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By e-mail: fsb@bis.org

Financial Stability Board
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Dear Sirs

Consultation Paper on Adequacy of Loss-Absorbing Capacity of Global Systemically Important Banks in Resolution

We refer to the Consultation Paper on Adequacy of Loss-Absorbing Capacity of Global Systemically Important Banks in Resolution published by the Financial Stability Board on 10 November 2014. On behalf of our members, we set out in the annex our detailed comments on the proposals in the consultative document.

We hope you would find our comments useful. Should you have any questions, please do not hesitate to contact Ms. Emily Ngan of the Secretariat at (852) 2526 6080.

Yours faithfully

Henry Chan
Secretary

Enc.

c.c. Ms Karen Kemp, Executive Director (Banking Policy), Hong Kong Monetary Authority

Submission of The Hong Kong Association of Banks in response to

the Financial Stability Board's 10 November 2014 Consultation Document on

Adequacy of loss-absorbing capital of global systemically important banks

2 February 2015

Introduction

The Hong Kong Association of Banks (***HKAB***) was created by The Hong Kong Association of Banks Ordinance in 1981, which among other things provides a framework for the Hong Kong Government to exchange views with the banking sector for the further development of the industry. Every fully licensed bank operating in the Hong Kong Special Administrative Region must be a member of HKAB and subject to HKAB's rules. The roles of HKAB include being a focal point for consultation on law reform, new legislation and regulatory matters.

HKAB has reviewed the Consultation Document on adequacy of loss-absorbing capacity of global systemically important banks (***G-SIBs***) issued by the Financial Stability Board (***FSB***) on 10 November 2014 (the ***Consultation Document***) and received feedback from members of HKAB (each, a ***Respondent***) on the Consultation Document. This paper, which was prepared with the assistance of international law firm Freshfields Bruckhaus Deringer, sets out the views of HKAB based on the feedback it has received from Respondents. Questions from the Consultation Document on which HKAB is providing its views are repeated below in bold italics, with HKAB's views set forth following each question.

Responses to Consultation Questions

Question 1: ***Is a common Pillar 1 Minimum TLAC requirement that is set within the range of 16 – 20% of risk-weighted assets (RWAs), and at a minimum twice the Basel III leverage requirement, adequate in the light of experiences from past failures to support the recapitalisation and resolution objectives set out in this proposal? What other factors should be taken into account in calibrating the Pillar 1 Minimum TLAC requirement?***

HKAB considers that there are a number of reasons for believing that the common Pillar 1 Minimum total loss absorbency capacity (***TLAC***) requirement to be established by the FSB should be at the lowest end of the range proposed in the Consultation Document (i.e., 16%), including:

i. all GSIBs will be required to meet additional buffer requirements of at least 3.0% (comprising 2.5% capital conservation buffer and minimum 0.5-1.0% G-SIB or management buffer). For some groups, this could raise the common Pillar 1 Minimum TLAC requirement to 25-30% of RWAs before any Pillar 2 or counter-cyclical requirements are added (HKAB notes that all banks may not necessarily maintain the same level of clearance over the TLAC requirements);

ii. groups may continue to have instruments in issue which have ceased to be eligible for the purpose of the common Pillar 1 Minimum TLAC requirement, for example because their duration is for less than one year. However, these instruments will still be available for bail-in and, therefore, represent an additional buffer to the common Pillar 1 Minimum TLAC requirement;

iii. the common Pillar 1 Minimum TLAC requirement is being calculated based on the recapitalisation of the entire entity so that it can return to operation. However, there may be elements of the business which are wound-down in a resolution scenario and, therefore, capital to support the entire ongoing business may not be required. The purpose of resolution is not necessarily to restore the G-SIB to its past structure with the same regulatory capital requirements and associated buffers;

iv. non-banking entities within a group (for example, insurers that are subject to different resolution regimes), or entities which are not controlled by the G-SIB (for example, associated entities), should be excluded from the calculation of the common Pillar 1 Minimum TLAC requirement;

v. the evolution of the regulatory reform agenda should ensure that the combined requirements do not place an excessive burden on the financial system and economy; and

vi. local needs should be accommodated and the wide diversity of banking models and legal structures should be adequately reflected.

