



The thing about ... Stefan Gannon

A decade after the global financial crisis, the Commissioner of the Hong Kong Monetary Authority's Resolution Office speaks to Patrick Dransfield about the new legal regime designed to manage orderly bank failures.

Asian-Mena Counsel: It has been 10 years since the start of the global financial crisis (GFC). What are the lessons to be drawn? What responsibility do central banks have to the general public?

Stefan Gannon: While bank failure in Hong Kong is rare, the Hong Kong Monetary Authority (HKMA) cannot be complacent when it comes to protecting Hong Kong's financial stability.

A key lesson from the GFC is that regardless of the size of the bank, it is possible for it to fail. As mentioned above, insolvency is not a desirable mechanism for managing the orderly failure of a bank as may be the case for other types of firms because once a bank enters insolvency, it would need to suspend all operations. Critical banking

functions provided by that bank, such as withdrawal of deposits, will be suspended, resulting in a disruption of credit and lending flows in the market. The larger and the more systemically important a bank is, the more acute and widespread the consequences of its entry into insolvency will be. This is why during the GFC many foreign governments were forced to use large sums of taxpayers' money to bail out too-big-to-fail banks. In order to make up for the astronomical amount of money spent on these substantial bail-outs, most of the governments concerned had to cut public spending, for example, by reducing national budgets for hospital services and education. This led to erosion of public confidence in the banking system and public outcry.

Furthermore, the fact that taxpayers had to pick up the tab for the failure of profit-minded commercial enterprises understandably led to public backlash. The crisis called into question the merits of an open and globalised financial system.

To combat this too-big-to-fail phenomenon, post-GFC, leaders of the G20 countries reached unprecedented international consensus to include resolution as a major component of the global financial regulatory agenda. The resulting product is the new international standards set out in the Financial Stability Board (FSB)'s Key Attributes of Effective Resolution Regimes for Financial Institutions (Key Attributes).

Hong Kong's Financial Institutions (Resolution) Ordinance (Ordinance), which is modelled on the Key Attributes, arms the HKMA with powers necessary to deal with bank failures in a quick and decisive manner, with the intention to minimise the consequences and the contagious effect of such failure and protecting the Hong Kong financial system on which the wider economy depends. For example, the powers may help to ensure that the critical services provided by a failing bank will continue, especially the provision of deposit and lending services to the general public and small and medium-sized enterprises. Bail-out of a failed bank with public funds while its shareholders and certain creditors are shielded from loss will no longer be tolerated. The HKMA, together with the relevant international counterparts, has been working with banks to structure their businesses in a way such that if banks were to fail in the future, their failure could be managed in an orderly manner.

AMC: What is the significance of the Ordinance for Hong Kong?

Gannon: The Ordinance, which was enacted in June 2016 and came into effect recently in July 2017, establishes the legal basis for a cross-sector resolution regime in Hong Kong, which is designed to be compliant with the international standards set by the FSB.

As an FSB member and international financial centre, it is of crucial importance for Hong Kong to implement the standards set out in the Key Attributes in a timely manner, progress of which is monitored and reported on by the FSB and other international standard setters.

Without an internationally compatible resolution regime in Hong Kong, the authorities would face difficulties in coordinating effectively with other key jurisdictions; both on resolution planning and, if necessary, execution in the event of a failure of a financial institution (FI). This may impact on the willingness of certain home jurisdictions to allow their FIs to maintain their current structure and operations in Hong Kong.

Absent an effective regime, Hong Kong would also be

exposed to any domestic failure of a systemically important FI and attendant risks to continuity of critical financial functions.

AMC: What is resolution? How does it differ from existing insolvency procedures?

