

**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 23 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 ("Rules") at the subcommittee meeting on 23 November 2018.

2. Key points are summarised as follows –

- (a) Authorised institutions ("AIs") in scope: No AI will be automatically subject to loss-absorbing capacity ("LAC") requirements under the Rules or LAC Code of Practice chapter<sup>1</sup>. It is only where the failure of an AI is expected to pose a risk to financial stability, including to depositors, that it would be subject to LAC requirements;
- (b) Threshold: The Monetary Authority ("MA") as resolution authority for AIs ("RA") intends to increase the total consolidated asset threshold from the currently proposed HKD 150 billion to HKD 300 billion when finalising the LAC Code of Practice chapter;
- (c) Timeline: The RA confirms that, excluding non-Chinese global systemically important banks ("G-SIBs"), the earliest at which any domestic systemically important bank ("D-SIB") will be required to meet LAC requirements is 1 January 2022, and the earliest at which any non-D-SIB will be required to meet LAC requirements is 1 January 2023. Where the RA determines that an entity will not be able to meet its LAC requirements to this timetable, the RA has the flexibility to consider allowing a longer implementation period on a case by case basis;
- (d) Minimum debt requirement: Following ongoing dialogue with industry, the RA proposes to permit eligible Additional Tier 1 ("AT1") capital instruments to count towards the minimum debt requirement, whether accounted for as debt or equity; and

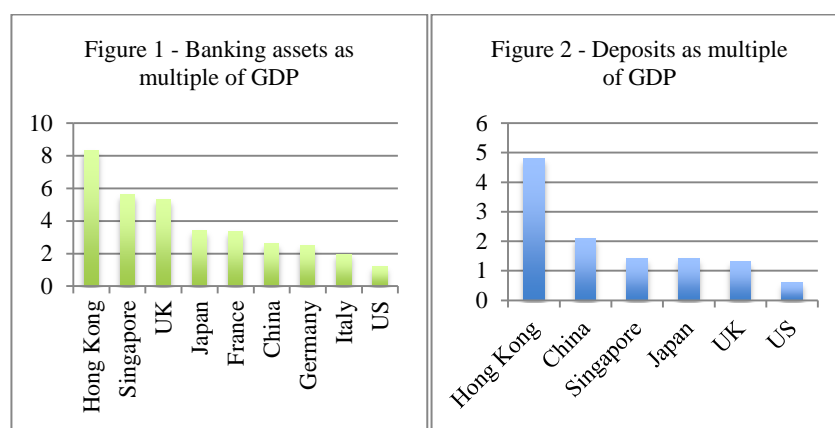
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<sup>1</sup> The draft Code of Practice chapter in relation to the Rules was published for consultation on 19 October 2018. The consultation will close on 3 December 2018.

- (e) Review of LAC Code of Practice chapter: The RA confirms that the RA intends to undertake a review of the forthcoming LAC Code of Practice chapter no later than three years after its introduction.

**(1) The Administration and the Hong Kong Monetary Authority (“HKMA”) are requested to:**

- (a) ***provide a comparison of the coverage of the Rules under the Hong Kong regime with other major international financial markets, including whether an entity which is neither a G-SIB nor a D-SIB will be subject to LAC requirements***



3. When considering the approach that different jurisdictions have taken to implementing loss-absorbing capacity requirements, it is informative to consider the size of the banking sector relative to that of the economy in each jurisdiction. Figure 1<sup>2</sup> shows the ratio of total banking sector assets to GDP for a number of international financial markets, which measures the degree of exposure an economy has to its banking sector. Figure 2<sup>3</sup> shows the ratio of deposits to GDP. On both measures, Hong Kong is significantly ahead of all other major international financial markets. This supports Hong Kong taking appropriate measures to improve bank resolvability that maintain financial stability and ensure the continued performance of critical financial functions – in particular, deposit-taking. Consistent with this, Table 1 shows that the proposed scope of AIs subject to the Rules is broadly aligned with comparable international financial market jurisdictions including European Banking Union jurisdictions, the UK and the US.

<sup>2</sup> Data from: <https://www.statista.com/>.

<sup>3</sup> Data from: [http://www.fsd.org.hk/sites/default/files/Overview%20of%20HK%20Financial%20Services%20Industry\\_E.pdf](http://www.fsd.org.hk/sites/default/files/Overview%20of%20HK%20Financial%20Services%20Industry_E.pdf).

