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An Effective Resolution Regime for Financial Institutions in Hong Kong

Financial Institutions (Resolution) Ordinance (Chapter 628)

Rules on Loss-Absorbing Capacity Requirements for Authorized Institutions

HONG KONG MONETARY AUTHORITY
香港金融管理局

ABOUT THIS DOCUMENT

(i) This consultation paper sets out the intended approach of the Hong Kong Monetary Authority (**HKMA**) for making rules under section 19 of the Financial Institutions (Resolution) Ordinance (Cap. 628) (**FIRO**) prescribing loss-absorbing capacity requirements for authorized institutions (**AI LAC Rules**). After considering the submissions received in response to this consultation paper, the HKMA intends to further refine its proposals as appropriate, with a view to introducing the AI LAC Rules into the Legislative Council for negative vetting in 2018.

(ii) A list of the questions raised in this consultation is set out for ease of reference in Annex A. Interested parties are invited to submit comments on these and any relevant or related matters that may have a significant impact on the proposals in this consultation paper.

(iii) Comments should be submitted in writing no later than 16 March 2018 by any one of the following means:

By mail to: Consultation on AI LAC Rules
Resolution Office
Hong Kong Monetary Authority
55th Floor
Two International Finance Centre
8 Finance Street, Central, Hong Kong

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(iv) Any person submitting comments on behalf of any organisation is requested to provide details of the organisation they represent. Please note that the names of respondents, their affiliation(s) and the contents of their submissions may be published or reproduced on the website of the HKMA and may be referred to in other documents. If you do not wish your name, affiliation(s) and/or submissions to be disclosed, please state this clearly when making your submissions. An automatic confidentiality disclaimer generated by your IT system on an e-mail will not, of itself, be regarded as indicating a wish for non-disclosure.

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(vii) Terms adopted in this consultation paper are used in a generic sense to reflect the concepts underpinning the proposals in question, unless the context otherwise provides. When the relevant proposals are implemented in the form of legislation, it is possible that these terms may be modified or replaced in order to better reflect the precise policy intent of the proposals in the law or to aid or address issues relating to the legal interpretation of such terms when used in the law.

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ABBREVIATIONS

AFC	Asian Financial Crisis
AI	Authorized institution
AT1	Additional tier 1
BCBS	Basel Committee on Banking Supervision
BCR	Banking (Capital) Rules (Cap. 155L)
BDR	Banking (Disclosure) Rules (Cap. 155M)
BO	Banking Ordinance (Cap. 155)
BRRD	EU Bank Recovery and Resolution Directive
CB ratio	Capital conservation buffer ratio
CCyB ratio	Countercyclical capital buffer ratio
CET1	Common equity tier 1
CFF	Critical financial function
CoP	Code of Practice
EME	Emerging market economy
FI	Financial institution
FIRO	Financial Institutions (Resolution) Ordinance (Cap. 628)
FSB	Financial Stability Board
G-SIB	Global systemically-important bank
HKMA	Hong Kong Monetary Authority
HLA ratio	Higher loss absorbency ratio
IRO	Inland Revenue Ordinance (Cap. 112)
LAC	Loss-absorbing capacity
MA	Monetary Authority
MREL	Minimum requirement for own funds and eligible liabilities
NCWOL	No creditor worse off than in liquidation
PONV	Point of non-viability
RCS	Regulatory capital security
RWAs	Risk-weighted assets
SDO	Stamp Duty Ordinance (Cap. 117)
T2	Tier 2
TLAC	Total loss-absorbing capacity

EXECUTIVE SUMMARY

Banks are not like normal companies. They provide important financial services to businesses and to the general public, who depend on continuous access to those services. Consequently, should a bank fail, putting it into insolvency may not be a realistic option. Doing so would lead to the immediate cessation of the provision of financial services and could threaten disruption of the financial system. The resulting risk of contagion may undermine other financial institutions (**FIs**) and damage the wider economy. In the past, various governments round the world have used public funds to bail out failing banks in order to avoid these consequences.

A new regime is needed that provides for the failure of a bank to be managed in an orderly way that allows for the functions of the bank to continue to be performed, avoids disruption to financial stability, and minimises the risk to public funds.[1] An important element of such a regime is ensuring that should a bank fail, where necessary it has sufficient financial resources of its own to absorb losses and be re-capitalised, thereby restoring it to viability. It is its investors who should bear the cost of failure, not the public purse.

Bank failure in Hong Kong is rare, but it has happened in the past and it may happen again in the future. Relying on public funds to bail out banks that get into trouble incentivises excessive risk-taking, and is unfair. Requiring banks to maintain additional financial resources does come at a cost, but the overall benefit to society and the wider economy of having safer banks is many times greater than that cost. Improved financial stability facilitates economic growth from which everyone benefits, including the banking sector. This consultation paper sets out proposals for rules to impose requirements on banks to make sure they have the resources to facilitate orderly failure, should that become necessary.

Set out immediately below are brief summaries of each of Parts I–XII of this consultation paper. These summaries are high level, reflect proposals only (not settled policy) and do not contain all the relevant details. For more details readers should refer to the relevant Part in the main body of the paper.

Part I: Introduction explains why resolution is important, and outlines the steps that have been taken in Hong Kong to put in place a cross-sectoral resolution regime for

[1] See an article on this topic by Norman Chan, Chief Executive of the HKMA: *Bank Resolution Regime - A Newly Established Line of Defence for Banking Stability*.

FIs that is aligned with internationally-agreed attributes for resolution regimes issued by the Financial Stability Board (**FSB**). Under this regime, established under the FIRO, the Monetary Authority (**MA**) is the resolution authority in respect of authorized institutions (**AIs**). Subject to certain conditions, the MA can initiate the resolution of a failing AI by applying resolution tools. These tools include a bail-in stabilization option, which allows the MA to write down or convert into equity certain liabilities of an AI in resolution, thereby restoring it to viability and various other stabilization options which allow the MA to transfer assets and liabilities of, and securities issued by, an AI in resolution. AIs need to have sufficient loss-absorbing capacity (**LAC**) to facilitate the orderly use of stabilization options if they fail. LAC comprises regulatory capital and certain other liabilities that can readily bear loss in resolution.

Part II: Capital and LAC introduces proposals for two types of LAC requirement – external and internal. The FIRO empowers the MA to devise **resolution strategies** to secure the orderly resolution of an AI. It is proposed that where a resolution strategy envisages the application of a stabilization option to a Hong Kong incorporated entity, the MA can classify that entity as a **resolution entity**, following which it will be subject under the AI LAC Rules to an **external LAC requirement**. Small AIs which are not expected to cause systemic risk in the event of failure are unlikely to be classified as resolution entities. The MA can group together a resolution entity and one or more of its subsidiaries as a **resolution group**, and can classify one or more of its Hong Kong incorporated subsidiaries as a **material subsidiary**. It is proposed that a material subsidiary will be subject under the AI LAC Rules to an **internal LAC requirement**. External LAC is LAC issued by a resolution entity to an entity outside its resolution group. Internal LAC is LAC issued by a material subsidiary to the resolution entity in its resolution group (directly or indirectly). The most important difference between external LAC and internal LAC is that the latter can be written down or converted into equity without the issuing entity going into resolution.

Part III: External LAC requirement describes proposals for calibrating a resolution entity's external LAC requirement. It is proposed that a resolution entity's external LAC requirement be calculated as the product of (i) the sum of its **capital component ratio** and its **resolution component ratio**; and (ii) the entity's risk-weighted assets (**RWAs**) (unless its capital position is constrained by the leverage ratio requirement, in which case a measure of its total assets is used instead of RWAs). The capital component ratio is (primarily) calibrated to absorb losses pre-resolution. For an AI,

it is proposed that the capital component ratio be fixed at a level equal to the AI's minimum total capital ratio (or 3%, if its capital position is constrained by the leverage ratio requirement). The resolution component ratio is calibrated to support the orderly resolution of a failed resolution entity. It is proposed that the AI LAC Rules will set the resolution component ratio equal to the capital component ratio, so that an AI can experience losses that wipe out its regulatory capital requirement and still have sufficient external LAC available to be bailed in to fully recapitalise the AI in resolution. But the MA will have the power to vary the resolution component ratio (up or down), where he judges it prudent to do so. Any exercise of this power will in particular take into account the relevant preferred resolution strategy.

Part IV: Internal LAC requirement describes proposals for calibrating a material subsidiary's internal LAC requirement. A material subsidiary's internal LAC requirement is scaled in the range of 75% to 100% (the **internal LAC scalar**) of what that entity's external LAC requirement would have been if it had been a resolution entity. A material subsidiary's internal LAC requirement is therefore the product of (i) the sum of the capital component ratio and the resolution component ratio that would have applied if it had been a resolution entity; (ii) the entity's RWAs (unless its capital position is constrained by the leverage ratio requirement, in which case a measure of its total assets is used instead of RWAs); and (iii) the internal LAC scalar. Internal LAC is particularly relevant for a cross-border group whose resolution strategy envisages the application of resolution tools to one entity in the group only, in its home jurisdiction (i.e. there is just one resolution entity in the group). A material subsidiary in a different jurisdiction can issue internal LAC to the resolution entity in the home jurisdiction, and then if necessary that internal LAC can be written down or converted into equity, thereby passing losses up to the resolution entity and restoring the material subsidiary to viability without it having to go into resolution itself.

Part V: Timeline for meeting LAC requirements sets out proposals for when LAC requirements need to be met. It is proposed that once the MA has classified an entity as a resolution entity, that resolution entity must meet its external LAC requirement within 24 months. Similarly, once the MA has classified an entity as a material subsidiary, that material subsidiary must meet its internal LAC requirement within 24 months. Global systemically-important banks (**G-SIBs**) may have to meet LAC requirements more quickly, in order to meet timelines set by the FSB for G-SIBs.

It is proposed that LAC requirements must be met on a consolidated basis and for AIs also on a solo basis.

Part VI: LAC eligibility criteria identifies which items can qualify as external LAC or internal LAC. Generally speaking, external LAC consists of regulatory capital, and debt instruments that meet certain criteria, including having a remaining contractual maturity of at least one year, being subordinated to depositors and general creditors, and being clearly subject to the application of resolution powers under the FIRO. Broadly the same criteria need to be met if an item is to qualify as internal LAC. In addition, the contractual terms of internal LAC need to specify that it is subject to write down and/or conversion into equity upon notification from the MA that the issuing entity has ceased, or is likely to cease, to be viable. Where internal LAC is issued cross-border, authorities in both jurisdictions should be involved in the decision to trigger internal LAC.

Part VII: Restrictions on sale and distribution of LAC debt instruments addresses concerns that the complex nature of **LAC debt instruments** (i.e. capital instruments in legal debt form and instruments that constitute non-capital LAC) makes them unsuitable as investments for retail investors. In particular, the hybrid nature of LAC debt instruments – debt-like on issue, but with equity-like loss-absorbing characteristics – makes it difficult to assess the likelihood and quantum of potential losses. It is proposed that appropriate restrictions be placed on the sale and marketing of LAC debt instruments, and in particular that they can be issued and distributed to 'Professional Investors' only.

Part VIII: Treatment of LAC investments sets out proposals to mitigate the risks that may arise when an AI invests in LAC issued by another AI. When this happens, should the issuing AI fail and its LAC bear loss, the LAC can act as a vehicle for contagion, spreading losses from one AI to another. It is proposed that where an AI invests in external LAC issued by an entity in a different resolution group, that investment should be deducted from the holder's capital. Where an entity holds internal LAC issued by another entity in its resolution group, it is proposed that to the extent that that holding is not already deducted from the holder's capital under the capital deductions framework, it should be deducted from the holder's LAC issuance.

Part IX: Minimum debt requirement reflects the FSB's recommendation that at least one-third of a LAC requirement should be constituted by LAC debt (as opposed to common equity tier 1 (**CET1**)). CET1 automatically absorbs loss on an ongoing basis.

As such, it is typically regarded as the 'best' form of capital. However, a consequence of this is that by the time an AI reaches the point of failure, it is likely that much of its CET1 will have been depleted. LAC debt is not at risk of depletion before failure, and provides a fixed quantity of financial resources that can support an orderly resolution. It is proposed that any entity that is subject to a LAC requirement must meet at least one-third of it with LAC debt, with the MA having the power to vary this requirement down.

Part X: Reporting, disclosure, procedure and reviews sets out proposals that Hong Kong incorporated AIs and Hong Kong incorporated holding companies of AIs be required to disclose to the general public details of their external and internal LAC issuance. In addition, it is proposed that for certain determinations that the MA can make under the AI LAC Rules, the MA must first serve a draft notice of determination on the affected entity, and allow a period for representations to be made. Relevant determinations include classifying an entity as a resolution entity or a material subsidiary, varying a resolution component ratio and setting an internal LAC scalar at a level above 75%. Furthermore, following the service of a final notice of determination on a number of key areas, an affected entity can seek a review by the Resolvability Review Tribunal established under the FIRO.

Part XI: Tax treatment of LAC debt instruments addresses the issue that, because of the loss-absorbing characteristics of LAC debt instruments, they may not be treated as debt for tax purposes. In this case, interest payments on LAC debt instruments would not be deductible from taxable profits, leading to higher tax liabilities for entities required to issue LAC. It was because of this issue that the Inland Revenue Ordinance (Cap. 112) (**IRO**) was amended in 2016 to allow (non-CET1) capital instruments issued by AIs to be treated as debt for tax purposes. Based on similar principles, it is now proposed to make further amendments to the IRO to also allow non-capital LAC debt instruments issued by AIs, and all LAC debt instruments issued by Hong Kong incorporated clean holding companies of AIs, to be treated as debt for tax purposes (subject to certain conditions).

Part XII: Impact of LAC requirements considers two aspects of the effect of imposing LAC requirements on AIs. Firstly, it considers the macroeconomic impact on the economy of Hong Kong as a whole. Imposing LAC requirements on AIs benefits the wider Hong Kong economy by reducing the likelihood and impact of financial crises. But it also brings a potential cost to the wider economy if AIs pass on the costs imposed on them as a result of higher LAC requirements by increasing the price of

financial services. A cost-benefit analysis conducted by the HKMA across a range of economic scenarios shows that even if AIs pass on all their costs, AIs maintaining LAC equal to 25% of RWAs would deliver a net benefit to the wider economy of up to HKD 31 billion per year. Secondly, Part XII considers the direct private cost to AIs. Analysis based on data provided to the HKMA by AIs shows that the aggregate cost to all AIs could be up to HKD 2.6 billion per year. This is a significant amount, but recall that the cost-benefit analysis referred to above indicates that even if all these costs are passed on, the result is still a big net benefit to the economy. To the extent that AIs do not pass on all the costs (for example, as a result of competitiveness considerations, or improved efficiency), the net benefit to society and the wider economy will be higher.

I. INTRODUCTION

1. In the absence of a mechanism to allow FIs to fail in a way that does not threaten financial stability, various governments have in the past used public funds to bail out failing FIs. When market participants expect that an FI will be bailed out if it runs into trouble, market discipline breaks down. Investors are willing to provide cheap funding with little scrutiny, leading to inefficient allocation of capital in the economy and excessive risk-taking by FIs.

2. In the short-term, this can produce high profits for investors and high levels of remuneration for executives. But should an FI then run into difficulties, public funds are required to be used to prevent disorderly failure. The benefits are privatised; the costs of failure are socialised. In order to avoid this outcome, a mechanism is needed for imposing the costs of the failure of an FI on those who take the benefits while it is doing well, principally its shareholders and other investors. This approach also has the benefit of requiring the risks associated with an FI's activities to be borne by those who are best able to manage them.

3. For the authorities to be able to resolve failing FIs in an orderly way that minimises the risk to public funds without undermining financial stability, a resolution regime for FIs is required. In Hong Kong, the FIRO was enacted by the Legislative Council in June 2016,[2] with its main provisions coming into force on 7 July 2017.[3] The FIRO establishes a cross-sectoral resolution regime for certain FIs in Hong Kong and is designed to meet the international standards set by the FSB in its "Key Attributes of Effective Resolution Regimes for Financial Institutions".[4]

4. Under the FIRO, the MA, the Insurance Authority and the Securities and Futures Commission are identified as resolution authorities for those **within scope FIs**[5] operating under their respective existing purviews.[6]

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[2] Gazetted version of the FIRO: http://www.gld.gov.hk/egazette/pdf/20162026/es12016202623.pdf

[3] Commencement Notice: http://www.gld.gov.hk/egazette/pdf/20172119/es22017211977.pdf

[4] First issued by the FSB in 2011 and updated in 2014. For the latest version see: Financial Stability Board, October 2014, *Key Attributes of Effective Resolution Regimes for Financial Institutions*

[5] As defined in section 2(1) of the FIRO.

[6] Note that while the scope of the FIRO extends to all AIs under the Banking Ordinance (Cap. 155) (**BO**), the resolution regime it establishes is not the only mechanism available for dealing with failing AIs. For example, where an AI can be put into liquidation without undermining the stability and

5. The FIRO sets out various powers for resolution authorities, including five **stabilization options** that resolution authorities may apply, alone or in any combination, in resolving within scope FIs. These options can be divided into two broad categories:

- four *transfer* stabilization options, whereby some or all of the assets, rights or liabilities of, or securities issued by, the FI are transferred to a purchaser (by way of, for example, a transfer of all or part of an FI's business), a bridge institution, an asset management vehicle and/or (as a last resort) a TPO[7] company (each a **transferee**); and

- the *bail-in* stabilization option, whereby certain liabilities issued by the FI are cancelled or modified (for example, by reducing their outstanding amount or converting them into equity).

6. An essential prerequisite to the bail-in stabilization option contributing towards the orderly resolution of an FI is the availability of a stock of liabilities to which the option can be applied. LAC refers to (i) regulatory capital;[8] and (ii) certain non-capital liabilities[9] 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 failing 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 FI to a transferee.[10] Section 19 of the FIRO empowers a resolution authority to make rules prescribing LAC requirements for within scope FIs or their group companies.

7. The cross-sectoral resolution regime established under the FIRO covers banking sector entities, insurance sector entities and securities and futures sector

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effective working of the financial system of Hong Kong, the use of normal insolvency procedures could be an alternative. Another option for AIs might be the use of the supervisory intervention powers in section 52 of the BO. Among other things, this section grants the MA a broad power to direct a failing AI to take such action as the MA may consider necessary in relation to its affairs, business and property, subject to certain conditions having been met as set out in the section.

[7] Temporary public ownership.

[8] Subject to regulatory capital meeting relevant eligibility criteria. See paragraph 113(i).

[9] Part VI considers the eligibility criteria that liabilities need to meet in order to constitute LAC.

[10] LAC can support an orderly resolution in which one or more transfer stabilization options are used by either (i) being written down or converted into equity; or (ii) 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 (see Figure 4 in Part III).

entities.[11] Section 19 of the FIRO allows for the prescription of LAC requirements for within scope FIs in any of those three sectors. However, bearing in mind the size, systemic importance, level of concentration, and scale of critical financial functions (**CFFs**) provided by the banking sector in Hong Kong, and the development of international guidelines for LAC for banks, it is considered that the development of LAC requirements should be prioritised for AIs.

8. The MA is the resolution authority under the FIRO for all AIs. The AI LAC Rules will prescribe LAC requirements for AIs and their group companies to support the use of the bail-in stabilization option and/or one or more transfer stabilization options in the resolution of an AI. No other within scope FIs will have LAC requirements imposed on them under the AI LAC Rules.

9. In developing policy on LAC requirements for AIs, the MA has reviewed relevant international standards, and the approaches taken in certain other jurisdictions that have adopted, or are in the process of adopting, rules on loss-absorbing capacity requirements for banks. Particular regard has been given to the FSB's guidance on total loss-absorbing capacity (**TLAC**) (the **FSB's TLAC Principles & Term Sheet**[12]) and on internal TLAC (the **FSB's Guiding Principles on Internal TLAC**[13]), and also to the approaches taken under the EU's Bank Recovery and Resolution Directive (**BRRD**)[14] (including in the UK[15]) and in the US.[16]

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[11] Each as defined in section 2(1) of the FIRO, and each a within scope FI (see paragraph 4).

