

**For discussion  
on 3 April 2018**

## **Legislative Council Panel on Financial Affairs**

### **Legislative proposals on loss-absorbing capacity requirements under the Financial Institutions (Resolution) Ordinance (Cap. 628)**

#### **PURPOSE**

This paper briefs Members on: (a) the proposed rules (“FIRO LAC Rules”) on loss-absorbing capacity (“LAC”) requirements for authorized institutions (as defined in the Banking Ordinance (Cap. 155) (“BO”), “AIs”) to be made as subsidiary legislation under the Financial Institutions (Resolution) Ordinance (Cap. 628) (“FIRO”); and (b) the proposed amendments to the Inland Revenue Ordinance (Cap. 112) (“IRO”) in relation to LAC debt instruments.

#### **BACKGROUND**

2. The FIRO was enacted by the Legislative Council (“LegCo”) in June 2016 and came into force on 7 July 2017.<sup>1</sup> The FIRO establishes a cross-sectoral resolution regime for within scope financial institutions (“within scope FIs”)<sup>2</sup> that is designed to meet the international standards set by the Financial Stability Board (“FSB”),<sup>3</sup> in its *Key Attributes of Effective Resolution Regimes for Financial Institutions*.<sup>4</sup> Under the FIRO, the

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<sup>1</sup> All provisions of the FIRO commenced except for Part 8 (sections 144 to 148), section 192 and Division 10 of Part 15 (sections 228 to 232).

<sup>2</sup> Within scope FIs include all AIs, certain licensed corporations, certain authorized insurers, settlement institutions and system operators of designated clearing and settlement systems, and recognized clearing houses. The scope of the FIRO also extends to holding companies and affiliated operational entities of within scope FIs.

<sup>3</sup> The FSB is an international body established by the G20 in 2009 in the aftermath of the global financial crisis. It seeks to assess the vulnerabilities in the global financial system and propose actions to address them.

<sup>4</sup> FSB, *Key Attributes of Effective Resolution Regimes for Financial Institutions*, first issued in 2011 and updated in 2014. See: [http://www.fsb.org/wp-content/uploads/r\\_141015.pdf](http://www.fsb.org/wp-content/uploads/r_141015.pdf).

Monetary Authority (“MA”), the Insurance Authority and the Securities and Futures Commission are the resolution authorities for those within scope FIs operating under their respective purviews – banking sector entities, insurance sector entities, and securities and future sector entities respectively. The FIRO confers powers and imposes duties on resolution authorities. The powers include five stabilization options that resolution authorities may apply when resolving within scope FIs.

3. The five stabilization options under the FIRO fall into two broad categories: (a) four transfer stabilization options, whereby some or all of the assets, rights or liabilities of, or securities issued by, a within scope FI, are transferred to (i) a purchaser; (ii) a bridge institution; (iii) an asset management vehicle; and/or (iv) (as a last resort) a temporary public ownership company; and (b) the bail-in stabilization option, whereby certain liabilities issued by the within scope FI are cancelled or modified.

4. An essential prerequisite to the bail-in stabilization option is the availability of a stock of liabilities to which the option can be applied. Such liabilities include LAC. LAC refers to: (a) regulatory capital (namely Common Equity Tier 1 (“CET1”) capital, Additional Tier 1 capital and Tier 2 capital, all of which are defined under the Banking (Capital) Rules (Cap. 155L)<sup>5</sup>); and (b) other LAC-eligible liabilities<sup>6</sup> that can be written down or converted into equity so as to reduce the issuer’s debt, thereby shoring up its balance sheet. LAC can also support the orderly resolution of a non-viable within scope FI where a transfer stabilization option has been applied to move some or all of the assets, rights or liabilities of, or securities issued by, that within scope FI to a transferee.<sup>7</sup>

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<sup>5</sup> This is subject to regulatory capital meeting relevant LAC eligibility criteria.