Table 1 – implementation progress of developing LAC requirements with respect to G-SIBs, D-SIBs and others

Region	Scope of LAC requirements	Non-G-SIBs / D-SIBs in scope of requirements ?
Hong Kong	All AIs were brought in scope of the Financial Institutions (Resolution) Ordinance (Cap. 628) (“FIRO”) when it came into force in July 2017. However, under the Rules, an AI can only be classified as a resolution entity if its preferred resolution strategy involves the application of resolution tools under the FIRO. Resolution tools can only be applied under the FIRO where the failure of an AI would pose a risk to financial stability. More generally, the Rules are designed to ensure that <b>it is <u>only</u> where the failure of an AI is expected to pose a risk to financial stability, including to depositors, that it would be subject to LAC requirements.</b>	Yes
Australia	Under a proposal published on 8 November 2018, all D-SIBs must meet additional LAC requirements through higher capital requirements. <b>Other authorised deposit-taking institutions will be assessed individually</b> in light of their resolution strategies.	Yes
European Union	The Bank Recovery and Resolution Directive (“BRRD”) requires Member States to ensure that institutions meet minimum requirements on own funds and eligible liabilities (“MREL”, a measure of loss-absorbing capacity). <sup>4</sup> <b>All credit institutions are in scope</b> , with resolution authorities to ensure that the MREL of each institution is sufficient to ensure that it can be resolved in a way that meets the resolution objectives, which include protecting public funds and depositors. For example,	Yes

<sup>4</sup> See: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02014L0059-20171228&from=EN>.

Region	Scope of LAC requirements	Non-G-SIBs / D-SIBs in scope of requirements ?
	Sweden has set MREL requirements for ten institutions, with the requirements ranging from 19.3% to over 52.1% of risk-weighted assets (“RWAs”). <sup>5</sup>	
UK	In line with the BRRD, the UK has set indicative MREL requirements <b>not only for G-SIBs and D-SIBs but also for other firms.</b> All relevant firms need to start meeting MREL requirements from 1 January 2020. The indicative MREL requirements (including capital buffers) range from 26.2% to 30.4% of RWAs. <sup>6</sup> The smallest firm subject to MREL requirements has total consolidated assets of around GBP 15 billion (around HKD 150 billion).	Yes
US	Final Total Loss-Absorbing Capacity (“TLAC”) requirements apply to <b>G-SIBs.</b> <sup>7</sup> The resolution of other bank failures are typically funded by the Federal Deposit Insurance Corporation (“FDIC”).	No, but FDIC funds available.
Japan	In scope AIs <b>include G-SIBs and D-SIBs.</b> <sup>8</sup>	No
Mainland	Imposition of TLAC requirements pending.	N/A
Singapore	Imposition of TLAC requirements pending.	N/A

<sup>5</sup> See: <https://www.riksdagen.se/en/press/press-releases/2017/requirements-set-and-plans-established-for-how-swedish-banks-are-to-be-managed-in-a-crisis/>.

<sup>6</sup> See: <https://www.bankofengland.co.uk/-/media/boe/files/financial-stability/resolution/indicative-firm-mrels-2018>.

<sup>7</sup> See: <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20161215a1.pdf>.

<sup>8</sup> See: <https://www.fsa.go.jp/en/news/2018/20180413/01.pdf>.

***(b) consider some members' suggestion that the Rules should provide that only G-SIBs and D-SIBs will be subject to LAC requirements***

4. If a bank fails, the authorities are likely to be faced with three options: (i) using public funds for a bail-out; (ii) allowing the bank to go into insolvency; and (iii) implementing an orderly resolution that minimises the risk to public funds.

5. A key objective of making banks resolvable is to **avoid publicly funded bail-outs**, and in using his powers under the FIRO, RA is **statutorily required** to, among other things, have regard to **protecting public money**.<sup>9</sup> This approach **protects the interests of Hong Kong taxpayers**.

6. When a bank goes into insolvency, all depositors will lose access to their funds and their accounts for some period of time, pending a pay-out under the Deposit Protection Scheme ("DPS"). According to the statistics of the Hong Kong Deposit Protection Board, about 90% of depositors of the DPS member banks are fully protected by the DPS. However, depositors whose funds are not fully covered by the DPS could lose access to at least part of their funds for several years, during the insolvency process. There are many non-G-SIBs and non-D-SIBs that have **hundreds of thousands of depositors, and tens of thousands of depositors who are not fully covered by the DPS**. The RA's view is that should a significant number of depositors lose access to at least some of their funds for a long period of time (potentially several years), this could undermine the general confidence of participants in the financial market in Hong Kong, and give rise to contagion within the financial system of Hong Kong. In using his powers under the FIRO, the RA is statutorily required to, among other things, have regard to **maintaining financial stability**. The RA's *ex ante* view is therefore that allowing banks at this scale to go into insolvency would not be a realistic option. This approach **protects the interests of Hong Kong depositors**.