[12] Financial Stability Board, November 2015, *Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution and Total Loss-absorbing Capacity Term Sheet*

[13] Financial Stability Board, July 2017, *Guiding Principles on the Internal Total Loss-absorbing Capacity of G-SIBs*

[14] European Parliament and EU Council, May 2014, *Directive establishing a framework for the recovery and resolution of credit institutions and investment firms*

[15] Bank of England, October 2017, *Internal MREL - the Bank of England's approach to setting a minimum requirement for own funds and eligible liabilities (MREL) within groups, and further issues*

[16] Federal Reserve System, December 2016, *Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements for Systemically Important U.S. Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations*

II. CAPITAL AND LAC

A. Resolution entities and resolution groups
B. External LAC and internal LAC
C. External LAC requirement
D. Internal LAC requirement
E. LAC requirements and capital buffers
F. Consequences of breach of LAC requirements

A. Resolution entities and resolution groups

10. The orderly resolution of an AI should allow the MA to manage the failure of the AI in a way that minimises risks to financial stability, disruption to CFFs, and risks to public funds.[17] A pre-condition for meeting these objectives is robust resolution planning in normal times. Section 13 of the FIRO provides that the resolution authority of a within scope FI (which includes, for the MA, all AIs) may, among other things, devise strategies for securing an orderly resolution of the FI or its holding company, and in support of any such strategies may develop one or more resolution plans, and/or adopt the whole or part of one or more resolution plans developed by a resolution authority in another jurisdiction.

11. The HKMA has previously set out its approach to resolution planning,[18] which may include the development of a preferred resolution strategy for an AI. Formulating a preferred resolution strategy will include the MA determining (a) which entity (or entities) it is anticipated would have one or more stabilization options applied to it should the AI fail; and (b) which stabilization options under the FIRO would be expected to be applied to such entity (or entities). It is proposed that any such entity can be classified by the MA under the AI LAC

[17] In exercising the stabilization options (and performing other functions under the FIRO), the resolution authorities must have regard to the resolution objectives set out in section 8(1) of the FIRO, which include (a) promoting and seeking to maintain the stability and effective working of the financial system of Hong Kong including the continued performance of CFFs; and (b) subject to the other resolution objectives, seeking to contain the costs of resolution and, in so doing, protecting public money.

[18] In *The HKMA's Approach to Resolution Planning (RA-2),* a chapter in the FIRO Code of Practice (**CoP**) issued by the MA pursuant to section 196 of the FIRO: http://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/resolutions/RA-2_The_HKMA_approach_to_resolution_planning.pdf

Rules as a **resolution entity**,[19] and that the MA can group any resolution entity together with one or more of its subsidiaries as a **resolution group.** This is discussed in more detail in paragraph 36.

12. Note that the development of a preferred resolution strategy for an AI will be informed by the MA's *ex ante* expectation of which stabilization options are likely to be applied should the AI fail. But these determinations should in no way be taken to imply that the indicated options would necessarily be used on failure. Should an AI reach the point at which it has ceased, or is likely to cease, to be viable (the point of non-viability, or **PONV**), the MA will determine the best course of action based on the prevailing circumstances without being in any way bound by earlier expectations, including any resolution strategy that has been devised for that AI.

B. External LAC and internal LAC

13. **External LAC** is LAC issued by a resolution entity to an entity outside the issuer's resolution group. It represents the financial resources external to a resolution group that are available to absorb losses and fund recapitalisations within the resolution group, should that prove necessary. Where a preferred resolution strategy anticipates the use of the bail-in stabilization option to recapitalise a resolution entity through the write-down or conversion of LAC, or where LAC is required to support the use of a transfer stabilization option,[20] in order for the strategy to be credible, the resolution entity will need to have sufficient external LAC.

14. But depending on an AI's group structure and the preferred resolution strategy,[21] it may be that the entity which initially suffers losses – typically an AI – is not itself a resolution entity. In these circumstances, a mechanism is required to pass losses up from the AI in which they first crystallise to a resolution entity, whose external LAC can then absorb the losses (for example,

[19] The only entities in respect of which resolution can be initiated under the FIRO are within scope FIs (section 25(1)), holding companies of a within scope FI (section 28(1)) and affiliated operational entities of a within scope FI (section 29(1)). For the purposes of this consultation paper, a resolution entity will therefore either be an AI, a holding company of an AI, or an affiliated operational entity of an AI.

[20] As described in paragraph 6.

[21] Note that in relation to a cross-border banking group, where the context so requires references to 'resolution strategy' shall be taken to include any relevant resolution strategy devised by the authorities in a different jurisdiction.

by an erosion of its equity and/or by non-equity LAC being written down or converted into equity). **Internal LAC** – LAC issued by an entity that is in a resolution group but is not itself a resolution entity, and issued to the resolution entity in that group – can fulfil this function. Depending on the circumstances and wider group structure of an AI, its orderly resolution may therefore require the issuance of both external and internal LAC.

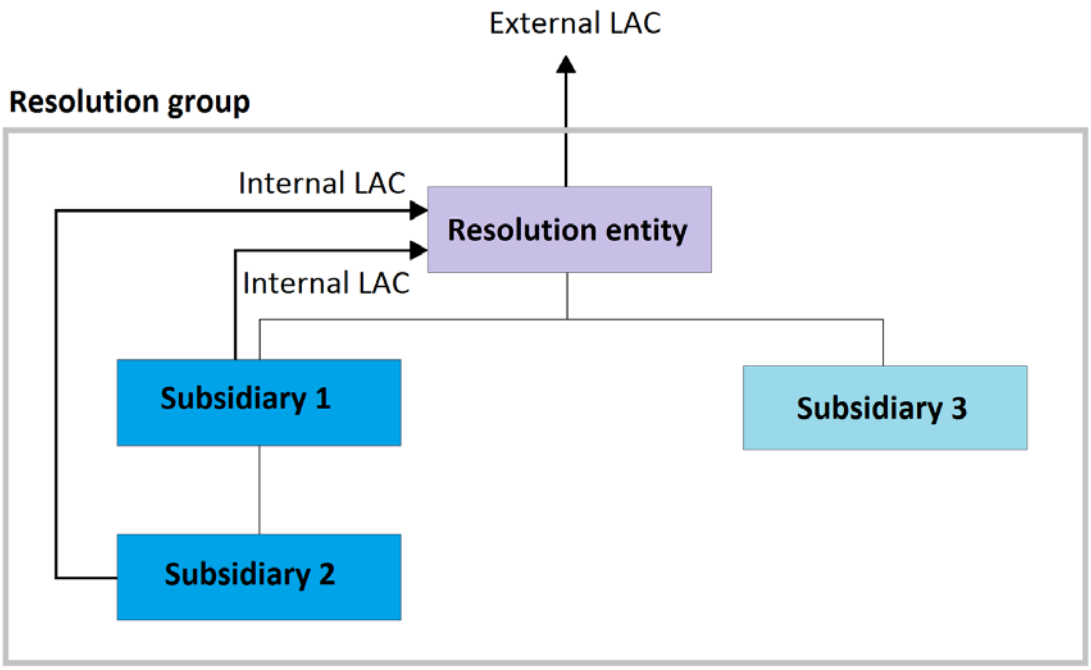
15. Figure 1 illustrates the relationship between external LAC and internal LAC. The resolution entity issues external LAC to investors outside the resolution group. In this example, Subsidiaries 1 and 2 are each subject to internal LAC requirements (as discussed in Part IV), and so they each issue internal LAC to the resolution entity. Subsidiary 3 is not subject to an internal LAC requirement (perhaps because its balance sheet is sufficiently small that should it run into trouble the expectation is that its parent could readily provide any further financial resources needed).

16. Should Subsidiary 1 (for example) suffer losses, the internal LAC that it has issued to the resolution entity can be written down, bolstering Subsidiary 1's balance sheet. As that internal LAC was an asset of the resolution entity, the resolution entity may reach its PONV after absorbing the losses and need to be put into resolution. In resolution, the external LAC issued by the resolution entity can be bailed in, recapitalising the resolution entity. In this way losses incurred in Subsidiary 1 are passed on up and out of the resolution group, and Subsidiary 1 can be recapitalised without going into resolution itself.

C. External LAC requirement

17. External LAC has two basic functions: it can absorb losses that are experienced by a resolution entity before resolution has been initiated, and it can be used to absorb losses or provide recapitalisation resources in resolution. In order to ensure that a resolution entity has sufficient external LAC to fulfil these two functions, it is important that each resolution entity is required to meet a minimum level of external LAC (an **external LAC requirement**).

Figure 1: Issuance of external LAC and internal LAC



18. The external LAC requirement for a resolution entity can be divided into two components, following its two basic functions:

    (i) the **capital component** of the resolution entity'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[22] that AIs are required to maintain, and section 70[23] of the BO effectively allows the MA to impose regulatory capital requirements on the holding companies of AIs. For a resolution entity subject to a regulatory capital requirement in Hong Kong, its capital component will be equal to the amount of such requirement;[24] and

[22] Based on an AI's RWAs and on its exposure measure (each as defined in the Banking Capital Rules (**BCR**)). See footnote 49.

[23] Section 70 of the BO provides that the MA may impose conditions on any person seeking to become a majority shareholder controller of an AI. This therefore allows the MA to require the holding company of an AI to comply with such conditions as the MA may think appropriate. See also paragraph 4.36 of the MA's *Guide to Authorization*.

[24] Note that a Hong Kong incorporated AI holding company that is not required to maintain a minimum level of capital as a condition imposed by the MA under section 70 of the BO, and a Hong Kong incorporated affiliated operational entity of an AI that is not subject to regulatory capital requirements, could also be resolution entities. The calibration of the capital component for such

(ii) the **resolution component** of the resolution entity's external LAC requirement, that is calibrated to support the orderly resolution of a failing resolution entity 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 financial resources are available to allow an AI (or its transferee) to meet its authorization criteria[25] in resolution, while minimising the risk of having to use public funds.

19. Part III sets out a detailed proposal for the imposition on resolution entities under the AI LAC Rules of an external LAC requirement which incorporates the relevant entity's capital component and its resolution component.

20. As is clear from the above, external LAC requirements can be regarded as complementing and extending regulatory capital requirements (where they apply). Under the existing capital adequacy framework for banking supervision in Hong Kong, regulatory capital requirements are applied only to entities incorporated in Hong Kong. Further, the primary purpose of imposing an external LAC requirement is to support the use of the MA's powers under the FIRO in managing the orderly resolution of a resolution entity in Hong Kong. Accordingly, it is not the intention to impose under the AI LAC Rules such requirements on entities incorporated outside Hong Kong.

21. **Proposal:** only resolution entities incorporated in Hong Kong will be required to meet an external LAC requirement under the AI LAC Rules. Entities incorporated outside Hong Kong,[26] including any branch in Hong Kong of such entities, will not be required to meet an external LAC requirement under the AI LAC Rules.

D. Internal LAC requirement

22. Where internal LAC is required to support a resolution strategy as explained in

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entities is considered in Part III.

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

[26] Note that where entities incorporated outside Hong Kong are in the resolution group of a Hong Kong incorporated resolution entity, they will be taken into account in the calculation of the resolution entity's external LAC requirement that applies on a consolidated basis.

paragraph 14, an entity that is in the relevant resolution group, but is not itself the resolution entity, may be required to maintain a minimum level of internal LAC (an **internal LAC requirement**). This is particularly likely to be the case for an entity that constitutes a significant part of its resolution group (each such entity a **material subsidiary**[27]).

23. Part IV sets out a detailed proposal for the imposition of internal LAC requirements on material subsidiaries. As is set out in that Part, it is proposed that an entity's internal LAC requirement be calibrated with reference to what its external LAC requirement would be, were it a resolution entity, multiplied by an appropriate scalar.

24. As with external LAC requirements, internal LAC requirements complement and extend regulatory capital requirements (where they apply). And where a resolution entity incorporated in Hong Kong has subsidiaries in its resolution group that are incorporated in a different jurisdiction, the imposition of internal LAC requirements (if any) on such subsidiaries would be achieved under the resolution regime in that jurisdiction.[28] Accordingly, it is not the intention that the AI LAC Rules impose internal LAC requirements on entities incorporated outside Hong Kong.

25. **Proposal:** only material subsidiaries incorporated in Hong Kong will be required to meet an internal LAC requirement under the AI LAC Rules. Entities incorporated outside Hong Kong,[29] including any branch in Hong Kong of such entities, will not be required to meet an internal LAC requirement under the AI LAC Rules.[30]

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[27] Defined in more detail in Part IV.

[28] Note that in these circumstances the MA would expect to engage with the resolution authority in the relevant jurisdiction in relation to the calibration and imposition of any internal LAC requirement (or equivalent).

[29] Note that any subsidiaries incorporated outside Hong Kong of a Hong Kong incorporated material subsidiary may be taken into account when considering what (if any) internal LAC requirement should be imposed on that material subsidiary.

[30] However, where (i) an entity incorporated in Hong Kong is in a resolution group; (ii) a subsidiary of that entity incorporated in a different jurisdiction is in the same resolution group; and (iii) either that other jurisdiction does not have a policy on loss-absorbing capacity or the authorities in that jurisdiction have not imposed an internal LAC requirement (or equivalent) on that subsidiary, then should the MA conclude that this absence of a requirement constitutes an impediment to resolvability, the MA may, in consultation with the authorities in that jurisdiction, propose an internal LAC requirement (or equivalent) for that subsidiary.

E. LAC requirements and capital buffers

26. External LAC requirements and internal LAC requirements (each a **LAC requirement**) are calibrated to include loss-absorbing capacity needs both before resolution and in resolution. Regulatory capital *buffers*[31] – which are designed to be able to be used by an AI on a going concern, pre-resolution basis – should be separate from and additional to such LAC requirements.[32] This will allow such buffers to be used without breaching LAC requirements. Note that as the capital component of the external LAC requirement is derived from the regulatory capital requirement, capital that counts towards meeting the regulatory capital requirement does also generally count towards meeting a LAC requirement.[33]

27. **Proposal:** CET 1 that counts towards meeting a LAC requirement cannot also count towards meeting a regulatory capital buffer.[34]

28. The interaction between the regulatory capital requirement, the external LAC requirement and the regulatory capital buffer for an AI that is a resolution entity that follows from the above analysis is illustrated in Figure 2.

F. Consequences of breach of LAC requirements

29. LAC requirements are designed to ensure sufficient resources are available to absorb losses and support recapitalisation in resolution. As such, entities subject to LAC requirements should not be allowed to breach those requirements pre-resolution. They should be treated as 'hard' requirements, not buffers.

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[31] In this consultation paper, references to an AI's regulatory capital *requirement* refer to the obligation on an AI to maintain capital in an amount at least equal to (i) its Pillar 1 + Pillar 2A regulatory capital requirement as a percentage of RWAs; and (ii) 3% of its exposure measure (with the latter requirement to be met with Tier 1 capital, as defined in the BCR). References to an AI's regulatory capital *buffer* are to the capital needed to ensure an AI meets any applicable capital conservation buffer ratio (**CB ratio**), countercyclical capital buffer ratio (**CCyB ratio**) and higher loss absorbency ratio (**HLA ratio**), each as defined in section 3E of the BCR.

[32] In the same way that capital resources that count towards minimum regulatory capital requirements cannot also count towards meeting regulatory capital buffers.

[33] See Part VI for more detail on this.

[34] This is consistent with the TLAC holdings standard published by the Basel Committee on Banking Supervision (**BCBS**), and would be effected by amendments to the BCR, rather than through the AI LAC Rules.

30. The *Minimum Criteria for Authorization* for AIs are set out in Schedule 7 to the BO. The criterion set out in paragraph 6 of that schedule is that, among other things, the MA is satisfied that the company presently has, and will if it is authorized continue to have, adequate financial resources (whether actual or contingent) for the nature and scale of its operations. An AI's LAC requirement mandates a minimum level of financial resources. As such, the consequences of a breach of that requirement could be considered a breach of the criterion set out in paragraph 6 of Schedule 7 of the BO, and a breach of a LAC requirement could therefore be regarded as comparable to a breach of a regulatory capital requirement.

31. It would be open to the MA to include compliance with any LAC requirement specified under the AI LAC Rules for the holding company of an AI as a condition for the holding company to be a majority shareholder controller of the AI under section 70 of the BO.[35] In those circumstances, any breach of that LAC requirement would constitute a breach of that condition.

32. Note that section 19 of the FIRO sets out sanctions for entities and their officers in relation to (i) a failure to comply with a requirement to notify the resolution authority about a notifiable matter under any rules made under section 19; and (ii) a failure to comply with a requirement to take remedial action in the event of an entity contravening any such rules (see paragraph 163).

Alignment with international standards

33. The proposals set out in this Part on the role of external LAC and internal LAC, and the interaction between regulatory capital requirements, LAC requirements and regulatory capital buffers are closely aligned with the FSB's *TLAC Principles & Term Sheet.* In particular, the FSB's *TLAC Principles & Term Sheet* provides that CET1 used to meet minimum TLAC requirements cannot also be used to meet regulatory capital buffers, and that a breach or likely breach of minimum TLAC requirements should be treated as severely as a breach or likely breach of regulatory capital requirements.

[35] See footnote 23.

Figure 2: Regulatory capital requirement, external LAC requirement and regulatory capital buffer for an AI that is a resolution entity

		Regulatory capital requirement, external LAC requirement and regulatory capital buffer	Eligible items	Comments
		Regulatory capital buffer[36] (CCB, CCyB, HLA ratios)	CET1	The regulatory capital buffer is in addition to the external LAC requirement.
External LAC requirement	Resolution component	Resolution component	External LAC, i.e. regulatory capital[37] and certain non-capital liabilities	Calibration of the resolution component is discussed in Part III.
	Capital component[38]	Pillar 2A Pillar 1	Regulatory capital	The ***regulatory capital requirement*** is set under the BO and the BCR. The capital component is discussed in Part III.

[36] This illustration does not include the Pillar 2B buffer, which would be set off against the regulatory capital buffer.
[37] Subject to eligibility criteria. See paragraph 113(i).
[38] In this illustration, the AI's binding regulatory capital requirement is based on RWAs. But it could instead be based on its exposure measure. See footnote 49 in Part III.

Q1.	**Do you agree with the proposal that only resolution entities and material subsidiaries incorporated in Hong Kong should be subject to external and internal LAC requirements, respectively, under the AI LAC Rules? If not, what other entities should also be in scope, and why?**
Q2.	**Do you agree with the proposal that for all AIs CET1 that counts towards meeting a LAC requirement cannot also count towards meeting a regulatory capital buffer? If not, why not?**

III. EXTERNAL LAC REQUIREMENT

A. External LAC requirements for resolution entities
B. Calibrating the capital component ratio
C. Calibrating the resolution component ratio

A. External LAC requirements for resolution entities

34. Part II explains that a resolution entity's external LAC requirement is made up of two components, the capital component and the resolution component. This Part III sets out proposals for the calibration of these two components through identifying ratios that will be applied to the resolution entity's RWAs or its exposure measure,[39] as applicable[40] (the entity's **reference measure**[41].) In addition, in order to be consistent with internationally agreed standards on minimum LAC requirements for G-SIBs, the external LAC requirement for resolution entities[42] that are part of G-SIB groups should be no less than the minimum requirements set out in the FSB's *TLAC Principles & Term Sheet.*

35. Where an AI is itself a resolution entity and it does not have any subsidiaries, the AI will constitute the entire resolution group. However, for many AIs it is likely that the resolution group will consist of more than just the resolution entity. In such circumstances, the only entity in the resolution group with an external LAC requirement will be the resolution entity. This requirement therefore needs to be calibrated to provide sufficient external LAC resources for the entire resolution group.

36. **Proposal:** the AI LAC Rules will provide that where the MA has devised a resolution strategy[43] for an AI that contemplates the application of one or more stabilization options under the FIRO to any (a) Hong Kong incorporated AI; (b) Hong Kong incorporated holding company of an AI; or (c) Hong Kong

[39] The Banking (Capital) (Amendment) Rules 2017 amend the BCR to require all AIs to maintain a leverage ratio of at least 3%. The denominator of the leverage ratio for an AI is its exposure measure, the calculation of which will be set out in a standard template to be specified by the MA under the BCR (as amended).
[40] See footnote 49.
[41] Whether a resolution entity's reference measure is its RWAs or its exposure measure will depend on how its capital component ratio (and therefore its resolution component ratio) has been determined. See paragraphs 43 and 45.
[42] Other than any affiliated operational entity, as defined in section 2 of the FIRO.
[43] See paragraph 47 on the devising of resolution strategies.

incorporated affiliated operational entity of an AI, the MA may by notice in writing to such entity, for the purpose of the application of the AI LAC Rules:

(i) classify it as a **resolution entity**;

(ii) classify it, together with one or more subsidiaries, as a **resolution group**;

(iii) where the resolution entity's capital component ratio (calibrated as described below) is equal to a minimum regulatory capital ratio to which it (or an AI in its resolution group) is subject on a solo or consolidated basis as described in paragraph 45, notify the entity of the relevant solo or consolidated basis; and

(iv) notify the entity of any variation to its resolution component ratio (calibrated as described below).

