 of the Banking Ordinance.** Section 52 authorizes the MA, in consultation with the FS to (i) require an AI to take any action in relation to its affairs, business and property; (ii) direct an AI to seek advice in relation to the management of its affairs, business and property from an “Advisor” appointed by the MA; (iii) appoint a “Manager” to manage the affairs, business and property of the AI in accordance with an objective specified by the MA not inconsistent with the provisions of the Banking Ordinance (e.g., to preserve the AI’s assets) or (iv) to report on the situation of the AI to the Chief Executive in

Council (as a prelude to the filing of a winding up petition by the FS as further described below). Outside of Section 52, where certain conditions are met, the MA also has the ability to withdraw his consent from (and thereby cause the removal of) the chief executive and executive officers of an AI and, (in respect of a locally incorporated AI), its directors<sup>17</sup> and to suspend<sup>18</sup>, impose conditions on<sup>19</sup> or revoke<sup>20</sup> the authorization of an AI.

**27. Section 52 powers can be used separately or in combination to address a range of circumstances specified in legislation, including where:**

- an AI is carrying on its business in a manner detrimental to the interests of its depositors and creditors;
- an AI is insolvent or likely to become unable to meet its obligations, or is about to suspend payments;
- an AI has failed to comply with the provisions of the Banking Ordinance or with any licensing condition;
- there are sufficient grounds for the MA to propose the revocation of an AI's authorization; and
- the FS has advised the MA that it is in the public interest to do so.<sup>21</sup>

**28. In the recent past, the MA has used Section 52 powers effectively to bring about remedial actions or take protective measures in relation to problem banks.** In 2005, there was a case where Section 52 powers were exercised against a locally incorporated AI. Specifically, a Manager was appointed to Delta Asia Credit Limited following the designation of the AI's parent bank as an institution of "primary money laundering concern" by the U.S. authorities. The MA's primary direction to the Manager was to conserve the assets of Delta Asia Credit Limited and restrict any increase in its liabilities. The MA subsequently revoked the appointment of the Manager and the AI's authorization.<sup>22</sup> Another example occurred in 2008 when the MA used his powers under Section 52 to appoint a Manager to Indover bank (Asia) Limited, the locally incorporated, wholly-owned subsidiary of a Dutch bank that was placed under administration in the Netherlands. Also in 2008, Section 52 powers were used against the Hong Kong branch of Melli Bank in light of the financial sanctions imposed by the overseas authorities on the bank and its parent bank. Finally, in 2009, restrictions to protect depositors were imposed on the affairs, business and property of the Hong

<sup>17</sup> Sections 71(4) and 71C(4) of the Banking Ordinance.

<sup>18</sup> Sections 24 and 25 of the Banking Ordinance.

<sup>19</sup> Section 16(5) of the Banking Ordinance.

<sup>20</sup> Sections 22 and 23 of the Banking Ordinance.

<sup>21</sup> The FS must be consulted before the MA takes action pursuant to Section 52 of the Banking Ordinance on all other grounds.

<sup>22</sup> Under the powers granted in Sections 22 and 23 of the Banking Ordinance.

Kong branch of United Commercial Bank under Section 52 powers, in conjunction with supervisory and resolution actions that were taken by the U.S. authorities against the home institution.<sup>23</sup>

**29. Rigorous administrative procedures apply to supervisory interventions.** For example, after consultation with the FS, and under grounds specified in the Banking Ordinance,<sup>24</sup> the MA may propose to revoke the authorization of an AI by serving on the institution a notice in writing.<sup>25</sup> Before exercising his power to propose revocation, the MA is required to inform the AI of the grounds for the proposed revocation and provide the institution with an opportunity to respond.<sup>26</sup> In response to the notice, the AI may either (i) notify the MA that such notice will not be appealed; (ii) allow the statutory time frame for lodging such an appeal to lapse; or (iii) appeal the proposed revocation of authorization to the Chief Executive in Council (i.e., the Chief Executive acting after consultation with the Executive Council).<sup>27</sup> Appeals to the Chief Executive in Council in these and in other circumstances<sup>28</sup> are considered to be an administrative remedy and subject to full review of the merits of the decision proposed or taken by the MA. In this regard, the Chief Executive in Council may confirm, vary or reverse the decision taken by the MA, substitute the decision for another decision, or make any other order as the Chief Executive in Council deems fit.<sup>29</sup>