7. The only realistic alternative to a publicly funded bail-out or insolvency is an orderly resolution that minimises the risk to public funds. This is only achievable if on failure a bank has sufficient LAC to provide the financial resources to support such a resolution. For this reason, the RA's view is that **restricting LAC requirements to G-SIBs and D-SIBs**

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<sup>9</sup> Subject to also meeting the resolution objectives set out in section 8(1)(a), (b) and (c) of the FIRO.

would mean that there would be banks that on failure would be likely to either need publicly funded bail-outs, or to go into insolvency with potentially significantly adverse implications for financial stability generally, and for depositors in particular. This would allow some banks to avoid LAC requirements, but **would undermine the resolution objectives set out in the FIRO, and would lead to increased risks for Hong Kong taxpayers and depositors.**

8. The draft LAC Code of Practice chapter proposes an indicative threshold of HKD 150 billion for AIs to be prioritised for resolution planning but it does not imply that an AI will automatically be required to meet LAC requirements (and vice versa). The RA recognises that the calibration of threshold is a matter of judgement, and that a number of Members have expressed concern that this threshold may have a disproportionate impact on some smaller AIs, with adverse cost and competitiveness implications. In light of Members' feedback to date, the RA intends to **increase the total consolidated asset threshold from the currently proposed HKD 150 billion to HKD 300 billion in the final version of the LAC Code of Practice chapter.** Following this, the RA will also give consideration to how the resulting increased risk to public funds can be appropriately mitigated or managed by other means.

*(c) provide written responses on views raised and submissions made by deputations*

9. A number of points made in the views raised and submissions made by deputations are covered off elsewhere in this paper. Additional responses are set out here.

10. In response to comments raised by Chong Hing Bank Limited, Dah Sing Bank, Limited, Fubon Bank (Hong Kong) Limited, Public Bank (Hong Kong) Limited and Shanghai Commercial Bank Limited, the following points are made:

- (a) The RA does not have “unfettered discretion” in determining whether an AI can be classified a resolution entity. The RA can only make this classification if the preferred resolution strategy for the AI involves the application of resolution tools under the FIRO. **This will only happen where the failure of an AI is expected to pose a risk to financial stability, including to depositors, in Hong Kong;**

- (b) The proposal is made that the threshold is set at 2% of total banking assets in Hong Kong. However, “total banking assets” is not a reliable denominator to use when assessing the potential risk the failure of an AI may pose to financial stability, because the ratio of banking assets to GDP varies significantly between jurisdictions, and is much higher in Hong Kong than in any other major international financial market (see Figure 1). A better denominator would be GDP. **HKD 300 billion represents more than 10% of Hong Kong’s GDP**, a substantial threshold. By comparison, the assets of the smallest institutions covered by minimum LAC requirements in Japan, the UK and the US constitute 7.3%, 0.75% and 1.3% of their GDP respectively; and
- (c) The proposal is made that banks below the 2% threshold referred to above should not be subject to LAC requirements, because of the impact meeting LAC requirements would have on their profitability and competitiveness. It is in order to ensure that LAC requirements are not unduly onerous that the Rules allow for flexibility, including **to reduce LAC requirements for smaller banks, and to extend the implementation schedule**. Setting the threshold as high as 2% of banking assets brings risks, not least as all AIs with total consolidated assets above HKD 300 billion have around 200,000 depositors, or more.

11. In response to comments raised by OCBC Wing Hang Bank Limited, the following points are made:

- (a) The proposal is made that the threshold is set at 3% of total banking assets. See paragraph 10b above; and
- (b) The point is made that other resolution tools apart from bail-in are available, which mitigates the need for LAC requirements. As set out in the draft LAC Code of Practice chapter, where other resolution tools could apply, this could indeed lead directly **to a reduced LAC requirement for an AI**.

12. In response to comments raised by The Bank of East Asia, Limited, the following points are made:

- (a) The proposal is made that AT1 capital instruments should count towards the minimum debt requirement even where accounted

for as equity. Following ongoing dialogue with industry, the RA proposes to permit eligible AT1 capital instruments to count towards the minimum debt requirement, **whether accounted for as debt or equity**; and

- (b) The proposal is made that the implementation of LAC requirements be phased in from 2022. This is in line with the RA's intention – see paragraph 20 below on how an individual AI's circumstances can be taken into account by the RA as part of bilateral resolution planning.