37. **Proposal:** the AI LAC Rules will provide that the external LAC requirement for a resolution entity will be equal to the sum of its capital component ratio and resolution component ratio, multiplied by its reference measure; and provided that where the entity[44] is in a G-SIB group[45] that is not based in an emerging market economy (**EME**):[46]

(i) from 1 January 2019, its external LAC requirement shall not be less than (a) 16% of its RWAs; and (b) 6% of its exposure measure; and

(ii) from 1 January 2022, its external LAC requirement shall not be less than (a) 18% of its RWAs; and (b) 6.75% of its exposure measure.

38. It is proposed that each resolution entity will need to meet its external LAC

[44] Other than any affiliated operational entity.

[45] Note that this provision only applies to G-SIBs first classified as such by the FSB before the end of 2015 (and that have not subsequently been removed from the FSB's G-SIBs list.) Provision will also need to be made for entities first classified as G-SIBs after the end of 2015 to be bound by minimum external LAC requirements in accordance with the timeline set out in the FSB's *TLAC Principles & Term Sheet.*

[46] The FSB's *TLAC Principles & Term Sheet* allows EME G-SIBs a longer timeline to meet minimum TLAC requirements than other G-SIBs, and that timeline for EME G-SIBs remains subject to change. Until the timeline for EME G-SIBs is finalised, the AI LAC Rules will apply to any EME G-SIBs – namely Chinese G-SIBs – in the same way that they apply to non-G-SIB AIs. It may be necessary to update the AI LAC Rules in due course to ensure that they reflect internationally agreed minimum TLAC requirements and implementation timelines for EME G-SIBs.

requirement on a consolidated basis with reference to its resolution group (and also on a solo basis, for AIs – see paragraph 100). This will require the quantum of the RWAs and the exposure measure of the resolution group to be known. However, the composition of a resolution group will not necessarily match that of an existing group that is consolidated for regulatory capital purposes, for which the RWAs and exposure measure will already have been calculated.

39. **Proposal:** the AI LAC Rules will require each resolution entity to calculate the RWAs and the exposure measure for its resolution group on a consolidated basis.[47]

40. External LAC that counts towards meeting a resolution entity's external LAC requirement needs to be available to bear loss in resolution. As the resolution entity is the only entity that it is anticipated will have one or more stabilization options applied to it under the preferred resolution strategy, it follows that such external LAC needs to be issued directly from that resolution entity. An exception may be made for LAC that is CET1 issued from another entity in the resolution group; CET1 can absorb loss before the issuer reaches the PONV, without the need for the issuer to be put into resolution.

41. **Proposal:** the AI LAC Rules will provide that external LAC that counts towards meeting a resolution entity's external LAC requirement must be issued directly by the resolution entity, unless it is CET1[48] issued from a different entity within the resolution group and would be recognised as CET1 for the resolution entity for regulatory capital purposes on a consolidated basis.

B. Calibrating the capital component ratio

42. As described in Part II, the capital component for a resolution entity is calibrated to allow it to absorb losses pre-resolution. This is the function of

[47] The MA may also use its information gathering power under section 158 of the FIRO to collect regular returns for consolidated resolution groups. This will be considered further in a CoP chapter that the MA expects to issue for consultation in the summer of 2018 (the **AI LAC CoP**).

[48] Note that the FSB *TLAC Principles and Term Sheet* provides that in some limited circumstances non-CET1 capital issued by subsidiaries of the resolution entity in a resolution group can be used to meet the resolution entity's minimum TLAC requirement, without reference to eligibility criteria. As this provision is time limited under the FSB *TLAC Principles and Term Sheet*, it is not proposed that it will be reflected in the AI LAC Rules.

regulatory capital requirements under the existing capital adequacy framework for AIs in Hong Kong.

43. **Proposal:** the AI LAC Rules will provide that the **capital component ratio** for a resolution entity whose resolution group is a group to which a regulatory capital requirement[49] applies on a consolidated basis should be set equal to:

(i) where the Pillar 1 plus Pillar 2A regulatory capital requirement applicable to that entity as a percentage of RWAs is greater than 3% of its exposure measure, the minimum total capital ratio the entity is required to have (and in this case the resolution entity's reference measure will be its RWAs); and

(ii) otherwise, 3% (and in this case the resolution entity's reference measure will be its exposure measure).

44. However, where the resolution group of a resolution entity is not a group to which a regulatory capital requirement applies on a consolidated basis, there needs to be another mechanism for calibrating the capital component ratio.

45. **Proposal:** the AI LAC Rules will provide that the **capital component ratio** for a resolution entity whose resolution group is not the same as a group to which a regulatory capital requirement applies on a consolidated basis will be set in accordance with the following:

(i) where the resolution entity is an AI and the MA has determined the minimum total capital ratio that would apply to the resolution entity under the BO and the BCR were it to be subject to a regulatory capital requirement on a consolidated basis with reference to its resolution group and has notified that ratio to the resolution entity, the capital component ratio will be set equal to that ratio;

(ii) where the resolution entity is an AI but (i) above does not apply, the capital component ratio will be set equal to the minimum total capital ratio to which the resolution entity is directly subject, either on a solo or

[49] For a resolution entity that is an AI, its regulatory capital requirements are (i) Pillar 1 + Pillar 2A regulatory capital requirement as a percentage of RWAs; and (ii) 3% of its exposure measure (the latter requirement to be met with Tier 1 capital, as defined in the BCR).

consolidated basis, that is calculated with reference to the legal entities that in the MA's determination (as notified to the resolution entity) most closely correspond to the make-up of the resolution group;

(iii) where the resolution entity is the Hong Kong incorporated holding company of an AI that is required to maintain a minimum total capital ratio under section 70 of the BO, the capital component ratio will be set equal to that ratio;

(iv) where the resolution entity is the Hong Kong incorporated holding company of an AI and (iii) does not apply, the capital component ratio will be set equal to the minimum total capital ratio applicable to an AI in the resolution group, either on a solo or consolidated basis, that is calculated with reference to the legal entities that in the MA's determination (as notified to the resolution entity) most closely correspond to the make-up of the resolution group; and

(v) where the resolution entity is an affiliated operational entity, the capital component ratio will be set equal to zero,[50]

Should the product of the capital component ratio generated under any of (i), (ii) or (iv) and the RWAs of the resolution group calculated on a consolidated basis be greater than 3% of the exposure measure of the resolution group calculated on a consolidated basis, or should (iii) apply, the resolution entity's reference measure will be its RWAs; otherwise, the capital component ratio will be 3% and the resolution entity's reference measure will be its exposure measure.

C. Calibrating the resolution component ratio

46. The purpose of the resolution component is to ensure the availability of LAC to support the orderly resolution of a failing AI, by facilitating the use of the bail-in

[50] Note that it is only through the MA varying the resolution component ratio that an affiliated operational entity can be subject to an external LAC requirement. By way of example, the MA may want to take this action to ensure that an affiliated operational entity that provides services that are critical to maintaining the operational continuity of an AI has sufficient financial resources to continue to provide those services during and following resolution. Relatedly, in a recent consultation paper (see footnote 15), the Bank of England has proposed requiring entities within a banking group that provide critical services to maintain financial resources equivalent to at least 25% of the annual operating costs of providing services.

stabilization option and/or one or more transfer stabilization options in the resolution of an AI. Where the MA has devised a preferred resolution strategy in respect of an AI, that strategy will set out whether or not on failure use of the bail-in stabilization option and/or one or more transfer stabilization options is anticipated. It follows from this that the appropriate resolution component for a resolution entity will vary depending on the preferred resolution strategy.

47. Factors that the MA will take into account when devising resolution strategies have been set out in the existing FIRO CoP chapter *The HKMA's Approach to Resolution Planning*.[51] It is anticipated that the AI LAC CoP (expected to issue for consultation in the summer of 2018) will provide additional guidance on the MA's approach to devising resolution strategies in the context of calibrating LAC requirements.

48. Where the preferred resolution strategy of an AI involves bail-in to recapitalise the AI (or relevant resolution entity), the goal is to restore the AI to viability as a going concern, with sufficient capital to allow it to meet its minimum authorization criteria and to regain the confidence of market counterparties so that it can continue to operate. The resolution component needs to be calibrated to provide sufficient resources that can be converted into capital to allow this objective to be met. However, the quantum of losses that may be experienced by an AI in the future is obviously unknown. This calibration therefore requires a determination to be made of the scale of the losses that an AI should be able to withstand while allowing its resolution strategy to remain feasible and credible.

49. An AI's capital is likely to be significantly or completely depleted in the run-up to failure. In the past, failed institutions have experienced a range of losses, on some occasions completely wiping out regulatory capital, on other occasions only partially doing so. The FSB has published[52] an analysis of the historical losses and recapitalisation needs of a sample of banks in the global financial crisis beginning in 2008 and in the Japanese banking crisis in the 1990s. The analysis found that the maximum losses experienced were close to 13% of

[51] See footnote 18.

[52] FSB's *Historical Losses and Recapitalisation Needs, Findings Report*, November 2015. The main findings were based on thirteen systemically important institutions that failed or received official support.

RWAs (Dexia, Fortis), with the maximum losses and recapitalisation needs together being up to 25% of RWAs (Fortis). The FSB's report also referenced previous studies on historical losses, including work by the BCBS which reported losses of up to 29% of RWAs, and a study by the UK's Independent Commission on Banking which concluded that loss-absorbing capacity of around 16-24% of RWAs would be sufficient to cover losses and recapitalisation needs for all the banks in the crises considered, if extreme outliers were excluded.

50. The figures quoted in paragraph 49 above refer to the highest levels of loss experienced in the cases that were examined; the average levels of loss were lower. In addition, regulatory frameworks have changed significantly in recent years. In particular, Basel III risk weights are not directly comparable to risk weights under previous rules that applied when the losses covered by the FSB's report were experienced. On the other hand, in conducting its analysis the FSB adopted a conservative approach to loss estimation, to ensure that the losses and recapitalisation needs were not over-estimated. And we cannot assume that the losses experienced by banks in any future crisis will be no greater than those experienced in the recent past.

51. The FSB's analysis provides useful context for the calibration of external LAC requirements, and suggests that an appropriate number might be in the range of 16%-29% of RWAs, depending on how conservative an approach is thought desirable. If, as an example, we assume a capital component ratio of 10% of RWAs, this implies setting a resolution component ratio in the range of 6%-19% of RWAs.

52. The HKMA has conducted a cost-benefit analysis of higher LAC requirements for AIs in Hong Kong. The costs are driven by a possible increase in lending spreads, which may dampen investment and output. The benefits arise from lower probability and reduced severity of financial crises. On the basis of a number of important assumptions, this analysis shows that in all three of the scenarios it addressed, the benefits exceeded the costs of setting external LAC requirements in the range of 16%-29% of RWAs referenced in paragraph 51 above. This supports the case for setting external LAC requirements in this range in the Hong Kong context. A summary of the cost-benefit analysis is included in Part XII.

53. Different AIs have different risk profiles, and setting a fixed percentage for the resolution component ratio for all resolution entities would mean that existing supervisory information about the risks associated with a resolution entity would not be reflected. However, this information can be incorporated by referencing a resolution entity's capital component ratio in the calibration of the resolution component ratio. As the capital component for an AI reflects its regulatory capital requirement, including the Pillar 2A element, this approach should better reflect risks associated with the entity (this is the approach adopted in the EU's regulatory technical standard[53] specifying criteria for setting MREL[54] under the BRRD). More specifically, setting the resolution component ratio *equal* to an AI's capital component ratio would mean that in a scenario where an AI experiences losses that wipe out its regulatory capital requirement, it would still have sufficient LAC remaining to be fully recapitalised in resolution, facilitating orderly resolution. (This is illustrated in Figure 3.)

54. **Proposal:** the AI LAC Rules will provide for the calibration of the resolution component ratio for a resolution entity to be equal to the capital component ratio[55] of that resolution entity,[56] subject to any variation made by the MA under the AI LAC Rules (see paragraph 59 below).

55. Figure 3 illustrates a stylised example of the application of the bail-in stabilization option to an AI whose resolution component ratio is equal to its capital component ratio (in other words, the MA has not used his variation power described in paragraph 59). In this example, the AI performs a range of CFFs[57] which are not in a readily-separable business unit. For simplicity, we assume a regulatory capital requirement of 10% of assets that is met with equity (150 x 10% = 15), that the rest of the external LAC requirement (another 15, as the resolution component is equal to the capital component) is met with

[53] European Commission, May 2016, *Regulations with regard to regulatory technical standards specifying the criteria relating to the methodology for setting the minimum requirement for own funds and eligible liabilities*

[54] Minimum requirement for own funds and eligible liabilities, analogous to the FSB's minimum TLAC requirement.

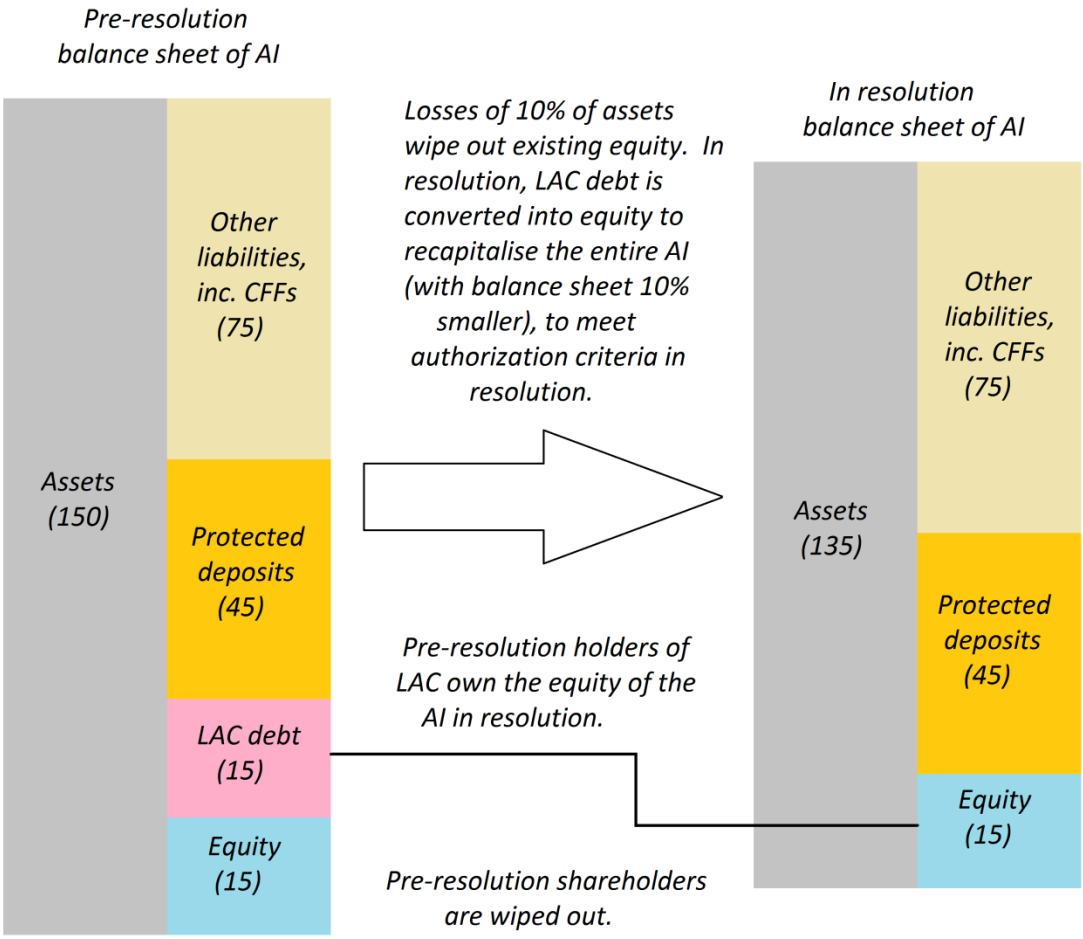
[55] A resolution entity's resolution component ratio will therefore follow the entity's capital component ratio in being expressed either as a percentage of RWAs, or as a percentage of the exposure measure.

[56] Consequently the resolution component of an affiliated operational entity of an AI will be zero, unless varied by the MA as described in paragraph 59.

[57] For simplicity, the examples in Figures 3 and 4 only reference CFFs that are associated with liabilities. There could also be CFFs associated with assets.

LAC debt instruments (which constitute **LAC debt**) and have not considered any capital buffer.

Figure 3: Stylised example of resolution applying the bail-in stabilization option to recapitalise an AI's entire balance sheet (resolution component ratio equal to capital component ratio)



56. A key objective of an orderly resolution is the continued performance of CFFs. As such, the preferred resolution strategy envisages the application of the bail-in stabilization option to convert the LAC debt into equity to recapitalise the entire AI. In this example, it is assumed that losses result in the AI's balance sheet shrinking by 10%. As a result of this reduction in the size of the balance sheet, the AI's capital after the bail-in of the LAC debt in fact slightly exceeds its regulatory capital requirement. In practice, this is likely to be necessary for the AI to regain the confidence of market counterparties.[58]

[58] Note that the relevant European Commission regulatory technical standard under the BRRD (see footnote 53) specifically contemplates increasing recapitalisation resources by an additional amount

57. Securing an orderly resolution in this example required the AI's resolution component ratio being equal to its capital component ratio.

58. It is however recognised that the calibration of the resolution component ratio in the manner described above is unlikely to accurately reflect all relevant factors, in all circumstances. In particular, where the preferred resolution strategy envisages use of a transfer stabilization option, rather than the application of the bail-in stabilization option to fully recapitalize a resolution entity, setting the resolution component ratio equal to the capital component ratio may result in an external LAC requirement that is higher than necessary.

59. **Proposal:** the AI LAC Rules will provide that the MA will have the flexibility to vary a resolution entity's resolution component ratio[59] if the MA is satisfied that it is prudent to make the variation taking into account:

(i) the stabilization option(s) anticipated to be deployed in the context of a resolution strategy devised in relation to the relevant resolution entity;

(ii) the level of financial resources anticipated to be required to absorb losses and contribute to the restoration of capital in the context of a resolution strategy devised in relation to the relevant resolution entity;

(iii) the findings of any relevant resolvability assessment(s) conducted under section 12(1) of the FIRO; and

(iv) the extent to which the non-viability of any AI in the relevant resolution group would pose a risk to the stability and effective working of the financial system of Hong Kong, including to the continued performance of CFFs.

60. It is anticipated that for each resolution entity and for each material subsidiary (see paragraph 87) the MA will review the necessity of varying the entity's resolution component ratio at least once every 12 months. It is intended that

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to maintain sufficient market confidence after resolution.

[59] It is proposed above that the capital component ratio for an affiliated operational entity of an AI is zero. As such, it is only where the resolution component ratio of such an entity is varied above zero in accordance with this provision that an affiliated operational entity can have an external LAC requirement above zero.

this will be addressed in more detail in the AI LAC CoP.

61. Figure 4 illustrates a stylised example in which the orderly resolution of an AI is achieved using a transfer stabilization option, and where the resolution component ratio has been varied downwards (i.e. to less than the capital component ratio). This type of preferred resolution strategy may be suitable for a smaller, less complex AI, whose CFFs are concentrated in a readily-separable business unit (e.g. deposit-funded mortgage lending), so that only the corresponding part of the balance sheet needs to be recapitalised. We again assume a regulatory capital requirement of 10% of assets that is met with equity (150 x 10% = 15), with the rest of the external LAC requirement – assumed to be 9 in this case – being met with LAC debt, and have not considered any capital buffer.

62. In this example, the resolution strategy envisages a transfer[60] of liabilities associated with CFFs (e.g. protected deposits), together with assets. The rump balance sheet of the AI is likely to be wound down, although its authorized status may remain for a period to enable the MA to continue to exercise powers under the BO and the FIRO. As in the example illustrated in Figure 3, it is assumed that losses result in the AI's balance sheet shrinking by 10%.

63. In this case, after the existing equity has been wiped out, the remaining assets and liabilities are matched (each at 135). It may be that a third party purchaser can be found who is willing to take on the protected deposits and a matching volume of assets (both at 81). Should this happen, the remaining assets (54) will match the remaining liabilities including the LAC debt (also 54), so that in a wind-down of the rump AI, the holders of the LAC debt are repaid their principal in full.

