asifma

Growing Asia's Markets

14 March 2018,

Resolution Office
Hong Kong Monetary Authority
55th floor, Two International Finance Centre
8 Finance Street, Central, Hong Kong

By post and by email (lacinfo@hkma.gov.hk),

Re: ASIFMA response to the HKMA consultation on Rules on Loss-Absorbing Capacity Requirements for Authorised Institutions

Dear Sirs,

The Asia Securities Industry & Financial Markets Association (ASIFMA)[1] and its members welcome the opportunity to provide feedback on this consultation paper, which sets out the Hong Kong Monetary Authority's (HKMA) intended approach for making rules under section 19 of the Financial Institutions (Resolution) Ordinance (Cap. 628) (FIRO) prescribing loss-absorbing capacity (LAC) requirements for authorised institutions (AI LAC Rules).

ASIFMA fully supports the development of a recovery and resolution framework in Hong Kong to safeguard the stability of Hong Kong's financial system while minimising public costs and economic impact in the event of a financial crisis. We therefore commend the HKMA's consultation paper on LAC rules for being generally well-aligned with the Financial Stability Board's (FSB) Key Attributes of Effective Resolution Regimes for Financial Institutions (the "Key Attributes").

We note several areas worth further consideration, however. For instance, since the AI LAC Rules are likely to have a significant impact on, and require significant effort on the part of, AIs, it is important that the rules be implemented gradually over a multi-year timeframe. This is to ensure that AIs have sufficient time to build up their LAC, particularly given that many have traditionally relied on customer deposits as their main source of funding.

Greater clarity is also needed on how the HKMA proposes to determine in-scope resolution entities and define material subsidiaries, material sub-groups and critical financial functions (CFFs). As currently outlined, the rules provide considerable flexibility in determining what institutions would be captured, which appears to deviate from international standards and from the approach taken in the FSB's Total Loss-

[1] ASIFMA is an independent, regional trade association with over 80 member firms comprising a diverse range of leading financial institutions from both the buy and sell side, including banks, asset managers, law firms and market infrastructure service providers. Together, we harness the shared interests of the financial industry to promote the development of liquid, deep and broad capital markets in Asia. ASIFMA advocates stable, innovative, competitive and efficient Asian capital markets that are necessary to support the region's economic growth. We drive consensus, advocate solutions and effect change around key issues through the collective strength and clarity of one industry voice. Our many initiatives include consultations with regulators and exchanges, development of uniform industry standards, advocacy for enhanced markets through policy papers, and lowering the cost of doing business in the region. Through the GFMA alliance with SIFMA in the United States and AFME in Europe, ASIFMA also provides insights on global best practices and standards to benefit the region.

Absorbing Capacity (TLAC) Term Sheet (FSB Term Sheet). Without a clear framework on these points, moreover, it is difficult for individual AIs to assess the rules' impact.

ASIFMA also agrees that the sale and distribution of LAC debt instruments needs to be restricted, given their relatively risky nature. But we recommend carefully calibrating such restrictions to ensure they do not depart from international practice in such a way that the appeal of Hong Kong-issued LAC on the global market is reduced. The proposed minimum denomination, for example, appears likely to create such a disadvantage.

ASIFMA further recommends against the proposal that entities subject to a LAC requirement be required to meet at least one-third of that requirement with debt. Such a quota would impose additional costs without improving resolvability.

Last and yet foremost, we recommend an explicit commitment in the rules to international cooperation. Given that LAC requirements are designed to facilitate the resolution of entire global financial institutions, international alignment is essential. Many AIs in Hong Kong are subsidiaries of global financial institutions and hence will need to consider the requirements in their home jurisdictions. It is crucial that the AI LAC Rules avoid creating inconsistencies with home jurisdiction requirements that make it unduly costly for global financial institutions to develop their operations in Hong Kong.

To avoid creating such inconsistencies, and to properly assess and optimise the LAC requirements for many AIs in Hong Kong, home and host authorities in the relevant Crisis Management Groups (CMG) will need to consult with each other. The consultation paper should include a stronger commitment to engaging home authorities in the CMG, particularly when designating material subsidiaries and material sub-groups.

We look forward to continued engagement with the Resolution Office on this issue. If you have further questions or would otherwise like to follow up, please contact Wayne Arnold, ASIFMA's Executive Director and Head of Policy and Regulatory Affairs, at warnold@asifma.org or +852 2531 6560.

Sincerely,

Mark Austen
Chief Executive Officer
Asia Securities Industry & Financial Markets Association

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?

ASIFMA agrees with the proposal on the applicability of the LAC requirements, which are in line with the FSB's guidelines and term sheets on LAC and internal LAC. In particular, ASIFMA welcomes the exclusion of branches of entities incorporated outside Hong Kong from any internal and external LAC requirements. This is consistent with the FSB Term Sheet (paragraph 16), which specifically excludes branches from any LAC requirements.