13. In response to comments raised by CMB Wing Lung Bank Limited, the following points are made:

- (a) The proposal is made that the threshold is set at 2.5% of total banking assets. See paragraph 10b above; and
- (b) The proposal is made that the RA implement LAC requirements on Chinese banks in line with the timeline of their parent banks' home regulator. In imposing LAC requirements in relation to any subsidiaries in Hong Kong of Chinese AIs – and indeed, any other subsidiaries of any AIs headquartered outside Hong Kong – the RA will seek to consult and co-ordinate with the relevant home authorities. In the case of Chinese AIs, the RA will therefore continue to liaise with the Chinese authorities. The goal will be to ensure that the imposition of LAC requirements on any relevant Hong Kong subsidiaries is co-ordinated with the Chinese authorities.

14. In response to comments raised by Bank of China (Hong Kong) Limited, the following points are made:

- (a) The proposal is made that the RA implements LAC requirements on Chinese banks in line with the timeline of their parent banks' home regulator. See paragraph 13b above; and
- (b) The proposal is made the external LAC requirements be calibrated at 18%. Under the Rules, the starting point for external LAC requirements is twice regulatory capital requirements. For most AIs this will be close to 18%, but has the advantage that by taking into account an AI's specific capital requirements, it will better reflect each AI's individual circumstances.



15. Nanyang Commercial Bank, Limited raised the proposal that LAC requirements should be applied at a combined or solo level, not consolidated. However, the underlying rationale behind calibrating LAC requirements at twice minimum regulatory capital requirements is that an AI should be able to suffer losses that fully deplete its minimum regulatory capital requirement, and still have sufficient resources to be re-capitalised in resolution. As an AI will continue to be subject to capital requirements in resolution on a consolidated basis, it is important that LAC requirements also apply on this basis.

*(2) The Administration and HKMA are requested to consider some members' suggestion that the following matters should be prescribed in the Rules instead of in a Code of Practice on the LAC requirements developed by HKMA:*

*(a) the asset threshold for AIs to be covered under the Rules and hence required to meet the LAC requirements*

16. The RA has considered whether the asset threshold for AIs that may be required to meet LAC requirements should be set out in the Rules, but has concluded that this would not be appropriate. In particular, it would mean that AIs above and below the line would be **automatically** in or out of scope. This would risk including AIs that should not be included, and excluding those that should be. It is important that there is enough flexibility to allow for institution-specific characteristics to be taken into account. Because the asset threshold is indicative only, it needs to be in the LAC Code of Practice chapter, not the Rules. Putting the threshold in the Rules would make it **inflexible**, and would deny AIs above the threshold the opportunity to demonstrate to the RA that their failure could be managed via insolvency, so that they need not be subject to LAC requirements. In addition, this would make it **more cumbersome to review and adjust over time** (for example, to take into account economic growth and inflation). The RA confirms that **the RA intends to undertake a review of the forthcoming LAC Code of Practice chapter no later than three years after its introduction.**

*(b) the factors to be considered by the MA in deciding the classification of an AI as a resolution entity or a material subsidiary (i.e. an in-scope AI)*

17. Under the Rules, an AI can only be classified as a resolution entity if its preferred resolution strategy involves the application of

resolution tools under the FIRO. Resolution tools can only be applied under the FIRO where the failure of an AI would pose a risk to financial stability. Thus the Rules are already designed to ensure that it is **only those AIs whose failure is expected to pose a risk to financial stability, including to depositors, in Hong Kong that could be classified as resolution entities.**

18. The Rules already provide that **unless an AI is in a resolution group covered by a resolution strategy, it cannot be classified as a material subsidiary.** Rule 6(1) sets out further criteria that need to be met before an AI can be classified as a material subsidiary.

*(c) the timeline for in-scope AIs to comply with the LAC requirements, and the mechanism for MA to defer the implementation schedule of a particular in-scope AI*

19. Under the Rules, the implementation schedule is already set out, at **24 months from classification.**<sup>10</sup> In addition, the mechanism for further deferral for a particular in-scope AI is also already included in the Rules. A substantial majority of LAC debt instruments to be issued by Hong Kong AIs under the Rules would be issued internally, to AIs' foreign parent companies.

20. In addition, the RA confirms that the earliest at which any D-SIB (other than a non-Chinese G-SIB) will be required to meet LAC requirements is **1 January 2022**, and the earliest at which any non-D-SIB will be required to meet LAC requirements is **1 January 2023**. Where the RA determines that an entity will not be able to meet its LAC requirements to this timetable, the RA has the flexibility to consider allowing a longer implementation period on a case by case basis.

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

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<sup>10</sup> Excluding non-Chinese G-SIBs, which can be required to meet LAC requirements within 3 months of classification.