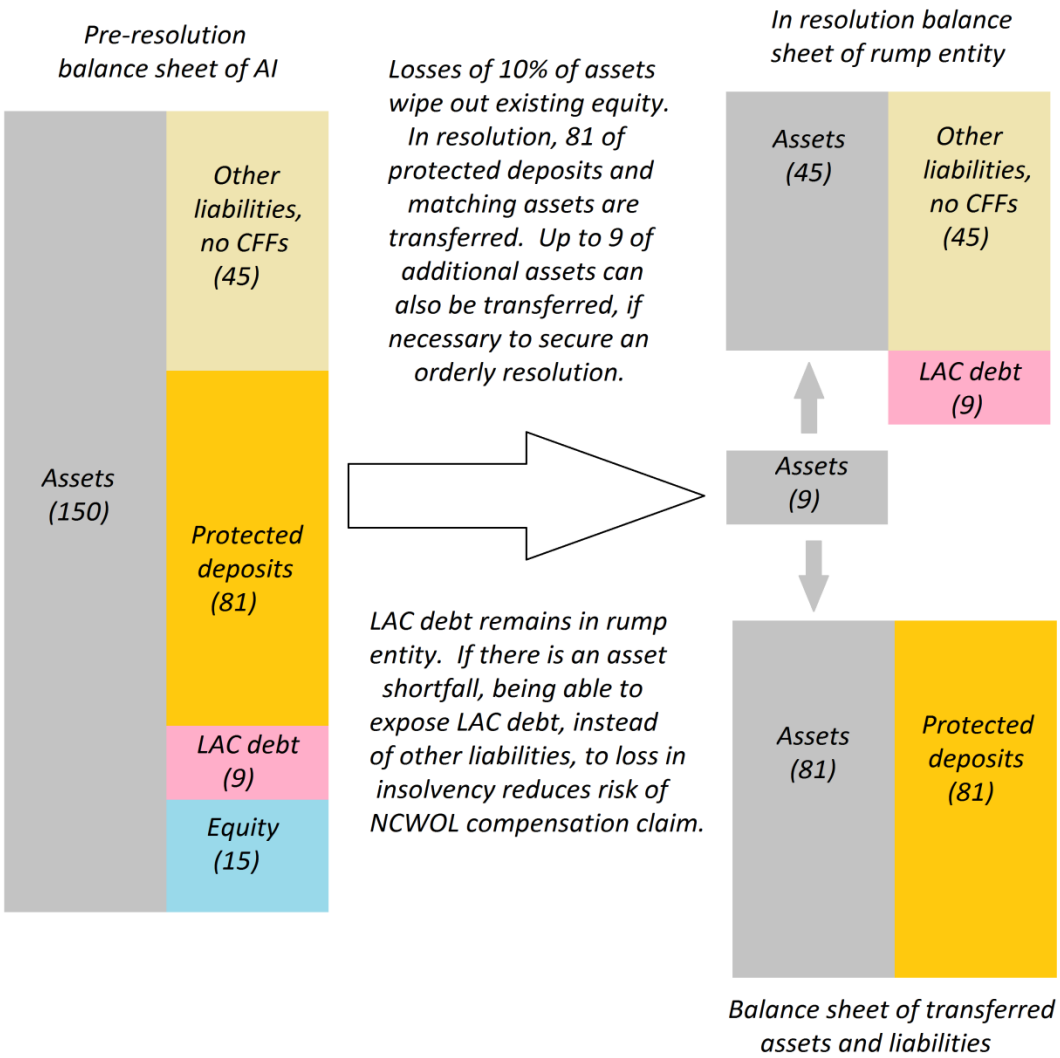
64. However, for this to work, the purchaser has to have, or be able to raise, additional capital to allocate to the RWAs that it has bought from the failed AI. If the purchaser is unable or unwilling to do this, in order to incentivise the purchaser to take on the protected deposits, it may be necessary to transfer an amount of assets that exceeds the amount of deposits;[61] for example, 81 of

[60] To, for example, a private sector purchaser, or a bridge institution.

[61] Note that rather than the amount of transferred assets 'exceeding' the amount of deposits, it could be that in the circumstances the fair value of the assets is reduced from their pre-resolution value,

protected deposits but 85 of assets. In this scenario, the remaining assets will only be 50, against remaining liabilities including the LAC debt of 54. In the wind-down, the holders of the LAC debt are not repaid all their principal. At the extreme, 90 of assets could be transferred along with 81 of protected deposits. This would mean the transferred balance sheet was fully-capitalised, greatly enhancing the prospects for orderly resolution. But the asset shortfall in the rump entity would be 9, resulting in the LAC debt being completely wiped out.

Figure 4: Stylised example of resolution where use of a transfer stabilization option leads to a reduced balance sheet in resolution (resolution component ratio is varied to lower than the capital component ratio)



possibly significantly so. The economic effect is the same – a purchaser will insist on receiving more assets along with the transferred liabilities, leaving fewer assets on the rump balance sheet which results in a bigger loss for the holders of the LAC debt.

65. Note that although this scenario does not envisage the use of the bail-in stabilization option, the LAC debt was still required to support an orderly resolution. Had the LAC debt not been in place, some of the losses would have fallen on the holders of the 'Other liabilities'. Those holders would have experienced greater losses than they would have in insolvency – when the losses would have been shared (to some extent) with the protected depositors – and so would have had a claim for compensation under the 'no creditor worse off than in liquidation' (**NCWOL**) safeguard.[62]

66. In this example, it was possible to secure an orderly resolution with the AI's resolution component ratio varied to below its capital component ratio, because not all of the balance sheet needed to be recapitalised in resolution.

67. It is anticipated that guidance on how the MA would expect to exercise his power to vary a resolution entity's resolution component ratio will be set out in the AI LAC CoP. This may include guidance on how, among other things, the following would feature in the MA's deliberations:

- the extent to which a resolution entity has subsidiaries[63] that are not included in its resolution group for the purposes of the AI LAC Rules and so do not feature in the calculation of the resolution group's RWAs or exposure measure, and where as a consequence the MA considers that the resolution component ratio being equal to the capital component ratio would not provide the level of financial resources expected to be required to absorb losses and contribute to the restoration of capital in the context of a resolution strategy devised in relation to the resolution entity; and

- the risk that requiring an AI to issue substantial amounts of external LAC at a higher cost than other potential types of funding (in particular, deposits) may incentivise it to invest in riskier assets that have the potential to generate the higher returns required to offset the greater funding costs, and to do so more quickly than it develops the requisite

[62] The 'No creditor worse off than in liquidation' safeguard is set out in Section 102 of the FIRO. It provides for pre-resolution creditors and pre-resolution shareholders of an entity in resolution to receive compensation should they receive less favourable treatment in resolution than they would have done had the entity gone into insolvency instead.

[63] Such companies could include insurance companies, securities and futures brokers, affiliated operational entities, and others.

systems, controls and capabilities to manage the risks of such new business, thereby undermining the resolvability of the AI (and possibly increasing the chance of it failing).

Alignment with international standards

68. The proposals set out in this Part on the calibration of external LAC requirements are consistent with the FSB's *TLAC Principles & Term Sheet*, and it is anticipated that the resulting calibrations will be broadly comparable to the external TLAC and/or external MREL requirements (in the case of the EU) imposed in other jurisdictions. The principles for calibration are closely aligned to those set out in the relevant EU regulatory technical standard[64] (followed by the Bank of England in its policy statement on setting MREL[65]).

Q3.	**Do you agree with the proposals for the classification of a resolution entity and a resolution group set out in this Part III? If not, how should resolution entities and resolution groups be identified?**
Q4.	**Do you agree with the proposals for the calibration of a resolution entity's external LAC requirement set out in this Part III, including the MA's power to vary a resolution entity's resolution component ratio? If not, how should such a requirement be calibrated?**
Q5.	**Do you agree with the other proposals set out in this Part III? If not, why not?**

[64] See footnote 53.
[65] See footnote 15.

IV. INTERNAL LAC REQUIREMENT

A. Internal LAC requirements for material subsidiaries
B. Material subsidiaries and material sub-groups
C. Modelled external LAC requirement and internal LAC scalar
D. Distribution of internal LAC
E. Role of internal LAC in cross-border resolution

A. Internal LAC requirements for material subsidiaries

69. There will be some resolution entities for which a resolution strategy has been devised that envisages (i) the application of one or more stabilization options[66] to the resolution entity with the result that external LAC bears loss; and (ii) the ongoing viability – without going into resolution – of one or more subsidiaries in the relevant resolution group. This scenario may occur for an entirely domestic AI group, but it can also arise in the case of a cross-border resolution group. Where the holding company of a Hong Kong incorporated AI is incorporated in a different jurisdiction, the MA may devise a resolution strategy[67] under which the resolution entity[68] for the AI's resolution group[69] is outside Hong Kong. In such a scenario there needs to be a mechanism for the subsidiary AI in Hong Kong to absorb losses without going into resolution, and for passing those losses on up to the overseas resolution entity. The issuance of internal LAC by the subsidiary can fulfil this function. (See *Role of internal LAC in cross-border resolution* below.)

70. Because the issuer of internal LAC is by definition not itself a resolution entity, in the context of the relevant resolution strategy it is not anticipated that it would have any of the stabilization options applied to it directly. Internal LAC must therefore be able to bear loss by being written down or converted into equity under its contractual terms[70] upon notification from the MA at the

[66] Or equivalent, in a different jurisdiction.
[67] Where a resolution group is spread across more than one jurisdiction, it is anticipated that the preferred resolution strategy would be developed jointly by the relevant authorities.
[68] Where the context requires, references to 'resolution entity' in this Part IV shall be taken to include any overseas entity that under a relevant resolution strategy it is anticipated would have resolution tools applied to it.
[69] Where the context requires, references to 'resolution group' in this Part IV shall be taken to include any resolution entity and all of its subsidiaries that are not themselves resolution entities or subsidiaries of another resolution entity.
[70] Note that internal LAC that is CET1 can also absorb losses on a going-concern basis as they arise.

PONV of the issuing subsidiary,[71] without relying on the direct application of the bail-in stabilization option.

71. As described in more detail below, it may not be optimal to impose internal LAC requirements on all of the entities of a resolution group or to require entities that do have such requirements to issue internal LAC in the same volume as they would be required to issue external LAC were they resolution entities. The key terms in the proposal in paragraph 72 are described in the rest of this Part IV.

72. **Proposal:** the AI LAC Rules will provide that the internal LAC requirement for a **material subsidiary** will be equal to the product of its **modelled external LAC requirement** and its **internal LAC scalar**.

73. It is proposed (see paragraph 100) that each material subsidiary will need to meet its internal LAC requirement on a consolidated basis with reference to its **material sub-group** (see paragraph 80). This will require the RWAs and the exposure measure of the material sub-group to be available. However, the composition of a material sub-group will not necessarily match with that of an existing group that is consolidated for regulatory capital purposes.

74. **Proposal:** the AI LAC Rules will require each material subsidiary to calculate the RWAs and the exposure measure for its material sub-group on a consolidated basis.[72]

B. Material subsidiaries and material sub-groups

75. Calibration of internal LAC requirements could be set to exactly match the calibration of external LAC requirements. However, a fixed mechanism requiring all the proceeds of external LAC to be used to fund internal LAC for each entity in a resolution group as if each such entity were a resolution entity would restrict the potential for such proceeds to be used to absorb losses arising elsewhere in the resolution group. This may not be the most efficient way of ensuring that a resolution group's resources are available to be

[71] Analogous to the write-down / conversion triggers in Tier 2 capital instruments set out in Schedule 4C to the BCR.

[72] The MA may also use its information gathering power under section 158 of the FIRO to collect regular returns for consolidated resolution groups. This will be considered further in the AI LAC CoP.

deployed flexibly to mitigate financial stress in one or more parts of the group. In addition, under this approach intragroup exposures between entities in a resolution group may lead to the sum of the internal LAC requirements being big enough to increase the external LAC requirement of the resolution entity, which is not the intention of these proposals.

76. This is not to say that an AI should have the freedom to allocate LAC resources within its resolution group(s) as it sees fit. The commercial considerations that would influence such allocation may not be well-aligned with financial stability considerations. However, there may be some efficiencies to be achieved by (i) not requiring resolution groups to issue internal LAC from their non-systemic entities; and (ii) allowing for some flexibility, as measured against the calibration of external LAC requirements, for larger entities. In particular, this allows some of the proceeds of external LAC issuance to be held at the level of the resolution entity, from where they can be deployed within the resolution group as needed. (Consequently, where not all the proceeds of LAC issuance by a resolution entity are required to be downstreamed to its subsidiaries, it is to be expected that those financial resources that are not required to be downstreamed would be readily available to be used as and when needed within the resolution group.[73])

77. If this approach is to be adopted, there needs to be (i) a method for identifying subsidiaries regarded as being sufficiently material to have internal LAC requirements imposed on them; and (ii) a mechanism for scaling internal LAC requirements down from the equivalent external LAC requirements. Where a resolution entity is in a different jurisdiction to other entities in its resolution group, the process of identifying material subsidiaries and scaling internal LAC requirements can also incentivise and facilitate cross-border co-operation between resolution authorities (see *Role of internal LAC in cross-border resolution* below).

78. **Proposal:** the AI LAC Rules will provide that the MA may by notice in writing to the relevant entity classify a Hong Kong incorporated AI, a Hong Kong incorporated holding company of an AI, or a Hong Kong incorporated affiliated

[73] For example, by being invested in high-quality liquid assets. TLAC that is left at the top of a resolution group in this way is referred to in the FSB's *Guiding Principles on Internal TLAC* as 'surplus TLAC'.

operational entity of an AI[74] as a **material subsidiary** for the purposes of the AI LAC Rules where:

(i) in the context of a relevant resolution strategy, it is in a resolution group but is not itself a resolution entity;[75] and

(ii) on its own or taken together with any of its subsidiaries[76] that are in its resolution group, the MA determines that it meets one or more of the following criteria:[77]

- it contains more than 5% of the consolidated RWAs of its resolution group;
- it generates more than 5% of the total operating income of its resolution group;
- its total exposure measure is greater than 5% of the consolidated exposure measure of its resolution group; or
- it is material to the provision of CFFs in Hong Kong.

79. In the same way that a resolution entity's external LAC requirement must be calibrated with reference to its resolution group, a material subsidiary's internal LAC requirement should be calibrated with reference to those of its subsidiaries that are relevant for the resolvability of the material subsidiary.

80. **Proposal:** the AI LAC Rules will provide that for any material subsidiary the MA may for the purposes of the application of the AI LAC Rules by notice in writing to that subsidiary identify a **material sub-group**, consisting of that material subsidiary and one or more of its subsidiaries.[78] In determining whether a subsidiary of a material subsidiary should be included within the material sub-group, the MA will have regard to:

(i) the extent to which the entity is connected with the material subsidiary

[74] Internal LAC requirements can only apply to Hong Kong incorporated entities, as per paragraph 25.
[75] The resolution entity could be incorporated outside Hong Kong, in which case the resolution group would have entities in different jurisdictions.
[76] Including subsidiaries incorporated outside Hong Kong.
[77] Note that the formulation of the first three criteria represents a slightly different approach to that adopted by the FSB, which proposes that in each case the 5% be assessed against the relevant measure for the resolution group's whole banking group.
[78] Excluding any entity that is itself a material subsidiary, or in the material sub-group of another material subsidiary. Note that if the MA does not identify a material sub-group in respect of a material subsidiary, the material subsidiary will itself constitute a material sub-group.

or other subsidiaries of it, and the potential for the level of connectedness to contribute to a risk of contagion between them;

(ii) the extent to which the entity is material to the performance of CFFs in Hong Kong; and

(iii) the findings of any relevant resolvability assessment(s) conducted under section 12(1) of the FIRO which cover the material subsidiary.

81. In order to calculate any internal LAC requirement that may apply to it, a material subsidiary needs to be able to work out its modelled external LAC requirement (for which it needs to know its capital component ratio and resolution component ratio), and be notified of its internal LAC scalar.

82. **Proposal:** the AI LAC Rules will provide that the MA may notify a material subsidiary of:

(i) where the capital component ratio of the material subsidiary is equal to a minimum regulatory capital ratio to which it (or an AI in its material sub-group) is subject on a solo or consolidated basis as described in paragraph 45, the relevant solo or consolidated basis;

(ii) any variation to its resolution component ratio; and

(iii) its internal LAC scalar (calibrated as described below).

C. Modelled external LAC requirement and internal LAC scalar

83. According to the FSB's *TLAC Principles and Term Sheet*, each material sub-group of a G-SIB must maintain internal TLAC of 75% to 90% of the external TLAC requirement that would apply to that sub-group were it a resolution group. This range provides a floor for material sub-groups of cross-border financial groups, while allowing the relevant authority in the jurisdiction in which a sub-group is located flexibility to increase the ratio above 75% where institution-specific circumstances so require.

84. However, this 75%-90% range may not be appropriate where internal LAC is issued from one entity in a particular jurisdiction to another entity in the same

jurisdiction, in particular where the group has a very simple organisational structure. For example, where a resolution group consists of a holding company that does not itself conduct banking activities and a single AI subsidiary, the preferred approach may be for all of the proceeds of external LAC issued by the holding company to be used to fund internal LAC issued by the subsidiary.

85. Adopting an approach on scaling internal LAC requirements that is consistent with that set out by the FSB requires three key steps:

(i) determining the capital component ratio and the resolution component ratio that would apply to a material subsidiary if it were to be a resolution entity;

(ii) multiplying the sum of the capital component ratio and the resolution component ratio by the reference measure to give the **modelled external LAC requirement**; and

(iii) determining a percentage of the modelled external LAC requirement that should be applied to the material subsidiary in calibrating its internal LAC requirement (such percentage being the **internal LAC scalar**).

86. **Proposal:** the AI LAC Rules will provide that the capital component ratio and the resolution component ratio for any material subsidiary will be equal to the capital component ratio and the resolution component ratio that would apply to that material subsidiary were it to be a resolution entity and its material sub-group constituted a resolution group.

87. The capital component ratio and the resolution component ratio for a material subsidiary will accordingly be calibrated using the methodology set out for the calibration of the capital component ratio and resolution component ratio for a resolution entity in Part III.

88. **Proposal:** the AI LAC Rules will provide that for any material subsidiary the MA may determine an internal LAC scalar for the purposes of the application of the AI LAC Rules in the range of:

(i) 75%-90%, where under the resolution strategy devised in relation to the

material subsidiary's resolution group, the internal LAC is to be issued to an entity incorporated in another jurisdiction; and

(ii) 75%-100%, where under the resolution strategy devised in relation to the material subsidiary's resolution group, the internal LAC is to be issued to another Hong Kong incorporated entity.

89. **Proposal:** the AI LAC Rules will provide that the MA's determination of the internal LAC scalar for a material subsidiary shall be made taking into account:[79]

(i) any resolution strategy which is relevant to the material subsidiary;

(ii) the findings of any relevant resolvability assessment(s) conducted under section 12(1) of the FIRO which cover the material subsidiary; and

(iii) in the event of any AI in the relevant material sub-group ceasing, or becoming likely to cease, to be viable:

- the level of financial resources expected to be required to absorb losses and contribute to the restoration of capital in the context of any resolution strategy devised in relation to the AI's resolution group; and

- the likely availability, or otherwise, of additional financial resources within the wider resolution group of which the material subsidiary is a member which could be expected to be deployed to support the AI with the result that it would again become viable.