However, further clarification on several key elements of the proposal would be required to make a definitive assessment. Specifically, we would appreciate greater clarity around how the HKMA will determine what constitutes a resolution entity and a material subsidiary, as the consultation paper does not provide clear definitions for these two categories. We understand that the Code of Practice (CoP) that HKMA plans to publish this summer will provide additional information, but given the 1 January 2019 deadline set out for non-emerging market economy (EME) global systemically important banking groups (G-SIBs) to meet minimum LAC requirements, we are concerned that this may not allow such groups sufficient time to understand the new rules before the HKMA begins making determinations on which AIs are in scope for LAC requirements.

Similarly, there is little clarity on what the HKMA considers to be a "small AI." We would appreciate further details on the criteria used to assess which institutions would be deemed small AIs, as opposed to AIs that would be deemed systemically important and would thereby need a resolution strategy.

Finally, while we applaud the fact that branches have been excluded from the LAC requirements, footnote 30 could benefit from different placement to clarify that it does not relate to the treatment of branches. While paragraph 25 makes it clear that only material subsidiaries incorporated in Hong Kong will face internal LAC requirements, footnote 30 stipulates that if an entity has a subsidiary in another jurisdiction that does not have TLAC requirements – or where host authorities have not imposed requirements on that subsidiary – then the HKMA could (in consultation with authorities of that jurisdiction) propose an internal LAC requirement for the subsidiary if the HKMA determines that the absence of such a requirement represents an impediment to resolvability. In relation to this statement in footnote 30, we would also welcome further details on the proposed treatment for multi-jurisdictional, material sub-groups and how the HKMA intends to coordinate with overseas resolution authorities if needed.

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?

ASIFMA does not oppose this proposal, as it is in line with the FSB Term Sheet.

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?

As noted above, we look forward to more clarity around how the HKMA will determine what constitutes a resolution entity and a material subsidiary, as this section does not provide clear criteria for assessing which institutions are deemed systemically important.

The rules should clearly acknowledge the need to obtain the agreement of the relevant CMG in designating a resolution entity or a resolution group. The classification of a resolution entity or a resolution group should be initiated by the relevant home authority in close collaboration with host authorities and other CMG members in accordance with FSB principles. The host authority should avoid making unilateral decisions in the classification of resolution entities and resolution groups.

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?

With reference to the proposal (paragraphs 39 and 45) that resolution groups calculate their risk-weighted assets (RWA) and exposure measure on a consolidated basis for the purposes of determining their capital component ratio, resolution component ratio and, by extension, their LAC requirement, we note the difficulty of assessing the practicality of this proposal without also having definite criteria for determining and defining resolution entities, resolution groups and CFFs. The same reservation applies to the proposal in paragraph 40 concerning the exception for LAC that is CET1 issued from another entity in the resolution group.

With reference to the proposal (paragraph 58) to set the resolution component ratio equal to the capital component ratio, we note that this could result in LAC requirements that exceed even the most conservative estimates cited in the consultation's discussion of historical losses. We therefore support the proposal to allow adjustment of the resolution component ratio, and appreciate the HKMA's attention to the potential for higher-cost LAC to incentivise greater risk-taking by AIs, thereby undermining the function of LAC. But we suggest that the conditions and criteria for the HKMA varying this ratio be made transparent, objective and consistent across AIs. We understand that the CoP slated for this summer will include guidance on how the HKMA would determine when and by how much to vary the resolution component ratio. Until we have had a chance to review such guidance, it would be difficult to evaluate the practical effect of the proposal.

We also note that calibrating LAC without fully understanding the impact of reforms to the calculation of RWA could result in significantly higher capital requirements. We therefore recommend that LAC requirements be assessed to ensure that they take into account other related workstreams, including the revised standards for calculating RWA recently adopted by the Basel Committee on Banking Supervision (BCBS) in connection with the finalisation of the Basel III package of reforms.

We further suggest that reviewing the need for varying the resolution component ratio every 12 months (paragraph 60) may be impractically frequent, both in terms of the HKMA's own resources as well as in terms of the ability of AIs to provide accurate and timely information and, potentially, adjust the level of LAC instruments they have in issuance. A yearly recalibration, either higher or lower, stands to introduce uncertainty to AIs' funding requirements and other regulatory calculations. We would suggest these reviews be conducted no more than biannually, particularly given that the HKMA already envisions a 24-month window for the initial issuance of LAC instruments and 12 months for the issuance of LAC to meet any increased requirements thereafter. Given this timeline, it is not difficult to envision a scenario in which an AI would still be adjusting its LAC from a given year while being reassessed and then required to adjust LAC again.

