Feedback on TLAC proposal term sheet

Bank of China Frankfurt Branch

This feedback complements the comments of the Bank of China Headquarter with regard to the proposed TLAC (Total Loss Absorbing Capacity) term sheet. It complements specially the feedback with regard to the potential consequences of the proposed introduction/calibration of the TLAC for Branches from Emerging Markets G-SIBs active in the German market. With some few exceptions, Branches from banking institutions with head quarters outside of the European Union are treated as subsidiaries for regulatory purposes. Consequently these Branches will be confronted with a series of additional requirements. In our opinion these additional requirements are not able to be fulfilled by a Branch on a standalone basis and would impair the efforts to achieve a level playing field internationally. For that reason, we would like to suggest that the proposed treatment of G-SIBs' Overseas Branches is specified in a more detailed way in the term sheet. In this way, a potential regulatory arbitrage can be avoided.

With regard to the other points, in accordance with our Headquarter feedback, we believe the proposed requirements of TLAC-eligible debt and leverage ratio are still too high. We agree with the suggestion that G-SIBs located in emerging market economies are initially exempt. The Pillar 1 TLAC requirement should be preliminary set at a maximum of 16% of risk-weighted assets (RWAs) or even lower depending on the results of the quantitative impact study (QIS). The Basel III leverage ratio should be maintained. The Pillar 2 TLAC requirement should be cancelled; and the requirement that at least 33% of the Pillar 1 TLAC is met with Tier 1 and Tier 2 debt capital instruments plus other TLAC-eligible liabilities should be relaxed.

I. Emerging markets will not be initially subject to TLAC

We believe that the initial waiver for G-SIBs headquartered in EMEs was justified through several aspects mentioned below. These aspects are also relevant for Overseas Branches as they can have enormous influence on Headquarter's decisions:

Liability structure: Financing in the European and American banking sector comes mainly from the wholesale market while financing of emerging markets banking institutions is mainly originated from customer deposits. Therefore, the new TLAC

regulation will lead to a comprehensive and costly restructuring of liability structure of such banks.

Business structure: Nowadays, the deposits of three G-SIBs in China make up 80% of their total debts. To protect the interests of depositors, the trigger point set by Chinese supervisory authorities for the resolution of commercial banks is when core tier-1 capital falls to 5%, and then considering the tier-2 capital and buffers so that a bank still holds some capital available for absorbing losses when it enters the resolution stage.

Immature Market: The bond markets in EMEs are subject to limited depth and complexity of products, so its capacity is quite limited. China domestic bond market could hardly absorb the TLAC funding demand if all three PRC incorporated G-SIBs raise TLAC eligible debts simultaneously. Although G-SIBs headquartered in EMEs may try to raise TLAC eligible debt offshore, their financing capability will be subject to the capital control issue (in some EMEs) and domestic market knowhow bias (of investors in advanced economies). In addition, G-SIBs headquartered in EMEs are much less covered than their peers in advanced economies by global institutional investors due to their absence in some major benchmarks..

Limited Globalization: Many G-SIBs in EMEs are less globalized and involved in derivatives and trading activities, and thus lead to limited contagion effect during the crisis. Therefore, the incremental systemic risk reduction from initial inclusion of G-SIBs headquartered in EMEs will be limited.

II. Transitional period

We suggest that the accurate TLAC timetable should not be set in the emerging country till conditions are ready. Conditions include mature debt market in the emerging country, overseas assets accounting for above 50%, etc.

If the final decision of FSB is to implement TLAC in emerging countries, we suggest: (1) TLAC requirements implementation should be delayed until the completion of Tier 2 capital debt replacement (ie, after 2023). Regarding Basel III, since 2013, old subordinated debts would be deducted in 10 years. The scale of old subordinated debts in emerging countries, including China is quite large. The pressure and competition for bank re-financing would increase if subordinated debts are further increased. TLAC instruments are similar to Tier 2 capital debts, both of them have debt financing instruments which can absorb loss. (2) Set a 10 to 12 years transitional period. At present, the standard of capital adequacy ratio of major banks in China is 11.5% (including capital buffers); if TLAC requirements are implemented, the sum of TLAC and capital buffers reaches at least 19.5% to 23.5%, so the new increased TLAC requirements would be 8% to 12%. In this regard, we suggest that TLAC requirements increased no more than 1% every year, and reach gradually the standards in 10 to 12 years.

III. Analysis on debt market capacity

1. Debt market scale in emerging markets is quite small. The capacity of the markets to absorb new debt should be analyzed before calibration of TLAC for emerging economies. The same is true with regard to the resolution entities and Branches as they are eventually not able to access the debt market in their respective jurisdictions.
2. Government debts take the main part in debt market, and credit debt market is very limited. The necessity of new debt emission to cover the TLAC could result in a crowding-out effect
3. Financial institutions, such as banks and insurance companies, are major investors in debts market in emerging economies. . The part held among G-SIBs will be deducted in TLAC. If banks are excluded, eligible investors for TLAC will be very limited. Non-banking institutions, insurance companies and investment fund companies have large investment in the banking sector. But relevant industries have normally strict regulations on applying funding investment. TLAC eligible instruments include mechanism of write-down and conversion to equity, which might not meet the admittance standards of industry investment, or the proportion of investment may be limited. This should be considered when during the new assessment of eligible liabilities. .

IV. Conditions on TLAC eligible debt instruments.

Debt instruments issued in emerging markets do not necessarily include terms of write-down and conversion to equity. Moreover, some debt instruments or CDs issued are ensured in some jurisdictions, so that they cannot be used to absorb loss. These factors should be considered when finally defining the conditions for TLAC eligible instruments. In this regard, deposit insurance fund as a source of resolution fund is helpful for an orderly resolution. It should be counted towards eligible TLAC.

V. Cancellation of Pillar 2 TLAC

The FSB proposal foresees the consideration of a Pillar 2 TLAC whose characteristics should be defined by the responsible authorities in the country of the resolution entity. In our opinion the consideration of an additional TLAC for Pillar 2 would even amplify the negative consequences of an extremely conservative calibration under Pillar 1 and strong limitation of instruments eligible for inclusion in external TLAC for Pillar 1. As Pillar 2 regulatory requirements are normally less harmonized than Pillar 1 regulatory requirements the consideration of a Pillar 2 TLAC would even be adverse to the principle of helping to achieve a level playing field internationally. If introduced the TLAC for Pillar 2 should be harmonized as good as under Pillar 1 to avoid regulatory arbitrage. This point is of crucial importance for Branches and Subsidiaries that belong to a different jurisdiction than the resolution entity they are part of.

VI. Clear specification of treatment of overseas branches and legal entities in different jurisdictions

In the FSB term sheet a differentiation between external and internal TLACs is made.

With regard to the internal TLAC the term sheet states that “Branches are not subject to internal TLAC requirements separate from any external or internal TLAC requirement applied to the legal entity of which they are a part”. However, taking into account that Branches and resolution entities (legal entities) could be active in different jurisdictions and therefore be subjected to different requirements, we would suggest that the treatment of cases in which overseas Branches and legal entity are in different jurisdictions is specified in a more detailed way in the term sheet. This would especially be necessary when the legal entity is in an Emerging Market and the Branch in an Industrial/Developed Country. Dependent on the legal and regulatory requirements in the jurisdiction of the Branch requirements for the external as well as internal TLAC might apply.