<sup>6</sup> Generally speaking, other LAC-eligible liabilities are constituted by liabilities (arising through a contract) which are, *inter alia*, fully paid in; unsecured; subordinated to claims of depositors and general creditors; not subject to set-off or netting rights; not having derivatives-linked features; having remaining contractual maturity of at least one year; and not being liabilities that are excluded from bail-in under section 58(4) of the FIRO.

<sup>7</sup> LAC can support an orderly resolution in which one or more transfer stabilization options are used by either: (a) being written down or converted into equity; or (b) bearing loss in insolvency (for example, where a failed institution is wound down after the application of a transfer stabilization option) ahead of other liabilities.

## **FIRO LAC Rules**

5. Section 19 of the FIRO empowers the resolution authorities to prescribe LAC requirements for within scope FIs and their group companies in the aforementioned three sectors. Taking into account the size, systemic importance, level of concentration and scale of critical financial functions of the banking sector in Hong Kong, as well as the development of international guidelines on LAC for banks (in particular the FSB’s guidance on total loss-absorbing capacity (“TLAC”) set out in its *Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution and Total Loss-absorbing Capacity (TLAC) Term Sheet* (the “*FSB TLAC Term Sheet*”)<sup>8</sup>), we consider that the development of LAC requirements for AIs should be prioritised.

6. The FIRO LAC Rules will prescribe LAC requirements for certain AIs and their group companies, under which they will be required to maintain minimum levels of LAC that are capable of providing loss-absorbing and recapitalisation resources to facilitate orderly resolution should the entity or the relevant AI cease, or become likely to cease, to be viable.

## **Amendments to the IRO**

7. LAC instruments are proposed to consist of CET1 capital instruments, Additional Tier 1 capital instruments, Tier 2 capital instruments and other LAC-eligible liabilities. Unlike CET1 capital instruments (which are equity), Additional Tier 1 capital instruments, Tier 2 capital instruments and other LAC-eligible liabilities (collectively “LAC debt instruments”) are hybrid in nature. While their legal form is debt-like, LAC debt instruments have an equity-like loss-absorbing feature as they can be converted into equity, or be written down, to absorb losses at the point of non-viability of the issuer. Their hybrid nature raises questions about their tax treatment, in particular

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<sup>8</sup> FSB, November 2015, *Principles on Loss-Absorbing Capacity and Recapitalisation Capacity of G-SIBs in Resolution and Total Loss-Absorbing Capacity Term Sheet*. See: <http://www.fsb.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf>. The FSB has also issued guidance on internal TLAC (see paragraph 11 below) that is issued within banking groups. FSB, July 2017, *Guiding Principles on the Internal Total Loss-Absorbing Capacity of G-SIBs*. See: <http://www.fsb.org/wp-content/uploads/P060717-1.pdf>.

whether they are eligible for debt-like tax treatment under the IRO. To address this uncertainty in respect of Additional Tier 1 and Tier 2 capital instruments issued by AIs under the regulatory capital regime, the IRO was amended in 2016 to provide debt-like tax treatment for these instruments. Other LAC-eligible liabilities were not covered in the 2016 IRO amendment exercise since the FIRO and the FIRO LAC Rules were not then in place. It is now necessary to amend the IRO again to remove tax uncertainty over other LAC-eligible liabilities to facilitate implementation of the FIRO LAC Rules.

8. To improve the resolvability of an AI, the preferred resolution strategy devised by the MA for certain AIs may involve the issuance of LAC debt instruments by a Hong Kong incorporated clean holding company<sup>9</sup> of an AI (instead of by the AI itself) to external investors or an overseas group company. Under the existing provisions of the IRO, the tax treatment of interest expenses incurred by entities which fall within the definition of “financial institution” and those that do not fall within that definition, is different. Whilst AIs fall within the definition of “financial institution”, a Hong Kong incorporated holding company of an AI, if it is not itself an AI or an associated corporation of an AI which would have been liable to be authorized as a deposit-taking company or restricted licence bank but for certain exemptions,<sup>10</sup> does not. Consequently, any distributions in respect of a LAC debt instrument issued by a Hong Kong incorporated holding company of an AI, even if they are treated as interest, will be subject to more stringent rules for interest deductibility than those in respect of a LAC debt instrument issued by an AI.