As a general point, HKAB considers that even where the common Pillar 1 Minimum TLAC requirement is 16% of RWAs, past experience would suggest that this is more than adequate to cover resolution needs (i.e., recapitalisation and preserving the critical functions of the G-SIB). There have been very few instances where diversified banks such as G-SIBs have entirely depleted their existing capital through losses in a crisis. Where there have previously been very large losses (for example, during the crisis in Ireland), this has been in respect of concentrated entities with both banking and regulatory failures.

The Quantitative Impact Study (***QIS***) should take these factors into account, as well as micro and macro-economic impact assessments and market surveys, to ensure that the calibration of common Pillar 1 Minimum TLAC requirements will have a solid economic foundation. HKAB is of the view that consideration should be given to setting a percentage level lower than 16% of RWAs if this is justified on the basis of the information provided by the QIS.

Given that there is an ongoing review of the Basel III leverage requirement, it may not currently be appropriate to determine the calibration of this metric. There are concerns that a common Pillar 1 Minimum TLAC requirement that is expressed as twice the Basel III leverage requirement may become problematic for G-SIBs with a high proportion of low risk assets that results in the Basel III leverage requirement being raised above the current level of 3% in one or more jurisdictions. In such a case, this may produce the undesired effect of incentivising those G-SIBs to increase the risk on their balance sheets. One suggestion would be that any requirement based on the Basel III leverage requirement should be, once determined, fixed as an absolute number and not as a multiple.

The FSB should take into account any changes to the RWAs calculation and determine whether such changes affect whether the common Pillar 1 Minimum TLAC requirement continues to be appropriate, especially where there are any increases or changes to the Basel III leverage requirement.

Question 2: ***Does the initial exclusion of G-SIBs headquartered in emerging market economies (EMEs) from meeting the Common Pillar 1 Minimum TLAC requirement appropriately reflect the different market conditions affecting those G-SIBs? Under what circumstances should the exclusion end?***

HKAB recommends that further work be carried out as part of the QIS in respect of how the proposed TLAC regime would impact both G-SIBs headquartered in EMEs and DMEs before determining how long the exemption period should last.

There are two diverging views within HKAB in respect of the proposed exemption for G-SIBs headquartered in EMEs and both views are expressed below.

View 1

Certain Respondents consider that an exemption for G-SIBs headquartered in EMEs should only be for a specified period of time and the relevant G-SIBs should fully commit to a timetable for full compliance. It is recommended that the FSB clearly sets out the economic rationale behind why this exemption is required for G-SIBs headquartered in EMEs, as this will make it easier to establish the circumstances in which the exemption can/should be withdrawn or amended.

These Respondents also take the view that the proposed exemption will create an unequal and/or distorted playing field, as, for example, subsidiaries of EME-headquartered G-SIBs and subsidiaries of G-SIBs that are headquartered in DMEs will operate alongside each other in Hong Kong and other international markets. It would be preferable for locally incorporated entities of all G-SIBs headquartered off-shore to be treated on an equal basis – equal treatment should be supported where possible.

This group of Respondents query whether material subsidiaries in EMEs of all G-SIBs (including G-SIBs headquartered in DMEs) should benefit from this exemption, among other reasons because many of these subsidiaries are funded largely by deposits rather than debt and requiring internal TLAC could lead to a comprehensive and costly restructuring of the liability structure of such subsidiaries. Furthermore, it is suggested that subsidiaries located in DMEs of a G-SIB headquartered in an EME should not benefit from this exemption.

View 2

For the reasons set out below, certain Respondents believe that: (i) the proposed exemption for G-SIBs headquartered in EMEs is justified; and (ii) the exclusion period for G-SIBs headquartered in EMEs should be determined only once the TLAC requirements for DMEs are in force to ensure that the impact of the TLAC requirements is fully understood:

i. *immature market*: the bond markets in EMEs are subject to limited depth and complexity of products. For example, the PRC domestic bond market is unlikely to be able to absorb the TLAC funding demand if all three PRC incorporated G-SIBs raise TLAC eligible debt simultaneously. Although G-SIBs headquartered in EMEs may try to raise TLAC eligible debt offshore, their financing capability may be subject to capital control issues and there may be a familiarity bias of investors in more advanced economies. Furthermore, G-SIBs headquartered in EMEs are much less covered than their peers in DMEs by global institutional investors due to their absence in some major benchmarks, such as S&P500 and MSCI World;

