Dear FSB,

This is Bank of China Luxembourg Branch. Thank you for your attention for our reply regarding TLAC just released a version for comments from your side.

From the contents, TLAC (Total Loss Absorbency Capacity) is a capacity of absorbing loss with ensuring that it is the shareholders and creditors rather than the tax payers that will assume the losses arising from its bankruptcy. The new TLAC requirements are designed to address the 'too big to fail' problem. Specifically, it is intended to ensure that a failed G-SIB could be resolved in an orderly resolution, which will contribute to prevent global systemically risk, and keep financial stability and development of the real economy.

However, we believe the requirements of TLAC-eligible debt and leverage ratio seems too high at this stage. We strongly suggest that G-SIBs located in emerging market economies would initially be exempted; the Pillar 1 TLAC requirement would be set at 16% of risk-weighted assets (RWAs), and the same with the Basel Ⅲ leverage ratio requirement; The Pillar 2 TLAC requirement would be cancelled; and at least 33% of the Pillar 1 TLAC requirement should be met with debt capital instruments and other TLAC-eligible liabilities would 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 in several aspects as below:

Liability structure: A certain amount of financing in the European and American banking sector comes from the wholesale market while the financing of emerging markets mainly comes from customer deposits. Taking China for instance, the deposits of three G-SIBs made up 80% of their total debts. (According to the annual report of 2013, the ratio of ICBC is 83%, ABC is 86%, and BOC is 78%.) Therefore, the new TLAC regulation will lead to a comprehensive and costly restructuring of the 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 familiarity 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 such as S&P500 and MSCI World.

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 country, we suggest: (1) TLAC requirements implement should delay to 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 the emerging country including China is quite large. Take China for an example, in 2012, the stock of old subordinated debts was about 2 trillion RMB, which means, 200bn need to be deducted in every year. The pressure of bank re-financing is concentrated; the market is hardly to carry on if subordinated debts are further increased. TLAC instruments are similar with Tier 2 capital debts, and both of them have debt financing instruments which can absorb loss. Therefore, TLAC should be delay to implement. (2) Set 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 is about 8% to 12%. Regarding G-SIBs' capacity is quite large, 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 of China.

1. Debt market scale of China is quite small, and there is a big gap between developed countries and China. At the end of 2014, among the total custody amount of debt market in China is 35.6 trillion RMB, the Central clearing company's amount of 28.73 trillion RMB, accounting for 80.6% of total amount; Shanghai clearing house's amount of 5.56 trillion RMB, accounting for 15.6% of total amount; the Exchange's amount of 1.35 trillion RMB, accounting for 3.79% of total amount. At present, indirect financing is still the main method in China. The capital market scale, such as debt and stocks, is relatively small. At the end of 2013, the proportion of debt market scale to GDP is about 47%, but this proportion of the US is about 225%.
2. Government debts take the main part in debt market, and credit debt market is very limited. At the end of 2014, among the total custody amount of the Central clearing company, government debts and Central Bank bill account for 37.4%, policy financial debts account for 34.7%, agency debts supported by government account for 3.8%, and credit debts account for less than 30%. In credit debts, such as corporate debts and medium term notes, better qualified issuers take the main part and credit level is relatively single. At present, the stock of bank Tier 2 capital debts issued in China market is 358.4bn, only accounting for 1.2%. Because of high risk and complicated structure, new banking capital instruments market is still in the primary stage, and it has limited capabilities when banks concentrate to issues massive instruments.
3. Financial institutions, such as banks and insurance companies, are mainly investors in debts market in China. The part held among G-SIBs will be deducted in TLAC. The main investors in the debt market of China are the commercial banks. Among the total custody amount of the Central clearing company, at the end of 2014, the held debts account for above 60% in debt market. If banks are excluded, eligible investors for TLAC will be very limited. In non-banking institutions, insurance companies and fund companies have large investment and the held debts account for about 10% respectively at the end of 2014. But relevant industries have strict regulation on applying funding investment. TLAC eligible instruments include mechanism of write-down and conversion to equity, which may not meet the admittance standards of industry investment, or proportion of investment may be limited. Thereby, needs of such investors may be reduced.