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

ASIFMA understands the difficulty associated with determining LAC requirements for EME G-SIB groups ahead of a final timeline for imposing such requirements by the FSB, as explained in footnote 46. Our concerns with the proposal to treat EME G-SIBs as non-G-SIB AIs until that timeline is finalised are, however, threefold: first, that applying rules to EME G-SIBs that are *ab initio* temporary in nature would create uncertainty over their funding structures that would complicate their ability to comply with the LAC requirement; second, LAC requirements would be imposed on EME G-SIBs on a preliminary basis before their home jurisdiction has developed and imposed equivalent rules on such G-SIBs' parents and so make it impossible to impose LAC requirements in consultation with the home authority as specified by the FSB Key Attributes; and third, that such temporary rules might introduce an un-level playing field that, however short-lived, may have a lasting impact on the market.

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?

ASIFMA welcomes more clarity on the definition of material subsidiaries. We are concerned with the high degree of flexibility provided to the HKMA in determining what institutions would be classified as material subsidiaries and thereby captured under LAC requirements (paragraph 78). As the consultation notes in footnote 77, this differs from the FSB Term Sheet, which – while granting some discretion – specifies that critical functions be identified by CMGs. We believe that the AI LAC Rules should clearly acknowledge the need to obtain the agreement of the relevant CMG with respect to the designation of material subsidiaries and material sub-groups, which would align with the process for designating material subsidiaries as described in the FSB Term Sheet.

More specifically, we note that both the AI LAC Rules and the FSB Term Sheet rely on a set of "5% tests" that are meant to be the principal, objective gauge of whether a G-SIB's subsidiary operations in a host jurisdiction justify the imposition of an internal LAC requirement on the hosted subsidiary or sub-group. The HKMA's specification of these quantitative tests for designating a Hong Kong subsidiary as material, though formulated slightly differently from the FSB Term Sheet, is consistent with the underlying principle: that the misallocation risks inherent in prepositioning LAC resources are so significant that they should only be judged as acceptable by home and host authorities if the subsidiary operations of a G-SIB in a host jurisdiction are so substantial that they are critical to the resolution of the G-SIB resolution group as a whole.

To implement this principle, the FSB Term Sheet supplements the 5% test with a provision that, even where these quantitative tests are not met, a material sub-group requiring application of a minimum internal TLAC requirement may be found to exist where the entities that comprise such a sub-group "have been identified by the firm's CMG as material to the exercise of the firm's critical functions." The AI LAC Rules, by contrast, provide that where the HKMA concludes – at its sole discretion – that a given Hong Kong subsidiary is "material to the provision of CFFs in Hong Kong," it may designate that subsidiary as material and subject it to a minimum internal LAC requirement.

This approach appears to give the HKMA latitude to unilaterally designate entities as material subsidiaries in a way contrary to the agreement among home and host authorities embodied in the FSB Term Sheet. We recommend the AI LAC Rules be amended so that – in the case of G-SIBs – the standard for designating a Hong Kong material subsidiary corresponds to the standard specified by the FSB Term Sheet.

Similarly, composition of material sub-groups should be guided by the materiality criteria in the FSB Term Sheet and further guidance from HKMA on the appropriate process and procedures for defining material

sub-groups. Determinations of materiality should be clearly supported by information made available to the relevant CMGs and firms, should not result in discrepancies with requirements that apply to other similar firms in the domestic market, and should be subject to review and, in principle, agreement by the relevant CMGs.

The FSB Term Sheet recommends that "the list of material sub-groups and their composition […] be reviewed by the home and host authorities within the CMG on an annual basis and, if necessary, revised by the relevant host authorities." Such a review process would respect and ensure the HKMA's oversight of the Hong Kong operations of cross-border groups, while appropriately acknowledging that the resolution of such operations would necessarily be part of wider-ranging resolution proceedings that require cross-border cooperation.

It should also be made clear that material sub-groups consist of material entities, rather than an aggregation of individually immaterial entities that, when combined, could meet the quantitative criteria. Aggregation of "sister companies" that are not otherwise part of an accounting or regulatory consolidation would cause unnecessary governance and risk management problems. Given that the objective of orderly resolution, and therefore LAC requirements, is to maintain the continuity of critical functions, subsidiaries should only be included within a material sub-group to the extent that they provide critical functions.

It should also be noted that not all entities in scope of application of the going concern requirements require internal LAC, in particular those not organised as banks or those that could be resolved through normal insolvency procedures, such as service entities.

Entities providing critical services in support of critical functions should normally not be required to have internal LAC, but instead should be able to demonstrate appropriate operational continuity measures. Internal LAC is not appropriate for such entities, as it would artificially raise RWA and leverage, inflating the overall balance sheet.

Operational continuity solutions, rather than internal LAC, would also be more appropriate for service-centre entities, which have no reason to be capitalised as if they were banks. Minimum debt requirements make no sense for service centres, which do not operate on the same basis or with the same funding as operating subsidiaries.

It would also be appropriate to develop in further detail why and how alternative arrangements (such as contingency planning, pre-positioned capital resources structured around the actual needs of an entity, guarantees or other devices) would be more appropriate for other types of entities, especially service companies or other non-financial entities. Asset management companies, for example, require relatively limited capital.

