



**Resolution Regime – Code of Practice**

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

**Purpose**

Section 196 of the Financial Institutions (Resolution) Ordinance (Cap. 628) (“FIRO”) empowers the Monetary Authority (“MA”) as a resolution authority in relation to banking sector entities (“resolution authority”) to issue a code of practice (“Code of Practice”) about any matter relating to the functions given to the MA in such capacity by the FIRO.

This publication is a chapter of the Code of Practice. It relates primarily to the Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements – Banking Sector) Rules (“LAC Rules”) made by the resolution authority under section 19(1) of the FIRO. The primary purpose of this chapter is to provide guidance on how the MA as resolution authority intends to exercise certain discretionary powers under the LAC Rules, and on the operation of certain provisions of the LAC Rules. This chapter is not designed to provide a comprehensive overview of requirements imposed by the LAC Rules.

**Application**

The entities which may be subject to requirements under the LAC Rules are authorized institutions (“AIs”) incorporated in Hong Kong, HK holding companies and HK affiliated operational entities. These types of entities are collectively defined as “classifiable entities” in the LAC Rules.



## Resolution Regime – Code of Practice

LAC-1

Resolution Planning – LAC  
Requirements

20.03.2019

### Structure

1.	Introduction .....	4
2.	Identifying a preferred resolution strategy (rule 3).....	8
3.	Classifying resolution entities (rule 5) .....	17
4.	Classifying material subsidiaries (rule 6) .....	19
5.	Varying the membership of LAC consolidation groups (rule 7)	23
6.	Notification of changes to LAC consolidation group or group activities (rule 9) .....	26
7.	Varying the capital component ratio (rule 18(4)).....	29
8.	Varying the resolution component ratio (rule 19 and rule 25)....	30
9.	Increasing the minimum external LAC risk-weighted ratio (rule 21(2)).....	38
10.	Increasing the minimum external LAC leverage ratio (rule 22(2)).....	39
11.	Increasing the internal LAC scalar (rule 26(2)).....	40
12.	Reducing the solo LAC scalar (rule 30(2)) .....	46
13.	Minimum LAC debt requirements for resolution entities and material subsidiaries (rule 33 and rule 34).....	49
14.	Reducing the minimum LAC debt requirement (rule 35) .....	52
15.	Resolution authority may require evidence (rule 41) .....	54
16.	Requirement not to include, or to discontinue inclusion of, items in external or internal loss-absorbing capacity (rule 42)	59
17.	Key metrics – loss-absorbing capacity – quarterly disclosures (rule 47) .....	61
18.	Composition of loss-absorbing capacity – semi-annual disclosures (rule 48) .....	63
19.	Resolution entity – creditor ranking at legal entity level – semi-annual disclosures (rule 49).....	65
20.	Material subsidiary – creditor ranking at legal entity level – semi-annual disclosures (rule 50).....	67
21.	Main features of regulatory capital instruments and of other non-capital LAC debt instruments – semi-annual disclosures	



**Resolution Regime – Code of Practice**

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

	(rule 51) .....	69
22.	Group disclosures and internet websites (rule 56) .....	71
23.	Requirement to notify resolution authority of failure or likely failure to comply (rule 60) .....	73
24.	Requirement to take remedial action (rule 61) .....	74
25.	Qualifying criteria to be met to be an external LAC debt instrument (section 1(1) of Schedule 1) .....	76
26.	Additional requirements for internal non-capital LAC debt instruments (section 2(3) of Schedule 2) .....	78



## Resolution Regime – Code of Practice

LAC-1

Resolution Planning – LAC  
Requirements

20.03.2019

### 1. Introduction

- 1.1 The FIRO was enacted by the Legislative Council in June 2016,<sup>1</sup> with its main provisions coming into force on 7 July 2017.<sup>2</sup> The FIRO establishes a cross-sectoral resolution regime for within scope financial institutions in Hong Kong and is designed to meet the international standards set by the Financial Stability Board in its *‘Key Attributes of Effective Resolution Regimes for Financial Institutions’*.<sup>3</sup>
- 1.2 Whilst the FIRO provides the legal framework for resolution, it is only the first step in ensuring that the failure of within scope financial institutions can be managed in an orderly way. In particular, resolution planning is recognised as an essential pre-requisite to orderly resolution.
- 1.3 Two key aspects of resolution planning are the development of resolution strategies, and identifying and removing barriers to the effective implementation of those strategies. One such potential barrier is inadequate loss-absorbing capacity. In order to address this barrier, section 19(1) of the FIRO empowers the MA as resolution authority to make rules prescribing loss-absorbing capacity (“LAC”)<sup>4</sup> requirements for relevant within scope financial institutions (including AIs) or their group companies.
- 1.4 The LAC Rules came into operation on 14 December 2018. The LAC Rules provide for the imposition of LAC requirements on Hong Kong incorporated AIs and certain of their Hong Kong incorporated group companies (i.e. classifiable entities). In relation to the timing of

<sup>1</sup> Gazetted version of the FIRO: <http://www.gld.gov.hk/egazette/pdf/20162026/es12016202623.pdf>

<sup>2</sup> Commencement Notice: <http://www.gld.gov.hk/egazette/pdf/20172119/es22017211977.pdf>

<sup>3</sup> First issued by the Financial Stability Board in 2011 and updated in 2014. For the latest version see: [Financial Stability Board, October 2014, Key Attributes of Effective Resolution Regimes for Financial Institutions](#)

<sup>4</sup> This chapter follows the approach adopted in the LAC Rules of generally using “loss-absorbing capacity” as a noun and “LAC” as an adjective.



## Resolution Regime – Code of Practice

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

implementation of LAC requirements, the resolution authority intends that, apart from any entities to which rule 32 of the LAC Rules applies, no domestic systemically important bank (“D-SIB”) (or group company thereof) will be required to meet any LAC requirement any earlier than 1 January 2022, and no other AI (or group company thereof) will be required to meet any LAC requirement any earlier than 1 January 2023.

- 1.5 LAC requirements are in addition to, and complement, regulatory capital requirements. Generally speaking, regulatory capital that counts towards meeting regulatory capital requirements (but not the regulatory capital buffer) also counts towards meeting LAC requirements – see Figure 1.
- 1.6 Each section of this chapter corresponds to a particular rule or subrule of the LAC Rules, and provides guidance on the manner in which the resolution authority proposes to exercise certain of the resolution authority’s powers under that rule or subrule, or other relevant guidance in relation to that rule or subrule. The guidance given is general in scope and does not take into account the particular circumstances of any individual classifiable entity. In the case of any conflict between this chapter and the LAC Rules, the LAC Rules prevail. As such, classifiable entities must read this chapter in conjunction with the LAC Rules and not in place of them.
- 1.7 This chapter includes references to a number of planning assumptions that will inform the exercise of certain discretionary powers by the resolution authority under the LAC Rules. It is important to bear in mind that these are general assumptions only, and that the way in which the resolution authority ultimately does or does not exercise any such powers will depend on the particular circumstances of each individual case.



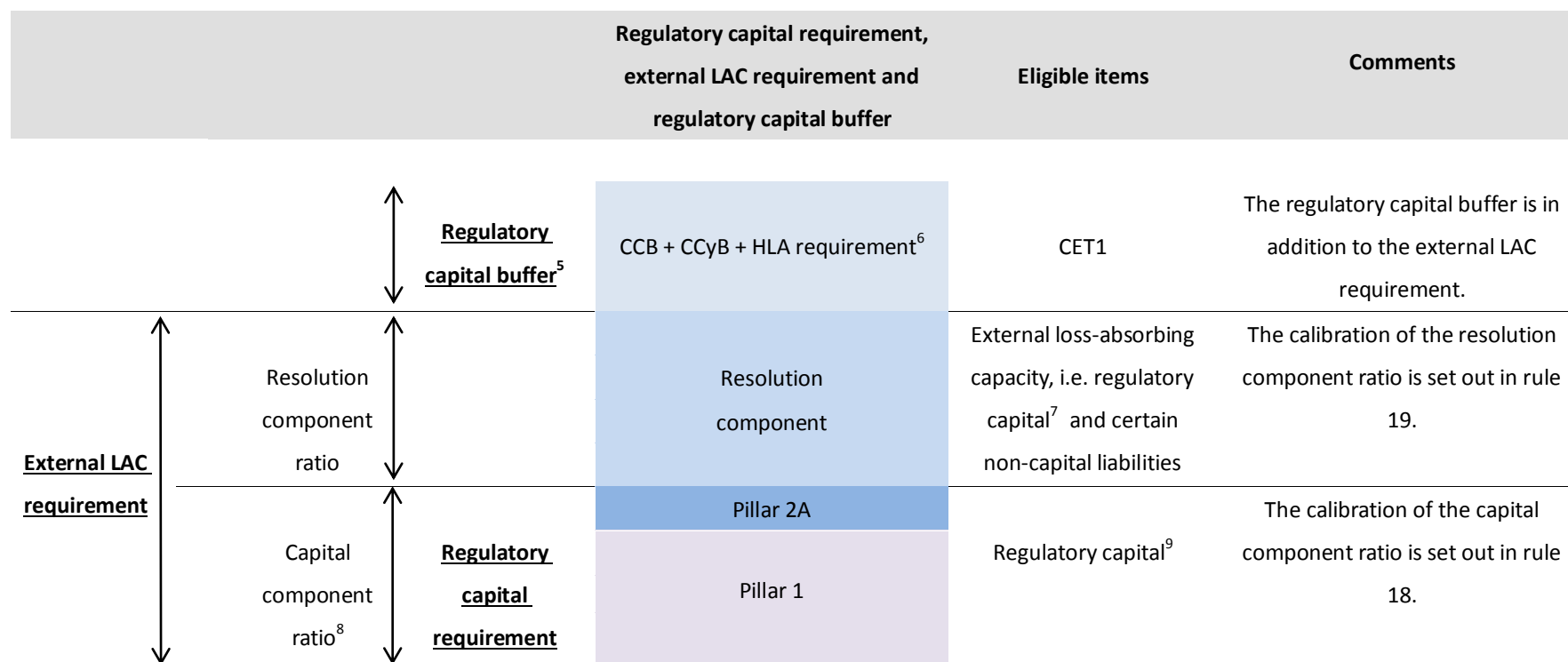
## Resolution Regime – Code of Practice

LAC-1

Resolution Planning – LAC Requirements

20.03.2019

Figure 1: Illustration of external LAC requirement (based on RWAs) for an AI that is a resolution entity



<sup>5</sup> This illustration does not include the Pillar 2B buffer, which would be set off against the regulatory capital buffer.