ii. *business nature*: many G-SIBs headquartered in EMEs are less globalised and involved in derivatives and trading activities, which means they face a more limited contagion risk (as seen from the global financial crisis). Therefore, the incremental systemic risk reduction from initial inclusion of G-SIBs headquartered in EMEs will be limited; and

iii. *macroeconomic impact*: G-SIBs in some EMEs are almost exclusively funded by deposits rather than debt. For example, in the PRC, the deposits of the three G-SIBs accounted for 77.1% of their total assets. The proposed TLAC regime would lead to a comprehensive and costly restructuring of the liability structure of such banks.

Specifically in respect of the PRC-headquartered G-SIBs, the proposed TLAC regime is likely to impact the domestic economy, as these 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 (these three G-SIBs contributed 36.5% of total deposits and 47.4% of total assets in the PRC banking sector as at December 2013). The economic cost associated with TLAC implementation (e.g., increased funding costs 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. It is unclear how these G-SIBs would invest the incremental TLAC funding proceeds given the higher funding cost and enormous amounts. The impact of implementing the proposed TLAC regime in the PRC to the local economy still remains uncertain.

These Respondents recommend that issues relating to the exemption for G-SIBs headquartered in EMEs are jointly determined by the FSB, the home regulator / central bank, the G-SIB and other relevant regulatory authorities.

Where such an exemption is determined jointly in respect of a specific G-SIB headquartered in an EME, host authorities should respect and comply with the exemption when setting internal TLAC for material subsidiaries / domestic-systemically important banks (***D-SIBs***). Specifically, no host authority should have the power to ring-fence capital resources of subsidiaries of G-SIBs headquartered in EMEs within the exemption period. This is important to enhance the trust between regulatory authorities and consistent with HKAB's response to Question 5, specifically that "host authorities should be bound by…the TLAC principles…".

In respect of the post-exemption period, these Respondents also agree with the response to Question 5 – host authorities should not assign an internal TLAC higher than the level suggested by the FSB.

Question 3: ***What factors or considerations should be taken into account in calibrating any additional Pillar 2 requirements?***

HKAB considers that further clarity is required on the Pillar 2 proposals (as the principles for Pillar 2 TLAC outlined in the Consultation Document only restate the overall TLAC objectives) before any detailed comments can be provided, including the FSB's rationale for introducing any additional Pillar 2 requirements.

Given the Pillar 2 requirements which are included within the conventional bank capital calculations and any adjustments which may be required as a result of stress-tests (both of which are additional to the buffers referred to above in response to Question 1), it is currently not clear that any additional Pillar 2 requirement is warranted for TLAC.

HKAB also notes that it is important for there to be consistency in how an additional Pillar 2 requirement is calibrated in different jurisdictions and, as noted above, in order to achieve this, the FSB should provide its rationale for introducing any additional Pillar 2 requirements.

Non-predictability due to national authorities' discretion in setting the level of the additional Pillar 2 requirement and its composition could lead to ambiguity in the market.

Question 4: ***Should TLAC generally be distributed from the resolution entity to material subsidiaries in proportion to the size and risk of their exposures? Is this an appropriate means of supporting resolution under different resolution strategies? Which subsidiaries should be regarded as material for this purpose?***

HKAB considers that it is more applicable and appropriate if TLAC is distributed from the resolution entity to material subsidiaries in proportion to the size and risk of their exposures under the circumstances and that the specific criteria of instruments counted towards satisfying the common Pillar 1 Minimum TLAC requirement for the resolution entity also apply to those of material subsidiaries and vice versa. This is important to ensure that there is consistency between home and host state regulators on what types of instruments are eligible for meeting the common Pillar 1 Minimum TLAC requirements. If different approaches were taken on this issue by different authorities then it would, for example, become more difficult for TLAC to be distributed from resolution entities to material subsidiaries.