**30. Supervisory interventions would also be subject to judicial review proceedings.** In these proceedings the Court will consider whether the actions of the MA (or the Manager) are within his powers, whether all required procedures have been followed for the exercise of those powers, and whether the powers have been exercised for a proper purpose and in a reasonable and proportionate manner. In general, on an application for judicial review, the Court has discretion to grant a range of remedies, including compelling the MA (or the Manager) to perform an act specified in the court order, prohibiting the MA (or Manager) from acting or continuing to act in a specified manner, or setting aside a decision taken by the MA (or Manager).

## B. Recovery and Resolution Plans

**31. The HKMA is developing formal requirements for AIs in relation to RRP.** In late 2012, the HKMA began a consultation process on the requirements for RRP. The HKMA is currently

<sup>23</sup> Powers similar to the MA's Section 52 powers were also successfully used by the Insurance Authority to manage the impact of the failure of AIG on its Hong Kong-based subsidiary, AIA.

<sup>24</sup> Banking Ordinance, Eighth Schedule: "Grounds for Revocation of Authorization"

<sup>25</sup> Section 22(1) of the Banking Ordinance.

<sup>26</sup> Section 23(1) of the Banking Ordinance.

<sup>27</sup> Section 22 of the Banking Ordinance.

<sup>28</sup> In addition to other circumstances specified in the Banking Ordinance, an AI may appeal actions taken by the MA under Section 52 of the Banking Ordinance to the Chief Executive in Council. See Section 53 and 132A of the Banking Ordinance.

<sup>29</sup> See, e.g., Section 64(5) of the Interpretation and General Clauses Ordinance and Section 53 of the Banking Ordinance.

refining its proposed guidance on recovery planning. Implementation of the requirements is expected to occur in phases, prioritizing institutions whose failure could pose the greatest risk to financial stability. It is expected that the first group of AIs will be required to submit recovery plans in the third quarter of 2014 and resolution plans will follow. As noted above, the HKMA is participating in CMGs for the nine G-SIBs that have significant operations in HKSAR. At present, the CMGs are focused on designing group-level RRP. The HKMA proposes to require local entities to be able to satisfy much of the RRP requirements by adapting the group level plan in a manner that addresses local concerns. Ultimately, it is proposed that the RRP requirements would apply to all AIs, albeit RRP would be proportionate and so less detailed for small and non-complex institutions.

## C. Liquidation

**32. In general, the winding-up of an AI is governed by the Companies Ordinance under the same rules that apply to any other company albeit subject to certain modifications under the Banking Ordinance.**<sup>30</sup> Accordingly, any creditor may petition the court for a winding up of an AI and the Court may grant the petition under fairly standard grounds (i.e., the company/AI is unable to pay its debts). In addition to the standard procedures that apply to companies under the Companies Ordinance, the FS can petition for the winding-up of an AI under the Banking Ordinance, either at the direction of the Chief Executive in Council (following a report to the Chief Executive in Council from the MA in exercise of the MA's powers under Section 52)<sup>31</sup> or on his own initiative,<sup>32</sup> following an investigation by the FS<sup>33</sup> (conducted at the behest of the MA<sup>34</sup>) into the state of conduct of the affairs, business and property of the AI. Where a petition for winding up of an AI is presented to the Court by a person other than the FS, a copy of the petition must be served on the MA, and he shall be entitled to be heard on the petition.<sup>35</sup> In the few cases where an AI has been liquidated, the MA has refrained from revoking the authorization of the AI until late in the liquidation process to ensure that the MA retains his statutory powers in relation to the AI, including the power to gather information about the AI's affairs. The Companies Ordinance was last applied to the liquidation of a bank in 1992, when the local subsidiary of Bank of Credit and Commerce International Group was liquidated.

