Subcommittee on Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements – Banking Sector) Rules

Responses to list of follow-up actions arising from the discussion at the meeting on 12 November 2018

This paper sets out the Government's response to the matters raised by Members in relation to Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements – Banking Sector) Rules ("LAC Rules") at the subcommittee meeting on 12 November 2018.

(1a) A comparison on the implementation progress of the resolution regime and the corresponding loss-absorbing capacity ("LAC") rules of Hong Kong with other major international financial markets including the United States, the United Kingdom, Singapore, Japan and the Mainland.

2. Table 1 below compares progress on the implementation of resolution regimes and LAC requirements for Hong Kong, the five jurisdictions identified in the question, and also Switzerland (included as it is another major international financial market).

(1b) The estimated interest rates of LAC instruments to be issued by local authorized institutions ("AIs") (particularly those AIs without any single major shareholders), and details of the relevant studies conducted by the Hong Kong Monetary Authority ("HKMA") on the matter.

3. As mentioned in the subcommittee meeting on 12 November 2018, as part of the development of the LAC policy proposals, the HKMA conducted an assessment of the likely impact of the introduction of LAC requirements in Hong Kong. This assessment is set out in Part XII of the consultation paper issued on 17 January 2018[1] and was subsequently published in Box 5 (pages 77-80) of the HKMA's Half-Yearly Monetary and Financial Stability Report in March 2018[2].

---

[1] See: https://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/resolution/LAC_CP_ENG.pdf.

[2] See: https://www.hkma.gov.hk/media/eng/publication-and-research/quarterly-bulletin/qb201803/E_Half-yearly_201803.pdf.

4. The core of this impact assessment was a detailed cost-benefit analysis of setting LAC requirements for AIs. An important element of this analysis was the determination of an appropriate interest rate for non-capital LAC debt instruments[3] to be used in the cost-benefit analysis. As no such instruments are yet in issue in Hong Kong, this required an estimate to be made of the likely interest rate.

5. The starting point for estimating the appropriate interest rate was the annual interest rate of T2 capital instruments issued by locally-incorporated licensed banks. Like non-capital LAC debt instruments, T2 capital instruments have loss-absorbing features, and in particular may be exposed to loss where an issuing AI reaches the point of non-viability. They therefore have similar risk characteristics which can be expected to impact on their pricing.

6. Non-capital LAC debt instruments will typically rank above T2 capital instruments in the creditor hierarchy. As such, they will be less risky, and so can be expected to have a lower interest rate than T2 capital instrument. This suggests that in estimating an annual interest rate for non-capital LAC debt instruments for the cost-benefit analysis, it would be appropriate to take a rate lower than that applicable to T2 capital instruments.

7. The weighted average cost of T2 capital from submissions to the HKMA in October 2017 by locally-incorporated licensed banks is slightly below 4%. However, in preparing the cost-benefit analysis, the HKMA generally took a conservative approach in estimating the cost of non-capital LAC debt instruments, so as not to over-estimate the net benefits of introducing LAC requirements. Consistent with taking a conservative approach, for the purposes of the cost-benefit analysis the HKMA estimated the annual cost of non-capital LAC debt instruments at 4%[4] – so in fact slightly higher than the weighted average of reported costs of T2 capital instruments.

---

[3] Any locally-incorporated AIs that are subject to LAC requirements will already be subject to capital requirements under the Banking (Capital) Rules (Cap. 155L), and many already have Additional Tier 1 ("AT1") capital instruments and Tier 2 ("T2") capital instruments in issue. As the price and the market for such capital instruments are established, the impact assessment and this response focus on non-capital LAC debt instruments.

[4] As set out in paragraph 178 of the consultation paper.

Table 1 – implementation progress on developing (i) a resolution regime; and (ii) LAC requirements

Region	Resolution regime[5]	LAC requirements
Hong Kong	*FSB Peer Review Feb. 2018*: "Hong Kong now has legal powers … related to resolution that are consistent with those required under the [Key Attributes]."	Once the LAC Rules have come into operation, the resolution authority will be able to classify resolution entities and material subsidiaries. Non-Mainland global systemically important banks ("G-SIBs") can be required to meet LAC requirements three months after classification. For all other AIs, the resolution authority's intention is that classification will be no earlier than 1 January 2020, with LAC requirements to be met under the LAC Rules 24 months after classification, i.e. no earlier than 1 January 2022. In addition, classification will be prioritised starting with domestic systemically important banks ("D-SIBs"). In practice, non-D-SIBs are therefore likely to be classified some time after 1 January 2020, with their need to meet LAC requirements being pushed back a corresponding period after 1 January 2022.
Japan	*FSAP July 2017*: "While efforts to align the resolution framework with the [Key Attributes] have progressed, the resolution framework has some remaining gaps."	Total loss-absorbing capacity ("TLAC") requirements being phased in from 31 March 2019.[6]
Mainland	*FSAP Dec. 2017*: "In line with the FSB requirements, Crisis Management Groups and recovery and resolution plans are in place for all five of China's [global systemically important financial institutions], and resolvability assessments and	Imposition of TLAC requirements pending. Under the TLAC term sheet issued by the FSB on 9 November 2015, Mainland G-SIBs do not have to meet TLAC requirements before 1 January 2025, subject to this deadline being brought

5 For each jurisdiction, an assessment of the resolution regime has been extracted from the more recent of (i) the most recent Financial Stability Board ("FSB") Peer Review for that jurisdiction; and (ii) the most recent IMF Financial Sector Assessment Program ("FSAP") for that jurisdiction. Reference to the "Key Attributes" are to the FSB's "Key Attributes of Effective Resolution Regimes for Financial Institutions", published in October 2011 and updated in October 2014.