Although HKAB agrees that the proportion should be based on the size and risk of exposures (i.e., RWAs), it notes that there is a risk, even at the discounted 75-90% rate, that the use of local RWAs to assess pre-positioning requirements versus consolidated RWAs to assess group requirements may result in the sum of the parts being greater than the whole. See also our response to Question 5 below relating to a pool of funding centrally held by a resolution entity.

The allocation of TLAC should be consistent with the G-SIB's preferred resolution strategy and used appropriately by regulators and should be coordinated and/or agreed within the G-SIB's Crisis Management Group (***CMG***). HKAB considers that a proportionate amount of pre-positioning to material subsidiaries could be appropriate and accepts the three test criteria put forward by the FSB for identifying materiality to the G-SIB group (section 21 of the Consultation Document). However, a fourth criteria should be added that the subsidiary is already deemed a D-SIB rather than being defined by reference to critical functions (as this would be more aligned to the principal purpose of TLAC).

Question 5: ***To what extent would pre-positioning of internal TLAC in material subsidiaries support the confidence of both home and host authorities that a G-SIB can be resolved in an orderly manner and diminish incentives to ring-fence assets? Is a requirement to preposition internal TLAC in the range of 75 - 90% of the TLAC requirement that would be applicable on a stand-alone basis, as set out in the term sheet (Section 22), appropriate to satisfy the goals of the proposal and ensure that TLAC is readily and reliably available to recapitalize subsidiaries as necessary to support resolution? Can this pre-positioning be achieved through other means such as collateralized guarantees?***

HKAB agrees that a certain amount of pre-positioning of internal TLAC in material subsidiaries could provide confidence in a resolution scenario and, therefore, reduce the incentives for the host authority to ring-fence assets domestically. It is acknowledged that host authorities will still need to assess the sufficiency of the resources which are pre-positioned recognising that cash resources at the parent level may have been exhausted in any recovery phase and that it may be difficult to extract cash which has been deployed into other subsidiaries of the group.

However, this pre-positioning may also have unintended consequences and, for example, significant pre-positioning should not override the need for there to be sufficient trust and cooperation between regulators. It is particularly important that such pre-positioning should be consistent with the G-SIB's resolution strategy. There is a danger that, despite a G-SIB pursuing a 'single point of entry' approach, pre-positioning becomes the starting point for further fragmentation of the group along country-specific lines. HKAB believes that host authorities should be bound by, or more strongly encouraged to comply with, the TLAC principles on the levels of pre-positioning required than is currently contemplated in the Consultation Document where a host authority's legal powers to impose internal or external TLAC requirements on a subsidiary are not limited by these principles. This is important to ensure consistency and a "level playing field". One option is for the CMGs to actively coordinate discussions on internal TLAC requirements between critical home and host authorities, rather than for the power to rest solely with the host authority.

Further, where the power to impose internal TLAC requirements on a subsidiary rests with a host authority (i.e., where the subsidiary itself does not meet the thresholds established by the FSB in the Consultation Document), the power should be applicable only to subsidiaries that are D-SIBs, rather than to all material subsidiaries of a G-SIB, as currently proposed, and should require the approval of the home and relevant host authority.

The level of internal TLAC must be monitored on an ongoing basis to ensure that there are never greater internal TLAC requirements imposed on individual entities within the G-SIB than are required for the G-SIB on a group basis (i.e., the sum of the parts should not be greater than what is required for the whole group).

The following should also be taken into account when determining internal TLAC requirements:

i. a consistent "discount" for all entities within a G-SIB should be agreed to ensure internal TLAC is evenly distributed at a consistent level and to avoid a 'race to the top';

ii. local market capacity restrictions (i.e., the investor capacity in the particular local market for purchasing new securities) should be considered as part of the QIS. For example, where G-SIBs headquartered in EMEs benefit from an exemption to the common Pillar 1 Minimum TLAC requirement (please see the response to Question 2 above) the same exemption should apply to a subsidiary operating in an EME of a G-SIB headquartered in a DME due to local market capacity issues);

iii. responsibility of the home regulator to review concentration / exposure limits to enable more efficient down-streaming, as this will be important for managing internal TLAC within a large group as pre-positioning is likely to affect existing single exposure limits;

iv. restrictions on deployment should be reviewed to ensure that internal TLAC can be utilised in an efficient and flexible manner to enable the entity to face issues / difficulties that may arise in one or more markets;