<sup>30</sup> E.g. Section 122(1) of the Banking Ordinance.

<sup>31</sup> Section 122(2) of the Banking Ordinance.

<sup>32</sup> Section 122(5) of the Banking Ordinance, pursuant to which the Court of First Instance may wind up a deposit-taking company or restricted license bank or former deposit-taking company or restricted license bank.

<sup>33</sup> Section 117(2) of the Banking Ordinance

<sup>34</sup> Section 117(1) of the Banking Ordinance.

<sup>35</sup> Section 122(7) of the Banking Ordinance.

## D. Findings and Recommendations

**33. The MA's existing powers to intervene in problem banks are useful but incomplete, particularly as they relate to the resolution powers which according to international good practices (as set forth under the KAs ) should be available.** As past practice has shown, Section 52 powers and the Companies Ordinance can be used to secure remedial actions or preventative measures in relation to a problem AI. However, experience has been limited to dealing with AIs whose failure, taking into consideration market conditions, did not have systemic implications and where, therefore, orderly liquidation might be possible in a case of non-viability. In addition, when such powers were used with respect to branches of foreign AIs, the MA's role was primarily to use his powers to take protective measures in conjunction with the actions of foreign authorities exercising their powers to resolve institutions overseas. Under the KAs (summarized in Annex I), broad categories of powers can be identified that are intended to facilitate the resolution of firms that could be systemically significant or critical at failure (Figure 1).

**Figure 1. Broad Categories of Resolution Powers Under the Key Attributes**

<b>Assume Control</b>	<ul style="list-style-type: none"> <li>• Assume powers of management and shareholders</li> <li>• Replace management</li> </ul>
<b>Restructure</b>	<ul style="list-style-type: none"> <li>• Transfer assets, liabilities to an existing entity, a bridge institutions, or an asset management company</li> <li>• Merge, sell, amalgamate, spin-off parts of the financial institution</li> <li>• Recapitalize the bank through a debt restructuring (e.g., Bail-in) or capital increase</li> </ul>
<b>Support</b>	<ul style="list-style-type: none"> <li>• Suspend payments to unsecured creditors; stay creditor actions</li> <li>• Temporarily stay early termination rights;</li> <li>• Obligate related group entities to continue to provide essential services and functions</li> </ul>

Source: "The Key Attributes of Effective Resolution Regimes for Financial Institutions—Progress to Date and Next Steps", IMF (August 2012).

**34. In comparison to these broad powers, under the current framework:**

- **Powers to assume control of an AI are limited.** While the MA has powers to assume some control of an AI (including by causing the removal of management; appointing an "Advisor" or "Manager" to the AI; or using his powers to issue directions) such powers are limited since neither the MA nor a Manager may assume powers of shareholders. The lack of such powers

may impede restructuring transactions that could otherwise be carried out in the interest of the AI's depositors, or the broader public.

- **Explicit powers to restructure an AI are absent.** The authorities should have at their disposal well-developed restructuring powers that would allow for (i) the transfer of assets and liabilities from a distressed AI to a healthy institution, a bridge bank, or asset management company; (ii) the transfer of shares of a distressed AI to a healthy institution; and (iii) the restructuring of the share capital of a locally incorporated AI by cancelling the whole or any part of the share capital, requiring the AI to issue new shares, and/or through the statutory conversion of creditors' claims to equity (i.e., "statutory bail-in"). Under the current framework, such powers are not explicitly provided for. The weakness is compounded by the lack of a statutory override of third-party consent requirements for the transfer of assets and liabilities, as well as the inability of the MA or a Manager to assume power of shareholders, as noted above.
- **Key supporting powers for resolution are generally lacking.** Supportive powers could be used to impede actions by a financial institution or other interested parties that could otherwise undermine the resolution or to compel actions from such parties that would support the resolution. In this regard, the MA does not have powers to require group entities to continue to provide essential services and functions to the firm in resolution unless the group entities are themselves AIs or where a Manager appointed to an AI exercises his voting powers in respect of operational subsidiaries for such purposes. Whilst the MA could direct an AI to suspend payments to unsecured creditors by means of section 52(1)(A), the MA does not have power to stay creditor actions, or temporarily stay early termination rights unless the counterparty is also an AI in which case the MA may give a direction to that counterparty under section 52(1)(A).