6 See: https://www.fsa.go.jp/en/news/2018/20180413/01.pdf.

Region	Resolution regime[5]	LAC requirements
	cross-border co-operation agreements are in progress." "Further work is needed to align approaches to resolving weak [financial institutions] with the [Key Attributes]."	forward if the corporate debt to GDP ratio exceeds 55% before the end of 2020. This ratio was close to 50% at the end of 2017.
Singapore	*FSB Peer Review Feb. 2018*: "Singapore has a resolution regime broadly in line with the Key Attributes."	Eligibility criteria for bail-in instruments set out in regulations[7] that came into force on 29 October 2018. Imposition of TLAC requirements pending.
Switzerland	*FSAP May 2014*: "The authorities are ahead of many jurisdictions in adopting reforms broadly aligned with the [Key Attributes]."	Final loss-absorbency requirements published in October 2015, phased in linearly until end of 2019.[8]
UK	*FSAP June 2016*: "The transposition of the EU Bank Recovery and Resolution Directive has completed the reform of the UK's Special Resolution Regime for banks, which is now broadly aligned with global standards."	UK firms will become subject to interim minimum requirements for own funds and eligible liabilities (which broadly correspond to LAC requirements) on 1 January 2020, prior to the final requirements coming into force in 2022.[9] In addition, UK G-SIBs will be required from 1 January 2019 to meet the minimum requirements set out in the FSB TLAC term sheet.[10]
US	*FSAP July 2015*: "Title II ("Orderly Liquidation Authority", OLA) of the [Dodd-Frank Wall Street Reform and Consumer Protection Act] sets forth a new resolution regime for "covered financial companies", granting resolution powers to the [Federal Deposit Insurance Corporation]. The OLA powers are extensive [and] align broadly with international best practice ..."	Final TLAC requirements to apply from 1 January 2019.[11]

7 See: https://sso.agc.gov.sg/SL/MASA1970-S714-2018?DocDate=20181026#pr23-.
8 See: https://www.finma.ch/en/news/2015/10/mm-tbtf-20151021/.
9 See: https://www.bankofengland.co.uk/financial-stability/resolution/indicative-mrels.
10 See: https://www.bankofengland.co.uk/-/media/boe/files/financial-stability/resolution/indicative-firm-mrels-2018.pdf?la=en&hash=4553DF2579E49077E92C6BD39A8C07C5D08D72D9.
11 See: https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20161215a1.pdf.

8. The reported interest rates of T2 capital instruments issued by locally-incorporated licensed banks that do not have a single major shareholder (such as a parent bank or holding company) are on average slightly higher than those of other banks. However, because the HKMA adopted the conservative approach of using an annual cost for non-capital LAC debt instrument that is higher than the weighted average of reported costs of T2 capital instruments, applying an estimate of 4% to the cost of non-capital LAC debt instruments remains a reasonable approach.

(1c) Given the expected substantial amount of loss-absorbing capacity products to be issued by the major banks in the Mainland, HKMA's assessment on the demand for LAC instruments to be issued by local AIs and thus the cost impact on local AIs.

9. As described above, the consultation paper issued on 17 January 2018 included a cost-benefit analysis of the LAC policy proposals. The impact assessment in the consultation paper also considered the practicability of AIs issuing sufficient LAC to meet their LAC requirements, and the specific question of how well-placed debt markets are to absorb the necessary LAC issuances.

10. The substantial majority of AIs non-LAC-eligible funding currently in place that may have to be re-financed in the coming years to LAC-eligible funding is expected to be constituted by LAC that is issued within international financial groups. The majority of AIs in Hong Kong that may be subject to LAC requirements will not issue LAC debt instruments to the external market, but will instead be issuing internal LAC to foreign parent companies within international financial groups. As such, compliance with the LAC Rules will represent a change to the terms and conditions of internal funding arrangements within cross-border banks, to ensure that there is adequate loss-absorbing capacity that meets internationally-agreed standards issued from Hong Kong incorporated subsidiaries of such banks. The funding for such LAC will ultimately be raised by cross-border banks with ready access to deep and active global debt markets. For such banks, the ability of the markets to cope with additional supply is not in question (not least as many G-SIBs have already successfully issued much of the TLAC that is required for their global operations, including, where relevant, for their Hong Kong operations).