9. To provide greater certainty of tax treatment of LAC debt instruments and to create a level playing field for banking groups in relation to interest expense deduction for LAC debt instruments, irrespective of whether such instruments are issued by an AI or a Hong Kong incorporated clean holding company of an AI, it is considered necessary to amend the IRO.

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<sup>9</sup> A “clean holding company” means a holding company which only conducts a very limited range of activities, including issuing funding instruments, holding funding instruments issued by its subsidiaries and any related ancillary activities.

<sup>10</sup> The second limb of the definition of “financial institution” under the IRO captures any associated corporation of an AI which, being exempt by virtue of section 3(2)(a) or (b) or (c) or the BO, would have been liable to be authorized as a deposit-taking company or restricted licence bank under that Ordinance had it not been so exempt.

Under these proposed amendments, both: (a) LAC debt instruments issued by AIs other than Additional Tier 1 and Tier 2 capital instruments (which already benefit from debt-like tax treatment); and (b) all LAC debt instruments issued by Hong Kong incorporated clean holding companies of AIs, will be treated as debt for profits tax purposes (i.e. the same profits tax treatment as that currently afforded to Additional Tier 1 or Tier 2 capital instruments issued by AIs). The proposed amendments will also have the effect of exempting the transfer of LAC debt instruments from stamp duty pursuant to the existing provisions under the Stamp Duty Ordinance (Cap. 117) (“SDO”) (i.e. extending the current stamp duty treatment afforded to Additional Tier 1 and Tier 2 capital instruments to all LAC debt instruments).

## **LEGISLATIVE PROPOSALS**

### **FIRO LAC Rules**

10. The FIRO empowers the MA to devise resolution strategies to secure the orderly resolution of an AI. It is proposed that the FIRO LAC Rules will provide that where a resolution strategy envisages the application of one or more stabilization options to an AI, a holding company of an AI or an affiliated operational entity (“AOE”)<sup>11</sup> of an AI, which in each case is incorporated in Hong Kong, the MA may classify that entity as a “resolution entity” and may group it together with one or more of its subsidiaries as a “resolution group”. A resolution entity must meet a LAC requirement with *external* LAC instruments that are issued to an entity outside its resolution group (“external LAC requirement”). External LAC instruments can be used in resolution to absorb losses experienced by a resolution entity and provide recapitalization resources to such entity.

11. The FIRO LAC Rules will also provide that the MA may classify an AI, a holding company of an AI or an AOE of an AI, which in each case is incorporated in HK, that is in a resolution group (or overseas equivalent) but is not itself a resolution entity as a “material subsidiary”, and may group it together with one or more of its subsidiaries as a “material sub-group”. A material subsidiary must meet a LAC requirement with *internal* LAC

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<sup>11</sup> Under the FIRO, an AOE, in relation to a within scope FI, means a body corporate that is a group company of the FI and that provides services, directly or indirectly, to the FI.

instruments that are issued, directly or indirectly, to the resolution entity in the material subsidiary's resolution group ("internal LAC requirement"). Internal LAC instruments can be contractually written down or converted into equity in case of the non-viability of a material subsidiary, thereby passing losses up to the resolution entity in its resolution group and restoring the material subsidiary to viability without it having to go into resolution itself.

12. The FIRO LAC Rules will specify certain qualifying criteria to be met in order for an instrument to count towards meeting an external/internal LAC requirement, and such qualifying criteria will be closely aligned with those set out in the *FSB TLAC Term Sheet*.

13. It is proposed that, under the FIRO LAC Rules, a resolution entity's minimum external LAC requirement is two times its minimum regulatory capital requirement, subject to any variations that may be made by the MA in light of an entity's particular circumstances. A material subsidiary's minimum internal LAC requirement is proposed to be scaled in the range of 75% to 100% of the external LAC requirement to which the material subsidiary would be subject were it a resolution entity. Resolution entities and material subsidiaries must meet their relevant LAC requirements within 24 months of being classified as resolution entities or material subsidiaries, as the case may be. That said, where a resolution entity or a material subsidiary is part of a global systemically important bank ("G-SIB")<sup>12</sup> group that is required to meet TLAC requirements in a shorter timeframe under the *FSB TLAC Term Sheet*, the shorter timeframe shall apply.