<sup>6</sup> The CCB is the capital conservation buffer; the CCyB is the countercyclical capital buffer; and the HLA requirement is the higher loss absorbency requirement applicable to D-SIBs.

<sup>7</sup> Subject to eligibility criteria – see Schedule 1 to the LAC Rules.

<sup>8</sup> In this illustration, the AI's binding regulatory capital requirements are based on RWAs. In practice, they could be based on its exposure measure.

<sup>9</sup> For illustrative purposes regulatory capital is shown here as contributing equally towards the regulatory capital requirements and the external LAC requirements. In practice, there are likely to be some minor differences – see rule 37 of the LAC Rules.



**Resolution Regime – Code of Practice**

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

- 1.8 This chapter should not be regarded as, or be considered as a substitute for obtaining, independent professional advice. A classifiable entity should consider obtaining such advice before taking action on any matters covered by this chapter, particularly if it has any doubt as to how any aspect of the LAC Rules might apply to it.
- 1.9 The resolution authority will keep under review the implementation of the LAC Rules and, where necessary, consider the need to revise this chapter as circumstances require.
- 1.10 Unless otherwise defined in this chapter, abbreviations and terms used in this chapter follow those used in the FIRO and the LAC Rules.



## Resolution Regime – Code of Practice

LAC-1

Resolution Planning – LAC  
Requirements

20.03.2019

## 2. Identifying a preferred resolution strategy (rule 3)

2.1 Rule 3 provides as follows:

*The resolution authority, by written notice served on a classifiable entity, may identify a resolution strategy as the preferred resolution strategy covering the entity.*

2.2 Under the FIRO, resolution can only be initiated in respect of an AI (or holding company or affiliated operational entity of an AI) when the AI meets the three conditions set out in section 25, the third of which is that (a) the non-viability of the AI poses risks to the stability and effective working of the financial system of Hong Kong, including to the continued performance of critical financial functions; and (b) resolution will avoid or mitigate those risks.<sup>10</sup>

2.3 All AIs are within the scope of the FIRO. However, it is neither practical nor desirable that detailed *ex ante* resolution planning be conducted for all such entities. The resolution authority therefore applies a proportionate, risk-based approach for the purposes of prioritising resolution planning. It is only where *ex ante* it is anticipated that the non-viability of a particular AI would be likely to pose a risk to the stability and effective working of the financial system of Hong Kong, including to the continued performance of critical financial functions, that the resolution authority would prioritise the development of a resolution strategy that relates to that AI.

### ***Determining which AIs should be prioritised for resolution planning***

2.4 In determining how best to prioritise AIs for resolution planning, including the development of resolution strategies, the resolution

<sup>10</sup> There are additional conditions that need to be met if the entity being resolved is a holding company or an affiliated operational entity of an AI. See sections 28 and 29 of the FIRO.





## Resolution Regime – Code of Practice

LAC-1

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

authority has given consideration to developing a framework that specifically takes into account a range of characteristics that may be relevant, including total assets, total volume of deposits, total number of depositors and other factors. However, the resolution authority's view is that developing a detailed framework that references multiple characteristics, each of which would have to be appropriately weighted, would lead to increased complexity without necessarily capturing all relevant institution-specific idiosyncrasies.

- 2.5 The resolution authority has therefore concluded that the better approach in prioritising the development of resolution strategies is to establish a framework that sets a threshold for developing resolution strategies that is based on a simple measure of the size of AIs, and allows for deviations from that threshold with reference to institution-specific factors.
- 2.6 In the resolution authority's judgement, the non-viability of any Hong Kong incorporated AI with total consolidated assets of more than HK\$150 billion would be likely to pose a risk to the stability and effective working of the financial system of Hong Kong, including to the continued performance of critical financial functions. The resolution authority's approach is therefore to set the framework threshold at HK\$150 billion, so that for any Hong Kong incorporated AI with total consolidated assets<sup>11</sup> above HK\$150 billion, the resolution authority will, for the purpose of securing orderly resolution of the AI, expect to devise a resolution strategy that covers such AI.
- 2.7 In calibrating the threshold at HK\$150 billion, the resolution authority has paid careful attention to the extent to which the non-viability of an AI would be likely to pose a risk to the continued performance of critical

<sup>11</sup> As reported in return MA(BS)24 *Return of Information for Assessment of Systemically Important AIs*. Where reporting on a consolidated basis is not available, reporting on a combined or Hong Kong office basis will be used.



**Resolution Regime – Code of Practice**

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

financial functions, in particular taking into account the extent of deposit-taking activities.

- 2.8 However, it does not follow that every AI that is prioritised for resolution planning should necessarily be subject to LAC requirements, not least as requiring an AI to meet LAC requirements is likely to impose additional costs on the AI. The resolution authority's planning assumption is that where a Hong Kong incorporated AI's total consolidated assets exceed HK\$300 billion, the AI (and possibly any HK holding company and/or HK affiliated operational entities of the AI) should be subject to LAC requirements. Where an AI's total consolidated assets are less than HK\$300 billion, the resolution authority's current planning assumption is that it will not be subject to LAC requirements.
- 2.9 The resolution authority's view is that setting the total consolidated asset threshold at the level of HK\$300 billion for identifying AIs to be subject to the imposition of LAC requirements strikes a reasonable balance between (i) ensuring that AIs the non-viability of which would be likely to pose a risk to the stability and effective working of the financial system of Hong Kong, including to the continued performance of critical financial functions, have sufficient loss-absorption and recapitalisation resources in place on their balance sheets; and (ii) avoiding, insofar as is prudent, the imposition of potentially onerous requirements on smaller institutions that are considered less likely to pose such a risk.
- 2.10 The resolution authority will keep these thresholds of HK\$150 billion and HK\$300 billion under review, but does not expect that growth in the size of Hong Kong's economy and of AIs' balance sheets should necessarily lead to these thresholds being raised as a matter of course. In relation to this, the resolution authority notes that HK\$300 billion represents more than 10% of Hong Kong's 2018 GDP, a substantial threshold. By way of comparison, in 2018 the assets of the smallest



## Resolution Regime – Code of Practice

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

institutions covered by minimum LAC requirements in Japan, the UK and the US constituted around 7%, 0.7% and 1% of those countries' 2018 GDPs, respectively.

2.11 As described above, in determining whether a resolution strategy should in fact be devised for any particular AI, the framework allows for departure from the threshold on the basis of institution-specific factors. In particular, setting the threshold for prioritisation for resolution planning at HK\$150 billion does not imply that a resolution strategy should not be developed for an AI below that threshold. In considering whether or not a resolution strategy should be developed that covers a classifiable entity, the resolution authority will also take into account the institution-specific circumstances of the relevant AI,<sup>12</sup> and the resolution authority's assessment of the likely consequences of the relevant AI's non-viability. A key issue for this assessment will be whether the nature and scale of the relevant AI's deposit-taking activities are such that they constitute a critical financial function.

2.12 Accordingly, in making a determination on whether a resolution strategy should be devised that covers a classifiable entity, in addition to the total consolidated assets of the relevant AI, the resolution authority may take into account, among other things, metrics related to the relevant AI's deposit-taking activities, such as number of depositors, volume of deposits, number of transactional accounts,<sup>13</sup> and number of depositors who have deposits at that AI which exceed the compensation limit under the Deposit Protection Scheme. Further, the resolution authority may exercise the resolution authority's powers under section 158(1) of the FIRO to require the provision of other

<sup>12</sup> Where a resolution entity, material subsidiary or classifiable entity is an AI, references in this chapter to "relevant AI" are references to that AI. Where a resolution entity, material subsidiary or classifiable entity is an HK holding company or an HK affiliated operational entity in respect of an AI, "relevant AI" refers to that AI.

<sup>13</sup> In a quantitative information survey issued to Hong Kong incorporated licensed banks in March 2018, 'transactional account' was defined as any account which had had more than twelve transactions (i.e. deposits or withdrawals) in a specified three month period.



## Resolution Regime – Code of Practice

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

information to the resolution authority, as described in the CI-1 ‘*Resolution Planning – Core Information Requirements*’ chapter of the Code of Practice.<sup>14</sup> That information may lead the resolution authority to conclude that a resolution strategy should be developed.

