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

Response to questions raised by Legal Service Division of the Legislative Council Secretariat in the letter dated 6 November 2018

This paper sets out the Government's response to the questions raised by Legal Service Division of the Legislative Council ("LegCo") Secretariat in the letter dated 6 November 2018.

	Clarification sought from LegCo Secretariat	Response
1.	Please clarify whether under the Rules and the Principles on Loss-absorbing and Recapitalisation Capacity of Global Systemically Important Banks ("G-SIBs") in Resolution ("the TLAC Principles") issued by the Financial Stability Board ("FSB"), the LAC debt instruments issued by a Hong Kong resolution entity ("RE") or a Hong Kong material subsidiary ("MS") could be directly or indirectly used to absorb losses and provide recapitalisation resources to facilitate orderly resolution of a non-HK entity if the HK RE or HK MS is associated with such non-HK entity. And if that is the case, whether such arrangement would adversely affect the viability or capital adequacy of the HK RE or HK MS in the resolution of the non-HK entity.	Non-HK entities are outside the scope of the Rules, and cannot be classified as REs or MSs under the Rules. Hence, strictly speaking, the Rules do not envisage that LAC debt instruments issued by a HK RE or HK MS would be used to absorb losses and provide recapitalisation resources to facilitate orderly resolution of a non-HK entity under the Rules. LAC debt instruments issued by a HK RE or HK MS only provide direct loss-absorption and recapitalisation resources to the issuer (i.e. the HK RE or HK MS). Having said that, in a situation where, for example, the HK RE or HK MS has a subsidiary in a different jurisdiction that fails, the HK entity's investment in that subsidiary is likely to suffer losses. This may in turn require the imposition of losses on LAC debt instruments issued by the HK entity, in order to prevent the failure of the HK entity. However, the issuance of the LAC debt instruments would not adversely affect the viability or capital adequacy of the HK entity. On the contrary, the issuance of such instruments would facilitate the continued viability of the HK entity, notwithstanding the failure of its (non-HK) subsidiary.

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2.	Please confirm that by making the Rules, the Monetary Authority ("MA") has satisfied the requirements in principles (ii), (iii), (iv) and (v) of the TLAC Principles.	Confirmed. Each of the four referenced LAC Principles is considered in turn immediately below: TLAC Principle (ii): Authorities should determine a firm-specific Minimum Total Loss-absorbing Capacity ("TLAC") requirement for each G-SIB, which respects principles (iii), (iv) and (v). ● See responses under (iii), (iv) and (v) below. TLAC Principle (iii): Each G-SIB should be required to meet a firm-specific Minimum TLAC requirement that is at least equal to the common minimum agreed by the FSB. ● Rules 21(2), 22(2) and 32 specifically reference to the TLAC Term Sheet issued by the Financial Stability Board on 9 November 2015 ("TLAC term sheet"), and are designed to ensure that each RE or MS that is in a G-SIB group is required to meet LAC requirements under the Rules that correspond to the common minimum agreed by the FSB. TLAC Principle (iv): In setting firm-specific Minimum TLAC requirements, authorities should make appropriately prudent assumptions about losses incurred prior to resolution, as well as losses realised in the prudent valuation necessary to inform resolution actions. TLAC Principle (v): After the resolution transaction, to ensure continuity of critical functions, the entity or group of entities emerging from resolution must meet the conditions for authorisation, including any consolidated capital requirements, and be sufficiently well capitalised to command market