**35. The authorities are encouraged to continue efforts to enact a resolution framework in line with emerging international good practices as a matter of priority.** In this regard, it is important to note that resolution regimes developed in accordance with the KAs are intended to apply to any financial institution that could be systemically significant or critical if it fails—and not just banks. In addition, the regime should also extend to the holding companies, non-regulated operating entities within a financial group or conglomerate that are significant to the business of the group or conglomerate, and to local branches of foreign institutions.<sup>36</sup>

**36. Tailoring the KAs to local circumstances will be an important part of the process.** In designing the resolution framework, the authorities could usefully pay particular attention to the following features:

- **The Role of Government.** Given potential risks of bank failures and their resolution for financial stability, public resources, and individual rights, many legal and political systems include a role for government in bank resolution processes. Nonetheless, the Key Attributes specifically advocate a governance framework for resolution authorities based upon operational

---

<sup>36</sup> Key Attribute 1.1.

independence and transparent processes as a means of contributing to financial stability.<sup>37</sup> In this context, the authorities might usefully consider whether the model in terms of the relation to Government used in respect of certain of the existing legal powers and obligations of the MA (as well as of the other regulatory authorities, given they could also be “resolution authorities” under the new framework) would be entirely appropriate in a resolution context. In particular, the authorities should consider whether the procedures for appeals to the Chief Executive in Council serve these aims.<sup>38</sup>

- **Expediency vs. Procedural Safeguards.** The objective of a resolution regime is to make feasible the resolution of financial institutions without severe systemic disruptions and without exposing taxpayers to loss, while protecting vital economic functions. To accomplish these objectives, speed, transparency and predictability of process are as important as procedural safeguards that protect the interest of stakeholders, such as creditors and shareholders. The authorities should give careful consideration as to whether processes established to support resolution appropriately balance expediency and procedural safeguards.
- **Private Sector Resolution Funding.** Where necessary, and to the extent possible, private rather than public resources should be used to fund resolution. In this regard, many jurisdictions are exploring a variety of forms of private sector resolution funding, including providing for statutory bail-in powers, establishing ex ante funded resolution funds and/or the imposition of ex post levies or taxes on the financial industry. In HKSAR, it is important that the existence of the Exchange Fund should not diminish the imperative to secure private sector contributions to resolution funding and thereby pose moral hazard. Other than the DPS (discussed in the next section), the current framework does not currently provide for private sector resolution funding.

## DEPOSIT PROTECTION SCHEME

### A. Governance and Mandate

**37. The DPB started its operations in 2006.** The DPB, operates the DPS, which is defined in the Deposit Protection Scheme Ordinance (DPSO).

**38. The DPB is a statutory body established under the DPSO; it is independent from the banking regulator and from the banking industry.** The governing body consists of nine members from different professions, of which two are ex-officio members representing the SFST and the MA. The other members are appointed based on their skills in relevant fields, such as financial, legal, accounting, or consumer protection. No currently serving banker may become a member of the DPB. The DPB rules establish a clear division of responsibilities between the Chairperson, the Chief

<sup>37</sup> Key Attribute 2.

<sup>38</sup> The authors note that at the time this Technical Note was prepared, the methodology for assessing compliance with the KAs had not been finalized.



Executive Officer, and the governing board. The management team is responsible for executing the board's decisions.