In summary, greater focus needs to be devoted to the question of how much internal LAC is appropriate for Hong Kong subsidiaries of cross-border groups and how to achieve that protection sensibly. The answer to this question can only be effectively determined through close collaboration between the home and host authorities and the other members of relevant CMGs. Excessive internal LAC structures that hinder the FSB's cross-border objectives should be avoided.

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?

ASIFMA would appreciate further clarity on the scope of application of the AI LAC Rules, in particular with respect to subsidiaries of foreign entities, as some sections of the consultation appear contradictory. While paragraph 25 makes it clear that only material subsidiaries incorporated in Hong Kong will face internal LAC requirements, footnote 30 stipulates that if such an entity has a subsidiary in another jurisdiction that does not have TLAC requirements – or where host authorities have not imposed requirements on that subsidiary – then the HKMA could (in consultation with authorities of that jurisdiction) propose an internal LAC requirement for that subsidiary if the HKMA determines that the absence of such a requirement represents an impediment to resolvability. Relatedly, it should also be made clearer that branches of a resolution entity are not in scope for internal LAC, even if they are part of the same legal entity as the resolution entity.

The AI LAC Rules should also clearly acknowledge the need for the internal LAC scalar to be set jointly by the home and host authorities as well in consultation with other members of the CMG. Internal LAC requirements for a material sub-group should generally not exceed such requirements for equivalent local banks. The proposal does give AIs an opportunity to submit representations to the HKMA following receipt of a draft notice of determination on an internal LAC scalar and before service of a final form notice (paragraph 165), which we take to mean that AIs would be given a chance to submit comments or evidence to assist the HKMA in reaching appropriate determinations. However, we urge the HKMA to include the determination of internal LAC scalar as one of the areas reviewable by the Resolvability Review Tribunal so that AIs have an opportunity to, as necessary, rebut potentially invalid assumptions and erroneous conclusions.

Calculating appropriate levels of internal LAC requires close and specific analysis of a resolution group's and its subsidiaries' structures, balance sheets and the composition of the relevant LAC-eligible instruments, avoiding simplistic assumptions about one-to-one relationships between external and internal LAC. It should be possible for any entity within a group (including a special-purpose financing entity), whether it is a resolution entity or not, to hold internal LAC for the benefit of a resolution entity, as long as the group's losses are up-streamed as necessary.

In addition, the requirement for material Hong Kong subsidiaries to calculate their LAC requirements at the subsidiary level, where RWA includes intragroup exposures that would net out at the group level, results in double counting of intragroup exposures in RWA and therefore a higher internal LAC calibration across the firm than would be warranted by the group's external LAC requirement, which would be based on an RWA that nets out those exposures. The inclusion of intragroup exposures in the RWA requirement that would be multiplied by 75% likewise, therefore, skews the internal LAC calibration.

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

ASIFMA is concerned by the proposed cooperation framework regarding the use of internal LAC in cross-border resolution between home and host authorities. The consultation paper states that, where a host authority is considering the contractual write-down and/or conversion of internal LAC outside of resolution, the host authority would notify the home authority and "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." ASIFMA would be grateful for more clarity on how discussions on cross-border resolutions would be handled between the HKMA and home jurisdictions. In questions of cross-border coordination during resolution, the home authority should be the lead authority and its decisions should take precedence.

Further, it would be appropriate to define detailed communication protocols with CMGs to be followed as a prerequisite for triggering internal LAC. This would ensure that the relevant home authority and CMG members are adequately informed and can take preparatory steps. While the protocols should specify the steps needed to ensure that the home authority and CMG members are informed early in the process, such protocols should not predetermine specific measures that could otherwise limit the flexibility of the CMG to react to a specific situation.

Finally, in reference to footnote 73, ASIFMA would appreciate further clarity on whether "surplus LAC" would be available for commercial purposes within a material sub-group and not be restricted to high-quality liquid assets (HQLA).

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?

To reiterate, the rules should clearly acknowledge the need to obtain the agreement of the relevant CMG with respect to the determination of an implementation and compliance timetable to meet LAC requirements. Notifications from the HKMA should be made available as soon as possible to allow banks in scope to comply (e.g., to finalise the design and structure of their internal LAC instruments). Looking at other Basel jurisdictions, and with reference to the 13th BCBS Progress Report on the adoption of international standards, we note that key members have yet to finalise their external and internal TLAC requirements. As global banks in Hong Kong operate in many jurisdictions, it is critical for the HKMA to collaborate and take into account emerging developments in other jurisdictions.

Beyond this, we are concerned that the 24-month window for issuing external LAC following classification as a resolution entity or material subsidiary risks creating a LAC supply glut, potentially raising the system-wide cost of issuance. While this may depend on how rapidly the HKMA can assess and classify AIs, it may be appropriate to devise staggered or phased deadlines for LAC issuance to avoid material impact on the market and to enable AIs to time issuance to minimise their funding costs.