- 2.13 Note that when devising resolution strategies that relate to cross-border banking groups, the resolution authority would expect to co-ordinate where appropriate with other relevant resolution authorities (for example, through crisis management groups of global systemically important banks (“G-SIBs”), resolution colleges or bilateral engagement).
- 2.14 It should also be noted that the development of a resolution strategy for an AI will be informed by the resolution authority’s *ex ante* determination of the appropriate measures that are expected to be taken in addressing a future situation in which the AI reaches the point at which it has ceased, or is likely to cease, to be viable (the point of non-viability, or “PONV”). But these determinations should not be taken to imply that the indicated measures would necessarily be used. Should an AI reach the PONV, the resolution authority will determine the best course of action based on the prevailing circumstances without being in any way bound by earlier expectations, including any resolution strategy that has been devised.
- 2.15 As set out above, the resolution authority expects to prioritise resolution planning, which will include the development of a resolution strategy, for any Hong Kong incorporated AI with total consolidated assets above HK\$150 billion. However, the formal identification of a preferred resolution strategy covering a classifiable entity under rule 3 is only required where that entity is to be classified as a resolution entity or a material subsidiary under the LAC Rules, and so be subject to LAC requirements. Further guidance on the development of preferred

<sup>14</sup> <https://www.hkma.gov.hk/eng/key-functions/banking-stability/resolution/resolution-publications/>



## Resolution Regime – Code of Practice

LAC-1

Resolution Planning – LAC  
Requirements

20.03.2019

resolution strategies for resolution entities and material subsidiaries is set out in the rest of this section. Additional information on the HKMA's approach to resolution planning for AIs more generally is set out in the chapter of the Code of Practice entitled '*The HKMA's approach to Resolution Planning (RA-2)*'.<sup>15</sup>

### ***Preferred resolution strategies – resolution entities***

2.16 Among other things, it is anticipated that the preferred resolution strategy identified under rule 3 for a resolution entity will set out which of the stabilization options provided for in the FIRO are expected to be applied in relation to that entity should it (or, where that entity is not an AI, the relevant AI) reach the PONV. These stabilization options can be divided into two broad categories:

- the **bail-in stabilization option**,<sup>16</sup> whereby certain liabilities issued by the entity are cancelled or modified (for example, by reducing their outstanding amount or converting them into equity); and
- four **transfer stabilization options**, whereby some or all of the assets, rights or liabilities (for example, the whole or part of an entity's business) of, or securities issued by, the entity are transferred to a purchaser, a bridge institution, an asset management vehicle and/or (as a last resort) a temporary public ownership company.

2.17 For those AIs with large, complex, interconnected businesses, it may be risky to rely on the use of one or more transfer stabilization options which may involve, for example, the break-up of the business, or its

<sup>15</sup> <https://www.hkma.gov.hk/eng/key-functions/banking-stability/resolution/resolution-publications/>

<sup>16</sup> In this chapter, "bail-in" is used to refer to the exercise of the statutory bail-in stabilization option. The write-down or conversion into equity of LAC debt instruments in accordance with their terms and conditions is referred to as "contractual loss transfer".



## Resolution Regime – Code of Practice

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

transfer to a purchaser, within a tight timeframe. Accordingly, for larger AIs, bail-in is likely to be the most suitable stabilization option for delivering an orderly resolution that minimises risks to the stability and effective working of the financial system of Hong Kong, including to the continued performance of critical financial functions.

- 2.18 Transfer stabilization options are more likely to be appropriate for smaller AIs, whose operations are simpler and less interconnected. This is because using a transfer stabilization option to transfer part of an AI's assets and liabilities ("partial property transfer") is more likely to be feasible where the business of the AI is such that it lends itself more readily to having some assets and liabilities separated out on failure, and this is more likely to be the case for smaller, simpler entities. And using a transfer stabilization option to transfer all of an AI's assets and liabilities, or the entire shareholding in an AI, to a third party ("whole bank transfer"), is more likely to be feasible where it is easier for the potential transferee to assess the entirety of the business of the failed AI, and the risks associated with it, in a timely manner.
- 2.19 It follows from the above that the resolution authority would not expect any transfer stabilization option to be the main stabilization option in the preferred resolution strategy of a D-SIB. In practice, transfer stabilization options are more likely to be feasible for AIs that are prioritised for resolution planning, but are not classified as resolution entities (or material subsidiaries) and so are not subject to LAC requirements, e.g. AIs with total consolidated assets above but near the HK\$150 billion threshold discussed above.
- 2.20 The general presumption is that the preferred resolution strategy for any entity classified as a resolution entity will therefore be the application of the bail-in stabilization option to support the entire balance sheet ("whole bank bail-in"). Note, however, that this is indicative only, and whether a preferred resolution strategy should be identified as covering



## Resolution Regime – Code of Practice

LAC-1

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

any particular classifiable entity, and the nature of that strategy, will depend on the institution-specific circumstances of the relevant AI, the outcome of the resolution authority’s resolution planning for that AI, and the resolution authority’s assessment of the likely consequences of the non-viability of that AI.

### ***Preferred resolution strategies – material subsidiaries<sup>17</sup>***

2.21 Material subsidiaries will be required to issue internal loss-absorbing capacity (directly or indirectly) to a resolution entity or a non-HK resolution entity. Should a material subsidiary reach the PONV, its preferred resolution strategy can therefore be expected to involve the imposition of loss on the internal loss-absorbing capacity through activation of contractual triggers (“contractual loss transfer”) included in the terms and conditions of the internal LAC debt instruments. Contractual loss transfer is analogous to bail-in in the sense that it involves LAC debt instruments being written down or converted into equity in order to absorb loss and/or contribute towards recapitalisation. Should, for whatever reason, contractual loss transfer not prove effective in imposing losses on relevant internal LAC debt instruments, the resolution authority would anticipate using the statutory bail-in stabilization option to do so, and so would also expect to see this option included in the preferred resolution strategy.

2.22 Where internal non-capital LAC debt instruments are issued to a group company incorporated in a non-Hong Kong jurisdiction, then as set out in section 2(2)(b)(ii) of Schedule 2 to the LAC Rules, contractual loss transfer can only be triggered if the home authority has consented, or not objected, within 24 hours of notification. However, if for any reason

<sup>17</sup> Note that where a resolution strategy covers a material subsidiary, it may also cover that material subsidiary’s resolution entity (or non-HK resolution entity) and other entities in the resolution group. In these circumstances, references in this chapter to a resolution strategy for, that relates to, or that covers, a material subsidiary, should be taken to be references to the relevant elements of any such broader resolution strategy.



**Resolution Regime – Code of Practice**

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

contractual loss transfer is not effected, this does not imply that the resolution authority will then necessarily apply stabilization powers without engaging with relevant non-Hong Kong resolution authorities. On the contrary, the resolution authority would expect to continue to liaise closely with such non-Hong Kong authorities, and where appropriate would anticipate co-ordinating with any such authorities when using any stabilization powers – such as the bail-in stabilization option – so as to continue to facilitate the imposition of losses on non-capital internal loss-absorbing capacity in a way that supports co-ordinated, orderly cross-border resolution, whilst acting in a way that the resolution authority considers to be most appropriate for meeting the resolution objectives.

- 2.23 The indicative preferred resolution strategy for any entity classified as a material subsidiary will therefore be contractual loss transfer, with the application of the bail-in stabilization option as an alternative should contractual loss transfer not prove effective. Note, however, that this is indicative only, and whether a preferred resolution strategy should be identified as covering any particular classifiable entity, and the nature of that strategy, will depend on the institution-specific circumstances of the relevant AI, the outcome of the resolution authority's resolution planning for that AI, and the resolution authority's assessment of the likely consequences of the non-viability of that AI.





## Resolution Regime – Code of Practice

LAC-1

Resolution Planning – LAC  
Requirements

20.03.2019

### 3. Classifying resolution entities (rule 5)

3.1 Rule 5(1) and (2) provides as follows:

- (1) *The resolution authority may, in accordance with rule 8, classify a classifiable entity as a resolution entity if there is a preferred resolution strategy covering the classifiable entity that contemplates the application of a stabilization option in respect of any assets, rights or liabilities of, or securities issued by, the classifiable entity.*
- (2) *In determining whether to classify a classifiable entity as a resolution entity, the resolution authority may take into account—*
  - (a) *the preferred resolution strategy covering the classifiable entity; and*
  - (b) *any other matters the resolution authority considers relevant.*

3.2 A consequence of the classification of a classifiable entity as a resolution entity under the LAC Rules is that that entity is required to meet one or more LAC requirements. In considering whether to classify an entity as a resolution entity under rule 5(2), the resolution authority will therefore have particular regard to whether implementation of the preferred resolution strategy, and the application of the stabilization options as contemplated under that strategy, are anticipated to require that loss-absorbing capacity in excess of the relevant entity's regulatory capital requirements (if any) be available to bear loss.

3.3 A pre-requisite for the application of the *bail-in* stabilization option is that there are liabilities available to which the resolution authority can apply the bail-in option, and the liabilities to which that option can be most readily applied are those that constitute loss-absorbing capacity. The desired outcome of the exercise of any of the *transfer* stabilization



## Resolution Regime – Code of Practice

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

options will be the continued performance of at least part of the activities of the resolution entity (or of a relevant AI, where the resolution entity is not itself an AI). This requires the availability of resources for absorbing losses and/or recapitalisation at the PONV that are in addition to those required to meet regulatory capital requirements (if any). And in such a scenario, the best source of such resources is loss-absorbing capacity that is maintained by the AI (or where relevant a group company) itself.

- 3.4 However, as discussed in section 2 above, the resolution authority's current planning assumption is that no AIs with total consolidated assets below HK\$300 billion would be subject to LAC requirements. The resolution authority's planning assumption is that where the preferred resolution strategy that covers an AI with total consolidated assets above HK\$300 billion contemplates the application of any one or more stabilization options in respect of a classifiable entity, the resolution authority would expect to classify such entity as a resolution entity under rule 5(1) to ensure that it was subject to external LAC requirements under the LAC Rules.<sup>18</sup>
- 3.5 Note that when making any resolution entity classifications in respect of cross-border banking groups, the resolution authority would expect to co-ordinate where appropriate with other relevant resolution authorities (for example, through G-SIBs' crisis management groups, resolution colleges or bilateral engagement).