v. there should be a balance between ensuring sufficient recapitalisation resources to provide for going-concern requirements for relevant subsidiaries and leaving adequate TLAC resources at the group level for deployment where needed;

vi. whether internal TLAC can be written-off or converted to equity via contractual arrangements. This should be agreed in advance so that the ownership and tax implications of taking such an action are understood and can be prepared for;

vii. use of guarantees and other contractual arrangements to fund should be allowed as an alternative option for G-SIBs to employ in consultation with the CMG / host authorities to provide greater flexibility to respond to different market conditions. It may also be easier, for example, to manage guarantees than to pre-position capital on an ongoing basis;

viii. with respect to clause 20 (Internal TLAC) of the proposed total loss absorbency capital (TLAC) term sheet in the Consultation Document (***Term Sheet***), a pool of funding which is centrally held by resolution entities should be allowed to support at least a proportion of internal TLAC requirements to help reduce the operational burden that would arise from ongoing calibration of internal TLAC for individual material entities;

ix. triggers (if applicable) should be agreed in advance and be consistent across all relevant subsidiaries. It is important that a firm's management team retain a pre-emption right to act in advance of a triggering of an internal TLAC requirement; and

x. the FSB should fix the exact requirement in respect of internal TLAC, rather than providing a range and giving additional discretion to the host authority.

Please also refer to our response to Question 1.

For the reasons set out above, HKAB considers that the internal TLAC requirements should be at the lowest end of the proposed range of pre-positioned internal TLAC and that it should not otherwise be greater than the local requirements for D-SIBs (once determined and implemented).

Furthermore, for reasons similar to those set forth above, HKAB is of the view that consideration should be given to setting the pre-positioning at a percentage level of between 65-75% (with a preference towards the lower level of 65%) of the TLAC requirement and that the QIS and/or micro and macro-economic impact assessments and market surveys should specifically consider this proposal.

Question 6: ***Are the eligibility criteria for TLAC as set out in the term sheet (Sections 8-17) appropriate?***

HKAB considers that the portion of excluded liabilities that constitute operating liabilities should be contractually, legally or structurally senior to eligible TLAC and other bail-in-able liabilities. A clearer distinction should be drawn between liabilities that are eligible for bail-in but not pari-passu with TLAC (e.g., preferred deposits and deposits that are not covered by a deposit guarantee scheme (***DGS***), other preferred liabilities and secured liabilities), and liabilities that are not eligible for TLAC but eligible for bail-in pari-passu with TLAC (e.g., TLAC with less than 12 months to run, derivatives and structured notes). This would prevent the interpretation of TLAC as a fixed ranking to be applied in resolution and/or liquidation scenarios.

The following should also be noted:

i. the current drafting of the holding company restrictions could preclude senior unsecured debt issued from the holding company from being eligible for TLAC as holding companies inevitably have other senior creditors, such as tax liabilities;

ii. the one year maturity TLAC eligibility cut-off could potentially cause a ‘cliff-effect’ that could be mitigated by the adoption of a more flexible approach that allows a portion of debt with less than one year residual maturity to be eligible for TLAC. An alternative method could be to allow no more than 10% of a group’s TLAC requirement to be met by instruments that have a remaining maturity of less than 12 months (and only if the instrument was issued with an original maturity of greater than 7 days);

iii. debt issued from special purpose vehicles guaranteed by a resolution entity should be explicitly eligible for TLAC in the same way as debt issued from holding companies;

iv. the structured note exclusion in respect of external TLAC should be reconsidered and such notes should be eligible as TLAC if specified criteria are met. These criteria should include, for example, the ability to bail-in the note, whether and how the value of the note can be readily defined and how they apply to losses; and

v. the grandfathering clause under the Basel III framework that allows for a gradual phase-out of certain subordinated debt from Tier 2 capital instruments should also apply to the TLAC requirement.