We would also like to draw attention to paragraph 102, which suggests that non-EME G-SIBs may be required, after written notice by the MA, to meet their LAC requirements by 1 January 2019. Given the time required to finalise thee AI LAC Rules, review the CoP and designate resolution entities, material subsidiaries and internal LAC scalars, this deadline may prove challenging and the HKMA should approach it with appropriate flexibility.

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?

As stated above, we are concerned that the 12-month issuance deadline for increased requirements will overlap with the 12-month review period, creating the possibility that resolution entities will still be adjusting LAC based on one review as they enter the next review. This will complicate funding plans and could create investor uncertainty. While the 12-month deadline for increased requirements may be workable, the review period needs to be made less frequent. This is particularly so given the long-term nature of LAC eligibility, in which only instruments with remaining contractual maturities of more than one year may be counted towards the LAC requirement. Furthermore, where an entity's LAC requirement

increases, the deadline by which the entity is required to meet the increased requirement should be agreed between the home and host authorities in the relevant CMGs.

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?

As mentioned above, it is difficult to assess the practicality of this proposal without also having definite criteria for determining and defining resolution entities, resolution groups and CFFs.

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?

This proposal appears reasonable given the likelihood that a breach would make it difficult, if not impossible, for an entity in the conditions outlined in paragraph 105 to issue new LAC instruments. However, given that the market is thus likely to anticipate a 24-month deadline for new issuance, it may be more advantageous for the HKMA to avoid a hard deadline and instead stipulate that it will set a grace period for affected entities in consultation with the entity and the CMG to allow for market conditions and thereby increase the chances of a successful re-building of the entity's LAC.

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?

The eligibility criteria outlined in Part VI appear largely consistent with the FSB Key Attributes. However, we would appreciate clarity on the circumstances under which the HKMA would allow for limited early redemption by the holder of a LAC instrument. We assume that the circumstances under which an instrument featuring an early redemption right by the holder may be treated as valid LAC would be limited to those in which the holder's right to redeem prior to the originally stated maturity preserves a one-year minimum residual maturity requirement.

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?

Subject to agreement by the relevant authorities, the FSB Term Sheet contemplates the substitution of on-balance sheet internal LAC with collateralised guarantees. ASIFMA encourages the HKMA to include the possibility of any such substitution in the AI LAC Rules. Use of guarantees to provide internal LAC in appropriate cases is important, notably because it alleviates the problem of deposit-funded banks, where on-balance-sheet LAC would necessarily lead to the addition of supplemental assets, creating more risk and increasing leverage.

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?

As described in the consultation paper, there do appear to be benefits to having a clean holding company structure for the purposes of resolvability. However, it is difficult to assess the practicality of such a structure without yet knowing the HKMA's specific resolution strategy for a given AI. And while it is in the HKMA's power to require LAC issuance by a clean holding company under FIRO section 14(2), we would recommend ensuring that the decision on whether to do so be aligned with the firm's existing business strategy or agreed resolution strategy, rather than be imposed for the purposes of resolution. We therefore welcome the recognition that use of this power is subject to safeguards that include providing the entity with the opportunity to make representations and to apply to the Resolvability Review Tribunal.

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

To address concerns that may arise concerning double leverage, we endorse the proposed flexibility articulated in paragraph 124, whereby the HKMA could use its power under section 14(2) of the FIRO in certain circumstances including, but not limited to, double leverage and liability mis-match.

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?

ASIFMA supports the proposal that the primary issuance of LAC debt instruments in Hong Kong be prohibited to persons other than Professional Investors (as defined in the Securities and Futures Ordinance (Cap. 571) (SFO), given the riskier and more complex nature of LAC debt instruments and the existence of potential conflicts of interest for those distribution AIs that are also issuers of such instruments. Professional Investors, who are expected to constitute the bulk of the market for LAC debt instruments, would be much better positioned to assess the risks and potential losses that may be incurred on LAC debt instruments.

In addition, it is important to note that LAC debt instruments would need to be issued through the debt capital markets and any primary issuance restrictions need to be proportionate and should not significantly affect the normal operation of the debt capital markets. Otherwise, the proposals may put Hong Kong AIs at a competitive disadvantage to non-Hong Kong financial institutions when issuing LAC debt instruments. Primary issuance of Additional Tier 1 or Tier 2 capital instruments by Hong Kong AIs into the international bond markets are already limited to Professional Investors to ensure compliance with the SFO. Similar restrictions on primary issuance also apply to non-Hong Kong financial institutions when they issue capital instruments in the international bond markets. Hong Kong AIs have not typically issued capital instruments into the Hong Kong local bond market given the limited liquidity and size of the Hong Kong local bond market.