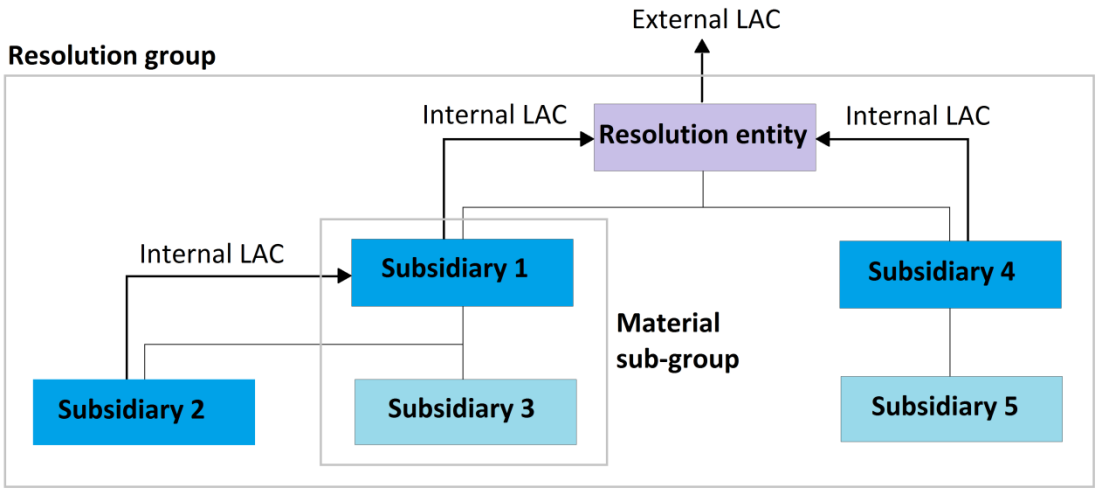
D. Distribution of internal LAC

90. Figure 5 illustrates an example of the distribution of external LAC and internal LAC in a resolution group (including a material sub-group). The resolution entity would need to meet its external LAC requirement on a consolidated basis, consolidated with reference to its resolution group, and on a solo basis[80] (see

[79] In scaling the requirement in the 75%-90% range for cross-border internal LAC, the MA, as the host authority, would expect to consult with the relevant home authority.
[80] On the assumption the resolution entity is an AI.

paragraph 100). The MA has classified each of Subsidiaries 1, 2 and 4 as a material subsidiary (see paragraph 78 above), and has determined that Subsidiaries 1 and 3 together constitute a material sub-group (see paragraph 80 above). Subsidiary 1 would need to meet its internal LAC requirement on a consolidated basis, consolidated with reference to its material sub-group, and on a solo basis[81] (see paragraph 100). Subsidiaries 2 and 4 would need to meet their internal LAC requirements on a solo basis only (as neither of them has a material sub-group). In this example, Subsidiaries 1 and 4 issue internal LAC directly to the resolution entity. Subsidiary 2's internal LAC is issued indirectly to the resolution entity, via Subsidiary 1.[82] Neither of Subsidiaries 3 and 5 is a resolution entity or a material subsidiary, so neither has a LAC requirement directly imposed on it.

Figure 5: Illustration of distribution of LAC issuance



91. As described above, the purpose of internal LAC is to pass losses incurred in a material sub-group up to its resolution entity, facilitating the orderly resolution of an AI in accordance with a relevant resolution strategy. Depending on the organisational structure of the resolution group, the prospects for orderly resolution may be undermined where internal LAC that counts towards the consolidated internal LAC requirement of a material subsidiary is not issued directly by that material subsidiary, or if the issuance is made to an entity outside the resolution group, in particular if the conversion of such LAC into

[81] On the assumption it is an AI.

[82] Note that the internal LAC issued by Subsidiary 2 and held by Subsidiary 1 would need to be deducted from the internal LAC issued by Subsidiary 1 for the purposes of assessing whether Subsidiary 1 is meeting its own internal LAC requirement, as described in paragraph 144.

equity may bring about a change in control. A similar proviso can apply for CET1 as applies for the issuance of external LAC by a resolution entity (see paragraph 41).

92. **Proposal:** the AI LAC Rules will provide that internal LAC that counts towards a material subsidiary's internal LAC requirement must be issued directly by the material subsidiary unless it is CET1 issued from a different entity within the material sub-group and would be recognised as CET1 for the material subsidiary for regulatory capital purposes on a consolidated basis. In addition, internal LAC issued by a material subsidiary must be issued to the relevant resolution entity, either directly or indirectly.

E. Role of internal LAC in cross-border resolution

93. Internal LAC is of particular importance for cross-border banking groups which have, within the same resolution group, a resolution entity in one jurisdiction (the **home jurisdiction**) and a subsidiary (direct or indirect) of that entity in another jurisdiction (the **host jurisdiction**).

94. In such situations, when a banking group comes under financial stress there is a risk of unco-ordinated, piecemeal application of local resolution powers in different jurisdictions. This risk can be mitigated by the resolution authorities in the home and host jurisdictions agreeing a cross-border resolution strategy in advance. The cross-border issuance of internal LAC from subsidiaries can be an important element of such a strategy, and can help align the national financial stability interests of the authorities in home and host jurisdictions. Such internal LAC constitutes pre-committed financial resources held in the host jurisdiction. This alleviates pressure on the authorities in the host jurisdiction to take pre-emptive resolution action. And it also incentivises co-operation from the authorities in the home jurisdiction, who will know that should there be a risk of disorderly failure of a subsidiary in a host jurisdiction, the host authority can put the subsidiary into resolution and impose losses on the internal LAC that the subsidiary has in issue, passing the losses up to the banking group's operations in the home jurisdiction.

95. Co-operation between authorities in the home and host jurisdictions can be further incentivised by requiring that the contractual write-down and/or conversion of internal LAC triggered by notification by a host authority outside

of resolution should be subject to agreement from a relevant home authority, if any.[83]

96. Aligning the financial stability interests of home and host authorities in this way helps facilitate a holistic, cross-border approach to resolution under which, should it prove necessary, both authorities can agree to impose losses on internal LAC issued by material subsidiaries, without those subsidiaries going into resolution.

Alignment with international standards

97. The proposals set out in this Part are broadly aligned with the FSB's *Guiding Principles on Internal TLAC*.

Q6.	**Do you agree with the proposals for the classification of a material subsidiary and a material sub-group set out in this Part IV? If not, how should material subsidiaries and material sub-groups be identified?**
Q7.	**Do you agree with the proposals for the calibration of a material subsidiary's internal LAC requirement set out in this Part IV, including the determination of the modelled external LAC requirement and the internal LAC scalar? If not, how should such a requirement be calibrated?**
Q8.	**Do you agree with the other proposals set out in this Part IV? If not, why not?**

[83] Should agreement from the home authority not be forthcoming within say, 24-48 hours, it would be open to the host authority to initiate resolution in respect of the issuer in the host jurisdiction, in order to bail in the internal LAC using a statutory bail-in power. The requirement for a joint trigger for cross-border internal LAC is included in the LAC eligibility criteria in Part VI.

V. TIMELINE FOR MEETING LAC REQUIREMENTS

98. As described above, an essential prerequisite to the effective use of the bail-in stabilization option is the availability of sufficient external LAC. A resolution strategy that involves the use of a transfer stabilization option may also require the availability of external LAC to bear losses to support implementation of that strategy. Internal LAC also needs to be in place, where so required by the relevant strategy. This implies that there are advantages to requiring AIs to meet LAC requirements as soon as possible.

99. However, it is recognised that in practice such requirements cannot be met immediately. Meeting LAC requirements is likely to require some changes, which in some cases will be significant, to how an AI funds itself. And should the issuance of new LAC be required, planning and executing issuance will also take some time. Further, while this consultation paper and the anticipated coming into force of the AI LAC Rules will provide AIs with an indication of the MA's thinking on the calibration of LAC, an AI's individual requirements will only become clear once the AI LAC Rules have been finalised, and the MA has devised a resolution strategy for that AI and provided relevant notifications to resolution entities and material subsidiaries.

100. **Proposal:** the AI LAC Rules will provide that following the classification of an entity by the MA as a resolution entity or a material subsidiary, the entity must meet its external LAC requirement or internal LAC requirement, as the case may be, within 24 months of such classification (or such longer period as the MA specifies). Where an entity's LAC requirement increases,[84] it must meet the increased requirement within 12 months[85] of the increase (or such longer period as the MA specifies). LAC requirements must be met by each resolution entity and material subsidiary on a consolidated basis with reference to their resolution group or material sub-group, respectively, and, for any resolution entity or material subsidiary that is an AI, also on a solo basis.[86]

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[84] This may happen where, for example, the minimum total capital ratio that applies to a relevant entity identified in accordance with paragraph 43 or paragraph 45 increases, or following the use (or change in the use) by the MA of his power to vary an entity's resolution component ratio, as provided for in paragraph 59.

[85] Provided that this shall not require the entity to meet any LAC requirement within less than 24 months of its classification as a resolution entity or material subsidiary, as the case may be.

[86] The requirements should be met on a solo basis as well as on a consolidated basis for an AI to ensure that adequate financial resources are maintained by the resolution entity or the material

101. The FSB's *TLAC Principles and Term Sheet* provides for non-EME G-SIBs to begin to meet minimum TLAC requirements sooner than implied by the timetable described in paragraph 100 above.

102. **Proposal:** the AI LAC Rules will provide that where the MA has by notice in writing to a Hong Kong incorporated AI or the Hong Kong incorporated holding company of an AI that is in each case part of a non-EME G-SIB[87] classified it:

(i) as a resolution entity, the entity must meet an external LAC requirement equal to the greater of (a) 16% of its RWAs; and (b) 6% of its exposure measure by 1 January 2019;[88] or

(ii) as a material subsidiary and notified it of its internal LAC scalar, the entity must meet an internal LAC requirement equal to the product of that internal LAC scalar and the greater of (a) 16% of its RWAs; and (b) 6% of its exposure measure by 1 January 2019.[89]

These LAC requirements must be met by each relevant resolution entity and material subsidiary on a consolidated basis with reference to their relevant resolution group or material sub-group, respectively, and, for any resolution entity or material subsidiary that is an AI, also on a solo basis.[90]

103. The MA intends to devise resolution strategies and classify entities as resolution entities or material subsidiaries in an order that prioritises those AIs that on failure would be likely to pose a higher risk to the stability and effective working of the financial system of Hong Kong. In so doing, the MA will have regard to the importance of maintaining a level playing field for AIs, and will seek to minimise any distortion of competition that may arise from imposing LAC requirements on AIs sequentially, rather than concurrently. Given the lead-in times required by AIs to meet LAC requirements, and in order to

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subsidiary (as applicable) after having taken into account the downstreaming of resources to any of its subsidiaries.

[87] Note that this proposal does not apply to G-SIBs newly identified as such by the FSB after 31 December 2015 and does not address the requirement for G-SIBs to meet higher minimum TLAC requirements by 1 January 2022. These cases can be addressed in due course by the operation of the proposal set out in paragraph 100, as can minimum TLAC requirements for EME G-SIBs.

[88] Or the date of classification, if later.

[89] Or the date of classification, if later.

[90] See footnote 86.

provide affected parties with as much certainty as possible as quickly as possible, the MA may communicate indicative capital component ratios and resolution component ratios to resolution entities, and capital component ratios, resolution component ratios and internal LAC scalars to material subsidiaries, in advance of providing any formal notifications under the AI LAC Rules.

104. As described in paragraph 29 above, LAC requirements should be treated as 'hard' requirements, not buffers. But should an entity that is subject to a LAC requirement come under financial stress with the result that losses are imposed on LAC issued by it, including where losses are imposed as a result of a voluntary agreement with investors to write down or convert LAC, it will be likely to be in breach of its LAC requirement. In these circumstances, it is appropriate to allow the entity a period of time to restore its LAC position.

105. **Proposal:** the AI LAC Rules will provide that where an entity breaches its LAC requirement:

(i) following the application of one or more stabilization options to that entity;
(ii) as a consequence of the activation of a trigger for conversion or write down, in the case of internal LAC or in the case of Additional Tier 1 capital (**AT1 capital**) instruments or Tier 2 capital (**T2 capital**) instruments (together, **capital instruments**);
(iii) following the making of a capital reduction instrument under section 31 of the FIRO; or
(iv) as a consequence of having reached a voluntary agreement[91] with investors to write down or convert LAC,

then that entity shall have a 24 month grace period before it will again be required to meet any applicable LAC requirement (or such longer period as the MA specifies).

Alignment with international standards

106. The proposals set out in this Part that apply to G-SIBs are broadly aligned with

[91] Provided that the MA has been given the opportunity to review the terms of any such agreement, and has not raised any objections.

the FSB's *TLAC Principles and Term Sheet.*

Q9.	**Do you agree with the proposal that resolution entities and material subsidiaries need to meet any applicable LAC requirements within 24 months of their classification as resolution entities and material subsidiaries (respectively)? If not, what should the conformance period be?**
Q10.	**Do you agree with the proposal that where an entity's LAC requirement increases, it should be required to meet the increased requirement within 12 months of the increase? If not, what should the conformance period be?**
Q11.	**Do you agree with the proposal that resolution entities and material subsidiaries should be required to meet their applicable LAC requirements on a relevant consolidated basis and, in the case of AIs, on a solo basis, as set out in this Part V? If not, why not?**
Q12.	**Do you agree with the proposal that where an entity breaches its LAC requirement in the circumstances described in paragraph 105, a 24 month grace period should apply before it is again required to meet any applicable LAC requirement? If not, should there be a grace period of a different length?**
Q13.	**Do you agree with the other proposals in this Part V? If not, why not?**

VI. LAC ELIGIBILITY CRITERIA

A. The rationale for LAC eligibility criteria
B. External LAC eligibility criteria
C. Internal LAC eligibility criteria
D. Additional considerations

A. The rationale for LAC eligibility criteria

107. If LAC requirements are to fulfil their purpose, the MA needs to have certainty that LAC will be available in Hong Kong at the PONV, and will feasibly and credibly be able to bear loss.

108. For external LAC, this means that the MA must be confident that LAC will be in place on AI failure, and that losses can be imposed on it using the bail-in stabilization option and/or to support the use of a transfer stabilization option, without material risk of compensation costs.

109. Such costs can arise under the NCWOL safeguard in the FIRO, which provides for pre-resolution creditors and pre-resolution shareholders of an entity in resolution to receive compensation should they receive less favourable treatment in resolution than they would have done had the entity gone into insolvency instead. The purpose of this safeguard is to provide clarity and protection to investors in relation to their position in the creditor hierarchy, and specifically to ensure their position will be no worse in resolution than in insolvency. But a consequence of this is that if LAC is to bear loss in resolution ahead of other liabilities without triggering compensation under the NCWOL safeguard, it must also bear loss ahead of other liabilities in insolvency, i.e. it must be subordinated. This requirement is reflected in paragraph 113(iii)(h) below.

110. These issues may at first glance appear less relevant for internal LAC, which is designed to bear loss without the issuer going into resolution (so that the NCWOL safeguard will not apply). But in circumstances where internal LAC is issued cross-border and the home authority objects to a proposal by the host authority to trigger internal LAC, the MA as host authority needs to have the flexibility to impose losses on the internal LAC in resolution using the powers

under the FIRO, should that prove necessary.

111. An additional consideration is that while in principle any liabilities other than those identified as "excluded liabilities"[92] (which include protected deposits) can be bailed in under the FIRO, in practice, some are easier to bail-in than others. For example, liabilities that are linked to derivatives, or are subject to netting, are less reliable as sources of loss-absorbing capacity on failure.

112. In light of these considerations, in order to count towards external or internal LAC requirements, loss-absorbing capacity should meet certain eligibility criteria.

B. External LAC eligibility criteria

113. **Proposal:** the AI LAC Rules will provide that only the following will constitute external LAC:

(i) regulatory capital (net of any deductions), less any contribution from capital instruments that do not meet the external LAC eligibility criteria;[93]

(ii) for any T2 capital instrument which meets the external LAC eligibility criteria, any portion of that instrument that has been subject to prudential amortization as set out in Schedule 4C of the BCR; and

(iii) liabilities constituted by instruments other than capital instruments that meet all of the following criteria (**external LAC eligibility criteria**):[94]

(a) be fully paid in;
(b) be unsecured;
(c) not be subject to set off or netting rights that would undermine their loss-absorbing capacity in resolution;
(d) have a remaining contractual maturity of at least one year[95] (or be

[92] "Excluded liability" is defined in section 58(9) of the FIRO.
[93] This means that because of paragraph 113(iii)(d), T2 capital with remaining maturity of less than one year will not constitute external (or internal) LAC.
[94] These are all identified in the FSB *TLAC Principles & Term Sheet* as conditions that should be met by TLAC instruments, with the exception of the criterion in paragraph 113(iii)(k).
[95] Note that where an instrument does not count as LAC because its remaining contractual maturity is less than one year, should the MA apply the bail-in stabilization option to the issuer, it is expected that

perpetual), with limited rights to early redemption by the holder;[96]

(e) not be funded or guaranteed directly or indirectly by the issuer or an affiliate[97] of the issuer (other than a holding company of the issuer), unless the MA has agreed that being so funded is not inconsistent with a relevant resolution strategy devised by the MA;

(f) not arise from derivatives or otherwise have derivative-linked features;

(g) not arise other than through a contract (so excluding, e.g., tax liabilities);

(h) be:

(1) contractually subordinated to depositors and general creditors; and/or

(2) be issued by a Hong Kong incorporated holding company of an AI, provided that the holding company's liabilities that are not eligible as external LAC and that rank *pari passu* or junior to any liabilities that are eligible, do not exceed 5% of its liabilities that are eligible[98] (i.e. be structurally subordinated);

(i) not be excluded liabilities;[99]

(j) be subject to (1) Hong Kong law; or (2) the law of another jurisdiction if, under that law, the application of resolution powers under the FIRO is effective and enforceable on the basis of binding statutory provisions or legally enforceable contractual provisions, as evidenced by independent legal advice; and

(k) the instrument contains contractual recognition of the statutory bail-in power under the FIRO, and contains language setting out that it is intended to be eligible as LAC under the AI LAC Rules.[100]

C. Internal LAC eligibility criteria

114. Internal LAC should meet all the criteria listed above (excluding the criterion in

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that instrument would still be bailed in and bear loss in a manner consistent with its place in the creditor hierarchy.

[96] An instrument that specifies one or more dates on which a holder can request redemption can still be eligible, but the maturity of the instrument would be determined by reference to the earliest possible date on which redemption can be sought.

[97] As defined in section 35 of the BCR.

[98] Liabilities that do not count as LAC only because of short maturity do not count towards the 5%.

[99] Certain liabilities that are excluded from bail-in under section 58(4) of the FIRO.

[100] It is proposed that there would an exemption from this criterion for capital instruments that are issued before the AI LAC Rules come into force.

paragraph 113(iii)(e)), and as described in paragraph 69, it also needs to be able to absorb loss without the issuer being put into resolution. Imposing losses on internal LAC involves losses being passed from the LAC issuer to the LAC holder. Where these entities are in different jurisdictions, it is therefore appropriate that the home authority has a role in the triggering of internal LAC. Effective cross-border resolution is greatly facilitated by co-ordination, and where possible agreement, between relevant authorities.

115. **Proposal:** the AI LAC Rules will provide that only the following will constitute internal LAC:[101]

(i) regulatory capital (net of any deductions), less any contribution from capital instruments that do not meet the internal LAC eligibility criteria;

(ii) for any T2 capital instrument which meets the internal LAC eligibility criteria, any portion of that instrument that has been subject to prudential amortization as set out in Schedule 4C of the BCR; and

(iii) liabilities constituted by instruments other than capital instruments that meet all of the following criteria (**internal LAC eligibility criteria**):[102]

(a) meet all of the external LAC eligibility criteria excluding the requirement not to be funded or guaranteed directly or indirectly by the issuer or an affiliate of the issuer; and

(b) the contractual terms of which specify that they are subject to write-down and/or conversion into equity upon notification from the MA at the PONV, as determined by the MA. Those terms should also specify that such write-down and/or conversion by the MA should be conditional on the relevant home authority, if any, not objecting.[103]

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[101] Subject to agreement by the relevant authorities, the FSB *TLAC Principles & Term Sheet* contemplates the substitution of internal TLAC with on-balance sheet collateralised guarantees. It is not proposed that the AI LAC Rules provide for any such substitution.

[102] These are largely identified in the FSB *TLAC Principles & Term Sheet* as conditions that should be met by TLAC instruments.

[103] Should the home authority object to the proposed write-down or conversion within a specified period, say 24-48 hours, it would be open to the MA to initiate resolution in respect of the issuer, and then impose losses on the internal LAC in resolution. Annex 3 of the FSB's *Guiding Principles on Internal TLAC* contains examples of language for a joint trigger involving both home and host

116. Note that in some circumstances resolvability may be increased by having the contractual terms specify that only one of write-down and conversion applies (for example, where conversion might lead to a change in control of the issuer that would have an adverse impact on resolvability).

117. **Proposal:** the AI LAC Rules will provide that the MA may require the contractual terms of an internal LAC instrument to specify that it is subject to only one of (i) write-down; and (ii) conversion into equity, upon notification by the MA at the PONV.

D. Additional considerations

118. Notwithstanding the criteria set out above, there may be specific cases where the nature of particular LAC instruments or the circumstances in which they are issued means that there is a risk they are not sufficiently loss-absorbing, or in some other way have the potential to undermine resolvability. In these situations, it is important that such instruments do not qualify as LAC.