11. However, it is likely that as a consequence of the LAC Rules a small number of locally-incorporated AIs will seek to issue LAC-eligible instruments directly to the market. Having engaged with a range of market participants, the HKMA's view is that there is little reason to doubt the market's ability to absorb the expected supply of external LAC issuance without there being any material impact on cost, notwithstanding likely future TLAC issuance by Mainland G-SIBs. Relevant factors include the following:

(a) relevant locally-incorporated AIs are already likely to have issued AT1 capital instruments and/or T2 capital instruments into the market, and so will have an established investor base should they elect to issue more capital to meet LAC requirements;

(b) should AIs instead determine to issue non-capital LAC debt instruments (which are likely to be cheaper than capital), the fact that such instruments will have similar features to existing AT1 capital instruments and T2 capital instruments, and there is an established market for such instruments, will both still be helpful factors;

(c) in relation to the potential issuance of TLAC by Mainland banks, the long lead time provided for in the LAC Rules and described in the code of practice chapter in relation to the LAC Rules ("LAC COP") (published for consultation on 19 October 2018) will allow AIs to optimise issuance dates in light of prevailing market conditions;

(d) the investor base for Mainland G-SIBs will not necessarily be the same as for locally-incorporated AIs issuing directly to the market. For example, Mainland G-SIBs typically issue bank debt to a domestic investor base. In addition, the investor base for Mainland G-SIBs may not be comparable to that for locally-incorporated AIs. These factors suggest that direct competition is unlikely to be a major factor;

(e) there is no requirement that such issuance be denominated in Hong Kong dollars, governed by Hong Kong law (subject to meeting the qualifying criterion in section 1(1)(k) of Schedule 1 to the LAC Rules) or issued in Hong Kong. As a result, the small number of locally-incorporated AIs who may be required to issue LAC would also have the option of seeking investors in global capital markets, not just local markets; and

(f) there is already a developed global investor base for these types of investment.

12. Notwithstanding the above, it is not possible to predict with certainty how market conditions will evolve in the future. Should there be unforeseen changes to market conditions that warrant exceptional treatment, the MA has the flexibility under the LAC Rules to address this. For example, the MA would be able to defer the classification of a resolution entity or material subsidiary under rules 5(1) and 6(1) of the LAC Rules, respectively. And in addition, it would be open to the MA to extend pursuant to rule 31 of the LAC Rules the implementation period beyond 24 months, should circumstances require.

(2) HKMA asked to consider some members' suggestion of allowing an AI to use part of its assets for meeting the capital adequacy ratio to fulfill the minimum external LAC requirement (if the AI is classified as a resolution entity) or minimum internal LAC requirement (if the AI is classified as a material subsidiary).

13. The constituent parts of external loss-absorbing capacity (for a resolution entity) or internal loss-absorbing capacity (for a material subsidiary) are set out in rules 37 and 39 (respectively). In each of these rules, the total capital of the relevant entity (subject to some caveats) is the first item that is identified as being included within external or internal loss-absorbing capacity. As such, the policy intention is precisely that, generally speaking, items that count towards meeting an entity's minimum regulatory capital requirements can also count towards meeting minimum LAC requirements.

14. For an illustration of this point in relation to external loss-absorbing capacity, see **Annex** (extracted from LAC COP). This clearly shows "Regulatory capital" (subject to footnote 5 in **Annex**) being included in the eligible items that count towards the external LAC requirement. It should, however, be noted that Common Equity Tier 1 that counts towards LAC requirements will not also be able to count towards regulatory capital buffers, also as shown in **Annex**. These buffers are designed to be able to be used by an AI on a going concern, pre-resolution basis. They therefore need to be separate from and

additional to LAC requirements, so that they can be used without an AI breaching its LAC requirements.

Financial Services and the Treasury Bureau
Hong Kong Monetary Authority
November 2018

Annex – Figure 1 from consultation draft of LAC Code of Practice chapter

			Regulatory capital requirement, external LAC requirement and regulatory capital buffer	Eligible items	Comments
		Regulatory capital buffer[1]	CCB + CCyB + HLA requirement[2]	CET1	The regulatory capital buffer is in addition to the external LAC requirement.
External LAC requirement	Resolution component ratio		Resolution component	External loss-absorbing capacity, i.e. regulatory capital[3] and certain non-capital liabilities	The calibration of the resolution component ratio is set out in rule 19.
	Capital component ratio[4]	**Regulatory capital requirement**	Pillar 2A	Regulatory capital[5]	The calibration of the capital component ratio is set out in rule 18.
			Pillar 1		

1 This illustration does not include the Pillar 2B buffer, which would be set off against the regulatory capital buffer.

2 The CCB is the capital conservation buffer; the CCyB is the countercyclical capital buffer; and the HLA requirement is the higher loss absorbency requirement applicable to domestic systemically-important banks.

3 Subject to eligibility criteria. See Schedule 1 of the LAC Rules.

4 In this illustration, the AI’s binding regulatory capital requirements are based on RWAs. In practice, they could be based on its exposure measure.

5 For illustrative purposes regulatory capital is shown here as contributing equally towards the regulatory capital requirements and the external LAC requirements. In practice, there are likely to be some minor differences – see rule 37 of the LAC Rules.