<sup>18</sup> This would not apply where contractual loss transfer is central to the preferred resolution strategy, with the bail-in stabilization option included as an alternative as described in paragraph 2.21 above.



**Resolution Regime – Code of Practice**

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

**4. Classifying material subsidiaries (rule 6)**

4.1 Rule 6(1) provides as follows:

- (1) *The resolution authority may, in accordance with rule 8, classify a classifiable entity as a material subsidiary if—*
- (a) *the classifiable entity is in a resolution group but is not a resolution entity; and*
  - (b) *the resolution authority determines that the classifiable entity taken on its own, or together with any of its subsidiaries in the resolution group—*
    - (i) *contains more than 5% of the risk-weighted assets of the resolution group;*
    - (ii) *generates more than 5% of the total operating income of the resolution group;*
    - (iii) *contains more than 5% of the unweighted assets of the resolution group; or*
    - (iv) *is material to the provision of critical financial functions.*

4.2 Rule 6(3) provides as follows:

- (3) *In making a determination under subrule (1)(b), the resolution authority may draw on any information and make any assumptions the resolution authority considers appropriate, taking into account the following matters—*
- (a) *the availability of data relating to the risk-weighted assets, total operating income and unweighted assets of the classifiable entity and other members of the resolution group;*
  - (b) *the comparability of data referred to in paragraph (a), taking into account that the classifiable entity and other members of the resolution group—*



## Resolution Regime – Code of Practice

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

- (i) may not all be authorized institutions or be otherwise regulated in Hong Kong or in a non-Hong Kong jurisdiction; and*
- (ii) may not all be located in the same jurisdiction;*
- (c) any other matters the resolution authority considers relevant.*

4.3 For any entity that is covered by a preferred resolution strategy, its resolution group is the group identified as such in that strategy. It follows from this that a classifiable entity can be classified as a material subsidiary under rule 6(1) where:

- (a) a resolution strategy has been identified as the preferred resolution strategy covering the classifiable entity in question, and that strategy identifies a resolution group of which the classifiable entity in question is a member; and
- (b) the classifiable entity in question has been determined by the resolution authority to meet one or more of the criteria set out in rule 6(1)(b).

4.4 The LAC Rules provide for the resolution authority to classify as a material subsidiary any classifiable entity that meets the criterion set out in rule 6(1)(a) and any one or more of the four criteria set out in rule 6(1)(b), but do not require the resolution authority to do so.

4.5 The resolution authority's planning assumption is that where such an entity does meet the criterion set out in rule 6(1)(a) and any one or more of the three criteria in rule 6(1)(b)(i), (ii) and (iii), and where the classifiable entity (or relevant AI, if the entity is not itself an AI) has total consolidated assets above HK\$300 billion (as discussed in section 2 above), the consequences of its non-viability (or that of one or more of its subsidiaries) are likely to be such that it should be classified as a material subsidiary and therefore subject to LAC requirements.



## Resolution Regime – Code of Practice

LAC-1

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

- 4.6 In relation to the criterion set out in rule 6(1)(b)(iv), the resolution authority’s planning assumption as set out in section 2 is that the non-viability of any Hong Kong incorporated AI with total consolidated assets above HK\$150 billion would be likely to pose a risk to the stability and effective working of the financial system of Hong Kong, including to the continued performance of critical financial functions. More specifically, the resolution authority’s planning assumption is that the non-viability of any such institution is most likely to pose a risk to the stability and effective working of the financial system of Hong Kong as a *result of* the impact of its non-viability on its ability to continue to perform critical financial functions. Section 2 also sets out the resolution authority’s current planning assumption that it is only where an AI is incorporated in Hong Kong and has total consolidated assets above HK\$300 billion that it (and possibly any HK holding company and/or HK affiliated operational entities of the AI) would be subject to LAC requirements.
- 4.7 In order to adopt a consistent approach, the resolution authority will therefore work on the planning assumption that any Hong Kong incorporated AI with total consolidated assets above HK\$300 billion is material to the provision of critical financial functions and should be subject to LAC requirements, and should therefore be classified as a material subsidiary under rule 6(1)(b)(iv) (subject to it also meeting the condition set out in rule 6(1)(a)).
- 4.8 In making any determinations under rule 6(1)(b), rule 6(3) allows the resolution authority to draw on any information the resolution authority considers appropriate, taking into account the matters specified. In practice, this could include (i) any relevant information in the public domain (including published financial statements); (ii) any relevant information provided by the entity to the resolution authority; and (iii) any relevant information provided by other relevant local or overseas authorities.



**Resolution Regime – Code of Practice**

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

- 4.9 It should be further noted that when making any material subsidiary classifications in respect of cross-border banking groups, the resolution authority would expect to co-ordinate where appropriate with other relevant resolution authorities (for example, through G-SIBs' crisis management groups, resolution colleges or bilateral engagement).



## Resolution Regime – Code of Practice

LAC-1

Resolution Planning – LAC  
Requirements

20.03.2019

### 5. Varying the membership of LAC consolidation groups (rule 7)

5.1 Rule 7 provides as follows:

- (1) *The resolution authority may, in accordance with rule 8, vary the LAC consolidation group of a resolution entity or material subsidiary by—*
  - (a) *removing one or more subsidiaries of the resolution entity or material subsidiary from the group; or*
  - (b) *adding one or more subsidiaries of the resolution entity or material subsidiary to the group.*
- (2) *The resolution authority may vary the LAC consolidation group of a resolution entity or material subsidiary under this rule if satisfied that it is prudent to do so.*
- (3) *In determining whether it is prudent to vary the LAC consolidation group of a resolution entity or material subsidiary, the resolution authority may take into account—*
  - (a) *the extent to which the subsidiary to be removed or added is connected to the resolution entity or material subsidiary and the potential for the level of connectedness to contribute to a risk of contagion between them;*
  - (b) *the preferred resolution strategy covering the resolution entity or material subsidiary; and*
  - (c) *any other matters the resolution authority considers relevant.*

5.2 The LAC Rules provide for the minimum external LAC risk-weighted ratio for a resolution entity to be the sum of its capital component ratio and resolution component ratio (rule 21(1)), and unless varied by the resolution authority under rule 19, for the resolution component ratio to be equal to the capital component ratio (rule 19(1)). This approach will



## Resolution Regime – Code of Practice

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

typically require a resolution entity that is an AI to have external LAC requirements that are calibrated at twice its regulatory capital requirements. The rationale underlying the principle that the calibration of LAC requirements should be based on twice the regulatory capital requirements is that an AI should be able to experience losses that entirely deplete the regulatory capital it is required to maintain and still have sufficient remaining loss-absorbing capacity to allow it to be fully recapitalised in resolution and so restored to viability. With LAC requirements being based on capital requirements in this way, it follows that the starting point for consideration of the consolidation basis for LAC requirements should be the consolidation basis for capital requirements. This is why – unless otherwise varied by the resolution authority under rule 7 – the LAC Rules set the membership of a LAC consolidation group as the same as the membership of the relevant capital consolidation group (plus the resolution entity or material subsidiary, if that entity is not itself an AI).

- 5.3 However, there may be circumstances in which the resolution authority considers it appropriate for entities to be removed from or added to the LAC consolidation group of a resolution entity or material subsidiary. An example of where this might be likely to be the case would be where there was a subsidiary not in the relevant capital consolidation group but the operations of which were sufficiently connected to those of the resolution entity or material subsidiary that failure of the subsidiary may undermine the preferred resolution strategy, and the resolvability of the resolution entity or material subsidiary. In those circumstances, the resolution authority may determine that because of the risk of contagion between the two entities, the subsidiary should be included in the LAC consolidation group. The effect of this would be that the risk-weighted amount and exposure measure of that subsidiary would be taken into account in determining how much external or internal loss-absorbing capacity the resolution entity or material subsidiary should maintain in order to meet its LAC requirements.





**Resolution Regime – Code of Practice**

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

- 5.4 In removing or adding any entity, the resolution authority also intends to have regard to the practicability of calculating the loss-absorbing capacity, risk-weighted amount and exposure measure for the entity to be removed or added, and would ordinarily expect to discuss this issue in advance with the relevant resolution entity or material subsidiary. The resolution authority appreciates that it would be undesirable to require a resolution entity or material subsidiary to meet LAC requirements under the LAC Rules in the absence of clarity on how the loss-absorbing capacity, risk-weighted amount and exposure measure should be calculated for the relevant LAC consolidation group.



**Resolution Regime – Code of Practice**

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

**6. Notification of changes to LAC consolidation group or group activities (rule 9)**

6.1 Rule 9 provides as follows:

(1) *A resolution entity must give written notice to the resolution authority of the following matters as soon as practicable after the resolution entity is aware of the matter or ought to be aware of the matter—*

- (a) *a subsidiary ceasing to be a member of the resolution entity's LAC consolidation group, other than as a result of the resolution authority removing the subsidiary from the group under rule 7(1)(a);*
- (b) *a subsidiary becoming a member of the resolution entity's LAC consolidation group, other than as a result of the resolution authority adding the subsidiary to the group under rule 7(1)(b);*
- (c) *the principal activities of a subsidiary referred to in paragraph (b);*
- (d) *any significant change to the principal activities of the resolution entity or any of its subsidiaries (including a subsidiary referred to in paragraph (b)).*

(2) *A material subsidiary must give written notice to the resolution authority of the following matters as soon as practicable after the material subsidiary is aware of the matter or ought to be aware of the matter—*

- (a) *a subsidiary ceasing to be a member of the material subsidiary's LAC consolidation group, other than as a result of the resolution authority removing the subsidiary from the group under rule 7(1)(a);*
- (b) *a subsidiary becoming a member of the material subsidiary's LAC consolidation group, other than as a result of the*



## Resolution Regime – Code of Practice

LAC-1

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

*resolution authority adding the subsidiary to the group under rule 7(1)(b);*

*(c) the principal activities of a subsidiary referred to in paragraph (b);*

*(d) any significant change to the principal activities of the material subsidiary or any of its subsidiaries (including a subsidiary referred to in paragraph (b)).*

6.2 The purpose of rule 9 is to ensure that a resolution entity or material subsidiary is required to notify the resolution authority of changes to the composition of its LAC consolidation group and of any material new information in relation to its principal activities as well as the principal activities of the members of that group. On the latter point, rule 9(1)(c) and (d) and rule 9(2)(c) and (d) respectively provide for a resolution entity and material subsidiary to notify the resolution authority of the principal activities of a new member of the LAC consolidation group, and of any significant change to the principal activities of an existing member.