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		confidence. ● Rule 19 provides that the starting point for the resolution component ratio is that it be set equal to the capital component ratio. The rationale behind this is that it allows an entity to incur losses that fully deplete its regulatory capital requirements, and still have sufficient remaining LAC to allow it to again meet its authorization conditions – in particular, its regulatory capital requirements – in resolution. Rule 19(2) allows the MA to vary the resolution component ratio on a firm-specific basis if the MA is satisfied that it is prudent to do so.
3.	Principle (ix) of the TLAC Principles provides that entities must be allowed to utilize the Basel III buffers without entering resolution. Please confirm that nothing in the Rules would interfere with such principle.	In order for resolution to be initiated, the three conditions set out in section 25 of the Financial Institutions (Resolution) Ordinance (Cap. 628) ("FIRO") need to be met. The first of these is that the relevant entity has ceased, or is likely to cease, to be viable. In order to cease to be viable (as set out in section 5 of the FIRO), among other things an AI must contravene a condition with which it must comply, or fail to meet a criterion that it must meet or fail to perform a duty that it must perform for it to continue to be authorized. Utilization of the Basel III buffers does not constitute any such contravention, failure to meet or failure to perform. Nothing in the Rules interferes with this principle.
4.	In paragraph 10 of the LegCo Brief (File Ref: B&M/2/1/29/4/1C(2018)) dated 16 October 2018, it is mentioned that authorized institutions ("AIs") which issue LAC debt instruments should be subject to appropriate	Restrictions on the sale and marketing of external LAC debt instruments are set out in sub-sections 1(1)(b), (m)(ii) and (n) of Schedule 1 to the Rules. In addition, enhanced investor protection measures (including selling restrictions) on the sale and distribution of debt instruments with loss-absorption features and related products by Registered Institutions are set

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	restrictions in the sale and marketing of the instruments. Please clarify if such restrictions are already included or reflected in the Rules, or whether they will be imposed through other rules, codes or guidelines to be issued by the MA.	out by the Hong Kong Monetary Authority ("HKMA") in a circular issued on 30 October 2018.[1]
5.	Please clarify if the "Notes" in rule 2(1) under "resolution authority" ("RA"), rule 21(2), rule 22(2), rule 60 or rule 61 are intended to have legislative effect. If that is the case, why such "Note" is not included in the legislative text? If not, please explain the intended effect or purposes of each such "Note" in the Rules.	The use of notes in legislation is a widely accepted plain language drafting approach adopted by the Department of Justice which helps to provide signposts or other factual information[2]. For rules 21(2) and 22(2), the notes are used to provide the reader with factual information that is available. For rules 2, 60 and 61, the notes are used to draw the reader's attention to other relevant provisions in the Legislation.
6.	Please clarify whether by virtue of the meaning of "reviewable decision" in rule 2(1) and rule 63, an aggrieved entity may apply to the Resolvability Review Tribunal ("RRT") to review any decision made by the RA under the Rules.	No, this is not the case. Rule 2(1) defines "reviewable decision" to mean "a decision of the RA under these Rules that may be reviewed by the Resolvability Review Tribunal" (emphasis added). Then rule 20(9) provides that "[t]he following decisions of the resolution authority are reviewable decisions—

[1] See: https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2018/20181030e2.pdf.

[2] See paragraph 9.4.3 of the "Drafting Legislation in Hong Kong – A Guide to Styles & Practices" published by the Law Drafting Division, Department of Justice, January 2012.

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		(a) a decision to vary a resolution entity's resolution component ratio; (b) a decision not to vary a resolution entity's resolution component ratio following the resolution entity's application under rule 19(3)". And rule 62(5) provides that "[a] decision of the resolution authority to require an entity to take remedial action is a reviewable decision". Other than the above stated decisions, other decisions made by the RA under the Rules are not reviewable. Note further that any decision by the MA as RA is open to judicial review under the common law.
7.	Please clarify whether the RA would specify the grounds of its decision to identify a particular resolution strategy as the preferred resolution strategy ("PRS") covering the relevant entity in its notice to that entity under rule 3 and why no procedure is provided for that entity to make written representations to the RA to object to the term(s) or matter(s) specified in that notice	The LegCo has accepted, in the process of scrutinising the FIRO, that the decision of initiating resolution on a particular entity under the FIRO is not a decision that is reviewable by the RRT. This approach is in line with the requirements under the "Key Attributes of Effective Resolution Regimes for Financial Institutions" issued by the FSB in 2014[3] ("Key Attributes") and is also attributed to the urgency of the crisis situation and the nature of the decision. The Key Attribute 5.4 requires that resolution authorities should have the power to act with the necessary speed and flexibility and should not be subject to *ex ante* judicial action that could hinder the effective exercise of

[3] See: http://www.fsb.org/what-we-do/policy-development/effective-resolution-regimes-and-policies/key-attributes-of-effective-resolution-regimes-for-financial-institutions/.