Question 7: ***What considerations bear on the desirability of an expectation that a certain proportion of the common minimum Pillar 1 TLAC requirement consists of (i) tier 1 and tier 2 capital instruments in the form of debt plus (ii) other eligible TLAC that is not regulatory capital?***

HKAB recognises the need for capital and debt to form part of TLAC to ensure it has an appropriate balance of ‘going concern’ and ‘gone concern’ loss absorbency. The principle is understood and is accepted, although the fixed quantum appears less helpful than if it were used as a guideline. HKAB advocates a more targeted approach managed between home regulators and firms on a bilateral basis to provide firms with flexibility on deciding the appropriate funding mix for a given situation. Although in some cases cost factors will justify the utilisation of a significant portion of debt, the expectation of a proportion of 33% may become too restrictive if outstanding senior debt cannot be used to fulfil it. Furthermore, it might lead to the undesired effect that banks that hold enough capital to fulfil the quantitative level of the TLAC requirement are deemed ‘non-compliant’ where they do not hold ‘enough’ debt that corresponds to, for example, the eligibility criteria of 33%.

Question 8: ***Are the conditions specified in the term sheet (Section 8) under which pre-funded commitments from industry-financed resolution funds to provide resolution funding contribute to TLAC appropriate?***

In some jurisdictions, resolution funds are available for supporting the stability of the financial system and HKAB considers that these must be allowed to play a role in the resolution of G-SIBs alongside TLAC. Unless this is the case, the G-SIBs would effectively be contributing to a resolution fund from which they would never derive a benefit – since they would always be resolved through the conversion of TLAC – and that would be inequitable.

The majority of Respondents consider that this position should also apply in respect of DGSs. DGSs should be required to contribute to resolution as if the entity had been through a liquidation process or other creditors would have cause to question whether they had been disadvantaged by the bail-in and the principle of ‘No Creditor Worse Off than in Liquidation’ (***NCWOL***) had been breached. As above, DGSs should count in some way towards TLAC to avoid a position where certain banks are contributing to a fund from which they cannot benefit.

Clearly the degree to which either resolution funds or DGSs could count towards TLAC would depend upon the terms on which such schemes can be applied and the contributions made or funds available (resolutions funds or DGSs should not be assumed to have unlimited capacity). Where resolution funds or DGSs do not hold the cash resources but rely on facilities from third parties, such as the local government or central bank, funded either ex-ante or ex-post, these funds should still be eligible.

Separately, the need for resolution funds or DGSs to possibly compensate for NCWOL issues should be taken into account.

As a general point, HKAB does not support ex-ante funded commitments by G-SIBs / banks but where such commitments are required locally for either resolution funds or DGSs, HKAB considers (as expressed above in response to this question) that such funds or DGSs should count towards TLAC.

Question 9: ***Is the manner in which subordination of TLAC-eligible instruments to excluded liabilities is defined in the term sheet (Section 13) sufficient to provide certainty regarding the order in which creditors bear loss in resolution, and to avoid potentially successful legal challenges or compensation claims? Where there is scope for liabilities which are not subordinated to excluded liabilities to qualify for TLAC, are the transparency and disclosure requirements set out in section 13 and 24 sufficient to ensure that holders of these instruments would be aware of the risk that they will absorb losses prior to other equally ranking but excluded liabilities? If not, what additional requirements should be adopted?***

HKAB recognises the substantial progress made in the development of these proposals and accepts that further work is still required to fully establish the potential impact to the creditor hierarchy, for example in respect of cross-border issues.

At this stage, HKAB recommends that a clearer distinction be drawn between liabilities:

i. that are eligible for bail-in but not pari-passu with TLAC (e.g., preferred deposits and deposits that are not covered by a DGS, other preferred liabilities and secured liabilities); and

ii. liabilities that are non-eligible for TLAC but eligible for bail-in on a pari-passu basis with TLAC (e.g., TLAC for a term of less than 12 months, derivatives and structured notes).

This would prevent the interpretation of TLAC as a fixed ranking to be applied in resolution and/or liquidation.

We agree with the concept of subordination of eligible TLAC to operating liabilities (but not in respect of all excluded liabilities), so that it is clear to the holders of eligible TLAC and other bail-in-able liabilities that they will absorb all losses before the holders of operating liabilities suffer any losses.