6.3 It is important that the resolution authority is provided with such information in order to ensure that when exercising discretionary powers under the FIRO and under the LAC Rules, the resolution authority is able to take into consideration all relevant information. It follows from this that determinations of what constitutes a “significant change to the principal activities” of a resolution entity or material subsidiary (or any of its relevant subsidiaries) should be informed by whether those changes could be relevant for the exercise by the resolution authority of those discretionary powers, including (without limitation) the resolution authority’s power to devise resolution strategies and develop resolution plans (section 13 of the FIRO); to vary the composition of the LAC consolidation group (rule 7); to vary the capital component ratio (rule 18); to vary the resolution component ratio (rule 19); and to vary the internal LAC scalar (rule 26). Changes that



**Resolution Regime – Code of Practice**

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

are likely to be relevant would therefore include (without limitation) changes that are material to the nature or extent of (i) business lines which are core to the entity’s operations; (ii) the entity’s key legal, financial and operational dependencies on group companies and external providers; and (iii) the entity’s financial functions.

- 6.4 Where a resolution entity or material subsidiary is uncertain as to whether a change to the principal activities of the resolution entity or the material subsidiary (or any of its relevant subsidiaries) is “significant” for the purposes of rule 9, it should bring the matter to the attention of the resolution authority.



## Resolution Regime – Code of Practice

LAC-1

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

### 7. Varying the capital component ratio (rule 18(4))

7.1 Rule 18(4) provides as follows:

(4) *The resolution authority may, in accordance with rule 20, vary the capital component ratio for a resolution entity referred to in subrule (2) or (3) if satisfied that it is prudent to do so to reflect the difference in membership of the resolution entity's LAC consolidation group and the capital consolidation group referred to in subrule (2) or (3) (as the case requires).*

7.2 Generally speaking, the intention is that the capital component ratio of a resolution entity should reflect the regulatory capital requirements that would be expected to be imposed on the resolution entity's LAC consolidation group were that group a capital consolidation group under the Capital Rules. The rationale for allowing the resolution authority to vary the capital component ratio as provided for in rule 18(4) is therefore to allow for adjustments to be made to reflect any particular risks that might be associated with the assets or operations of entities that are within the resolution entity's LAC consolidation group but not included in its capital consolidation group. This could lead to the resolution authority either increasing or decreasing the capital component ratio.

7.3 By way of example, there could be circumstances in which there is an entity that is included in the LAC consolidation group of a resolution entity or material subsidiary but not in the relevant capital consolidation group, and were it included in the capital consolidation group it may lead to higher (or lower) regulatory capital requirements in relation to that capital consolidation group under the Capital Rules. In such circumstances, the resolution authority may increase (or decrease) the capital component ratio of the resolution entity or material subsidiary accordingly.



**Resolution Regime – Code of Practice**

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

**8. Varying the resolution component ratio (rule 19 and rule 25)**

8.1 Rule 19(2) provides as follows:

(2) *The resolution authority may, on the resolution authority's volition or on a resolution entity's application, in accordance with rule 20, vary a resolution entity's resolution component ratio if satisfied that it is prudent to do so.*

8.2 Rule 19(5) provides as follows:

(5) *In determining whether it is prudent to vary a resolution entity's resolution component ratio (including whether to accept a resolution entity's application for variation under subrule (3)), the resolution authority may take into account—*

- (a) *any stabilization options expected to be applied under the preferred resolution strategy covering the resolution entity;*
- (b) *any risks to resolvability related to the fact that there may be entities that are in the resolution entity's resolution group but not in its LAC consolidation group, and whose assets are therefore not otherwise taken into account when determining the resolution entity's LAC requirements; and*
- (c) *any other matters the resolution authority considers relevant.*

8.3 In deciding whether or not to vary a resolution entity's resolution component ratio, the resolution authority will be seeking to ensure that the external loss-absorbing capacity that the resolution entity is required to maintain in excess of that needed to meet its regulatory capital requirements (if any) is sufficient to facilitate an orderly resolution through the implementation of the preferred resolution strategy.



## Resolution Regime – Code of Practice

LAC-1

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

- 8.4 One scenario which might give rise to a reduction in the resolution component ratio for a resolution entity that is a smaller AI, is where the preferred resolution strategy envisages a partial property transfer, for example because the business associated with the performance of critical financial functions is limited and more easily separable. In such a scenario, only part of the balance sheet of the resolution entity would be expected to be recapitalised in resolution, which would be likely to require fewer recapitalisation resources (i.e. less loss-absorbing capacity).
- 8.5 Another scenario which might give rise to a reduction in the resolution component ratio for a resolution entity that is an AI is where the preferred resolution strategy envisages a whole bank transfer, for example because its business is relatively small and simple. In such a scenario, the business of a failed AI is expected to be taken over in resolution in a timely manner as a going concern by a transferee AI.
- 8.6 Orderly resolution of a failed (smaller) AI in this way may be possible with fewer LAC resources than would be required for a whole bank bail-in (with no transfer), because the transferee may already have sufficient capital, and/or may be willing and able to quickly raise additional capital, to support the transferred business in whole or in part. Where a transferee has made the commercial judgement that there is value to it in the failed AI (e.g. business synergies), the transferee may be willing to incur costs (e.g. by injecting capital to cover losses) to access that value.
- 8.7 It may also be the case that in such a scenario the whole bank transfer would involve the business of an AI that uses the standardised approach to risk-weighting its assets being transferred to an AI that uses the internal models-based approach. In these circumstances, it could be anticipated that over a transition period the transferee would seek to extend its internal models-based approach to the assets of the



## Resolution Regime – Code of Practice

LAC-1

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

failed AI that have been transferred to it (subject to the prior approval of the MA). Once complete, this could be expected to lead to a more granular assessment of the risks associated with the transferred assets, with the potential to generate some capital efficiency over time. This may result in fewer recapitalisation resources being required to restore the business of the failed AI to viability, and consequently justify lower *ex ante* LAC requirements for the relevant resolution entity. It is of course not possible to be certain in advance that any transferee would be using the internal models-based approach. But if the resolution authority considers this to be sufficiently likely, some reduction in the resolution component ratio, and hence the LAC requirements, might be considered.

8.8 As described above, the resolution authority's view is that using a transfer stabilization option is more likely to be feasible for smaller, simpler AIs. In particular, as discussed in section 2 above, the resolution authority would not expect that any such options would be central to the preferred resolution strategy of a D-SIB.

8.9 It follows from the above that the scope of the appropriate reduction (if any) in the resolution component ratio for a resolution entity covered by a preferred resolution strategy that includes partial property transfer and/or whole bank transfer would depend on the size and nature of the resolution entity's operations, and where the resolution entity is not an AI, then also the size and nature of the relevant AI. Generally speaking, it could be anticipated that where a resolution entity has a smaller, simpler business it could more readily be resolved through partial property transfer or whole bank transfer, and so a larger reduction in the resolution component ratio may be justified. For larger, more complex businesses it is likely that the appropriate reduction would be small, if not zero. In particular, no reduction would be anticipated in the case of any resolution entity that is a D-SIB.





**Resolution Regime – Code of Practice**

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

- 8.10 Any such reduction can necessarily only reflect the resolution authority’s *ex ante* assessment of the quantity of loss-absorbing capacity that may be required to facilitate an orderly resolution in as yet uncertain future circumstances. In order to ensure that an appropriately prudent approach is adopted in taking such uncertainty into consideration, the resolution authority’s expectation is that, while acknowledging that the scope of any reduction in the resolution component ratio will ultimately depend on the particular circumstances of an individual resolution entity, even if all the above-mentioned factors were to apply, a total reduction in the size of the resolution component ratio of more than 50% would be unlikely to be considered prudent. This implies that in a situation where a reduction is justified but the supporting factors are fewer, or less clear, it is likely that any reduction would be less than 50%.
- 8.11 An example of a scenario which might lead to an increase in the resolution component ratio is where a resolution entity has one or more subsidiaries that are not in its LAC consolidation group, but whose operations are sufficiently connected to those of the resolution entity that failure of any such subsidiary may undermine the resolvability of the resolution entity. In such a scenario, one response would be for the resolution authority to include the relevant subsidiaries in the LAC consolidation group under rule 7. However, should that prove undesirable or impractical, an alternative would be to increase the resolution component ratio of the resolution entity. This would have the effect of requiring the resolution entity to maintain more external loss-absorbing capacity. These additional resources could then be used to address the failure of the subsidiary, thereby mitigating a risk to resolvability. In these circumstances any increase in the resolution component ratio would be calibrated to reflect the level of risk associated with the relevant subsidiary or subsidiaries not included within the LAC consolidation group.