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	by the RA. Please elaborate what factors would be taken into account by the RA when it identifies a particular resolution strategy to the relevant entity under rule 3.	resolution powers. Further, Key Attribute 5.5 requires that resolution regimes should not provide for channels through which the decisions of an RA could be reversed (where they have been carried out within the RA's legal powers in good faith) but instead provide for compensation if justified. It was also considered unnecessary to establish a specific channel of review of the RA's decision to initiate resolution, or apply stabilization options, under the resolution regime, given the availability of judicial review under the common law which also meets the requirements of the Key Attributes. Since the MA's decision on setting a PRS for a particular entity (albeit *ex ante* and presumptive) involves a decision on whether it is anticipated that a particular entity will or will not be resolved and if so, how this is to be done (i.e. which of the stabilization options is to be applied), it is therefore logical that such a decision should also not be subject to specific review by the RRT. With respect to the MA's decision on setting a PRS for a particular entity, section 13(1) of the FIRO empowers an RA of a within scope financial institution to devise strategies for securing an orderly resolution of the financial institution or a holding company of the financial institution. This primary statutory power does not include any procedure for the making of written representations by an affected entity, or for the setting out of grounds for the development of a resolution strategy, and so it would not be consistent to include any such procedure in the Rules. Further, setting a PRS for a particular entity is a decision that will be best made by the MA as RA who understands the institution, including how it can be resolved in an orderly manner, the industry and the wider economy of Hong Kong, and participates in the international dialogue of these matters.

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		Note further that Section 196 of the FIRO empowers the MA to issue a code of practice ("Code of Practice") about any matter relating to the functions given to the MA in such capacity by the FIRO. Under the HKMA's *Code of Practice: Resolution Planning - Core Information Requirements (CI-1)*, AIs with initial views on an appropriate resolution strategy may explain their thinking and elaborate on potential impediments to the strategy they have identified, and on how such impediments might be removed, as part of making a CI-1 submission to the MA at the outset of the resolution planning processes and before the MA makes a formal decision to set a PRS for an AI. On 19 October 2018 the MA issued for industry consultation a LAC chapter of the Code of Practice, to provide guidance on how the MA as RA for banking sector entities intends to exercise certain discretionary powers under the Rules, and on the operation of certain provisions of the Rules. Section 2 of the draft LAC Code of Practice chapter discusses the identification of PRSs under rule 3, and provides guidance on how the MA will make PRS determinations. Whether a PRS should be identified as covering any particular classifiable entity, and the nature of that strategy, will depend on the institution-specific circumstances of that entity, the outcome of the RA's resolution planning for that entity, and the RA's assessment of the likely consequences of the non-viability of the relevant AI. In practice, should an affected entity consider that any term(s) or matter(s) in a PRS is incorrect or unreasonable, and as a consequence the entity's LAC requirements under the Rules are higher than they otherwise would be, the

