

4 September 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 Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements – Banking Sector) Rules

Dear Sirs,

The Asia Securities Industry & Financial Markets Association (ASIFMA)¹ and its members welcome the opportunity to provide feedback on the Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements - Banking Sector) Rules (AI LAC Rules), which the Hong Kong Monetary Authority's (HKMA) proposes will take effect as subsidiary legislation under the Financial Institutions (Resolution) Ordinance (Cap. 628) (FIRO).

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. As part of that support, we submitted responses in March 2018 to the HKMA's consultation paper "Rules on Loss-Absorbing Capacity Requirements for Authorised Institutions" (CP18.01) and in May 2018 to the HKMA's proposals for implementing in Hong Kong the Banking Committee on Banking Supervision (BCBS) final standard on "TLAC holdings." We therefore commend the HKMA's consultation paper for being in line with the expectations set in those prior consultations and for being generally well-aligned with the Financial Stability Board's (FSB) Key Attributes of Effective Resolution Regimes for Financial Institutions.

ASIFMA also welcomes the exclusion of branches of entities incorporated outside Hong Kong from any internal and external LAC requirements, which is consistent with the FSB Term Sheet. Likewise, we support the flexibility afforded to the resolution authority to extend the period for meeting the LAC requirement, as this may avoid a rigid deadline for LAC issuance that stands to create a glut of supply. Finally, we

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.

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appreciate the flexibility to reduce the minimum LAC debt requirement in limited circumstances, as we feel a requirement that at least 33% of internal LAC be in the form of debt is unnecessarily restrictive to banks' funding needs.

We note several areas worth further consideration, however. The rules would benefit from greater clarity on what general criteria the HKMA will use to determine resolution entities and define material subsidiaries and critical financial functions, even if the HKMA leaves the specific criteria and formulas to subsequent determination and periodic review. And while we respect that Hong Kong legislation cannot and should not defer to a foreign organisation, we still feel the rules would be improved by explicitly acknowledging the need to obtain the agreement of the relevant Crisis Management Group (CMG) in designating a resolution entity and to establish a cooperation arrangement with relevant home authorities. We appreciate however that the HKMA explicitly mentioned the need to cooperate with relevant stakeholders in its conclusions to CP18.01.

Likewise, ASIFMA supports the proposal to allow adjustment of the resolution component ratio, but the rules as now drafted don't sufficiently specify the criteria for varying that ratio, leaving latitude that will need to be explicitly defined. Also, the interactions between some of the rules of the framework are not explained and would benefit from greater clarity. Similarly, the rules might reasonably expand the scope of decisions that can be submitted for review by the Resolvability Review Tribunal, particularly any decision to set a material subsidiary's internal LAC scalar higher than 75%. Lastly, we feel the minimum denomination requirement as now proposed will unnecessarily disadvantage Hong Kong AIs when issuing to global investors without effectively preventing retail investors from holding LAC.

We look forward to discussing the Code of Practice (CoP) and further regulation drafts related to LAC before the rules come into place and recommend providing sufficient lead time to allow AIs to prepare for implementation of the new rules.

Our detailed comments on the draft AI LAC Rules, set forth below, are based on member feedback and on discussions with a number of financial institution clients.

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

Part 1: Preliminary

For greater simplicity and to facilitate compliance, ASIFMA advises against repeated referrals to definitions provided in previous legislation. For example, the definition of “Additional Tier 1 capital instrument” (AT-1) in Part 1, Rule 2, sub-rule (1)(a), refers to section 2(1) of FIRO, which in turn defines AT-1 instruments by referring to the criteria set out in Schedule 4B to the Banking (Capital) Rules (Cap. 155 sub. leg. L) (BCR). It would be useful to reiterate the specific criteria in these rules and refer to the relevant legislation parenthetically or in a footnote. The same is true for repeated reference to the “Capital Rules,” which are then defined as “the Banking (Capital) Rules (Cap. 155 sub. Leg. L.)” (e.g. in the definition for “counterparty credit risk”).

The definition for the “capital component ratio” – which reads “see rule 18” – suggests a potentially more practical solution, which is to embed the definitions in the text where the term is first used and then combine these definitions into a glossary. Similarly, referring to the rules in the definitions argues for including the definition in the relevant rule. For example, the definition of “consolidated basis” refers to Rules 15 and 16, while the definition of “exposure measure” depends on the outcomes of no less than five subsequent rules – 14(3)(a), 15(3)(a), 16(3)(a), 38, 40, and the Capital Rules. Such variability suggests that determining the “exposure measure” may defy easy definition and instead merit its own schedule to the rules.

The part of the definition of “clean HK holding company” that relates to liabilities (i.e. section (b) of the definition) seems unclear. We would appreciate greater clarity and precision in this section defining the thresholds for liabilities beyond which a holding company would no longer be considered “clean.” It might also be helpful to include this definition in the relevant rule(s).