IV. Conditions on TLAC eligible debt instruments.

At present, debt instruments issued or renewed by Chinese commercial banks mainly include four categories, that is, new Tier 2 capital debts, old subordinated debts, senior debts and currency market instruments. (1) New Tier 2 capital debts can be TLAC eligible instruments. (2) Compared with TLAC eligible standards, the old subordinated debts do not include terms of write-down and conversion to equity. Part of old subordinated debts can be redeemed without supervisory approval. (3) Compared with TLAC eligible standards, senior debts do not include terms of write-down and conversion to equity and subordinated terms. It is not clear that the order of redemption and loss absorbing in resolution. (4) Currency market instruments mainly include commercial deposit (CD) and commercial paper (CP) etc. Compared with TLAC eligible standards, currency market instruments do not include terms of write-down and conversion to equity and subordinated terms. It is not clear that the order of pay-off and loss absorbing in resolution. Moreover, some CDs issued by overseas branches are insured in its jurisdictions, which cannot absorb loss. The most of period is less than 1 year, which does not meet the TLAC requirements about remaining period.

Suggestions for TLAC eligible standards: if TLAC is implemented in China before 2022, there would be still old subordinated debts in Chinese market. We suggest that part of old subordinated debts can be counted towards TLAC in transitional period and deducted year by year according to the Grandfather Clause in Basel III. Although old subordinated debts no longer meet the requirements of Basel III about Tier 2 capital instruments, its stock part still can be partly count towards Tier 2 capital, and deducted gradually in 10 years with using the nominal quantity at 1 January 2013 as base number. Thereby, the pressure caused by banks concentrate to supplement capital can be relieved. Given TLAC contains Tier 2 capital in concept, it is suggested that the Grandfather Clause can be applied.

Deposit insurance fund as a source of resolution fund is helpful for an orderly resolution. It should be counted towards eligible TLAC.

V. Gap analysis of TLAC for the Bank

According to the proposal term sheet of TLAC, a resolution entity in a G-SIB with a 1% G-SIB surcharge need to maintain, including combined capital buffers, at least 19.5% - 23.5% of the RWA. At present, loss-absorbing ratio (is the same with the capital adequacy ratio) is only about 14%. Even if use 19.5% which is the minimum requirement to calculate and without considering the future business increase, there would be still about 500bn gap to TLAC.

VI. Macroeconomic Impact

G-SIBs in some EMEs are almost exclusively funded by deposits rather than debt.

European and American banks can meet the supervisory authorities' requirements for “bail-in debts” by changing their bond financing structure while the emerging markets need to issue “bail-in debts” to meet supervisory requirements. It will undoubtedly drive up the operating cost of banks and the financing cost of the real economy.

Such impact is likely to further spread in the domestic economy and even the global economy, as the three PRC incorporated G-SIBs make up a substantial part of the local banking system which serves as the primary driver of the economy and a major receiver of domestic savings in China. The economic cost associated with TLAC implementation (e.g., increased funding cost for banks and lower deposit rates due to the reduced demand for deposits) will be extremely large especially when its effect is contrary to the monetary policy of the central bank. On the other hand, how to invest the incremental TLAC funding proceeds remains a question given its higher funding cost and enormous amount. The impact of implementing the TLAC requirements to the China Economy is quite uncertain.

Considering the reasons above, the countries in EMEs still mainly depends on indirect funding, and commercial bank is the most important resource of real economy funding. Without the initial waiver for G-SIBs headquartered in EMEs, it will drive up the operating cost of banks and the financing cost of the real economy. If the development of economies becomes moderate in EMEs, it will cause adverse effect on global economy reviver and financial stability.

Best Regards

Bank of China Luxembourg Branch