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		entity would be able to seek a reduction in its resolution component ratio under rule 19(3). Should the RA decline to agree to any such request, the affected entity would have the opportunity to make representations and, ultimately, to apply to the RRT for a review of the decision. Note further that it would also be open to an affected entity to seek judicial review in respect of the decision on the PRS under the common law.
8.	According to the relevant meaning under Rule 2(1), a "HK holding company" means an entity that is a holding company incorporated in HK of an AI incorporated in HK, but is not itself an AI. For the sake of clarity, please consider if it would be helpful to also refer to section 13 of the Companies Ordinance (Cap. 622) in that meaning.	Section 31(1) of the Interpretation and General Clauses Ordinance (Cap. 1) provides that "[w]here any Ordinance confers power to make any subsidiary legislation, expressions used in subsidiary legislation shall have the same meanings as in the Ordinance conferring the power; …". By reason of this section, since the term "holding company" has been defined by reference to section 13 of the Companies Ordinance in section 2(1) of the FIRO, this same term does not need to be defined in the same way again in the Rules.
9.	As a resolution entity's resolution component ratio is equal to its capital component ratio by virtue of rule 19(1), please clarify whether the variation of the capital component ratio under rule 18(4) automatically varies the resolution component ratio by the same amount.	Any variation of the capital component ratio under rule 18(4) would directly vary the resolution component ratio by the same amount, yes (subject to any exercise by the MA of the power to vary the resolution component ratio under rule 19(2)).
10.	It is noted that a resolution entity may apply under rule 19(3) to vary its resolution	There are two principal reasons why there is no procedure in rule 18 for an RE to apply for variation of its capital component ratio.

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	component ratio. Please explain why no procedure is provided in rule 18 for a resolution entity to apply for variation of its capital component ratio as well.	Firstly, the capital component ratio for any RE or MS reflects the minimum capital that the MA considers an AI should maintain as a going-concern and is set (as the "Total capital ratio") by the Banking (Capital) Rules (Cap. 155L) ("Capital Rules"). There is a mechanism under section 97F(7) of the Banking Ordinance (Cap. 155) for the MA to vary the Total capital ratio on an AI-specific basis. Should the MA seek to do so, an affected AI has the opportunity under the Banking Ordinance to make representations, and ultimately can apply to the Banking Review Tribunal for a review of the decision under section 101B of the Banking Ordinance. Secondly, whereas rule 19(5) empowers the MA to take into account a broad range of factors when determining whether it is prudent to vary a resolution component ratio, rule 18(4) only allows for the capital component ratio to be varied with reference to one specific factor, namely any difference in membership of the RE's LAC consolidation group and the capital consolidation group referred to earlier in rule 18(2) or 18(3). With the Rules only empowering the MA to take into account this one single factor in determining any change to the capital component ratio, allowing an affected entity to request a variation – which could only be determined with reference to this one specific factor – would add very little, if anything. Note further that as the capital component ratio affects the calibration of the resolution component ratio, if an affected entity is ultimately of the view the calibration of its resolution component ratio cannot be justified because the capital component ratio is too high, it is open to the entity to request a reduced resolution component ratio. Should the RA decline to agree to any such request, the affected entity would have the opportunity to make

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		representations and, ultimately, to apply to the RRT for a review of the RA's decision.
11.	Please explain why a RE or MS is required to meet the LAC requirement 24 months after being classified as a RE or MS under rules 28 and 29 respectively, whereas a RE or MS which is also a G-SIB or related to it, under rule 32(1) is obliged to meet the LAC requirement only 3 months after being classified as a RE or MS.	For REs and MSs that are not covered by rule 32, it is appropriate that the Rules provide for a substantial implementation period after classification, to allow such REs / MSs sufficient time to issue any necessary LAC debt instruments and make any other necessary changes to their funding structure, and to avoid a situation where all REs / MSs issue LAC in a narrow window, which may stretch the capacity of the market to absorb such issuances, thereby pushing up funding costs. Hence the Rules provide such REs and MSs with a period of 24 months after classification before they have to meet their LAC requirements. REs and MSs that are covered by rule 32 are part of banking groups that where designated as G-SIBs on or before 31 December 2015. As the FSB TLAC term sheet was issued in November 2015, such entities have already had more than three years to prepare for meeting minimum loss-absorbing capacity requirements. Further, section 21 of the TLAC term sheet requires such REs and MSs to meet minimum loss-absorbing capacity requirements from 2019. As such, it is appropriate and proportionate that the Rules require such entities to meet minimum LAC requirements within 3 months of classification.
12.	Please elaborate the relation and provide comparison between the minimum LAC ratios requirement in Part 4 of the Rules and the minimum capital adequacy ratio	Capital requirements are principally designed to ensure that AIs are robust to shocks, thereby improving their resilience and reducing the likelihood of their failure. LAC requirements, on the other hand, are expressly designed to ensure that should an AI – notwithstanding the capital adequacy regime –