119. **Proposal:** the AI LAC Rules will provide that the MA may require an entity that is subject to a LAC requirement to provide evidence that instruments issued, or to be issued, by the entity meet the eligibility criteria, including (without limitation) an independent legal opinion to that effect. Where the MA considers that the imposition of loss on a certain LAC instrument may give rise to material risk of legal challenge or valid compensation claim, or otherwise undermine orderly resolution, the MA may determine that the instrument in question should not be eligible for the purposes of meeting LAC requirements.

Clean holding companies

120. Where external LAC is issued out of a holding company the operations of which are limited to issuing funding instruments, holding funding instruments issued by its subsidiaries and any related ancillary activities (such holding company a **clean holding company**), this achieves the structural subordination described in paragraph 113(iii)(h)(2). But requiring an AI to have a clean holding company also has resolvability

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authorities.

benefits that extend beyond LAC policy, in particular where an AI's resolution strategy contemplates the use of the bail-in stabilization option, and/or the transfer of all of the ordinary shares issued by an AI to a transferee. Notably, it means that on failure the holding company goes into resolution (or possibly insolvency), but the AI itself will not. This would enhance operational continuity, mitigate risks to the continued performance of CFFs and reduce the impact of the failure of the AI on financial stability more generally.[104]

121. The benefits of requiring the issuance of external LAC from a clean holding company are less clear where a relevant resolution strategy envisages the transfer of part of an AI's business to a transferee, under which the AI will in any case be put into resolution. When devising resolution strategies and preparing resolution plans, the MA will give consideration on a case-by-case basis to whether external LAC should be required to be issued by a clean holding company. Where the MA determines that issuance from a clean holding company should be required in order to mitigate a significant impediment to orderly resolution, it would be open to the MA to use his power under section 14(2)[105] of the FIRO to mandate this. Note that the use of any such power is subject to safeguards, including providing an affected entity with the opportunity to make representations, and to apply to the Resolvability Review Tribunal established under the FIRO.[106]

Double leverage and liability mis-match

122. When a resolution group contains one or more material subsidiaries that issue internal LAC to the resolution entity, the resolution entity will fund that internal LAC with the proceeds of external LAC that it issues. However, in some circumstances a mis-match between the form of external LAC and the form of internal LAC could have an adverse impact on the resilience of the resolution group, in particular where the internal LAC is more readily

[104] Note that in the US, banks that are required to issue external TLAC are required to do so from clean holding companies (subject to certain exceptions). Similarly, banks in the UK with external MREL requirements that are in excess of their capital requirements are required to issue external MREL from clean holding companies.

[105] Section 14(2) of the FIRO allows the MA to require an AI to take any measures in relation to its structure, operations, assets, rights or liabilities that are, in the opinion of the MA, reasonably required to remove or mitigate the effect of any significant impediments to the orderly resolution of the AI, in accordance with a resolution plan developed or adopted pursuant to section 13.

[106] See section 17(1) of the FIRO.

loss-absorbing than the external LAC (e.g. where the internal LAC is CET1 but the external LAC is non-capital LAC.)

123. To take an extreme example, suppose a resolution entity is a holding company that is not subject to regulatory capital requirements, and that meets its external LAC requirement almost entirely through issuing non-capital LAC instruments (i.e. debt). Where that holding company has a material subsidiary that is an AI, that AI will issue capital, including equity, to the holding company to meet its regulatory capital requirements. The holding company uses the proceeds of the debt that it has issued to fund the equity. But if the AI suffers a loss, the holding company will need to write-down the value of its equity holding in the AI on its balance sheet. With (almost) no equity of its own to absorb that loss, the holding company will be more likely to enter insolvency than in a situation where it was less highly leveraged.

124. In order to reduce risks arising from this sort of liability mis-match, the MA will generally expect resolution groups to conduct their LAC issuance in such a way that any differences in the composition of external LAC versus internal LAC do not threaten the credibility of the resolution strategy. While mis-matches will not necessarily cause a problem,[107] should the MA conclude that any mis-match constituted a significant impediment to orderly resolution it would be open to the MA to use his powers under section 14(2) of the FIRO (as referenced in paragraph 121 above) to require the situation to be remedied.

Alignment with international standards

125. The proposals set out in this Part on eligibility criteria for external LAC and internal LAC are closely aligned with the FSB's *TLAC Principles & Term Sheet.*

[107] For example, external LAC in the form of senior debt issued by a resolution entity that is a holding company (and that is therefore structurally subordinated – see paragraph 113(iii)(h)(2))) could fund contractually-subordinated internal LAC issued by a subsidiary, without the mis-match being problematic.

Q14.	**Do you agree with the proposed external LAC eligibility criteria set out in this Part VI? If not, why not, and what should the eligibility criteria be for external LAC?**
Q15.	**Do you agree with the proposed internal LAC eligibility criteria set out in this Part VI? If not, why not, and what should the eligibility criteria be for internal LAC?**
Q16.	**Do you agree that there are resolvability benefits to an AI having a clean holding company? If not, why not, and is there any other type of organisational structure that does provide resolvability benefits?**
Q17.	**Do you agree with the other proposals set out in this Part VI? If not, why not?**

VII. RESTRICTIONS ON SALE AND DISTRIBUTION OF LAC DEBT INSTRUMENTS

126. LAC is designed to be able to absorb losses, should that prove necessary when an AI fails. Where LAC does absorb losses, this will lead to a reduction (possibly to zero) in the value of the LAC in the hands of investors. Resolution is designed to mitigate risks to the financial system that the disorderly collapse of an AI may produce. It is therefore critical that where the resolution strategy of an AI may involve imposing losses on LAC investors, the crystallisation of such losses does not itself give rise to, or exacerbate, material systemic risk or contagion.

127. Two important points follow from this:

(i) investors in LAC must properly understand the risks that come with such investments, and be equipped to bear those risks. Should the issuing entity run into difficulties, those investments could be written down completely or converted into equity, handing the investors a substantial loss; and

(ii) investment by AIs in the LAC of other AIs needs to be subject to restrictions or deduction mechanisms, to mitigate contagion risks that might otherwise arise (this is addressed in Part VIII).

128. On point (i), the risks associated with capital instruments and instruments that constitute non-capital LAC are complex and hard to assess accurately, in particular because of their loss-absorbency features. Unlike many investment opportunities, LAC debt instruments are not primarily designed with investors in mind. Such instruments will be issued by AIs in response to regulatory requirements, and are expressly designed to bear loss should an AI become non-viable. The circumstances in which LAC debt instruments may be required to bear loss are difficult to predict, not least because to date there has been no triggering of loss on these or related instruments in Hong Kong. And *ex ante* assessments of the quantum of loss will also be highly uncertain. The fact that LAC debt instruments can be written down or converted allows for a full spectrum of loss, up to 100%. When compared with more conventional instruments issued by banks (such as ordinary shares,

or senior unsecured debt), the loss-absorbing nature of these instruments is therefore highly unusual and unpredictable.

129. It can be argued that LAC debt instruments are no more risky than equities, which are readily accessible to all types of investors. But while equities are certainly risky, the market is mature and the risks are generally well-understood. And the hybrid nature of LAC debt instruments – debt-like on issue, but with equity-like loss-absorbing characteristics – in some respects makes them more complex than equities. In particular, the debt-like aspect of these instruments raises a concern that not only may investors struggle to properly assess the risk of loss, but they may in fact mistakenly regard the risk associated with such instruments as similar to that of normal bank debt.

130. Imposing restrictions on who can invest in LAC debt instruments would reduce the risk of such instruments ending up in the hands of those who do not fully understand the risks they entail. In particular, bearing in mind the risky nature of these investments, they are less likely to be suitable for retail investors.[108] Also, there may be conflicts of interest for those distributing AIs that are also issuers of the LAC debt instruments, making them still less suitable for the retail market.

131. In light of the above, and bearing in mind the high degree of trust that retail banking customers may have when investing in any products issued by an AI, a prudent approach, that restricts the distribution of LAC debt instruments, is warranted. Specifically, LAC debt instruments (including capital instruments) may not be considered suitable for retail banking customers, and their distribution should be restricted to Professional Investors, as defined in section 1 of Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571), that are not retail banking customers.[109]

132. **Proposal:** the AI LAC Rules will prohibit the primary issuance of LAC debt instruments in Hong Kong to persons other than Professional Investors. In addition, any such instruments must have a minimum denomination of HKD 8

[108] Similar concerns have led authorities in some other jurisdictions to impose restrictions and/or strict risk disclosure requirements on the sale of certain regulatory capital instruments that are expected to absorb losses following a determination by the authorities that the issuer has reached the PONV. See paragraph 138.

[109] "Retail banking customers" include individuals, sole proprietors, partnerships and small and medium enterprises.

million, or equivalent in another currency.

133. Similar arguments to those that support restricting primary distribution of LAC debt instruments can likewise apply to secondary distribution of such instruments, and to the distribution of investment products that primarily invest in, or whose returns are closely linked to, the performance of LAC debt instruments or similar instruments issued under the laws of a jurisdiction outside Hong Kong. Such investment products, together with LAC debt instruments or similar instruments issued under the laws of a jurisdiction outside Hong Kong, are referred to below as **restricted products**.

134. **Proposal:** it is proposed that the following measures[110] will apply to primary and secondary market distributions of restricted products:

(i) restricting the sale by any AIs of restricted products to Professional Investors that are not retail banking customers, only;

(ii) requiring the offering and product documents for restricted products to set out the selling restrictions referred to in paragraph 132 and this paragraph 134;

(iii) requiring a written statement from every investor in a restricted product acknowledging that the investor understands and accepts the risks associated with the investment;

(iv) requiring AIs to make adequate disclosure by directing potential investors in any restricted product to the selling restrictions in the offering and product documents, and explaining to them the structure, features and risks of such restricted product;

(v) requiring AIs to assure themselves that customers who wish to invest in restricted products have adequate knowledge or experience in products with bail-in, contingent convertible or convertible features;

(vi) requiring AIs who offer non-leveraged investment opportunities in restricted products to treat them as of at least high risk, with any

[110] It is proposed that these additional measures will be set out in circulars issued from time to time by the HKMA, and not included within the AI LAC Rules.

leveraged opportunities being treated as of the highest risk, and to assign appropriate product risk ratings accordingly; and

(vii) setting out that AIs are not expected to have any risk-mismatch transactions[111] in restricted products, and that a strong justification would be needed for any such transaction.

135. AIs dealing with Individual Professional Investors (i.e. individuals falling under section 3(b) of the Securities and Futures (Professional Investor) Rules (Cap. 571D)) should observe all the investor protection measures set out in paragraph 134 above without any exemption.

136. As reflected in the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (**SFC's Code of Conduct**), AIs dealing with Institutional Professional Investors[112] are automatically exempt from paragraphs 134(v) to (vii), while AIs dealing with Corporate Professional Investors[113] could be exempted from the investor protection measures set out in paragraphs 134(v) to (vii) if they have complied with the procedures required under the SFC's Code of Conduct.

137. Hong Kong incorporated AIs have already issued a number of LAC debt instruments, namely AT1 and T2 capital instruments that include triggers for write-down or conversion should the issuer reach the PONV. Should restrictions on the secondary distribution of LAC debt instruments be introduced, these restrictions would apply to any future sales in the secondary market of instruments already in issue.

Alignment with international standards

138. A number of other jurisdictions have imposed[114] restrictions on the sale of

[111] I.e. a transaction in which a customer's risk profile is lower than the risk rating of the investment product being purchased.

[112] I.e. persons falling under paragraphs (a) to (i) of the definition of "professional investor" in section 1 of Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571).

[113] I.e. trust corporations, corporations or partnerships falling under sections 3(a), (c) and (d) of the Securities and Futures (Professional Investor) Rules (Cap. 571D).

[114] Germany's Federal Financial Supervisory Authority has said that in view of their complex and innovative structure and associated risks, the potential conflicts of interest for banks, and the challenges for retail investors in assessing whether the coupon represents appropriate compensation for the risks taken, contingent convertible bonds are not suitable for active distribution to retail clients

certain complex and high-risk instruments (such as those with complex loss-absorbing characteristics) to retail investors. In particular, the Financial Conduct Authority in the UK has prohibited the sale of certain hybrid capital instruments with loss-absorbency features to retail investors (subject to certain exceptions).[115]

Q18.	**Do you agree with the proposal that the primary issuance of LAC debt instruments in Hong Kong be prohibited to persons other than Professional Investors? If not, why not, and what restrictions, if any, should be placed on such issuance?**
Q19.	**Do you agree with the proposal that LAC debt instruments must have a minimum denomination of HKD 8 million, or equivalent in another currency? If not, why not, and is there a different minimum denomination that should apply?**
Q20.	**Do you agree with the other proposals set out in this Part VII? If not, why not? Are there any additional or different restrictions on the sale and/or distribution of LAC debt instruments or restricted products that should be imposed, other than those mentioned here?**

(although has not imposed a formal ban) (link). Historical mis-selling of bail-in bonds in Italy has led the Bank of Italy to consider introducing restrictions on the distribution of such investments (link).

[115] https://www.fca.org.uk/publication/policy/ps15-14.pdf

VIII. TREATMENT OF LAC INVESTMENTS

139. The purpose of the FIRO is to establish a regime for the orderly resolution of FIs with a view to avoiding or mitigating the risks otherwise posed by their non-viability to the stability and effective working of the financial system of Hong Kong, including to the continued performance of CFFs.[116] Large-scale investment by AIs in LAC issued by other AIs risks undermining this by – far from mitigating systemic risks – acting as a vehicle for financial contagion, spreading losses from one AI to another. As mentioned in Part VII, investment by AIs in LAC issued by other AIs needs to be constrained, to mitigate contagion risks that might otherwise arise.

140. Under the existing capital deductions framework in Hong Kong, all AIs must deduct holdings of capital issued by other financial sector entities from their own regulatory capital (subject to a materiality threshold).

141. Under the BCBS' TLAC holding standard[117] banks' holdings of external TLAC instruments issued by G-SIBs must also be deducted from regulatory capital (again subject to a materiality threshold). This approach is not currently in force in Hong Kong, but relevant policy proposals will be developed for consultation with industry, with a view to local rules taking effect from 1 January 2019 (through amendments to the BCR). It is currently envisaged that the local rules would extend the treatment to cover external LAC instruments issued by all AIs – including where the issuer is in a different resolution group but in the same financial group as the holder[118] – not just G-SIBs. However, the BCR will not cover entities that are not AIs. Where any such entity is subject to a LAC requirement but not to a capital requirement, holdings of external LAC should be deducted from any LAC issued by the holder.

142. **Proposal:** the AI LAC Rules will provide that where an entity that is subject to

[116] Section 4(a) of the FIRO.
[117] http://www.bis.org/bcbs/publ/d387.htm
[118] Under this approach, an AI that invests in LAC issued by a resolution entity in the same financial group but different resolution group needs to deduct that investment from its own regulatory capital. Note that the proposal here is more stringent than that set out in the FSB's *TLAC Principles and Term Sheet*, which provides for exposures between resolution groups in the same financial group that correspond to items eligible for TLAC to be deducted from TLAC resources (not capital).

a LAC requirement holds external LAC[119] issued by an entity in a different resolution group, to the extent that such holdings have not otherwise been deducted from capital,[120] they will be deducted (without the application of any materiality threshold) from any LAC issued by the holder, for the purposes of assessing whether the holder is meeting any relevant LAC requirement.

143. Requiring the deduction of external LAC from capital resources (rather than LAC resources) for AIs is justified as capital resources are (primarily) designed to provide loss-absorbency on a going concern basis. If external LAC is only deducted from the holder's own LAC resources, which may only be able to bear loss in resolution, this could increase the risk of contagion. Should the LAC be written down or converted into equity, the holder may not have sufficient going concern loss-absorbency to cope, and so could be driven into resolution. Losses in one resolution group would have triggered resolution in another. Such concerns are less significant for internal LAC, which is by definition issued within a single resolution group. As such, holdings of internal LAC can be deducted from the holder's own LAC resources (subject to the normal operation of the capital deductions framework, for holdings of capital).

144. **Proposal:** the AI LAC Rules will provide that where an entity that is subject to a LAC requirement holds internal LAC issued by another entity in the same resolution group, to the extent that such holdings have not been deducted from capital under the capital deductions framework, they will be deducted (without the application of any materiality threshold):

(i) *firstly* from any LAC issued by the holder that is not in the form of regulatory capital; and

(ii) where that is not sufficient, *secondly* from the holder's regulatory capital

[119] Note that holdings of instruments that no longer count as LAC because their remaining contractual maturity is less than one year will still need to be deducted from the holder's own LAC resources. This is because should the issuer of such instruments fail, notwithstanding their short maturity those instruments may still be bailed in. The same point applies to paragraph 144.

[120] As per paragraph 141, it is envisaged that holdings of external LAC by AIs will be addressed under the capital deductions framework. In addition, where a Hong Kong incorporated holding company of an AI is required to meet regulatory capital requirements under section 70 of the BO, that requirement may stipulate that any holdings of external LAC are deducted from regulatory capital for the purposes of assessing whether not the requirement has been met.

(first from T2 capital, then from AT1 capital, then from CET1),[121]

for the purposes of assessing whether the holder is meeting any relevant LAC requirement and regulatory capital requirement.

145. Where holdings of LAC instruments are deducted in accordance with the rules set out above, they would also be deducted from RWAs and the exposure measure, and would be excluded from large exposure limits.

Alignment with international standards

146. The proposals set out in this Part on treatment of cross-holdings are broadly aligned with the FSB's *TLAC Principles & Term Sheet* and the FSB's *Guiding Principles on Internal TLAC.*

Q21.	**Do you agree with the proposal that an AI's holding of external LAC issued by an entity in a different resolution group should be deducted from regulatory capital, including where the issuer's resolution group is in the same wider banking group as the holder's resolution group as described in paragraph 141? If not, why not?**
Q22.	**Do you agree that, to the extent holdings of external LAC have not otherwise been deducted from capital issued by the holder, they should be deducted from any LAC issued by the holder? If not, why not?**
Q23.	**Do you agree that, except to the extent deducted in accordance with the capital deductions framework, internal LAC should be deducted firstly from the holder's own LAC, and secondly, if necessary, from the holder's regulatory capital? If not, why not?**

[121] Note that it is proposed that this provision in sub-paragraph (ii) be effected through the BCR, not through the AI LAC Rules.

IX. MINIMUM DEBT REQUIREMENT

147. In some respects, CET1 can be regarded as the best form of LAC, as it automatically absorbs losses on an ongoing basis. However, LAC requirements under the AI LAC Rules are designed to support resolution, not to increase prudential or going concern loss-absorbing resources. And LAC debt has an advantage over CET1 in that it will be available to absorb losses at the PONV, by which time it is likely that much or all of an AI's CET1 will have been depleted.

148. A counter-argument to this is that if the AI had more CET1 (instead of LAC debt) to start with, it would have been less likely to reach the point of failure, as CET1 can absorb losses on a going concern basis. But this is only achieved by pushing back the point of failure, with the result that should the AI still ultimately fail, it would then have less available LAC to support resolution. The risk would remain that for as long as the AI has a CET1 cushion, resolution will be delayed to the point at which there are not enough resources left for the AI to be recapitalised without an external source of funds.

149. Unlike CET1, LAC debt is not at risk of depletion before failure,[122] and provides a known quantity of recapitalisation resource in excess of going concern capital. In the absence of LAC debt, should CET1 have been materially depleted before an AI enters resolution, the only alternative source of financial resources to effect a recapitalisation is likely to be public funds.

150. Accordingly, the FSB *TLAC Principles & Term Sheet* contains an expectation that at least one-third of a G-SIB's minimum TLAC requirement should be constituted with eligible debt instruments, i.e. AT1 and T2 capital instruments in the form of debt liabilities, and other non-capital TLAC eligible instruments. The FSB's *Guiding Principles on Internal TLAC* also reference this minimum debt requirement. This requirement has been reflected in the US rules on TLAC, which require that at least one-third of minimum TLAC requirements be made up of debt. Note that the UK has not imposed a minimum debt requirement, but because of the way in which UK banks have traditionally

[122] As long as maturing debt can be replaced. Requiring LAC debt to have minimum remaining maturity of at least 12 months provides some mitigation against the risk that maturing debt cannot be rolled over.

funded themselves, it is likely that any banks with a bail-in resolution strategy would in any case issue significant amounts of required loss-absorbing capacity in the form of debt.[123]

151. However, there may be some entities which have LAC requirements for which it would be particularly onerous to issue one-third of their requirements as debt. This may include smaller AIs that in the absence of a minimum debt requirement would be able to meet most or all of their LAC requirements with CET1, or entities whose (external or internal) LAC requirement is not much higher than their regulatory capital requirement. In the former case, the resolvability benefits of mandating a minimum level of LAC debt could be outweighed by the risks that may result from requiring an AI to expand its balance sheet, funded by debt. In the latter case, imposing a one-third LAC debt requirement may have the effect of imposing restrictions on how the entity meets it regulatory capital requirement, which is not the intention of these proposals.