**39. In its communications, the DPB has interpreted the stated objectives of the DPS to be:**

- Reducing the probability of failure by reducing the risk of rumor-driven runs.
- Providing an orderly means of compensating depositors should a failure occur.
- Reducing the potential contagion effects of a bank failure.

**40. The DPB operates as a pay-box only.** Hence, it cannot be drawn on to fund resolution (nor does it have any mandate to effect the resolution of banks, nor to supervise or to regulate banks). During its existence, the pay-out function has never been used.

**41. To assist the DPB, there is a staff of some 20 persons.** Some are provided by the HKMA, others are recruited externally. The DPB may also rely on ordinary HKMA staff resources, for instance, through joint working groups analyzing issues relevant to the DPS.

## B. Membership, Premiums and Scope of Coverage

**42. Where the DPS is activated, deposits may be compensated by up to HK\$500,000 (approx. US\$63,000) per depositor and bank.** Compensation is granted on a net basis, i.e., after deducting liabilities from the deposits of the same customer in the same bank. There is no coinsurance element—the DPB will compensate for the full net amount up to the limit of HK\$500,000.

**43. The definition of a “covered deposit” is broad.** It includes most forms of deposits, including deposits denominated in foreign currencies and deposits from non-bank financial institutions. The main categories exempted from coverage are:

- Deposits from banks or other AIs;
- Off-shore deposits; and
- Time deposits with a maturity exceeding five years.

**44. All licensed banks<sup>39</sup> are members of the DPS.** Membership is one of the conditions for being granted a banking license. The DPS covers 91 percent of all depositors and 21 percent of the total amount of deposits in the banking system.

---

<sup>39</sup> Except the branches of two German banks, which are instead members of their home country deposit guarantee system – also covering their deposits in HKSAR. The DPS allows for exemptions of membership to banks which are

(continued)

## C. Funding

**45. The DPS is prefunded by a yearly fee levied on member banks.** The premium varies between 0.0175 percent and 0.0490 percent of the total amount of covered deposits, depending on the risk profile of each bank as measured by the CAMEL framework of the HKMA. The Board has the power to set a surcharge on bank premiums should the DPS Fund decline below a defined level.

**46. DPS premiums are used (i) for pay-outs to depositors, and (ii) to cover the expenses for the ongoing operations by the DPS.** The target size for the DPS Fund is 0.25 percent of the total amount of covered deposits. Although this may appear small relative to some international peers,<sup>40</sup> it has been determined taking into account the estimated likelihood of bank failure, loss given bank failure, and the expected short time-frame to recover funds from liquidators.<sup>41</sup> Based upon the present level of covered deposits, this implies a target amount of HK\$3.8 billion (equivalent to US\$0.6 billion). Currently, some HK\$1.8 billion has been accumulated. The DPS Fund is invested in safe but liquid assets, such as deposits with the HKMA, Exchange Fund bills and U.S. Treasury Bills. In the case of an actual bank failure, should the DPS Fund prove inadequate to cover the full pay-out, the DPB may borrow up to HK\$120 billion (US\$17 billion) from the Exchange Fund and the drawdown can be made in a short time period to support a fast payout.

## D. Payout Procedures

**47. The DPB prepares itself to achieve swift and smooth pay-outs in various ways, including:**

- Ascertaining whether banks can report depositor information according to a specified format in a timely manner.
- Conducting crisis simulations, both separately and together with other parties.
- Continuing refinement of its tools and procedures for swift pay-out.

**48. According to the early warning indicators agreed between the two authorities, the DPB will be informed by the MA about problems in member banks:**

---

incorporated in a country with a deposit protection scheme which is adequately underpinned and which provides protection on terms which are not less generous than those provided by the DPS.

<sup>40</sup> For example, the European Union has proposed a target size of 0.80 percent in the draft Directive on Deposit Guarantee Schemes. Within the region, Malaysia has a minimum size of 0.60 percent (depending on the characteristics of deposits), Korea a minimum of 0.825 percent (depending on the characteristics of deposits), and Singapore 0.30 percent.