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	requirement in section 3B of the Capital Rules for an AI.	reach the point of non-viability, it has sufficient loss-absorption and re-capitalisation resources to facilitate an orderly resolution. Capital generally counts towards both capital requirements and LAC requirements. As such, external LAC requirements can be regarded as complementing regulatory capital requirements. The external LAC requirement for a RE can be divided into two components, following its two basic functions: (a) the capital component of the RE's external LAC requirement, that is calibrated to allow it to absorb losses before resolution (but is not designed to also provide resources for a substantial recapitalisation in resolution). The existing capital adequacy framework for banking supervision in Hong Kong sets out the regulatory capital requirements that AIs are required to maintain. For an RE subject to a regulatory capital requirement in Hong Kong, its capital component ratio under the Rules will be equal to the minimum total capital ratio that it is required to maintain under the Capital Rules; and (b) the resolution component of the RE's external LAC requirement, that is calibrated to support the orderly resolution of a failing RE by ensuring the availability of external LAC that can bear loss ahead of other liabilities, and/or provide recapitalisation resources, following the use of one or more stabilization options in resolution. This ensures that

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		financial resources are available to allow an AI (or its transferee) to meet its authorization criteria[4] in resolution, while minimising the risk of having to use public funds. The relationship between external LAC requirements and capital requirements is illustrated in the diagram attached as **Annex** (extracted from the consultation draft of the LAC Code of Practice chapter).
13.	Principle (xi) of the TLAC Principles states that investors, creditors, counterparties, customers and depositors should have clarity about the order in which they will absorb losses in resolution. Please explain whether Part 6 of the Rules would adequately achieve that objective of principle (xi).	Yes, the intention is that Part 6 will adequately achieve this objective. The key provisions in this regard are those set out in rules 49 and 50, which require the disclosure of information on the priority that creditors of each RE and each MS would enjoy on the winding up of the relevant entity. As set out in the consultation draft of the LAC code of practice chapter, the MA is planning to issue for industry consultation drafts of disclosure templates in relation to the disclosure obligations in the Rules (rules 47-51). These templates will be developed from (but are not necessarily limited to) those set out in *Standards Pillar 3 disclosure requirements – consolidated and enhanced framework*[5] published in March 2017 by the Basel Committee on Banking Supervision.
14.	To avoid the misunderstanding that the reviewable decisions under rule 63 are restricted to only three types of decisions	There is no misunderstanding. "Reviewable decisions" under the Rules are only those decisions specifically identified as such in the Rules, i.e. a decision to vary a resolution component ratio (rule 20(9)), a decision not to vary a

[4] Insofar as they relate to its regulatory capital requirement.

[5] See: https://www.bis.org/bcbs/publ/d400.pdf.

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	made by the RA that are referred to in rule 63(6), please consider if it would improve the clarity of the rule by adding "without limiting subsection (1)" before "In this rule" in rule 63(6).	resolution component ratio (rule 20(9)), and a decision to require an entity to take remedial action (rule 62(5)). Note further that any decision by the MA as RA is open to judicial review under the common law.
15.	According to section 10 of the FSB's TLAC term sheet, TLAC-eligible instruments must not include, among other things, liabilities arising from derivatives and debt instruments with derivative-like features. Please confirm that the derivative related criteria mentioned in the TLAC term sheet above are adequately reflected in the qualifying criteria for external LAC debt instruments and internal LAC debt instruments in Schedules 1 and 2 to the Rules, respectively.	Confirmed. Schedule 1 section 1(1)(g) and Schedule 2 section 1(1)(f) specifically require that in order to be eligible as an external LAC instrument or internal LAC instrument, respectively, cashflows arising from the instrument must not change by reference to the value of, or any fluctuation in the value of, one or more than one underlying asset, index, financial instrument, rate or thing designated in the instrument and the instrument does not otherwise have derivative-linked features.