## Resolution Regime – Code of Practice

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

8.12 The preceding paragraphs identify a number of factors that could be taken into account by the resolution authority in any consideration of whether to vary a resolution component ratio, and if so by how much. However, these should not be regarded as an exhaustive list, and the resolution authority may have regard to any other relevant factors.

8.13 The resolution authority will take into account all factors that the resolution authority considers relevant when making any determination on whether or not to vary a resolution entity's resolution component ratio (and if so, by how much). It follows from this that where circumstances change, it may be appropriate for the resolution authority to re-visit any determination to vary, or not to vary, a resolution component ratio. Accordingly, for each resolution entity the resolution authority will keep this issue under review. Should it be the case that following a change in circumstances the resolution authority determines that a variation (or a different variation) is prudent, this would be effected using the mechanism set out in rule 20, which provides the relevant resolution entity with the opportunity to make representations to the resolution authority and ultimately to apply to the Resolvability Review Tribunal for a review of the resolution authority's decision.

8.14 Rule 25 provides as follows:

- (1) *A material subsidiary's modelled minimum external LAC risk-weighted ratio and modelled minimum external LAC leverage ratio are equal to the minimum external LAC risk-weighted ratio and minimum external LAC leverage ratio, respectively, that would apply to the material subsidiary if it were a resolution entity.*
- (2) *For the purposes of determining its modelled minimum external LAC risk-weighted ratio and modelled minimum external LAC leverage ratio, these Rules apply to a material subsidiary in the same way, and to the same extent, as they apply to a resolution*



## Resolution Regime – Code of Practice

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

*entity in the determination of its minimum external LAC risk-weighted ratio and minimum external LAC leverage ratio.*

- 8.15 As is clear from rule 25, determining a material subsidiary's resolution component ratio is a key step in the calibration of its modelled minimum external LAC risk-weighted ratio and modelled minimum external LAC leverage ratio, and from there its internal LAC requirements. Contractual loss transfer will be central to the preferred resolution strategy of any material subsidiary. This is analogous to bail-in in the sense that it involves LAC debt instruments being written down or converted into equity in order to absorb loss and/or contribute towards recapitalisation. As such, in determining a material subsidiary's minimum external LAC risk-weighted ratio and minimum external LAC leverage ratio as if that material subsidiary were a resolution entity, the resolution authority will in particular take into account the resolution component ratio that would apply to that material subsidiary were it a resolution entity with whole bank bail-in as its preferred resolution strategy.
- 8.16 Note further that as a consequence of rule 25, the paragraphs above in this section 8 that apply to the variation of a resolution entity's resolution component ratio also apply in a corresponding manner to the calculation of a material subsidiary's resolution component ratio (which will then impact on the calculation of its modelled minimum external LAC risk-weighted ratio and modelled minimum external LAC leverage ratio).
- 8.17 Paragraphs 8.4 and 8.5 above describe examples in which having partial property transfer or whole bank transfer as a preferred resolution strategy could justify a reduction in a resolution entity's resolution component ratio. However, as discussed above, it is anticipated that the preferred resolution strategy of a material subsidiary would be contractual loss transfer, and if necessary bail-in – but not any of the transfer stabilization options. As such, it is not expected that the



**Resolution Regime – Code of Practice**

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

examples in paragraphs 8.4 or 8.5 could apply to any material subsidiary.

8.18 Indicative examples of the outcome of the combined guidance set out in section 2 above and this section 8 for resolution entities and material subsidiaries are set out in Table 1 below. Note, however, that these are examples only, and the nature of a preferred resolution strategy, and whether any adjustment to the resolution component ratio is prudent, will depend on the institution-specific circumstances of that entity, the outcome of the resolution authority's resolution planning for that entity, and the resolution authority's assessment of the likely consequences of the non-viability of the relevant AI.

8.19 For completeness, Table 1 also covers AIs with total consolidated assets below HK\$300 billion, which, under the resolution authority's current planning assumption, would not be classified as resolution entities or material subsidiaries. Note that in line with the guidance set out in section 2 above, for AIs that are prioritised for resolution planning but not subject to LAC requirements, the resolution authority would expect that partial property transfer and/or whole bank transfer (as opposed to bail-in) would likely only be appropriate as possible resolution strategies for smaller, simpler institutions.



## Resolution Regime – Code of Practice

LAC-1

Resolution Planning – LAC Requirements

20.03.2019

*Table 1: Indicative preferred resolution strategy, resolution component ratio and (consolidated) LAC requirements  
(based on internal LAC scalar of 75%)*

Relevant AI	RE or MS	Indicative preferred resolution strategy	Indicative resolution component ratio	Internal LAC scalar	Indicative LAC requirement (consolidated)
D-SIB	RE	Whole bank bail-in	1 x capital component ratio	-	2 x capital component ratio <i>(external LAC)</i>
	MS	Contractual loss transfer	1 x capital component ratio	75%	1.5 x capital component ratio <i>(internal LAC)</i>
Non-D-SIB Hong Kong incorporated AI with total consolidated assets greater than HK\$300bn	RE	Whole bank bail-in	1 x capital component ratio	-	2 x capital component ratio <i>(external LAC)</i>
	MS	Contractual loss transfer	1 x capital component ratio	75%	1.5 x capital component ratio <i>(internal LAC)</i>
Non-D-SIB Hong Kong incorporated AI with total consolidated assets greater than HK\$150bn but less than HK\$300bn	n/a	Bail-in, with partial property transfer or whole bank transfer possible options for smaller, simpler banks near the HK\$150bn threshold  (LAC requirements will not be imposed under the resolution authority's current planning assumption)	n/a	n/a	n/a
Other AI	n/a	Development of a resolution strategy is not currently prioritised	n/a	n/a	n/a



**Resolution Regime – Code of Practice**

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

**9. Increasing the minimum external LAC risk-weighted ratio (rule 21(2))**

9.1 Rule 21(2) provides as follows:

(2) *The resolution authority, by written notice served on a resolution entity that is a global systemically important bank, may increase the resolution entity's minimum external LAC risk-weighted ratio to reflect the minimum TLAC requirements set out in the TLAC term sheet.*

9.2 Where the operation of the other provisions of the LAC Rules results in a minimum external LAC risk-weighted ratio for a G-SIB resolution entity that is less than the corresponding minimum TLAC requirement set out in the TLAC term sheet, rule 21(2) allows the resolution authority to increase the minimum external LAC risk-weighted ratio accordingly.

9.3 The intention is that the minimum external LAC risk-weighted ratio under the LAC Rules for a G-SIB resolution entity should be no less than the corresponding minimum TLAC requirement set out in the TLAC term sheet applicable to that entity. As a member of the Financial Stability Board, it is incumbent on Hong Kong to adopt Financial Stability Board standards, and therefore where necessary, the resolution authority intends to use the power set out in rule 21(2) to achieve this outcome.

9.4 Note that through the operation of rules 23 and 25, the provisions of rule 21(2) also provide for the minimum internal LAC risk-weighted ratio of a material subsidiary to be increased if necessary to align with the applicable minimum internal TLAC requirements set out in the TLAC term sheet.



**Resolution Regime – Code of Practice**

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

**10. Increasing the minimum external LAC leverage ratio (rule 22(2))**

10.1 Rule 22(2) provides as follows:

(2) *The resolution authority, by written notice served on a resolution entity that is a global systemically important bank, may increase the resolution entity's minimum external LAC leverage ratio to reflect the minimum TLAC requirements set out in the TLAC term sheet.*

10.2 Where the operation of the other provisions of the LAC Rules results in a minimum external LAC leverage ratio for a G-SIB resolution entity that is less than the corresponding minimum TLAC requirement set out in the TLAC term sheet, rule 22(2) allows the resolution authority to increase the minimum external LAC leverage ratio accordingly.

10.3 The intention is that the minimum external LAC leverage ratio under the LAC Rules for a G-SIB resolution entity should be no less than the corresponding minimum TLAC requirement set out in the TLAC term sheet applicable to that entity. As a member of the Financial Stability Board it is incumbent on Hong Kong to adopt Financial Stability Board standards, and therefore where necessary, the resolution authority intends to use the power set out in rule 22(2) to achieve this outcome.

10.4 Note that through the operation of rules 24 and 25, the provisions of rule 22(2) also provide for the minimum internal LAC leverage ratio of a material subsidiary to be increased if necessary to align with the applicable minimum internal TLAC requirements set out in the TLAC term sheet.



## Resolution Regime – Code of Practice

LAC-1

Resolution Planning – LAC  
Requirements

20.03.2019

### 11. Increasing the internal LAC scalar (rule 26(2))

11.1 Rule 26(1), (2), (3) and (4) provides as follows:

- (1) *Subject to subrules (2) and (5), a material subsidiary's internal LAC scalar is 75%.*
- (2) *The resolution authority may, in accordance with rule 27, increase a material subsidiary's internal LAC scalar if satisfied that it is prudent to do so.*
- (3) *In determining whether it is prudent to increase a material subsidiary's internal LAC scalar, the resolution authority may take into account—*
  - (a) *the preferred resolution strategy covering the material subsidiary;*
  - (b) *the likely availability of additional financial resources within the material subsidiary's resolution group that could be expected to be deployed to restore to viability any authorized institution in the material subsidiary's material sub-group; and*
  - (c) *any other matters the resolution authority considers relevant.*
- (4) *The maximum percentage to which the resolution authority may increase a material subsidiary's internal LAC scalar under subrule (2) is—*
  - (a) *90% where the preferred resolution strategy covering the material subsidiary envisages all internal loss-absorbing capacity issued by the material subsidiary being issued directly to an entity that is not incorporated in Hong Kong; or*
  - (b) *100% where the preferred resolution strategy covering the material subsidiary envisages some or all internal loss-absorbing capacity issued by the material subsidiary being issued directly to an entity that is incorporated in Hong Kong.*





## Resolution Regime – Code of Practice

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

11.2 Under the LAC Rules, the internal LAC scalar acts to lower a material subsidiary's internal LAC requirements below what its external LAC requirements would be if it were a resolution entity. The rationale for this is that a material subsidiary will necessarily be part of a wider group, and it can be expected that resources from that wider group will be available to be deployed to support the material subsidiary should that prove necessary. This justifies setting a lower requirement for the level of financial resources that need to be pre-positioned on the balance sheet of the material subsidiary.