Part 2: Resolution Entities, Material Subsidiaries and LAC Consolidation Groups

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, the proposed rules would benefit from greater clarity around a) how the HKMA will devise the preferred resolution strategy introduced in Part 1, Rule 3; and b) what aspects of the preferred resolution strategy the HKMA proposes to consider when determining in-scope resolution entities and defining critical financial functions and material subsidiaries. We understand that more specific guidance on this issue will be included in the AI LAC CoP, but would like to reiterate that the rules provide considerable flexibility in determining what institutions would be captured as resolution entities and material subsidiaries, which makes it difficult for individual AIs to assess the rules’ impact and to prepare themselves. Part 2, Rule 5, sub-rule (2)(a) of the draft AI LAC Rules states that the HKMA may, in considering whether to classify an entity as a resolution entity, take into account the preferred resolution strategy covering the entity and any other matters HKMA considers relevant. We believe the factors mentioned are not clearly defined and may create uncertainty. Similarly, Part 2, Rule 6, sub-rule (3)(c) sets out that, in classifying material subsidiaries, the HKMA may take into account any matters it considers relevant. ASIFMA believes the criteria should be more precisely defined.

In addition, Part 2, Rule 6, sub-rule (1)(b), paragraph (iv), states that the resolution authority may classify a classifiable entity as a material subsidiary if the resolution authority determines that the classifiable entity, taken on its own, or together with any of its subsidiaries in the resolution group, is material to the provision of critical financial functions. We understand the HKMA's view that a framework based on key metrics to identify material subsidiaries cannot be applied to all situations mechanically, and that the HKMA wishes to retain discretion and flexibility in classifying material subsidiaries. However, the HKMA's proposed approach appears to give it 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.

For instance, Rule 6, sub-rule (3) appears to give the HKMA latitude to employ whatever data it believes most appropriate in a manner that could undermine the ability of a classifiable entity to avail itself of Rule 8, sub-rule 1(c) to make written representations concerning any financial assumptions used to determine whether it is a material subsidiary. The HKMA may also end up defining an entity as performing critical financial functions before the final CoP becomes available, leaving the entity and its investors in doubt as to its specific requirements.

Finally, we highlighted in our response to CP18.01 that the rules should clearly acknowledge the need to obtain the agreement of the relevant Crisis Management Group (CMG) in designating a resolution entity. The classification of a resolution entity should be initiated by the relevant home authority in close collaboration with host authorities and other CMG members, in accordance with FSB principles. We also believe that the host authority should avoid making unilateral decisions in the classification of resolution entities and resolution groups. Similarly, we believe that the AI LAC Rules should 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. We understand, however, that the subsidiary legislation that will implement these proposals cannot defer to a foreign organisation, particularly one without legal or diplomatic authority, and look forward to discussing these issues once the draft CoP is available.

Part 3: LAC Ratios

ASIFMA does not have any comment regarding this section.

Part 4: Determination of Minimum LAC Ratios

With reference to Part 4, Division 1, Rule 19, sub-rule (5) and Part 4, Division 3, Rule 25, sub-rule (2), ASIFMA supports the proposal to allow adjustment of the resolution component ratio for resolution entities and material subsidiaries for the purpose of determining its modelled minimum external LAC risk-weighted ratio or modelled minimum external LAC leverage ratio. We suggested in our response to CP18.01 that the HKMA's conditions and criteria for varying the ratio be transparent, objective and consistent across AIs. Although the HKMA provided a list of factors to be taken into account, the inclusion of "any other matters the HKMA considers relevant" does not provide certainty on the factors that might be considered. The same reasoning applies to Part 4, Division 3, Rule 26, sub-rule (3) in determining whether it is prudent to increase a material subsidiary's internal LAC scalar.

ASIFMA welcomes the possibility, as stated in Part 4, Division 4, Rule 31, that the resolution authority may, by written notice served on a resolution entity or material subsidiary, extend the period after which the resolution entity or material subsidiary must meet a LAC requirement, if the authority is satisfied that it is prudent to do so. As outlined in our response to CP18.01, ASIFMA is concerned that a rigid, 24-month

window for issuing external LAC following classification as a resolution entity/material subsidiary would risk creating a LAC supply glut, potentially raising the system-wide cost of issuance. ASIFMA therefore welcomes the conclusion of CP 18.01 that HKMA intends to follow a staggered approach for LAC issuance to avoid material impact on the market and enable AIs to time issuance to minimise their funding costs. We believe that the possibility of extending the period after which the resolution entity or material subsidiary must meet a LAC requirement will provide further comfort to AIs that they will not necessarily be forced to issue LAC during adverse market conditions. We would appreciate further guidance on the practical implementation of LAC requirements and how the HKMA will determine the deadlines to meet them.