<sup>41</sup> This is in line with one of the approaches outlined in Hoelscher, D. S., M. Taylor, and U. H. Klueh (2006), *The Design and Implementation of Deposit Insurance Systems*, Occasional Paper No. 251, Washington, DC: IMF; the alternative approach suggested is to survey international peers.

- When a bank does not operate in a safe and sound manner or its supervisory rating is downgraded to a certain level.
- When the MA takes measures to remedy deficiencies in financial soundness or other serious matters of concerns.
- When capital adequacy has fallen below a specified level.
- When there are concerns about the liquidity of a bank.

There are no legal impediments on the exchange of information on the above matters.

**49. The current goal of the DPB is to make preliminary pay-outs to depositors within two weeks of the trigger event, and complete payment within six weeks.** Trigger events include a court decision on winding-up a member bank, or a notice to the DPB from the MA on his decision that depositors should be compensated by the DPS (for example, with respect to an AI where a Manager has been appointed). Recent crisis simulations with realistic content (i.e., comprising one medium-sized bank) proved successful in completing pay-outs within the targeted timeframes. The DPB is currently developing and implementing various enhancements to further increase the speed of payouts.

**50. After a pay-out, the rights of the depositor will be subrogated to the DPB.** Hence, the claims of the Board will have the same priority as a depositor, and relevant legislation provides for “depositor preference.” Consequently, its claims would rank fairly high in any bank liquidation.

**51. The DPB uses a variety of communication channels to enhance the public’s awareness of the DPS.** Recent surveys indicate high degrees of such awareness—close to 80 percent of surveyed individuals were aware of the existence of the DPS, and similarly high numbers knew about its key features.

## E. Findings and Recommendations

**52. In the context of crisis management and bank resolution, several aspects of a DPS are important:**

- The objectives of the DPS should be clear and separate from those of the HKMA and other authorities. At the same time, the tasks of the different authorities in the financial safety net should complement each other.
- The rules, procedures and features of deposit protection must be transparent and aim to counteract moral hazard. The general public should be aware of the DPS and its key features.
- The DPS should be regarded as reliable, which requires that it should have immediate access to sufficient liquidity to facilitate swift pay-outs and to augment the credibility of the system.

**53. While the DPS contains many good features, there are some areas where further improvements would strengthen the system.**

- **The modalities of funding should be reviewed.** The long-term costs to the DPB are reduced since the MA may require a problem bank to maintain assets up to 200 percent of its covered deposits under the DPSO to minimize the shortfall risk suffered by the DPS Fund and the DPB is entitled to priority claims under the insolvency regime through subrogation under section 38 of the DPSO. Nonetheless, the pay-outs in the liquidation of a bank could reduce the DPS Fund balance substantially or even exceed the target size of the fund, depending on the size of the bank. While the DPS Fund might recover these outlays through recoveries in the liquidation process, this could take several years and may only be partial. The DPS Fund may also be replenished through surcharges on the banks; however, this would take a prolonged period given the constraints on the maximum size of these surcharges, if the shortfall is sizeable. While, given the Exchange Fund credit line, the limited target size of the DPS Fund may not impede the credibility or functioning of the DPS, the funding arrangements warrant review to ensure there is appropriate burden sharing with banks of the costs of their own actions and losses. This would be in line with international good practice.
- **The netting policy should be replaced with a policy to pay out on a gross basis.** This would significantly increase the speed of payouts by reducing the complexity of (and potential legal uncertainty surrounding) the calculation.<sup>42</sup> In addition, the netting policy may cause unintended behavior by bank depositors. For instance, large value deposit holders can protect themselves far above the HK\$500,000 limit by maintaining corresponding amounts of liabilities with the same bank. Paying out on a gross basis would also be in line with the practice in many other countries.
- **Other steps to increase the speed of payouts should be continued.** In particular:
  - The present instrument for pay-outs, checks, is a “slow medium”, and should be complemented by faster instruments, including electronic payments.
  - The HKMA and the DPB have already identified a number of early warning indicators (e.g., downgrading of CAMEL rating of an AI to a certain rating and an AI’s total CAR falling below a certain level) so that the MA, when he becomes aware of the occurrence of the triggers, will serve an advance notice to the DPB to facilitate its early preparation for potential payouts. Such arrangement is being formalized between the MA and the DPB.