11.3 The default value for the internal LAC scalar set out in the LAC Rules is 75%. This is at the lower end of the 75%-90% range for internal TLAC set out in the TLAC term sheet. Setting the starting point for the internal LAC scalar at 75% allows for the most efficient use of loss-absorbing capacity because fewer resources pre-positioned at the level of subsidiaries means more non-pre-positioned LAC resources<sup>19</sup> are available for deploying to wherever within a resolution group they may be required.

11.4 However, not increasing the internal LAC scalar above 75% for a material subsidiary can only be justified where, in the resolution authority's opinion, reliance can be placed on the fact that should that subsidiary run into difficulties and need access to non-pre-positioned LAC resources, those resources are likely to be readily available and can be deployed as anticipated. If this is not the case, it is likely to be prudent for the resolution authority to increase a material subsidiary's internal LAC scalar above 75%.

11.5 Accordingly, when considering whether it is prudent to increase an

<sup>19</sup> In the LAC Rules, 'non-pre-positioned loss-absorbing capacity' is only used in relation to Hong Kong incorporated resolution entities and material subsidiaries. In this chapter, where the context requires, the term 'non-pre-positioned LAC resources' should be interpreted to include such resources whether held by Hong Kong entities or overseas entities of a relevant banking group.



## Resolution Regime – Code of Practice

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

internal LAC scalar above 75%, the resolution authority expects to have regard to the preferred resolution strategy covering the material subsidiary, and to the likely availability of additional financial resources within the resolution group that could be expected to be deployed to support the material subsidiary, should that prove necessary. Factors that may influence the availability of such resources could include (but are not limited to):

- whether the resolution group has sufficient external LAC resources in place to support the group-wide resolution strategy;
- the approach taken by other host jurisdictions in calibrating their local equivalents (if any) of the internal LAC scalar;
- whether there is a robust policy framework on the treatment of non-pre-positioned LAC resources in the jurisdiction in which such resources are located;
- whether there is a legally enforceable agreement in place between relevant entities (e.g. between a resolution entity on whose balance sheet non-pre-positioned LAC resources are held and a material subsidiary) with clearly defined triggers for provision of the support necessary to effect execution of the group's preferred resolution strategy;
- evidence or reporting to demonstrate that any non-pre-positioned LAC resources are (i) readily available, e.g. dedicated high-quality liquid assets or other unencumbered assets, perfected security interests in specified collateral etc.; and (ii) sufficient to allow the performance in full of obligations under any agreement to support the execution of the group's preferred resolution strategy (see previous point);
- the scale of the material subsidiary's operations relative to the



## Resolution Regime – Code of Practice

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

resolution group as a whole; and

- the nature of any regulatory or operational obstacles to the timely deployment of non-pre-positioned LAC resources to a relevant material subsidiary under financial stress (e.g. potential creditors' challenges, governance obstacles, directors' fiduciary responsibilities, absence of governance framework for co-operation between home and host authorities etc.), and the extent to which they have been mitigated.

11.6 The LAC Rules allow for the internal LAC scalar to be increased up to 100% where the preferred resolution strategy envisages that some or all of the internal loss-absorbing capacity will be issued from one Hong Kong incorporated entity to another Hong Kong incorporated entity. This additional flexibility reflects the fact that in such a circumstance the resolution authority is the relevant authority for both the subsidiary and the parent, and there would be no need to balance potentially competing financial stability priorities across different jurisdictions. Increasing the internal LAC scalar up to 100% may be optimal in particular where the group has a very simple organisational structure. For example, where a resolution group consists of a holding company that does not itself conduct banking activities and a single directly-owned AI subsidiary, the preferred approach may be for all of the proceeds of external loss-absorbing capacity issued by the holding company to be used to fund internal loss-absorbing capacity issued by the subsidiary.

11.7 Note that in the LAC Rules the preferred resolution strategy features, among others, both in the list of factors that the resolution authority may take into account in making any determination to vary the resolution component ratio, and in the list of factors that the resolution authority may take into account in making any determination to vary the internal LAC scalar. This reflects the fact that the preferred resolution strategy will cover a number of different areas that are expected to be relevant



## Resolution Regime – Code of Practice

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

for any resolution of the relevant entity. The intention is not that a single aspect of the preferred resolution strategy would be used in isolation to justify, for example, an increase in both the resolution component ratio and the internal LAC scalar, in a way that results in unduly high overall LAC requirements.

11.8 As provided for in rule 29(1), each material subsidiary is required at all times after the relevant period<sup>20</sup> to meet its minimum internal LAC risk-weighted ratio and its minimum internal LAC leverage ratio on a consolidated basis with reference to its LAC consolidation group. Each of these minimum ratios are determined with reference to the material subsidiary's internal LAC scalar. In addition, as provided for in rule 29(2), any material subsidiary that is an AI must maintain on a solo basis (or solo-consolidated basis,<sup>21</sup> as applicable) an internal LAC risk-weighted ratio that is not less than its minimum internal LAC risk-weighted ratio multiplied by its solo LAC scalar, and an internal LAC leverage ratio that is not less than its minimum internal LAC leverage ratio multiplied by its solo LAC scalar. This means that the minimum ratios that a material subsidiary that is an AI must meet on a solo basis (or solo-consolidated basis, as applicable) are calibrated with reference to both its internal LAC scalar and its solo LAC scalar.

11.9 By way of example, if a material subsidiary that is an AI has an internal LAC scalar of 75% and a solo LAC scalar of 90% it must at all times after the relevant period maintain:<sup>22</sup>

- (i) on a consolidated basis with reference to its LAC consolidation group, (a) an internal LAC risk-weighted ratio that is not less than 75% x the material subsidiary's modelled minimum external LAC risk-weighted ratio; and (b) an internal LAC leverage ratio that is not less than 75% x the material subsidiary's modelled minimum

<sup>20</sup> For material subsidiaries, the "relevant period" is defined in rule 29(3).

<sup>21</sup> If the AI has been granted an approval under section 28(2)(a) of the Capital Rules (see rule 29(2)).

<sup>22</sup> It must also meet minimum debt requirements – see rule 34.



**Resolution Regime – Code of Practice**

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

external LAC leverage ratio (see in particular rule 25 and rule 29(1)); and

- (ii) on a solo basis (or solo-consolidated basis, as applicable), (a) an internal LAC risk-weighted ratio that is not less than 75% x the material subsidiary's modelled minimum external LAC risk-weighted ratio x 90%; and (b) an internal LAC leverage ratio that is not less than 75% x the material subsidiary's modelled minimum external LAC leverage ratio x 90% (see in particular rule 25 and rule 29(2)).

11.10 It should be further noted that when making any determination to increase the internal LAC scalar above 75% in respect of a material subsidiary that is part of a cross-border banking group, the resolution authority would expect to co-ordinate where appropriate with other relevant resolution authorities (for example, through G-SIBs' crisis management groups, resolution colleges or bilateral engagement).



## Resolution Regime – Code of Practice

LAC-1

Resolution Planning – LAC  
Requirements

20.03.2019

### 12. Reducing the solo LAC scalar (rule 30(2))

12.1 Rule 30(1), (2) and (3) provides as follows:

- (1) *Subject to subrules (2) and (5), the solo LAC scalar for a resolution entity or material subsidiary that is an authorized institution is 100%.*
- (2) *The resolution authority, by written notice served on a resolution entity or material subsidiary that is an authorized institution, may reduce the solo LAC scalar for the resolution entity or material subsidiary if satisfied that it is prudent to do so.*
- (3) *In determining whether it is prudent to reduce a solo LAC scalar for a resolution entity or material subsidiary that is an authorized institution, the resolution authority may take into account—*
  - (a) *the extent to which the solo LAC scalar being set at 100% would result in the resolution entity or material subsidiary having to maintain a greater amount of loss-absorbing capacity than required to meet its LAC requirements on a consolidated basis;*
  - (b) *the extent to which the solo LAC scalar being set at 100% would impact on the quantity and availability of non-pre-positioned loss-absorbing capacity; and*
  - (c) *any other matters the resolution authority considers relevant.*

12.2 Under the LAC Rules, the solo LAC scalar may act to lower the LAC requirements imposed on a solo basis (or solo-consolidated basis, as applicable) on a resolution entity or material subsidiary that is an AI, below what those requirements would otherwise be (see paragraphs 11.8 and 11.9 for a description of how the solo LAC scalar achieves this for a material subsidiary).

12.3 AIs are required to meet regulatory capital requirements on a solo basis



## Resolution Regime – Code of Practice

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

(or solo-consolidated basis, as applicable), and, where relevant notices have been given under section 3C of the Capital Rules, on a consolidated basis. The rationale underlying the principle that the calibration of LAC requirements should be based on twice the capital requirements is that an AI should be able to experience losses that fully deplete the regulatory capital it is required to maintain and still have sufficient remaining loss-absorbing capacity to allow it to be fully recapitalised in resolution and so restored to viability. With LAC requirements being based on capital requirements in this way, it follows that the basis on which LAC requirements are imposed should match the basis on which regulatory capital requirements are imposed. This implies that, as a general rule, AIs should therefore be required to meet LAC requirements not only on a consolidated basis but also on a solo basis (or solo-consolidated basis, as applicable), with a solo LAC scalar of 100%.