Accordingly, proposals to extend primary issuance restrictions to Professional Investors *who are not retail banking customers* would be inconsistent with existing SFO restrictions that apply to Hong Kong AIs when issuing capital instruments in the international bond market. In addition, requiring that primary issuance of LAC debt instruments be restricted to Professional Investors *who are not retail banking customers* would go beyond the restrictions in place in other key financial centres. In the United Kingdom, for example, the Financial Conduct Authority's (FCA) rules on the distribution of contingent convertible securities (CoCos) restrict the promotion and sale of CoCos to retail investors (i.e. retail banking customers who are neither sophisticated nor high net worth, or who do not meet any of the other permitted professional investor criteria). Similarly in the United States, no additional restrictions are imposed on the sale and distribution

of capital instruments, other than those restrictions to qualified investors that generally apply to all debt securities offerings (i.e., normal senior bonds as well as capital instruments).

Furthermore, the proposals to extend the primary issuance restrictions on LAC debt instruments to sales in the *secondary* markets, as well as to retrospectively extend the LAC debt instruments restrictions to outstanding Additional Tier 1 and Tier 2 capital instruments, go beyond existing SFO restrictions that apply to Hong Kong AIs when issuing capital instruments in the international bond market. The FCA considered a similar point in the context of restrictions on the distribution of CoCos. The FCA concluded that it would only apply such restrictions to sales in the primary market, which is where the FCA believed the greatest risk of inappropriate distribution existed. The FCA noted that it remained the responsibility of market intermediaries to have proper regard to the characteristics and risks of the investment and the profile of the investor before recommending any investment. US regulators have also not imposed restrictions on TLAC debt instruments in the secondary markets.

Even in Hong Kong, there are currently no additional requirements to sales of Additional Tier 1 or Tier 2 instruments in the secondary market. Rather, licensed firms that sell debt instruments (including Additional Tier 1 or Tier 2 instruments) to investors, whether in the primary or secondary markets, are required to comply with the principles set out in the SFC's Code of Conduct for Persons Licensed by or Registered with the SFC. These principles prescribe various requirements, including around investor due diligence and suitability procedures. We believe such existing requirements are sufficient to address concerns relating to sales of LAC debt instruments in the secondary markets.

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?

As mentioned above, ASIFMA agrees with the proposal to restrict primary issuance of LAC debt instruments to Professional Investors (as defined in the SFO) only. We also agree that the requirement of minimum denominations as a safeguard to ensure LAC debt instruments are issued to Professional Investors only is a sensible approach.

However, the minimum denomination of HKD8mn may be too rigid, particularly as non-Hong Kong financial institutions are able to issue capital instruments in the international bond markets at minimum denominations of EUR100,000 or the equivalent. Imposing a HKD8mn minimum denomination requirement would place Hong Kong AIs at a disadvantage to non-Hong Kong financial institutions: first, by making the Hong Kong AIs' LAC debt instruments less tradeable and marketable (both in the primary distribution and in the secondary markets); and second, by potentially hindering investors' ability to hedge their exposure to such LAC debt instruments.

While we acknowledge that a minimum denomination requirement may play some role in ensuring that LAC debt instruments do not fall into the hands of ordinary retail investors without relevant experience and expertise with the risks associated with such instruments, denominations are only one aspect of the overall framework, and a HKD8mn minimum denomination requirement could have unintended consequences on the liquidity and marketability of such instruments in the international bond markets. What is equally, if not more, important is to ensure that market participants involved in the sale and distribution of LAC debt instruments have robust procedures in place in relation to investor suitability, the requirements for which are already adequately provided for in the SFC Code of Conduct.

ASIFMA therefore suggests that HKMA explore setting up a smaller denomination or explore imposing a minimum ticket size, rather than a HKD8mn minimum denomination.

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?

It is proposed in Part VII (paragraph 134, iii), of the consultation paper that a written statement will be required from every investor in a restricted product acknowledging that the investor understands and accepts the risks associated with the investment. It is also required (paragraph 134, iv) that AIs make adequate disclosure by directing potential investors in any restricted product to the selling restrictions in the offering and product documents, and explain to them the structure, features and risks. In addition, the consultation paper proposes that AIs offering non-leveraged investment opportunities in restricted products be required to treat them as of at least high risk, with any leveraged opportunities being treated as of the highest risk, and to assign appropriate product risk ratings accordingly (paragraph 134, vi).

ASIFMA agrees that there should be adequate disclosure to investors on restricted products and associated risks. It is worth noting that disclosure to investors can be achieved in various ways – for example, disclosure by way of an offering document or disclosure by obtaining the informed consent of investors through investor representation letters when they make their investment decision. Professional Investors are expected to have the necessary experience and expertise to read and understand the structure and features of restricted products and the risks involved, without the need to impose a corresponding positive obligation on AIs to direct them to the relevant disclosure or explain it to them.