**54. The issues on deposit protection and overall mandate of the DPB should also be reviewed in the context of the work on the crisis resolution framework.** The structure of the Hong Kong financial system suggests that liquidation of failed institutions, and consequent pay-outs to depositors, would only be contemplated in a limited number of cases. That said, an appropriately

<sup>42</sup> Netting payouts may be more prone to legal challenge, which is itself a source of delay.

structured deposit protection framework is an important component of the financial safety net. For instance, the mandate of the Scheme could be extended to include financing the transfer of protected deposits to a healthy institution or bridge bank, on a least-cost basis (i.e., when such financing carries lower costs than direct payouts to depositors).

## Annex I. The Key Attributes of Effective Resolution Regimes for Financial Institutions

Summarized below are the 12 attributes considered essential for an effective resolution regime:

- KA1. The **scope** of the resolution regime should cover any financial institution that could be systemically significant or critical if it fails, and also apply to holding companies and, non-regulated operational entities within a financial group or conglomerate; and branches of foreign firms.
- KA2. A **resolution authority (or resolution authorities)** should be designated as being responsible for exercising the powers under the resolution regime and should be operationally independent, have clear mandates, roles, and responsibilities.
- KA3. Resolution authorities should have **broad resolution powers** that would enable them to assume control of a financial institution and restructure it so as to achieve continuity for some or all of the failing institution's business activities in order to secure continuity of critical financial services, payment, clearing and settlement services, and to protect financial stability. In particular, the KAs say that a resolution authority should be able to transfer ownership of a failing financial institution to a sound financial institution, or to transfer some or all of its business to a sound financial institution, or as an intermediate measure to a bridge institution. Powers to bring about an officially-mandated debt-for-equity swap or bail-in to recapitalize the failing financial institution should also be provided for.
- KA4. Rules governing **set-off, netting, collateralization, segregation of client assets** should be clear, transparent and enforceable during a crisis or resolution, although the authorities should also be able to temporarily suspend the operation of netting and set-off rights, subject to adequate safeguards.
- KA5. While resolution authorities may depart from the hierarchy of claims which would otherwise apply in liquidation, **legal safeguards** should be in place, that if necessary, allow for payment of compensation to creditors assessed to be worse off in resolution as compared with liquidation and for the decisions of resolution authorities to be subject to judicial review.
- KA6. Authorities should **minimize the use of public funds** to resolve firms, ensuring that the costs are met by the shareholders and creditors of the failed financial institutions, and thereafter by the wider industry, and that any use of public funds is temporary.
- KA7. **Framework for cross-border cooperation:** Resolution authorities should be empowered and encouraged to achieve cooperative solutions with foreign resolution authorities.

- KA8. Home and key host authorities should maintain **CMGs** that actively review and report on resolvability and on the recovery and resolution planning process for Global Systemically Important Financial Institution (G-SIFIs).
- KA9. **Institution-specific cross-border cooperation agreements** should be in place among relevant authorities to manage the sharing of information and specify responsibilities in respect of all G-SIFIs.
- KA10. **Resolvability assessments** should be regularly undertaken for all G-SIFIs, and the relevant authorities should be able to require changes to business practices, structure or organization to promote resolvability.
- KA11. Jurisdictions must require **recovery and resolution planning** for firms with local operations where those could be critical or systemically significant.
- KA12. **Information sharing:** Jurisdictions should eliminate impediments to the domestic and cross-border exchange of information among authorities, both in normal times and during a crisis.