152. **Proposal:** the AI LAC Rules will provide that any entity that is subject to a LAC requirement (external or internal) will be required to meet at least one-third of that requirement with LAC debt instruments; provided that the MA may vary down[124] this requirement, where the MA is satisfied that it is prudent to do so taking into account:

(i) any regulatory capital requirement, the LAC requirement and the capital issuance of the entity; and

(ii) the findings of any relevant resolvability assessment(s) conducted under section 12(1) of the FIRO.

153. Note, however, that this flexibility is not designed to support unsustainable business models that are unable to internalise the costs of the risks associated with their operations and are ultimately backed by an assumption by the market that should the AI fail, public funds will be used to bail it out.

[123] From clean holding companies – see footnote 104.

[124] It is proposed that where this requirement has been varied down, the MA should also have the flexibility to vary it back up again, to no more than one-third of the relevant LAC requirement.

Alignment with international standards

154. The proposals set out in this Part are well aligned with the FSB's *TLAC Principles & Term Sheet* and the FSB's *Guiding Principles on Internal TLAC.*

Q24.	**Do you agree with the proposal that any entity that is subject to a LAC requirement should be required to meet at least one-third of that requirement with LAC debt (subject to the MA's power to vary down)? If not, why not, and should there be a different minimum debt requirement?**

X. REPORTING, DISCLOSURE, PROCEDURE AND REVIEWS

A. Reporting and disclosure
B. Procedure and reviews

A. Reporting and disclosure

155. Where an entity is subject to external or internal LAC requirements under the AI LAC Rules, it will be important that it reports to the MA periodically on the LAC that it has in issue, and on its future issuance plans. This will enable the MA to monitor the extent to which requirements are being met, and also to monitor the maturity profile of an entity's issued LAC and to keep track of future issuance needs not only for individual entities, but across the market as a whole.

156. The MA has a broad information gathering power under section 158 of the FIRO. Where necessary to supplement the disclosure requirements described in paragraphs 158 and 159 below, the MA may use that power to require any Hong Kong incorporated AI or any Hong Kong incorporated holding company of an AI to submit to the MA (i) details of any external LAC or internal LAC issued by it or any of its subsidiaries; and (ii) future LAC issuance plans for itself and any of its subsidiaries, in such form as may be specified by the MA. It is expected that more guidance on how the MA might exercise this power will be set out in the AI LAC CoP.

157. In addition to reporting to the MA, public disclosure of levels of LAC is also important. This will assist shareholders, investors, other counterparties, rating agencies etc. in assessing the risk profile of an AI, supporting market discipline.

158. **Proposal:** every Hong Kong incorporated AI will be required periodically to disclose to the general public:

(i) the issuer, amount, maturity, composition (CET1, AT1, T2 or non-capital LAC) and ranking in the creditor hierarchy of all external LAC and internal LAC issued by it or any of its subsidiaries and, for external LAC issued,

details of the terms and conditions of every instrument;[125] and

(ii) the LAC position in terms of RWAs and exposure measure on solo and consolidated bases, as applicable, of itself and any subsidiaries with LAC in issue,

provided that disclosure by an AI's Hong Kong incorporated holding company shall be deemed to satisfy any disclosure requirement on the AI, to the extent of disclosure by the holding company.

159. **Proposal:** the AI LAC Rules will provide that every Hong Kong incorporated holding company of an AI will be required periodically to disclose to the general public:

(i) the issuer, amount, maturity, composition (CET1, AT1, T2 or non-capital LAC) and ranking in the creditor hierarchy of all external LAC and internal LAC issued by it or any of its subsidiaries, and for external LAC issued, details of the terms and conditions of every instrument; and

(ii) the LAC position in terms of RWAs and exposure measure on solo and consolidated bases, as applicable, of itself and any subsidiaries with LAC in issue,

provided that disclosure by an AI shall be deemed to satisfy any disclosure requirement on its holding company, to the extent of disclosure by the AI.[126]

160. Where a relevant entity is failing, or is likely to fail, to meet a LAC requirement to which it is subject, it is important that it brings this to the attention of the MA.

161. **Proposal:** the AI LAC Rules will provide that should any entity fail, or become aware that it is likely to fail, to meet any LAC requirement, it will promptly report all relevant facts, circumstances and information to the MA, and will provide any further particulars to the MA on request.

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[125] It is envisaged that this requirement will be imposed in due course through amendments to the Banking (Disclosure) Rules (Cap. 155M) (**BDR**), and will be based on the relevant BCBS templates.

[126] It is proposed that this requirement will go into the AI LAC Rules, as holding companies of AIs are not directly covered by the BDR.

162. **Proposal:** the AI LAC Rules will provide that should any entity fail to meet a LAC requirement, the MA may, by written notice served on that entity, direct it to take, within a period specified in the notice, remedial action.

163. Note that section 19 of the FIRO provides that any entity that, without reasonable excuse, fails to comply with:

(i) a reporting requirement under the AI LAC Rules; or

(ii) a requirement applicable to it under the AI LAC Rules to take remedial action,

commits an offence, and is liable to a fine. If an entity commits such an offence and an officer of the entity authorized or permitted the commission of the offence, or was knowingly concerned in the commission of the offence, that officer also commits an offence, and is liable to a fine and to imprisonment.

B. Procedure and reviews

164. The proposed AI LAC Rules will provide for the MA to make a number of decisions or determinations in circumstances where, given their potential effect, it is considered appropriate for affected entities to be given an opportunity to make representations to the MA, and to be given the right to apply for review of the decision by the Resolvability Review Tribunal established under the FIRO.[127]

165. **Proposal:** the AI LAC Rules will provide that, where the MA intends to make a determination on any of the areas listed below, the MA must first serve a draft notice of determination on the affected entity setting out the proposed determination and allowing a period of no less than 14 days for representations. Having taken any such representations into account, the MA may then serve a final form notice. In addition, any determination on (iii) (variation of resolution component ratio) or (viii) (direction to take remedial action) made by the MA shall be reviewable by the Resolvability Review

[127] See Part 7, Division 1 of the FIRO.

Tribunal.

(i) Any classification of an entity as a resolution entity as described in paragraph 36.

(ii) Any classification of a resolution group, as described in paragraph 36.

(iii) Any decision to vary a resolution component ratio as described in paragraph 59.

(iv) Any classification of an entity as a material subsidiary as described in paragraph 78.

(v) Any identification of a material sub-group as described in paragraph 80.

(vi) Any decision to set the internal LAC scalar applicable to a material subsidiary, as described in paragraph 88, at a level above 75%.

(vii) Any decision to designate an instrument as non-eligible for the purposes of meeting LAC requirements, as described in paragraph 119.

(viii) Any direction to take remedial action following a breach of a LAC requirement, as described in paragraph 162.

Q25.	**Do you agree with the proposed disclosure requirements on AIs and Hong Kong incorporated holding companies as set out in this Part X? If not, why not, and what disclosure requirements (if any) should apply?**
Q26.	**Do you agree that where the MA intends to make certain determinations, the MA should be required to serve a draft notice and allow for a period of representation, as described in this Part X? And should certain determinations be reviewable by the Resolvability Review Tribunal? If not, why not, and are there any other safeguards that should be put in place?**
Q27.	**If you agree that safeguards should be put in place in respect of certain determinations that the MA can make under the AI LAC Rules, do you agree with the list of determinations set out in paragraph 165? If not, why not, and which determinations should be on the list?**
Q28.	**Do you agree with the other proposals in this Part X? If not, why not?**

XI. TAX TREATMENT OF LAC DEBT INSTRUMENTS

166. LAC debt is designed to be able to absorb loss through being written down or converted into equity, either following the application of the bail-in stabilization option, or in accordance with its contractual terms. As such, LAC debt instruments are hybrid in nature in that their legal form is debt-like, but with an equity-like loss-absorbing feature. The hybrid nature of such instruments raises questions about their tax treatment, and in particular whether such instruments should receive debt-like tax treatment under the IRO.

167. To address this uncertainty in respect of AT1 and T2 capital instruments, the IRO was amended in 2016 through the Inland Revenue (Amendment) (No. 2) Ordinance 2016. The amendment introduced the definition of regulatory capital securities (**RCS**) into the IRO, defined to include both AT1 and T2 capital instruments, and provided for RCS to receive debt-like tax treatment under the IRO. Non-capital LAC debt instruments do not currently fall within the definition of RCS.

168. To provide certainty on tax treatment and to avoid tax asymmetry (which may result when issuers and holders of the same LAC instrument take different views regarding the nature of the instrument), it is proposed that the IRO be further amended to afford all LAC debt instruments debt-like tax treatment, both in terms of interest expense deductibility on the part of the issuer, and income taxability on the part of the holder.

169. Further, under the IRO, the tax treatments of interest expenses incurred by AIs (falling within the definition of "financial institutions" under the IRO) and non-financial institutions are different. A clean holding company of an AI, if it is not itself an AI, does not fall within the definition of "financial institution". Consequently any distributions in respect of a LAC debt instrument issued by a clean 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.

170. With a view to maintaining a level playing field for banking groups in relation to interest expense deduction for LAC debt instruments, regardless of whether

they issue LAC debt instruments from an AI or from the clean holding company of an AI, it is proposed that comparable tax treatment for interest expense deduction should be accorded to AIs and to clean holding companies of AIs. It is proposed that the IRO be amended so that LAC debt instruments issued by the clean holding company of an AI receive the same debt-like tax treatment – from the perspective of both the issuer and the holder of such instruments – as that proposed for LAC debt instruments issued by an AI.

171. Currently, transfers of RCS are exempt from stamp duty under the Stamp Duty Ordinance (Cap. 117) (**SDO**). It is proposed that the same exemption from stamp duty be granted in respect of transfers of all LAC debt instruments.

172. **Proposal:** it is proposed that legislative amendments be made to:

(i) treat all LAC debt instruments issued by an AI as debt instruments which will receive debt-like tax treatment under the IRO, both in terms of interest expense deductibility on the part of the issuer, and income taxability on the part of the holder;

(ii) provide the same debt-like tax treatment for LAC debt instruments issued by a Hong Kong incorporated clean holding company of an AI, from the perspective of both the issuer and the holder of such instruments, as that proposed for LAC debt instruments issued by an AI, provided that the clean holding company of the AI is subject to a LAC requirement, and subject to the same set of rules and anti-avoidance provisions currently applicable to interest expense deduction by AIs in respect of RCS;

(iii) bring interest, gains or profits derived from LAC debt instruments made by a Hong Kong incorporated clean holding company of an AI into the scope of chargeable profits tax by deeming the amounts to be trading receipts in order to achieve tax symmetry. Accordingly, the principle that means that interest, gains or profits from RCS made by AIs are currently deemed to be trading receipts will equally apply to Hong Kong incorporated clean holding companies of AIs in respect of LAC debt instruments; and

(iv) exempt transfers of all LAC debt instruments from stamp duty.

Alignment with international standards

173. The approach of treating LAC debt instruments as debt securities for tax purposes has been developed with reference to approaches adopted in the UK and the US. In the *UK Revenue and Customs Brief 24 (2014): Special Securities – Provisions of the Corporation Tax Distribution Rules*, HM Revenue & Customs state that the fact that changes in the terms of a security could be triggered by an exercise of statutory bail-in powers (which forms part of the Special Resolution Regime in the UK Banking Act 2009) will not in itself make that security "result dependent", and consequently outside the scope of section 1015(4) of the UK Corporation Tax Act 2010 and so not treated as a "distribution" for the purposes of the Act.[128] Pursuant to the US Revenue Procedure 2017-12, the Inland Revenue Service treats internal TLAC that is issued by a US intermediate holding company of a foreign G-SIB to its foreign parent company (i.e. outside the US) as indebtedness for federal tax purposes (to the extent that the internal TLAC has not been subject to a debt conversion order).[129]

Q29.	**Do you agree with the proposal to extend debt-like tax treatment to all LAC debt instruments issued by AIs? If not, why not, and are there any other changes that should be made to address the tax treatment of such instruments?**
Q30.	**Do you agree with the proposal to extend debt-like tax treatment to LAC instruments issued by a Hong Kong incorporated clean holding company of an AI that is subject to a LAC requirement, as set out in paragraph 172? If not, why not?**
Q31.	**Do you agree with the other proposals in this Part XI? If not, why not?**

[128] https://www.gov.uk/government/publications/revenue-and-customs-brief-24-2014-special-securities-provisions-of-the-corporation-tax-distributions-rules

[129] https://www.irs.gov/pub/irs-drop/rp-17-12.pdf

XII. IMPACT OF LAC REQUIREMENTS

A. Cost-benefit analysis of impact on Hong Kong economy of higher LAC requirements

B. Private cost to Hong Kong AIs of higher LAC requirements

A. Cost-benefit analysis of impact on Hong Kong economy of higher LAC requirements

174. The proposal set out in this consultation paper for external and internal LAC requirements for Hong Kong incorporated AIs and their group companies is closely aligned with international standards for increasing the loss-absorbing capacity requirements of systemically important banks. However, while increasing the loss-absorbing capacity of AIs clearly brings societal benefits by reducing the likelihood and severity of financial crises, it will also bring costs.

175. Requiring AIs to maintain minimum levels of LAC to increase their resolvability means that should an AI fail, the costs will be borne by investors, not by taxpayers. This is as it should be, but a corollary of this is that investors can be expected to seek a higher return to compensate them for their increased risk. AIs are likely to pass some of these costs on to their customers,[130] leading to an increase in the cost of (at least some) financial services.

176. The HKMA has conducted a cost-benefit analysis to compare the societal benefits that can be expected to accrue from higher LAC requirements with the costs to the wider economy. This analysis assumed an increase in the LAC-to-RWAs ratio[131] (**LAC ratio**) of all Hong Kong incorporated AIs, and then sought to assess and compare the resulting macroeconomic costs and benefits. The analysis followed the methodology adopted in other studies, in particular those conducted by the Bank of England[132] and the US Federal Reserve

[130] There are alternatives to passing all the costs on to customers: AIs could change the mix of business activities they undertake to reduce their RWAs or they could absorb some of the costs by reducing return on equity and/or levels of remuneration (including bonuses). The extent to which they are able to pass on costs may in any case be constrained by competitiveness considerations.

[131] The proposal for imposing LAC requirements on AIs as set out in this consultation paper envisages LAC requirements being calibrated with reference to an AI's RWAs or its exposure measure. The cost-benefit analysis focuses on the former measure, only.

[132] Brooke, M. et al., December 2015, *Measuring the macroeconomic costs and benefits of higher UK bank capital requirements*, Bank of England Financial Stability Paper No. 35

Board.[133]

Methodology for estimating the macroeconomic costs of increased LAC-to-RWAs ratios for all Hong Kong incorporated AIs

177. The principal channel through which higher LAC ratios affect the real economy is assumed to stem from higher lending spreads, which in turn have a dampening effect on investment and output.[134] The methodology adopted for estimating the costs of higher LAC ratios therefore involved using an error-correction model to examine the relationship between lending spread and output.

178. In addition, the following key assumptions were made in the estimation for the increased macroeconomic costs:

(i) Hong Kong incorporated AIs have a LAC ratio of 18.7% of RWAs (based on aggregate consolidated total capital ratio as at June 2017);

(ii) increases to LAC ratios to meet higher LAC requirements are met two-thirds with equity and one-third with non-capital LAC debt, and this LAC funding replaces the most expensive non-LAC funding currently on AIs' balance sheets;

(iii) based on data submitted to the HKMA by Hong Kong incorporated AIs, the annual cost of equity and non-capital LAC debt is 9% and 4%,[135] respectively, and the next most expensive non-LAC funding currently on AIs' balance sheets has an annual cost of 1.7%;

(iv) increasing an AI's LAC ratio by introducing more LAC will reduce the cost

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[133] Firestone, S. et al., March 2017, *An Empirical Assessment of the Costs and Benefits of Bank Capital in the US,* Finance and Economics Discussion Series 2017-034. Board of Governors of the Federal Reserve System

[134] Other potential channels through which higher LAC requirements could affect economic output have not been taken into account due to difficulties in quantification. Brooke et al. (2015) lists a number of other possible channels through which higher capital arising from LAC requirements could affect output.

[135] The weighted average cost of Tier 2 capital from submissions to the HKMA by Hong Kong incorporated licensed banks is slightly below 4%. The cost of non-capital LAC debt should in principle be lower than that of Tier 2 capital, as it ranks above Tier 2 capital in the creditor hierarchy. In order not to over-state the net benefits of higher LAC requirements, the analysis assumes a cost of LAC debt of 4%.

of liabilities higher up the creditor hierarchy, as they have more protection from loss;[136]

(v) to the extent that LAC ratios are increased through the issuance of additional equity, rather than debt, there is a tax cost[137] arising from the fact that distributions on equity are not deductible for profits tax purposes; and

(vi) 100% of the additional cost of funding experienced by AIs as a result of maintaining higher LAC ratios are passed through to customers through increased lending spreads.

Methodology for estimating the macroeconomic benefits of increased LAC-to-RWAs ratios for all Hong Kong incorporated AIs

179. The macroeconomic benefits of increased LAC ratios are assumed to come about solely through reducing the probability of financial crises occurring (for these purposes, increased LAC ratios are not assumed to deliver any reduction in impact of financial crises when they do occur). This benefit is therefore estimated by multiplying the reduction in probability of a crisis with the cost of a crisis.

180. The methodology adopted for estimating the *reduced probability of a crisis* occurring involved using an econometric model on a dataset of OECD and EMEAP economies (including Hong Kong). A two-step process was adopted whereby:

(i) *firstly*, the probability of crisis with different LAC ratios was estimated by modelling the relationship between the probability of crisis and total capital ratios;[138] and

[136] The Modigliani-Miller (**MM**) theorem states that, under assumptions for a perfect market, any increase in the cost of funds arising from financing more by equity (instead of debt) would be offset by a decrease in the cost due to lower risks. In practice, markets are not perfect, so full MM offset should not be assumed. The degree of MM offset for Hong Kong is estimated to be around 50% based on a sample of locally-incorporated licensed banks listed in Hong Kong.

[137] Based on an effective profits tax rate of 16.5%.

[138] This is taken as a proxy for the overall LAC ratio, and so assumes that an increase in the LAC ratio has a comparable benefit to the increase in the total capital ratio.

(ii) *secondly*, the modelled probabilities of crisis were reduced by 30%[139] to reflect the fact that having an operational resolution regime in Hong Kong leads to a lower probability of crisis. A principal channel for this is stronger market discipline[140] (AI shareholders and other investors are less willing to tolerate excessive risk-taking if they expect a bail-in, not a bail-out).

181. The methodology adopted for estimating the *cost of a crisis* involved:

(i) following other studies, using the model of Romer and Romer (2017)[141] – augmented to include EMEAP economies – to project the adverse impact on GDP of a financial crisis for the five-year period following a crisis (as illustrated in the years 0-5 in Figure 6);

(ii) modelling the adverse impact on GDP of the crisis for the period beyond five years from the crisis, under three different scenarios, i.e. (1) a permanent output loss; (2) a persistent but decaying output loss with a 5% rate of decay;[142] and (3) a temporary output loss that is fully dissipated after 10 years, similar to the Asian Financial Crisis (**AFC**) episode[143] (these three scenarios are illustrated in the years 5-10 in Figure 6); and

(iii) similar to the approach taken above, reducing[144] the modelled adverse impact of crisis to reflect the prompt re-capitalisations that are facilitated

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[139] Firestone et al. (2017) applies a 30% reduction on the probabilities of crisis which is based on the empirical approach adopted by the Financial Stability Board (2015). The Financial Stability Board (2015) estimates that banks' probability of failure would reduce by approximately one-third if there was no government support. See Financial Stability Board, November 2015, *Assessing the economic costs and benefits of TLAC implementation*.

[140] Including this 30% reduction because of the presence of an effective operational resolution regime in the cost-benefit analysis of higher LAC requirements which themselves make a major contribution to the credibility of the resolution regime has an element of circularity. However, this will lead to an understatement, rather than an overstatement, of the net benefits of higher LAC requirements, and so is in keeping with the conservative approach adopted in the cost-benefit analysis.

[141] Romer and Romer, October 2017, *New evidence on the aftermath of financial crisis in advanced countries*, *American Economic Review*, 107(10), 3072–3118.