The measures set out in paragraph 134 (iii) and (iv) (namely, the requirement for two-way investor representation letters and to the imposition of a positive obligation on AIs to direct investors to the relevant disclosure and explain the structure, features and risks of the restricted product) seem to go beyond the requirements for disclosure imposed in other key jurisdictions. For example, in the context of the sale of CoCos in the UK, AIs have responded to the regulator's concerns around investor protection by using one-way investor representation letters to ensure that investors in CoCos understand the nature and risks of the instruments. It should also be noted that CoCos are capital instruments that contain a contingent capital trigger (as opposed to capital instruments which only have a non-viability trigger – which will be the case for most Additional Tier 1 and Tier 2 capital instruments issued by Hong Kong AIs) and so are arguably a riskier and more complex category of instruments than the LAC debt instruments and other capital instruments issued by Hong Kong AIs. To the extent the HKMA intends to require Hong Kong AIs to use investor representation letters for distributing restricted products, it would be appropriate to limit this to *one-way* investor representation letters (rather than *two-way* investor representation letters) in order to ensure that the approach is aligned with the requirements of other key jurisdictions.

Regarding the requirement that AIs offering non-leveraged investment opportunities in restricted products be required to treat them as of at least high risk, with any leveraged opportunities being treated as of the highest risk, and to assign appropriate product risk ratings accordingly (paragraph 134, vi), ASIFMA agrees that the HKMA should require AIs offering non-leveraged investment opportunities in restricted products treat them as of at least high risk, but would appreciate the ability to differentiate products with even higher risk compared with LAC products bought on a leveraged basis.

In addition, the measures set out in paragraph 134 should only be applicable to distributions of restricted products in the *primary* market and not the *secondary* market, where imposing such measures would pose

various hurdles. As mentioned previously, this is in line with the position in other jurisdictions, including the UK, where the FCA concluded that restrictions should only apply to primary distribution, as this is where there is the greatest risk of inappropriate distribution. ASIFMA also suggests not requiring the same restrictions on AT1/T2 capital instruments as on LAC debt instruments. For AT1/T2 capital instruments in issue, we propose restrictions to focus on disclosures and PI-only restrictions.

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?

As noted in footnote 118, this proposal is more stringent than the FSB's LAC Principles and Term Sheet. Our concern is that deducting LAC issued by a resolution group in the same financial group as the holder may prove unnecessarily conservative and put Hong Kong AIs at a disadvantage to regional peers. Moreover, the risks associated with holding LAC instruments should already be factored into revised calculations of RWA. Requiring that LAC holdings also be deducted from regulatory capital appears redundant and difficult to calculate.

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?

Yes, this seems consistent with the BCBS' standards on TLAC holdings and stands to help reduce contagion risk.

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?

As explained above, deducting internal LAC from the holder's regulatory capital appears redundant to revised calculations of RWA for the purposes of capital requirements.

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?

ASIFMA believes that it is not appropriate to transpose the 33% debt requirement to internal LAC and that the HKMA should follow the examples of the European Union and the UK, where no such requirement exists. A minimum debt requirement for external LAC may be defensible on the grounds that it provides for market monitoring by external debt holders, but this argument does not apply to internal LAC. The same monitoring function can be performed in other ways by regulators and resolution authorities for material sub-groups (and there is no market oversight), so there is no reason to constrain funding choices with a debt requirement. Unlike external LAC, the equity and debt holder of internal LAC may be the same entity, minimising the need for the separate debt requirement if sufficient equity capital is held in the form of internal LAC. Additionally, certain subsidiaries may already hold sufficient equity capital to meet their internal LAC requirements; a debt requirement would impose additional costs without an apparent benefit to resolvability.

ASIFMA also believes the 33% requirement may also be inappropriate for external LAC. Such a requirement may unnecessarily limit firms' flexibility in deciding the appropriate funding mix for a given situation while not improving loss-absorbency. Firms may choose to include debt in their funding to some extent for tax or other reasons, but should have the ability to determine the funding mix most appropriate to their corporate structure.

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?

ASIFMA would appreciate greater clarity on the frequency envisioned for these disclosure requirements, particularly as they may overlap or conflict with the proposed annual review of LAC requirements. As outlined above, we feel such frequent reassessments may paradoxically introduce market uncertainty and complicate AIs funding efforts.

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?

ASIFMA agrees with and commends the HKMA for introducing procedural safeguards that provide firms the opportunity to present information and make appropriate appeals. However, we do note certain inconsistencies in the availability of appeal to the Resolvability Review Tribunal, which we detail in the answer to Q27 below.

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?

ASIFMA agrees with the list of determinations that the MA can make under the AI LAC Rules. However, it is proposed in the consultation paper that only decisions to vary the resolution component ratio and directions to take remedial action shall be reviewable by the Resolvability Review Tribunal. This seems to contradict part 7, Division 1 of the FIRO, which implies a broader scope. ASIFMA encourages the HKMA to consider allowing determinations made in the other areas listed in paragraph 165 of the consultation paper to be reviewable by the Resolvability Review Tribunal, particularly a decision to set the internal LAC scalar applicable to a material subsidiary at a level above 75%.

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?