Question 10: ***Do you agree that the TLAC requirement for G-SIBs should be integrated with Basel III such that the minimum TLAC requirement should be met first, and only after TLAC is met should any surplus common equity tier 1 (CET1) be available to meet the Basel III buffers?***

HKAB generally supports the idea that the TLAC requirements should be integrated with the existing Basel III capital requirements. On this basis, the exclusion of the Basel III capital buffers is understandable, as it would allow G-SIBs to utilise buffers without breaching the TLAC requirements or entering resolution. However, this should lead to a lower calibration of the common Pillar 1 Minimum TLAC requirement, as this could otherwise push the total requirement to between 19.5% and 23.5% of RWAs. Please also refer to our response to Question 1.

Question 11: ***What disclosures (in particular in terms of the amount, nature and maturity of liabilities within each rank of the insolvency creditor hierarchy) should be required by resolution entities and material subsidiaries to ensure that the order and quantum of loss absorption in insolvency and resolution is clear to investors and other market participants?***

HKAB suggests that any proposals should be proportionate, compatible and consistent with existing practices and it may be appropriate for there to be a review of practices to ensure consistency. Sufficient time should also be allowed to meet any new requirements.

Question 12: ***What restrictions on the holdings of TLAC are appropriate to avoid the risk of contagion should those liabilities be exposed to loss in resolution?***

HKAB takes the view that, whilst it is important to recognise, and aim to reduce the risks of, contagion across the economy as a whole, there must be a balance to ensure that efficient operating markets are maintained. There are currently no prudential restrictions on holders of bank equity, other bank capital or even bank debt and it is not clear why such restrictions should be imposed specifically for holdings of TLAC.

HKAB does not consider that issuers of TLAC instruments should bear responsibility for such risks of contagion to the holders of TLAC instruments. It should be for the prudential authorities setting rules for, and supervising, the potential holders of TLAC instruments to consider whether any restrictions should be imposed (for example, banking regulators should set the limits for banks, insurance regulators for insurance companies and so on). Arguably, current large-exposure limitations may be sufficient to address the concerns regarding contagion risk.

Specifically in respect of banks, consideration should be given to market-making requirements. This is critical to provide liquidity in these instruments without which the investor base would be considerably constrained. The market-making principle was accepted in the discussions relating to the Capital Requirements Regulations / Capital Requirements Directive IV and allow for a 5 year temporary waiver period and this could also be adopted for these purposes.

Question 13: ***Should G-SIBs be required to conform with these requirements from 1 January 2019? Why or why not? What, within the range of 12 to 36 months following the identification as a G-SIB, should be the conformance period for banks identified as G-SIBs at a future date?***

HKAB agrees that G-SIBs that are already identified as such should be required to conform with the requirements from 1 January 2019 (this date coincides with the date of conformance in respect of other Basel III capital requirements) at the <u>earliest</u>, provided that the final requirements reflect the comments made in the responses to the Consultation Document, specifically in respect of being at the lower end of the range for the common Pillar 1 Minimum TLAC requirement.

The proposed timetable for compliance is rather tight given that: (i) the FSB will not agree the proposals until the G-20 Summit in Turkey at the end of 2015; and (ii) national regimes will then need to put in place appropriate rules. It is only then that G-SIBs can implement the requirements, which may include: (i) adjusting their corporate structure to introduce the necessary structural subordination; (ii) redeem and reissue existing instruments with new subordination clauses; and/or (iii) issue additional instruments to satisfy any TLAC deficit. The FSB should ensure that G-SIBs are given suitable time to put in place the required measures, which have a very significant impact, and should consider the deadline in light of when the requirements will be fully agreed/clarified. The relevant period should ultimately be informed by the outcome of the QIS.

The FSB should also consider whether it would be appropriate to phase-in requirements from 1 January 2019 rather than to impose one deadline.

HKAB believes that the conformance period for banks that are identified as G-SIBs at a future date should be 36 months to allow for suitable time to put in place the required measures but that the relevant period should ultimately be informed by the outcome of the QIS.

Question 14: ***How far is the TLAC proposal, if implemented as proposed, likely to achieve the objective of providing sufficient loss-absorbing and recapitalization capacity to promote the orderly resolution of G-SIBs?***

HKAB notes the efforts of the FSB to develop the TLAC proposals. It is not currently possible to assess if these proposals will be effective given the number of issues that still require clarity (as outlined in the responses to the other questions). The outcomes of the QIS should provide further clarity.