14. The loss-absorbing characteristics of LAC debt instruments make it difficult to assess the likelihood and quantum of potential losses in advance, rendering the instruments unsuitable for retail investors. It is proposed that AIs which issue LAC debt instruments should be subject to appropriate restrictions in the sale and marketing of LAC debt instruments. In particular, for an instrument to be eligible as a LAC debt instrument, primary issuance of such instrument in Hong Kong needs to be limited to Professional Investors<sup>13</sup> only.

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<sup>12</sup> The FSB, in consultation with Basel Committee on Banking Supervision and national authorities, identifies a list of G-SIBs and updates the list annually.

<sup>13</sup> As defined in section 1 of Part 1 to the Securities and Futures Ordinance (Cap. 571) and section 3 of the Securities and Futures (Professional Investor) Rules (Cap. 571D).

15. It is proposed that the FIRO LAC Rules will also contain provisions requiring that: (a) where an entity that is subject to a LAC requirement holds LAC instruments issued by another entity, the amount of that holding should be deducted from its own capital or LAC resources when determining whether it meets any minimum capital or LAC requirements of its own<sup>14</sup>; (b) unless varied by the MA in light of an entity's particular circumstances, at least one-third of any LAC requirement must be met with LAC debt instruments (i.e. cannot be fully met with CET1 capital instruments); and (c) relevant entities must periodically disclose to the general public details of their LAC issuance.

### **Amendments to the IRO**

16. We propose that amendments be made to the IRO so that –

- (a) all LAC debt instruments issued by an AI or a Hong Kong incorporated clean holding company of an AI will receive debt-like tax treatment under the IRO, subject to the same set of constraints and anti-avoidance provisions currently applicable to interest expense deduction by AIs in respect of Additional Tier 1 and Tier 2 capital instruments;
- (b) interest, gains or profits received by or accrued to an AI or a Hong Kong incorporated clean holding company of an AI from all LAC debt instruments will be deemed trading receipts and hence be chargeable to profits tax, thus upholding tax symmetry. This would extend the current treatment for interest, gains or profits derived from Additional Tier 1 and Tier 2 capital instruments received by or accrued to an AI to all LAC debt instruments; and
- (c) as an effect of amending the definition of “regulatory capital securities” under the IRO, transfers of all LAC debt instruments will be exempt from stamp duty under the SDO. This would extend the current stamp duty treatment for transfers of Additional Tier 1 and Tier 2 capital instruments to all LAC debt instruments.

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<sup>14</sup> Note that it is proposed that deductions from capital resources under item (a) will be set out in the Banking Capital Rules (Cap. 155L), not in the FIRO LAC Rules, to the extent that they apply to AIs.

## **PUBLIC CONSULTATION**

17. The Hong Kong Monetary Authority conducted a two-month public consultation (from 17 January 2018 to 16 March 2018) on the legislative proposals on LAC (including the proposed amendments to the IRO). We engaged with key stakeholders during the consultation period, and received 10 submissions from AIs, industry associations, professional bodies and others. We will further consult the industry on the draft text of the FIRO LAC Rules in summer 2018.

## **WAY FORWARD**

18. The drafting of the FIRO LAC Rules and an Inland Revenue (Amendment) Bill to implement the above legislative proposals is underway. Subject to the drafting progress and the outcome of the industry consultation in summer, our target is to table the FIRO LAC Rules for negative vetting in the second half of 2018, followed by introduction of the Bill into LegCo for first and second reading.

## **ADVICE SOUGHT**

19. Members are invited to note the legislative proposals as set out in this paper.

**Financial Services and the Treasury Bureau (Financial Services Branch)  
Hong Kong Monetary Authority  
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