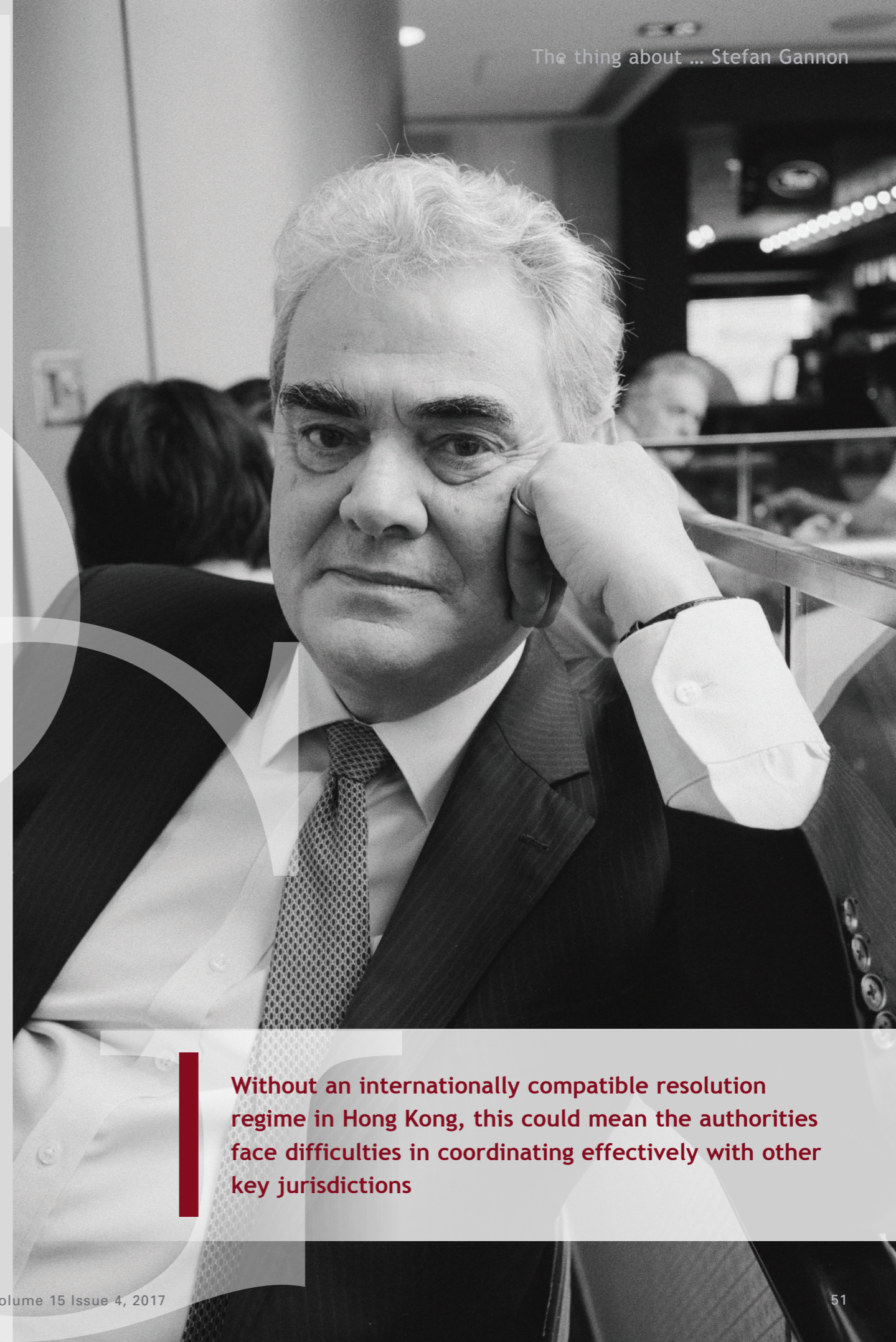
Gannon: Resolution is an administrative process which enables authorities to manage the failure of an FI in an orderly manner and mitigate its impact on the financial system and the wider economy if such failure could have adverse systemic consequences. This process is intended to protect public funds and maintain stability of the financial system.

Resolution sits alongside existing insolvency procedures. They differ in that resolution is designed to, among others, preserve the continuity of critical financial functions of an FI, and to place the costs of failure on the shareholders and certain creditors of the FI rather than on the taxpayers. It is important to note that insolvency remains a default option in the event of an FI's failure where that FI is not expected to pose a threat to the stability and effective working of the financial system of Hong Kong. Likewise, where it is assessed to be necessary to stabilise and restructure only part of a critical or systemic FI following a resolution, the residual entity would likely be dealt with via existing insolvency arrangements.

Resolution is achieved by using the powers available under the Ordinance to intervene and to manage the failure of an FI. One of the key resolution powers provided to the HKMA is 'bail-in'. It is a way to recapitalise a distressed bank so that its shareholders and certain creditors will bear the losses of the failure, obviating the need for any injection of public funds. The HKMA may use this power to write down the bank's liabilities, or convert them into equity, thereby offsetting the losses of a failed bank, essentially giving it an equity 'boost' and improving its financial condition. By aligning the interests of a bank with those of its shareholders and creditors, this arrangement creates a stronger incentive for these interested parties to constantly monitor and constrain the risks the bank is taking today to avoid future failure.