[142] Following Firestone et al. (2017)

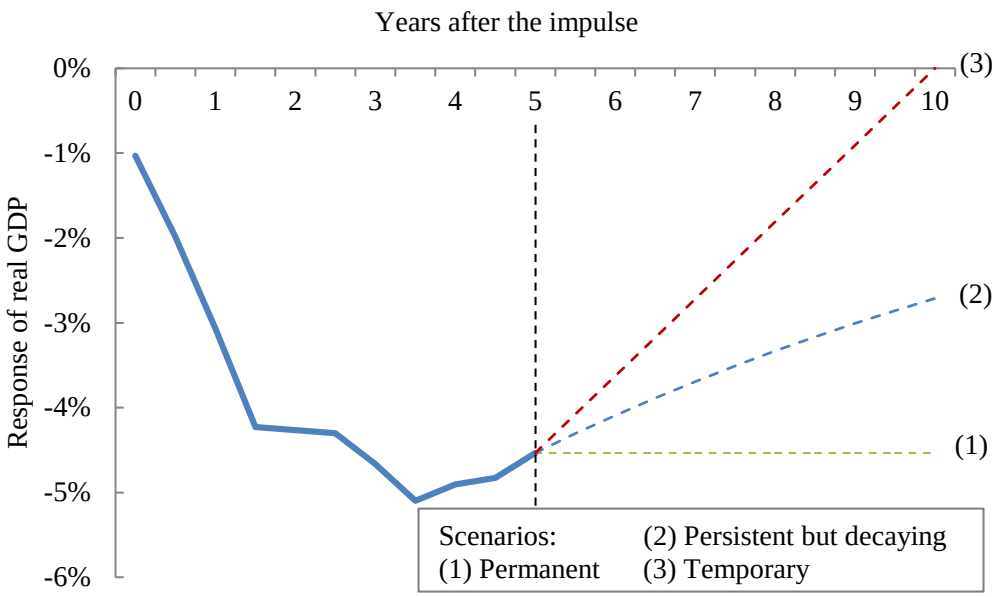
[143] This scenario essentially resembles what happened during the AFC for Hong Kong. However, the AFC had a longer-lasting impact on some Asian economies.

[144] Again, including this reduction because of prompt re-capitalisations which are facilitated by the higher LAC requirements that are the subject of the cost-benefit analysis has an element of circularity. However, this will lead to an understatement, rather than an overstatement, of the net benefits of higher LAC requirements, and so is in keeping with the conservative approach adopted in the cost-benefit analysis.

by an operational resolution regime, so that the time to a GDP trough is two years, as opposed to three and a half years, and the duration of effects is three years, rather than five (see Figure 7);[145] and

(iv) computing the net present value of the cost of crisis by discounting future loss with an appropriate long-run real risk-free interest rate, namely the real 10-year government bond yield of 3.0%.[146]

Figure 6: Unadjusted impact of financial crisis on real GDP under three scenarios

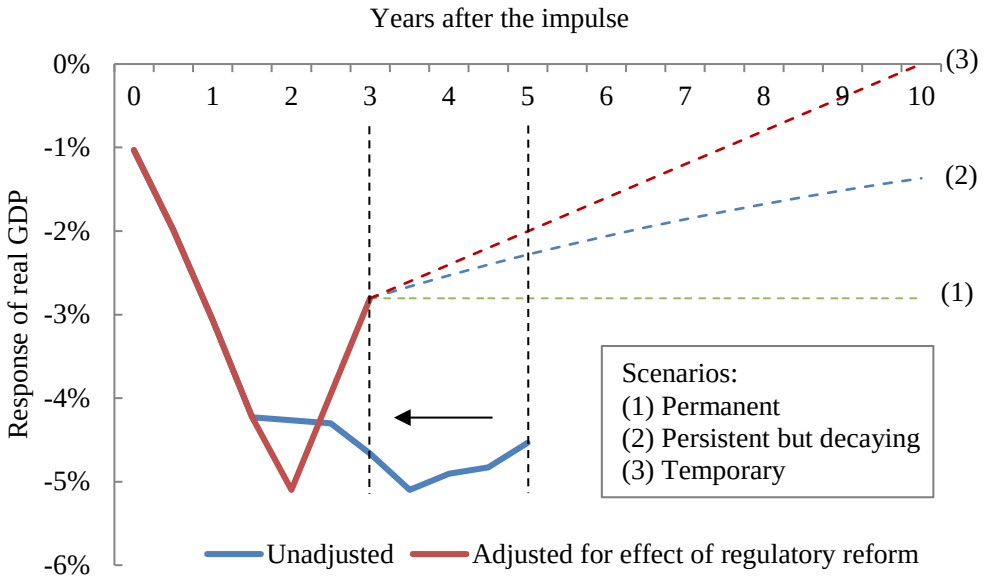


182. The gross macroeconomic benefit resulting from higher LAC ratios is calculated for each of the three scenarios by multiplying the adjusted reduction in the modelled probability of crisis by the adjusted net present value of cost of crisis, for each scenario.

[145] Following adjustments made by Firestone et al. (2017), which in turn are based on the findings of Homar and van Wijnbgergen, October 2017, *Bank recapitalization and economic recovery after financial crises*, *Journal of Financial Intermediation*, 32, 16–28.

[146] The discount rate is calculated as the average yield on 10-year Exchange Fund Note in the period from 29 October 1996 to 27 February 2015 (4.3%) minus the average inflation rate in the same period (1.3%). Using this approximately 20-year period-average leads to a higher risk-free rate than would have resulted from only considering, say, a recent 10-year period-average; again adopting this approach is consistent with the preference for understatement rather than overstatement of net benefits.

Figure 7: Impact of financial crisis on real GDP under three scenarios, adjusted for improved resolvability



Summary of the comparison of the macroeconomic costs and benefits

183. The estimated net economic benefit for Hong Kong of higher LAC ratios is the difference between the costs and the gross benefits. Figure 8 illustrates the results of the cost-benefit analysis, for each of the three scenarios. The value of the net benefit is the difference between the blue line (gross benefit) and red line (costs) for each scenario. This net benefit is positive across all three scenarios up to a LAC ratio of 30% of RWAs, but the estimated net benefit is highly dependent on whether the impact on output from the financial crisis is long-lasting or not, and AIs' cost of funding of LAC. By way of example, if AIs meet total LAC requirements of 25%[147] of RWAs, the estimated annual net benefit is up to 1.28% of annual real GDP, i.e. approximately HKD 31 billion.[148] If the impact from a financial crisis is only temporary and/or the average funding costs for LAC are greater than modelled, the net benefit would be smaller.

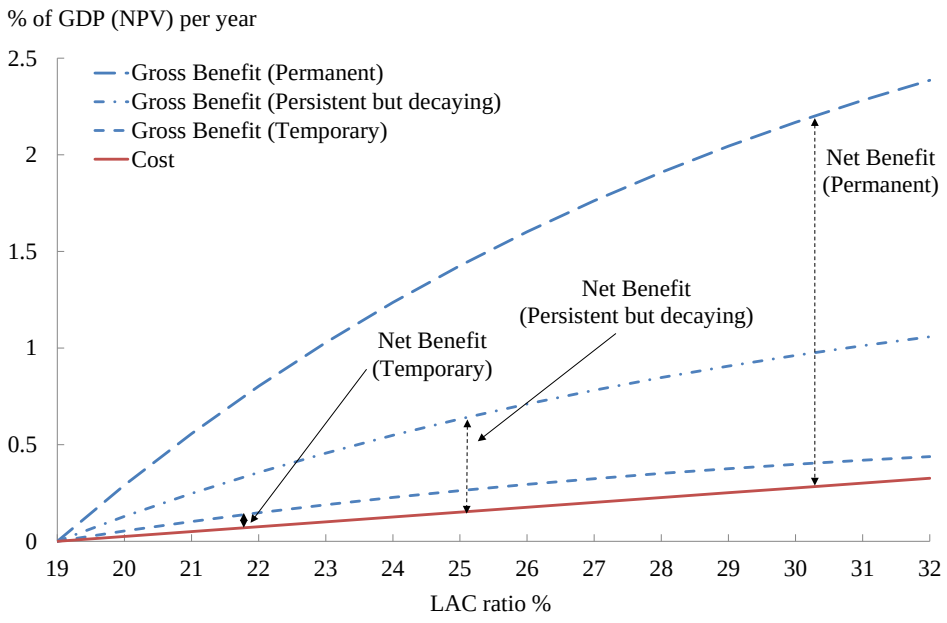
[147] This is illustrative only. If an AI had a capital component ratio of 10%, a resolution component ratio of 10%, and was subject to a capital conservation buffer ratio of 2.5% and a countercyclical capital buffer ratio of 2.5%, its total LAC requirement plus regulatory capital buffer would be 25% of RWAs.

[148] Based on 2016 real GDP of c.HKD 2.45 trillion.

184. As will be clear from the above, the cost-benefit analysis is based on a number of assumptions and qualifications. As such, an important caveat is that the analysis can at best only provide a broad overview of the likely net impact of higher LAC ratios, rather than accurate quantification. Different assumptions would have yielded different results. Having said that, the fact that this analysis indicates positive net economic benefits for high LAC ratios (i.e. up to 30% of RWAs) across all three scenarios considered does provide supporting evidence for requiring Hong Kong incorporated AIs and their group companies to meet LAC requirements in accordance with the proposals set out in this consultation paper.

185. Note that although this analysis assumes that all the costs of LAC requirements are passed on to AIs' customers, in practice, due to competition and market dynamics, AIs are unlikely to be able to pass on 100% of the costs. As such, they will be incentivised to consider other options, e.g. balance sheet restructuring and improved internal efficiency. To the extent AIs do absorb any costs themselves, the estimates of net macroeconomic benefits of higher LAC ratios will be higher than those indicated here.

Figure 8: Net benefit of higher LAC ratios for three scenarios



B. Private cost to Hong Kong AIs of higher LAC requirements

186. The cost-benefit analysis described above indicates that increasing LAC ratios delivers net economic benefits for the wider Hong Kong economy over a range of scenarios. This analysis assumes that to the extent that LAC requirements result in higher funding costs for AIs, all the cost is passed on in the form of higher lending spreads.[149] Nonetheless, it will be informative to consider the issues of both the direct cost, and the practicability, of AIs increasing their LAC requirements in line with the proposals set out in this paper.

Direct costs

187. As illustrated in Figure 2 in Part II, regulatory capital issued by AIs can be used to meet regulatory capital requirements and LAC requirements, or the regulatory capital buffer. One consequence of this is that it is difficult to isolate the impact of higher LAC requirements on AIs' funding costs from the overall impact of the broader loss-absorbing capacity regime.

188. The HKMA has therefore performed some analysis of the potential increase in AIs' funding costs from the position as at 31 December 2016, to a situation where not only are regulatory capital requirements met in full, but all regulatory capital buffers, and all LAC requirements implied by the proposals set out in this paper, are met in full.

189. Subject to a number of assumptions, this analysis indicates that in order to fully meet their regulatory capital requirement, LAC requirements and regulatory capital buffers, Hong Kong incorporated AIs will have to refinance approximately HKD 391 billion of non-LAC-eligible funding to LAC-eligible funding over the coming years.

190. This represents a significant change in funding strategy for AIs, but there are a number of important factors that need to be considered to put this into context, in particular:

(i) the aggregate balance sheet for all Hong Kong incorporated AIs comes to approximately HKD 15 trillion in terms of exposure measure, of which

[149] See footnote 130.

HKD 391 billion represents around 2.6%;

(ii) the majority of this refinancing will be required of G-SIBs, all of which are headquartered in home jurisdictions which are committed to implementing the higher loss-absorbing capacity requirements set out in the FSB's *TLAC Principles and Term Sheet*; and

(iii) relatedly, the majority of the aggregate figure is expected to be constituted by LAC that is issued *within* international financial groups. As such, it represents 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.

191. After taking these points into consideration, the HKMA's analysis indicates that the volume of Hong Kong incorporated AIs' funding that may have to be refinanced from non-LAC-eligible funding directly to external LAC issued to investors could be around HKD 136 billion, or approximately 0.9% of the aggregate funding raised by all Hong Kong incorporated AIs. Using the numbers set out in paragraph 178(iii) above, this implies a gross funding cost increase of HKD 136 billion x (4% - 1.7%) = HKD 3.1 billion, and so an aggregate net after-tax cost of HKD 2.6 billion per year to Hong Kong incorporated AIs.[150] Note that this is not to imply that the requirements imposed on G-SIBs, and that relate to internal LAC, are costless. But to the extent that the AI LAC Rules impose such requirements, these are largely to reflect international standards that are in any case being imposed on such entities by the relevant authorities in their home jurisdictions.

192. In this consideration of the potential direct costs to AIs of higher LAC requirements, it is worth re-iterating that the macroeconomic cost-benefit analysis above makes the simplifying assumption that *all* these higher costs are passed on in the former of higher lending spreads, so are not borne by the AIs. To the extent that AIs do bear any of these costs, the net benefit to the wider economy would increase accordingly.

[150] Assuming an effective profits tax rate of 16.5%.

Practicability

193. The preceding paragraphs discuss the likely direct cost of requiring AIs to meet higher LAC requirements. An important related question is the practicability of AIs issuing sufficient LAC to meet those requirements – how well-placed are debt markets to absorb the necessary LAC issuances?

194. As discussed above, the majority of the funding that AIs would be required to shift from non-LAC-eligible to LAC-eligible as a result of the proposals set out in this consultation paper is that issued by G-SIBs and/or will be replaced by internal LAC. As such, 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).

195. However, on the above analysis, there may be the need to refinance around HKD 136 billion of funding into external LAC issued by Hong Kong incorporated AIs to investors. If we conservatively assume an average maturity of five years for such debt, this implies an issuance volume of HKD 27.2 billion (i.e. USD 3.5 billion) per year. This is a material amount in the context of the annual supply of Hong Kong bank capital issuances in recent years, but in absolute terms, and certainly in the context of expected APAC bank capital supply, this is not a large number. And as discussed above, the experience of G-SIBs to date in issuing TLAC demonstrates that there is already a developed global investor base for these types of investment. As such, and bearing in mind that there is no requirement that such issuance be denominated in Hong Kong dollars or governed by Hong Kong law (subject to meeting the eligibility criterion in paragraph 113(iii)(j)), there is little reason to doubt the ability of markets to absorb the expected supply of external LAC issuance.

196. It is possible that an increase in supply, in particular from names with which the market is less familiar, may have an effect on price (in particular in a market which, as noted above, is likely to see significant volumes of APAC bank capital issuance). But it is not expected that this will have a material impact on the analysis in this Part XII, not least because (i) as set out in footnote 135, the assumed price for LAC debt in this Part is above that of T2 capital, when in practice such debt is likely to be cheaper than T2 capital; and (ii) with much LAC

debt issued by Hong Kong AIs being internal LAC and ultimately funded by G-SIBs in global debt markets, the proportion of LAC debt that may be affected by supply in the regional market is likely to be small.

Q32.	**Do you have any comments on any of the proposals set out in this consultation paper that are not covered by the preceding consultation questions? If so, please set out your comments together with justifications.**

ANNEX A: CONSULTATION QUESTIONS

Q1. Do you agree with the proposal that only resolution entities and material subsidiaries incorporated in Hong Kong should be subject to external and internal LAC requirements, respectively, under the AI LAC Rules? If not, what other entities should also be in scope, and why?

Q2. Do you agree with the proposal that for all AIs CET1 that counts towards meeting a LAC requirement cannot also count towards meeting a regulatory capital buffer? If not, why not?

Q3. Do you agree with the proposals for the classification of a resolution entity and a resolution group set out in this Part III? If not, how should resolution entities and resolution groups be identified?

Q4. Do you agree with the proposals for the calibration of a resolution entity's external LAC requirement set out in this Part III, including the MA's power to vary a resolution entity's resolution component ratio? If not, how should such a requirement be calibrated?

Q5. Do you agree with the other proposals set out in this Part III? If not, why not?

Q6. Do you agree with the proposals for the classification of a material subsidiary and a material sub-group set out in this Part IV? If not, how should material subsidiaries and material sub-groups be identified?

Q7. Do you agree with the proposals for the calibration of a material subsidiary's internal LAC requirement set out in this Part IV, including the determination of the modelled external LAC requirement and the internal LAC scalar? If not, how should such a requirement be calibrated?

Q8. Do you agree with the other proposals set out in this Part IV? If not, why not?

Q9. Do you agree with the proposal that resolution entities and material subsidiaries need to meet any applicable LAC requirements within 24 months of their classification as resolution entities and material subsidiaries (respectively)? If not, what should the conformance period be?

Q10. Do you agree with the proposal that where an entity's LAC requirement increases, it should be required to meet the increased requirement within 12 months of the increase? If not, what should the conformance period be?

Q11. Do you agree with the proposal that resolution entities and material

subsidiaries should be required to meet their applicable LAC requirements on a relevant consolidated basis and, in the case of AIs, on a solo basis, as set out in this Part V? If not, why not?

Q12. Do you agree with the proposal that where an entity breaches its LAC requirement in the circumstances described in paragraph 105, a 24 month grace period should apply before it is again required to meet any applicable LAC requirement? If not, should there be a grace period of a different length?

Q13. Do you agree with the other proposals in this Part V? If not, why not?

Q14. Do you agree with the proposed external LAC eligibility criteria set out in this Part VI? If not, why not, and what should the eligibility criteria be for external LAC?

Q15. Do you agree with the proposed internal LAC eligibility criteria set out in this Part VI? If not, why not, and what should the eligibility criteria be for internal LAC?

Q16. Do you agree that there are resolvability benefits to an AI having a clean holding company? If not, why not, and is there any other type of organisational structure that does provide resolvability benefits?

Q17. Do you agree with the other proposals set out in this Part VI? If not, why not?

Q18. Do you agree with the proposal that the primary issuance of LAC debt instruments in Hong Kong be prohibited to persons other than Professional Investors? If not, why not, and what restrictions, if any, should be placed on such issuance?

Q19. Do you agree with the proposal that LAC debt instruments must have a minimum denomination of HKD 8 million, or equivalent in another currency? If not, why not, and is there a different minimum denomination that should apply?

Q20. Do you agree with the other proposals set out in this Part VII? If not, why not? Are there any additional or different restrictions on the sale and/or distribution of LAC debt instruments or restricted products that should be imposed, other than those mentioned here?

Q21. Do you agree with the proposal that an AI's holding of external LAC issued by an entity in a different resolution group should be deducted from regulatory capital, including where the issuer's resolution group is in the same wider banking group as the holder's resolution group as described in paragraph 141? If not, why not?

Q22. Do you agree that, to the extent holdings of external LAC have not

otherwise been deducted from capital issued by the holder, they should be deducted from any LAC issued by the holder? If not, why not?

Q23. Do you agree that, except to the extent deducted in accordance with the capital deductions framework, internal LAC should be deducted firstly from the holder's own LAC, and secondly, if necessary, from the holder's regulatory capital? If not, why not?

Q24. Do you agree with the proposal that any entity that is subject to a LAC requirement should be required to meet at least one-third of that requirement with LAC debt (subject to the MA's power to vary down)? If not, why not, and should there be a different minimum debt requirement?

Q25. Do you agree with the proposed disclosure requirements on AIs and Hong Kong incorporated holding companies as set out in this Part X? If not, why not, and what disclosure requirements (if any) should apply?

Q26. Do you agree that where the MA intends to make certain determinations, the MA should be required to serve a draft notice and allow for a period of representation, as described in this Part X? And should certain determinations be reviewable by the Resolvability Review Tribunal? If not, why not, and are there any other safeguards that should be put in place?

Q27. If you agree that safeguards should be put in place in respect of certain determinations that the MA can make under the AI LAC Rules, do you agree with the list of determinations set out in paragraph 165? If not, why not, and which determinations should be on the list?

Q28. Do you agree with the other proposals in this Part X? If not, why not?

Q29. Do you agree with the proposal to extend debt-like tax treatment to all LAC debt instruments issued by AIs? If not, why not, and are there any other changes that should be made to address the tax treatment of such instruments?

Q30. Do you agree with the proposal to extend debt-like tax treatment to LAC instruments issued by a Hong Kong incorporated clean holding company of an AI that is subject to a LAC requirement, as set out in paragraph 172? If not, why not?

Q31. Do you agree with the other proposals in this Part XI? If not, why not?

Q32. Do you have any comments on any of the proposals set out in this consultation paper that are not covered by the preceding consultation questions? If so, please set out your comments together with justifications.