On divisions 3 and 4, ASIFMA would appreciate greater clarity and examples on the interactions between the internal LAC scalar as set under Rule 26 and the solo LAC scalar under Rule 30 for material subsidiary. Within division 3, we note that the factors under Rule 25, which are relevant to adjustments to the resolution component ratio, and those under Rule 26, which are relevant to adjustments to the internal LAC scalar, are not mutually exclusive. We believe that the factors relevant to each rule should be distinct to avoid a situation in which the internal LAC scalar and the resolution ratio component are adjusted for the same reasons. We recommend amending the rules to establish this distinction.

Finally, ASIFMA welcomes the flexibility introduced in Part 4, Division 5, Rule 35 with regards to the possible reduction of the minimum LAC debt requirement in limited circumstances. It is ASIFMA's view that it is inappropriate to transpose a 33% debt requirement to internal LAC, as doing so could have a negative impact on an AI's ability to maintain and manage its leverage ratio. It may also unnecessarily limit firms' flexibility in choosing the appropriate funding mix for a given situation without improving loss-absorbency. Firms may elect 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. It is ASIFMA's view that the home authorities should be consulted and that the resolution authority should take into consideration the home authorities, LAC requirements and the institution's LAC composition when varying LAC requirements.

Part 5: Calculation of LAC

With regards to the external LAC eligibility criteria, ASIFMA would like to reiterate that, 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 such substitution in the AI LAC Rules as is done in other jurisdictions (e.g. the United States). Use of guarantees to provide internal LAC in appropriate cases is important, notably because it alleviates the problem facing deposit-funded banks, for which on-balance-sheet LAC would require taking on additional liabilities, creating more risk and increasing their leverage. To enable the most effective application of the proposed LAC eligibility criteria in the case of G-SIBs that have adopted secured support agreements covering Hong Kong subsidiaries that were deemed material for home country resolution planning purposes, we urge the HKMA to clarify that a qualified secured support agreement can substitute for the contractual write-down/conversion provision that would otherwise be required in an instrument eligible as internal LAC.

Part 6: Disclosure

With regard to the requirement in Rule 50, sub-rule (1)(a) that disclosures be prepared in the Chinese and English languages, we believe that to avoid confusion it might be appropriate to specify which form of written Chinese is acceptable, whether traditional, simplified, or either. We understand that the HKMA's

disclosure templates are not finalised yet, but would appreciate that these forms be made available to AIs as early as possible.

We have some concern that Rule 57 on ensuring that no material information has been excluded in disclosures may conflict with Rule 56 giving a resolution entity flexibility to, with the resolution authority's prior consent, decline to disclose proprietary or confidential information. There may be instances where information that is proprietary and/or confidential is also material. This apparent conflict might be avoided by making Rule 57 explicitly subject to any approved application of Rule 56.

Part 7: Enforcement

ASIFMA does not have any comment regarding this section.

Part 8: Review by Resolvability Review Tribunal

The HKMA proposes in the draft AI LAC Rules that only decisions to vary the resolution component ratio and directions to take remedial action will be reviewable by the Resolvability Review Tribunal. As explained in our response to CP18.01, this seems to contradict Part 7, Division 1 of the FIRO, which suggests a broader scope of decisions for potential review. ASIFMA encourages the HKMA to consider allowing determinations made in the other areas to be reviewable by the Resolvability Review Tribunal, particularly a decision to set a material subsidiary's internal LAC scalar to a level above 75%. AIs would then have an additional opportunity to, as necessary, rebut any assumptions or conclusions they consider unjustified.

Without this, any AI that considers an increased internal LAC scalar (or other decision) unfeasible may be impelled to seek comfort under Part 7, Division 1, Rule 58; Division 2, Rule 59, Rule 60, sub-rule (1)(c) and sub-rule (5); and Part 8, Rule 61, by: a) notifying the resolution authority that it has become aware it is likely to fail to comply, despite having a reasonable excuse, with a revised internal scalar, b) receiving written notice of remedial action, c) making written representation to the resolution authority within 14 days of receiving that notice of remedial action and then d) seeking review within 30 days of receiving the notice or remedial action. Application in this way to the Resolvability Review Tribunal would thus reasonably operate as a stay of execution of complying with a decision to increase the internal scalar (Part 8, Rule 61, sub-rule (5)). While this avenue may embrace any decision made by the resolution authority while discouraging frivolous appeals, it also forces AIs to risk committing an offence in order to appeal to the tribunal, and potentially disincentivises constructive interaction with the resolution authority.