Financial Services and the Treasury Bureau
Hong Kong Monetary Authority
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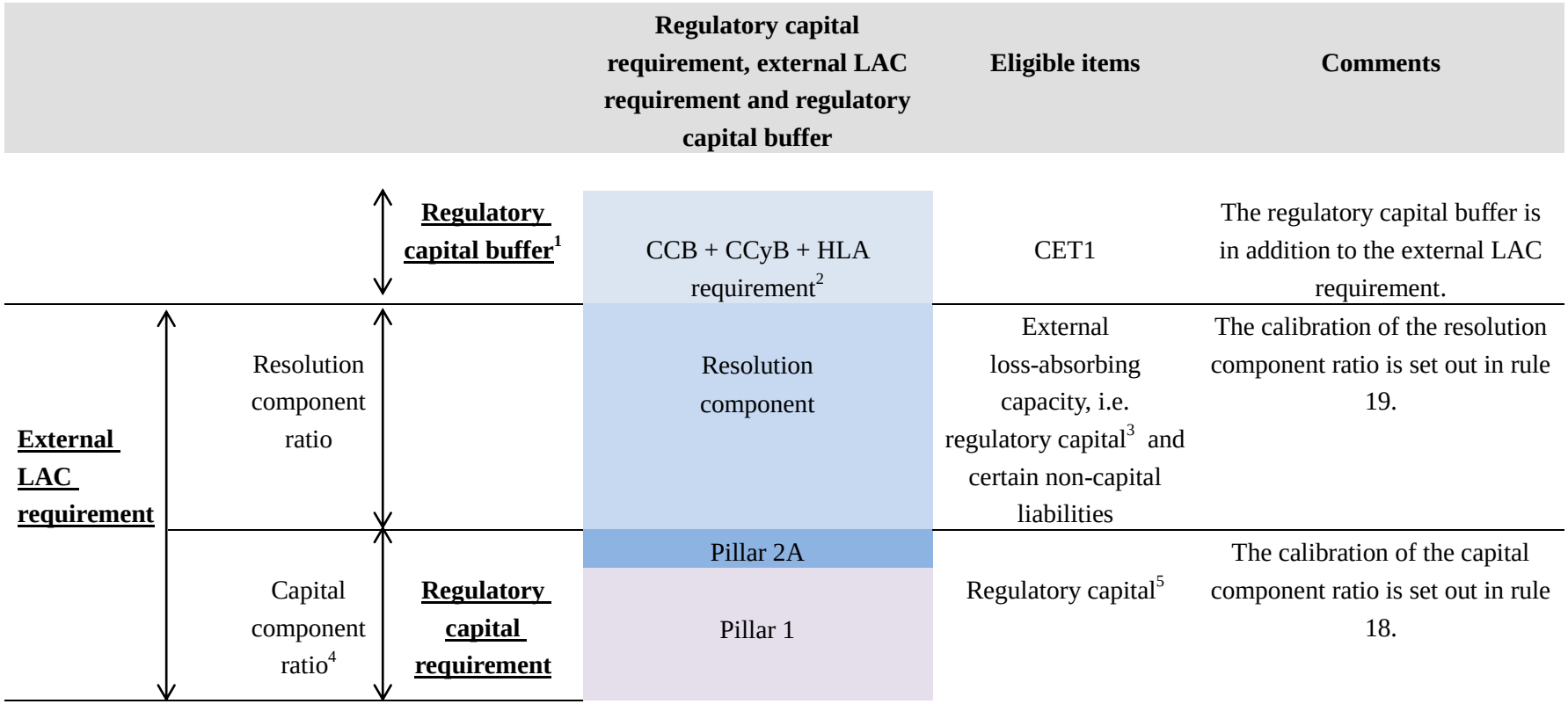
Annex – Figure 1 from consultation draft of LAC Code of Practice chapter



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 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 Rules.