AMC: What protections will be provided under the resolution regime?

Gannon: In comparison to insolvency, resolution may be better at protecting a broad set of stakeholders, including depositors, investors (with client assets) and policyholders, in that it is intended to deliver an outcome such that critical businesses of a failing FI will be stabilised, restructured and continued. This means that some or all depositors and investors with client assets at a failing FI will have close to uninterrupted access to their



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accounts, funds and assets. This contrasts with insolvency, whereby all operations of a failing FI would have to be suspended.

Importantly, it is within the objectives of the resolution regime to seek to protect deposits or insurance policies as well as client assets, of a within-scope FI in no lesser degree than they would be protected on a winding-up of the FI. Furthermore, one of the key statutory safeguards underpinning our resolution regime is the principle that no creditors shall be worse off than in liquidation. This establishes protection for pre-resolution shareholders and pre-resolution creditors of an FI in resolution, entitling them to compensation if they do not receive at a minimum in resolution what they would have received had the FI been wound up under the applicable insolvency regime.

AMC: How can an in-house lawyer play a progressive, innovative and constructive role in society, particularly as it relates to financial stability and the public interest?

Gannon: Now that the Ordinance is in force, the Resolution Office's priorities are to work with the banks to prepare and plan for resolution with a view to enhancing the effectiveness of resolution arrangements in the event of a bank failure. The former priority requires banks to make changes to their legal, financial and operational structures to remove impediments to resolution. The latter priority requires the HKMA to execute resolution transaction structures to recapitalise failed FIs or transfer their assets, rights or liabilities, both with the objective of ensuring continuity in the FI's essential banking services.

This work has many aspects: policy development, industry engagement, restructuring of banks and their group structure, transaction structuring for various resolution scenarios, and detailed valuation analysis. A common thread through all these works is the undertaking of legal analysis, both for planning during peace time and resolution implementation at the time of a bank failure. In-house lawyers play a core role in assisting the resolution authority in operationalising the resolution regime by supporting the translation of the high level enabling statutory resolution regime into viable action plans for their clients. One of their duties is to ensure that the resolution planning and relevant transactions to facilitate the resolution process can withstand legal challenges such that resolution objectives could be duly achieved. Such work may involve facilitating the resolution planning process, structuring resolution transactions and supporting the development of legally robust processes and procedures for the implementation of resolution actions (such as developing the operational mechanics for effective application of bail-in power to

write-down or convert the liabilities of a failed AI).

AMC: Can you comment on the industry involvement relating to the preparation of FIs' resolution plans?

Gannon: The HKMA has been actively engaging with banks and relevant authorities overseas in the preparation of resolution plans. For the global systemically important banks (G-SIBs), the HKMA attends the crisis management groups of 12 G-SIBs organised by the relevant home authorities to develop resolution strategies for individual banks, assess the resolvability of each banking group and identify any structural changes required to remove impediments to resolvability. The HKMA also took the lead in organising an annual regional crisis management group for a local banking subsidiary of a major international bank attended by the host regulators from the Asia-Pacific region.

Locally, the HKMA has commenced the resolution planning process with the domestic systemically important banks (D-SIBs) and requested D-SIBs to submit a set of "core information" to facilitate resolution planning. To this end, the HKMA published a Code of Practice chapter under the Ordinance to provide guidance to banks on, among other things, the scope and content of the core information to be submitted by banks in order to facilitate resolution planning.

In addition, it is worth noting that the cross-sector resolution regime under the Ordinance is designed to be compliant with the international resolution standards set out in the Key Attributes, which are already reflected in the resolution regimes of jurisdictions that have implemented such a regime, such as the US and the EU. Drawing from their experience in operating in these jurisdictions, we expect banks to already have a reasonable understanding of applicable standards and to an extent, the requirements derived from those standards.

AMC: What is your hinterland?

Gannon: Prior to taking up my current position as the Commissioner of the Resolution Office, I was the general counsel of the HKMA from its establishment in 1993, advising on all aspects of the HKMA's activities and contributing to the formulation of policy. From 1987 to 1993, I was the legal adviser to the Monetary Affairs Branch of the Hong Kong government, and before moving to Hong Kong, I practised as a barrister and was an international legal adviser to Midland Bank, then one of the largest British banking groups in London. I am the representative member of Hong Kong to the Resolution Steering Group of the FSB, and was until recently the chairman of its legal experts working group. I am also a Fellow of the Society for Advanced Legal Studies and a member of the Committee on International Monetary Law of the International Law Association.