ASIFMA supports the HKMA’s proposal that amendments be made to legislation in Hong Kong so that LAC debt instruments are generally given debt-like tax treatment by Hong Kong’s Inland Revenue Department. As the consultation paper notes, this proposal would provide beneficial certainty on tax treatment under Hong Kong law. The consultation paper points out that Hong Kong previously determined in 2016 to grant debt-like tax treatment to other capital instruments that are hybrid in nature, with debt-

like legal forms and equity-like loss-absorbing features, and we agree that it makes sense to put LAC debt instruments on the same footing as such instruments, including the exemption of transfers from stamp duty. We also support the proposals by the HKMA that are directed at ensuring that the tax treatment of interest expense associated with LAC debt instruments issued by a clean holding company of an AI is made appropriately equivalent to that associated with instruments issued by an AI. However, there are areas that require further certainty and clarity:

- Where non-capital LAC debt instruments will be subject to the same set of tax rules and anti-avoidance provisions as those that currently apply to regulatory capital securities (RCS), the following issues need to be addressed where RCS/LAC debt instruments are issued to an associated entity/Specified Connected Person (SCP):
    - It is not possible to do one-to-one tracing of external issuances by large global banking groups out of a group holding company with multiple resolution entities/operating banks in different jurisdictions due to fungibility of funds and other market and regulatory considerations. This is especially a problem if one-to-one tracing of external issuances is required on down-streams within large global banking groups that adopt multiple point of entry resolution strategy with single point of external issuance. Despite the fact that LAC debt instruments are issued for genuine commercial purposes, unless the Inland Revenue Department adopts a pragmatic approach to the application of section 17F(2) (e.g., comparing the cumulative RCS/LAC debt instruments funded by group holding company and the cumulative external issuance), AIs of overseas banking groups will encounter difficulties in demonstrating compliance with the relevant Inland Revenue Ordinance (IRO). We believe this goes against the legislative intent to allow tax deduction on distributions payable by AIs on RCS/LAC debt instruments as necessary under Basel III capital/LAC requirements. The fund tracing requirement should be eliminated or Departmental Interpretation and Practice Note (DIPN) 53 should be amended to include additional guidance and examples (e.g., introduce a "safe harbour" such that the requirements are deemed to be met where, in aggregate, the external debt issuance by the SCP exceeds the aggregate of instruments down-streamed to the AIs and all other associated corporations).
    - Following the above, tracing and comparing the amount of interest payable by AIs to the respective external issuance by an SCP is also not possible. Given domestic transfer pricing in Hong Kong domestic law and tax treaties, this contradictory sub-section should be repealed. Alternatively, at a minimum, there should be clarification in DIPN 53 that this sub-section will only be invoked as an anti-avoidance provision.
- As it takes time for AIs to build up LAC debt instruments in order to comply with the requirements at the effective date (1 January 2019), the legislative amendment should be applied retrospectively (at least allowing a 6-month grace period) to confirm that LAC debt instruments issued prior to the effective date are also subject to the same debt-like tax treatment.
- While we understand the need to extend the deeming provision on gains or profits from RCS to LAC debt instruments, there should be clarification that, where losses are suffered from RCS or LAC debt instruments upon redemption or sale, symmetrical tax treatment applies to allow a tax deduction to be claimed. We also suggest that the HKMA clarify whether the treatment applies to mark-to-market income, gains and/or losses.
- We suggest that a new section be added to the Inland Revenue Ordinance stipulating the tax treatments of LAC debt instruments together with specific and separate definitions on the types of instruments that qualify as LAC versus those that qualify as RCS, and that the LAC provisions are separate from and do not overlap with the RCS provisions.

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?

We 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 subject to a LAC requirement, subject to the following:

- the considerations and issues noted above;
- a workable definition of "clean holding company;" and
- clarification that Section 17D(2) of the IRO (which disregards accounting fair value change on RCS/LAC debt instruments issued to SCP) is also applicable to a connected person (e.g., the Hong Kong clean holding company) of the issuer even though such connected persons are not SCP in order to avoid tax mismatch between the connected person and the issuer given any fair value change of the issuer is disregarded under Section 17C(2) of the IRO.

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

We agree in principle with the proposals in Part XI subject to the above. However, we would like to add that debt-like tax treatment for LAC debt instruments should also apply to instruments issued by an affiliated operational entity that is designated by the HKMA as a resolution entity in order to maintain a level playing field.

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.

We would like to reemphasise the importance of cross-border coordination between home and host authorities and statutory recognition of foreign resolution orders with regard to bail-ins for subsidiaries of overseas-incorporated financial institutions, which is critical for effective resolution planning. We therefore suggest the HKMA include a stronger commitment to engagement with home resolution authorities in the final AI LAC Rules. Pre-positioning LAC can support – but not replace – true cooperation, which would be supported by the development of agreements between home and host authorities. To the extent possible, cooperation protocols should ensure that home and host authorities adhere to the procedural and substantive standards set by FSB guidance with respect to the determination of material entities, calibration of common external Pillar 1 TLAC and determination of the level of internal TLAC prepositioning.