Schedules 1 and 2: Qualifying Criteria to be Met to be an External/Internal LAC Debt Instrument

With reference to Schedule 1, Section 1, paragraph (1), subparagraph (n) of the draft AI LAC Rules, ASIFMA appreciates HKMA's revision of the proposal set out in CP18.01 so that external LAC debt instruments denominated in Hong Kong dollars, US dollars, Euros or other currencies are required to meet minimum denomination requirements of HK\$2 million, US\$250,000, EUR200,000 or the equivalent of HK\$2 million in another currency, respectively. While ASIFMA supports the overall goal of restricting the primary and secondary market sale and distribution of LAC debt instruments to professional investors only, it is important to ensure a level playing field for all financial institutions (whether Hong Kong AIs or non-Hong Kong financial institutions) given Hong Kong's position as an open, global financial centre. As the minimum denomination requirement laid out in the draft AI LAC Rules only applies to Hong Kong AIs, non-Hong Kong financial institutions (which are not bound by the draft AI LAC Rules) would be able to issue LAC instruments in lower minimum denominations, with no obstacle to their purchase by Hong Kong investors.

Also, given the additional investor protections (e.g. additional risk disclosures and selling restrictions in Schedule 1, Section 1, paragraph (1), subparagraph (m)(ii)) proposed in the draft AI LAC Rules, the benefit of the US\$250,000, EUR200,000 or HK\$2 million equivalent minimum denomination requirement may be somewhat limited if only Hong Kong AIs are required to comply, and may make it more difficult for Hong Kong AIs to raise external LAC not only in Hong Kong, but also in global capital markets. Notwithstanding the above response, if the HKMA believes minimum denomination requirements of HK\$2 million, US\$250,000, EUR200,000 or the equivalent of HK\$2 million in another currency are still needed, ASIFMA proposes that it would be better addressed through a separate public consultation with the Securities and Futures Commission to ensure all LAC instruments – whether issued by Hong Kong AIs or non-Hong Kong financial institutions – would be treated equally.

In addition, we note that Schedule 1, Section 1, paragraph (1), subparagraphs (m)(ii)(A) - (C) of the draft AI LAC Rules sets out certain requirements in relation to “any prospectus, notice, circular, advertisement or brochure” for any external LAC instrument. Given its wide application, it may be preferable to use the phrase “adequately discloses” (or another equivalent phrase) instead of “discloses” or “contains a statement” formulation used in subparagraphs (m)(ii)(A - (C). We believe the use of the phrase “adequately discloses” gives greater flexibility to the HKMA to set out further guidance on any detailed disclosure or format requirements in the CoP itself.

Furthermore, referring to Schedule 1, Section 1, paragraph (1), subparagraph (o) of the draft AI LAC Rules, the proposed funding restrictions on external LAC instruments are more restrictive than those currently prescribed under the BCR. The BCR requires that “the institution has not directly or indirectly funded the purchase of the instrument” and “neither the institution nor an affiliate of the institution over which the institution exercises control or significant influence (excluding the holding company of the institution) has purchased the instrument.” In contrast, the draft AI LAC Rules have used a different formulation for external LAC and restrict any entities from a Hong Kong AI’s resolution group from holding that AI’s external LAC instrument (even if this other entity is not controlled or significantly influenced by the issuing AI and even if the AI has not directly or indirectly funded the purchase by this other entity). While ASIFMA generally agrees with the underlying rationale – to prevent other entities from the same resolution group from holding a Hong Kong AI’s external LAC instruments – it is important to ensure the scope of the current requirement in subparagraph (o) is not unduly restrictive and does not result in inadvertent non-compliance (with the resulting loss of LAC eligibility for the relevant external LAC instrument). This is particularly relevant in the context of large resolution groups where the Hong Kong AI is not the parent entity and the Hong Kong AI has no control or significant influence over sister entities in the same resolution group. We believe that the current BCR formulation strikes a better balance between the regulatory objective of ensuring that the external LAC instruments will be able to absorb losses and the need for certainty for Hong Kong AIs.

ASIFMA would also welcome further clarity on Schedule 1, Section 1, paragraph (1), subparagraph (p) concerning the approval by the HKMA of redemption of call options and whether the HKMA would deliver these approvals on a deal-by-deal basis or according to annual quotas. ASIFMA is concerned that this requirement may prove onerous and that it is inconsistent with other key global market LAC rules, e.g. those in the US.

The exception outlined in Schedule 1, Section 1, paragraph (3) would benefit by making it clearer that, as ASIFMA understands it, using a reference rate to determine an instrument’s coupon does not represent a

“derivative-linked” feature disqualifying that instrument as an external LAC debt instrument under Schedule 1, Section 1, paragraph (1)(g).

Schedules 3 and 4: Deduction of Holdings of Own Non-capital LAC Liabilities and Other Non-capital LAC Liabilities

ASIFMA does not have any comment regarding this section of the draft AI LAC Rules as it is in line with the HKMA’s proposals for implementing in Hong Kong the Banking Committee on Banking Supervision (BCBS) final standard on TLAC holdings.