The following points are important to note when considering whether the TLAC proposals will achieve the stated objective:

i. the TLAC proposal must operate within a much broader framework of central bank liquidity support, as well as economic and macro-prudential policy;

ii. using a TLAC bail-in tool is only likely to be feasible in the case of an idiosyncratic failure of a G-SIB and, where appropriate, other approaches should be considered. If bail-in is applied more broadly to address systemic failures, the degree of contagion to other elements of the financial system would be significantly increased, along with the intensity of stakeholder reactions;

iii. all regimes must introduce sufficient regulatory powers to enforce the proposals (i.e., introducing statutory bail-in where this power is not already available); and

iv. there must be effective coordination between national resolution authorities.

Question 15: ***What will be the impact on G-SIB's overall funding costs of the adoption of a Pillar 1 Minimum TLAC requirement?***

HKAB expects that the adoption of a common Pillar 1 Minimum TLAC requirement will substantially increase a G-SIB's overall funding costs for the following reasons:

i. the costs of issuing instruments which have a much higher probability of bail-in than existing senior debt will be higher but we anticipate that the costs of senior debt are unlikely to fall, so overall costs for existing instruments which are 'reformatted' for TLAC purposes will be higher;

ii. these costs will be exacerbated if: (a) there is limited capacity within the investor market; (b) banks are forced to pay a premium to attract additional funds; or (c) there is limited liquidity in the instruments given the restrictions on bank holdings, which will affect investor appetite; and

iii. banks that are fully funded by customer deposits will be required to issue instruments to satisfy minimum TLAC requirements when they have no options to deploy the additional funds. If these surplus funds are then invested in low yield liquid assets, there will be a negative spread to the bank, reducing profitability, tax payable and retained earnings. This point is particularly important in Hong Kong, which has traditionally been deposit-funded, but is also relevant across a range of emerging markets.

The full impact of the TLAC proposals on G-SIBs' costs of funding should be a key focus of the QIS. The QIS should be sufficiently broadly scoped to review all the potential macro and micro implications from such substantial alterations to the funding markets.

Question 16: ***What will be the impact on the financial system and its ability to provide financing to the real economy?***

HKAB considers that regulatory initiatives which impose higher costs on banks inevitably reduce the support which those banks can provide to the real economy (especially where the TLAC proposals incentivise banks to deleverage), either directly because marginal activities become less attractive or indirectly because banks will retain less profit and find it more difficult to attract capital. The scale of the impact will depend on the cost of funds, and crucially, on the extent to which banks are forced to raise TLAC for which they have no productive application.

Furthermore, to the extent that TLAC is provided cross-border with no scope for productive deployment, there is a risk that profits and taxes are reduced in the home jurisdiction with an effect on that jurisdiction's real economy.

In terms of the overall structure of the TLAC proposals, HKAB is concerned that the TLAC metric based on a leverage analysis may have a material adverse impact on genuinely lower risk business models.

There is also a concern that substantial inflows into local funding markets may result in an increase in asset prices.

The QIS should be sufficiently broadly scoped to comment on these points.

Question 17: ***Do you have any comments on any other aspects of the proposals?***

In addition to the points raised above, HKAB welcomes the use of the QIS as this will be an opportunity to assess the full impact (including the unintended consequences) of the TLAC proposals globally, and in specific markets such as Hong Kong, and in respect of both the banking sector and other parts of the economy.

The QIS should specifically consider:

i. the impact of the requirement not just to meet TLAC requirements at a group level but also at a material subsidiary level as a result of the internal TLAC requirements;

ii. the economic impact to global and local markets (e.g., a shift away from deposit funding to wholesale funding);

iii. the competitive impact to global and local markets;

iv. the capacity of the local funding markets to provide such TLAC without impacting the availability of funding in corporate bond markets;

v. the potential impact of internal TLAC requirements on capital fungibility and asset prices in local markets;

vi. the homogenising effect on banking models;

vii. the likely impact to D-SIBs that may be held to similar standards by the market;

viii. the impact of future regulatory change, such as in respect of regulatory capital buffers; and

ix. the ‘cliff-effect’ of the 12-month minimum maturity requirement.