- 12.4 In many situations, the appropriate calibration of the solo LAC scalar will accordingly be 100%. However, in some circumstances requiring an AI to meet its LAC requirements on a solo basis (or solo-consolidated basis, as applicable) with a solo LAC scalar set at 100% may result in inefficiencies in the allocation of LAC resources that could be avoided by setting the solo LAC scalar below 100%, without having any material impact on the resolvability of the AI.
- 12.5 For example, setting the solo LAC scalar at 100% could result in the resolution entity or material subsidiary having to maintain a greater amount of loss-absorbing capacity than required to meet its LAC requirements on a consolidated basis. This fact would not be sufficient to justify a reduction in the solo LAC scalar in isolation. But in the context of the circumstances of a particular resolution entity or material subsidiary, and in particular the relevant preferred resolution strategy, the resolution authority could determine that reducing the solo LAC scalar would not in practice have a material impact on the resources available to support the absorption of losses and recapitalisation in



**Resolution Regime – Code of Practice**

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

resolution of the resolution entity or material subsidiary. At the same time, it could facilitate better availability of non-pre-positioned LAC resources for deployment across the resolution group to support the preferred resolution strategy. In those circumstances, the resolution authority may consider reducing the solo LAC scalar below 100%, if satisfied that it is prudent to do so.





**Resolution Regime – Code of Practice**

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

**13. Minimum LAC debt requirements for resolution entities and material subsidiaries (rule 33 and rule 34)**

13.1 Rule 33 provides as follows:

(1) *Subject to rule 35—*

- (a) *if a resolution entity is required by these Rules to meet a minimum external LAC risk-weighted ratio, the external LAC risk-weighted ratio that it would have if its external loss-absorbing capacity was equal to the sum of its relevant debt instruments must be not less than one-third of its minimum external LAC risk-weighted ratio;*
- (b) *if a resolution entity is required by these Rules to meet a minimum external LAC leverage ratio, the external LAC leverage ratio that it would have if its external loss-absorbing capacity was equal to the sum of its relevant debt instruments must be not less than one-third of its minimum external LAC leverage ratio;*
- (c) *if a resolution entity is subject to a requirement under rule 32(2)(a)(i), the external LAC risk-weighted ratio that it would have if its external loss-absorbing capacity was equal to the sum of its relevant debt instruments must be not less than one-third of the external LAC risk-weighted ratio required by rule 32(2)(a)(i); and*
- (d) *if a resolution entity is subject to a requirement under rule 32(2)(a)(ii), the external LAC leverage ratio that it would have if its external loss-absorbing capacity was equal to the sum of its relevant debt instruments must be not less than one-third of the external LAC leverage ratio required by rule 32(2)(a)(ii).*

(2) *For the purposes of this rule, a relevant debt instrument is an external LAC debt instrument that—*

- (a) *constitutes a liability; and*



**Resolution Regime – Code of Practice**

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

(b) *is issued by the resolution entity.*

13.2 Rule 34 provides as follows:

(1) *Subject to rule 35—*

- (a) *if a material subsidiary is required by these Rules to meet a minimum internal LAC risk-weighted ratio, the internal LAC risk-weighted ratio that it would have if its internal loss-absorbing capacity was equal to the sum of its relevant debt instruments must be not less than one-third of its minimum internal LAC risk-weighted ratio;*
- (b) *if a material subsidiary is required by these Rules to meet a minimum internal LAC leverage ratio, the internal LAC leverage ratio that it would have if its internal loss-absorbing capacity was equal to the sum of its relevant debt instruments must be not less than one-third of its minimum internal LAC leverage ratio;*
- (c) *if a material subsidiary is subject to a requirement under rule 32(2)(b)(i), the internal LAC risk-weighted ratio that it would have if its internal loss-absorbing capacity was equal to the sum of its relevant debt instruments must be not less than one-third of the internal LAC risk-weighted ratio required by rule 32(2)(b)(i); and*
- (d) *if a material subsidiary is subject to a requirement under rule 32(2)(b)(ii), the internal LAC leverage ratio that it would have if its internal loss-absorbing capacity was equal to the sum of its relevant debt instruments must be not less than one-third of the internal LAC leverage ratio required by rule 32(2)(b)(ii).*

(2) *For the purposes of this rule, a relevant debt instrument is an internal LAC debt instrument that—*

- (a) *constitutes a liability; and*

**Resolution Regime – Code of Practice****LAC-1****Resolution Planning – LAC  
Requirements****20.03.2019**

*(b) is issued directly or indirectly to, and held directly or indirectly by, the resolution entity or non-HK resolution entity in the material subsidiary's resolution group.*

- 13.3 In some respects, equity can be regarded as the best form of loss-absorbing capacity, as it automatically absorbs losses on an ongoing basis. But loss-absorbing capacity that is constituted by debt has an advantage over equity in that it will be available to absorb losses at the PONV, by which time it is likely that much or all of a resolution entity's or material subsidiary's equity will have been depleted. Loss-absorbing capacity that is in the form of debt as opposed to equity is at less risk of depletion before failure, and provides a known quantity of loss-absorbency and recapitalisation resource in excess of going concern capital.
- 13.4 This rationale clearly holds for LAC debt instruments that are accounted for as liabilities, rather than equity. But the fact that LAC debt instruments are accounted for as equity does not necessarily imply that they are at material risk of depletion before failure. Specifically, the resolution authority's view is that the limited circumstances in which Additional Tier 1 capital instruments bear loss means that the contribution they make to loss-absorbing capacity is unlikely to be at material risk of depletion before failure. As a result, they should be able to count towards any relevant minimum debt requirement (subject to their meeting other relevant requirements in the LAC Rules), whether they are accounted for as liabilities or as equity.
- 13.5 As such, the resolution authority expects that all relevant LAC debt instruments – including those that are capital instruments – should be able to count towards meeting any minimum debt requirement under the LAC Rules. Such instruments must also meet the qualifying criteria set out in Schedule 1 or Schedule 2, as applicable. The contribution that any such instrument makes towards the sums referenced in rule 33(1) and rule 34(1) is equal to its outstanding principal amount.



## Resolution Regime – Code of Practice

LAC-1

Resolution Planning – LAC  
Requirements

20.03.2019

### 14. Reducing the minimum LAC debt requirement (rule 35)

14.1 Rule 35(1) and (2) provides as follows:

- (1) *The resolution authority, by written notice served on a resolution entity or material subsidiary, may reduce the minimum LAC debt requirement under rule 33 or 34 for the resolution entity or material subsidiary to below one-third, if satisfied that it is prudent to do so.*
- (2) *In determining whether it is prudent to reduce the minimum LAC debt requirement for a resolution entity or material subsidiary, the resolution authority may take into account—*
  - (a) *the LAC requirements of, and the capital adequacy ratios maintained by, the resolution entity or material subsidiary;*
  - (b) *the preferred resolution strategy covering the resolution entity or material subsidiary; and*
  - (c) *any other matters the resolution authority considers relevant.*

14.2 As discussed in the previous section, the LAC Rules require resolution entities and material subsidiaries to meet one-third of their LAC requirements with debt instruments.

14.3 However, there may be some entities with total consolidated assets above but near the HK\$300 billion threshold referenced in section 2, which are subject to LAC requirements but for which it would be particularly challenging to meet one-third of their requirements with debt. This may include (i) a resolution entity or material subsidiary that in the absence of a minimum debt requirement would already be able to meet most or all of its LAC requirements with equity; (ii) a resolution entity or material subsidiary whose (external or internal) LAC requirements are materially less than twice its regulatory capital requirements; or (iii) a resolution entity which has not previously been an active issuer in local debt capital markets so that having to issue a significant volume of



**Resolution Regime – Code of Practice**

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

external LAC debt instruments may be difficult and/or costly.

- 14.4 In case (i), the resolvability benefits of mandating a minimum level of LAC debt could be outweighed by the potential risks that may result from requiring an AI to expand its balance sheet funded by debt in a way faster than business needs would otherwise require. In case (ii), imposing a one-third LAC debt requirement may have the effect of imposing restrictions on how the entity meets its regulatory capital requirements, which is not the intention of the LAC Rules. And in case (iii), the resolution authority may conclude that the cost of requiring an entity to issue sufficient external LAC debt instruments in a short period of time is disproportionate when compared with the resolvability benefit that would result from the requirement being imposed.
- 14.5 In circumstances where one or more of cases (i), (ii) and (iii) apply, the resolution authority may, taking into consideration any evidence provided by the relevant resolution entity or material subsidiary, consider whether it is prudent to allow the relevant entity a longer initial period following classification to meet the one-third minimum debt requirement, by temporarily reducing the minimum LAC debt requirement. In exceptional cases where strong evidence has been provided, the resolution authority may consider further extending the initial conformance period.



## Resolution Regime – Code of Practice

LAC-1

Resolution Planning – LAC  
Requirements

20.03.2019

### 15. Resolution authority may require evidence (rule 41)

15.1 Rule 41 provides as follows:

- (1) *The resolution authority, by written notice served on a resolution entity, may require the resolution entity to provide to the resolution authority, within the time specified in the notice, evidence of a kind specified by the resolution authority that the resolution entity's external loss-absorbing capacity, or items claimed by the resolution entity to form part of its external loss-absorbing capacity, meet the requirements of these Rules.*
- (2) *The resolution authority, by written notice served on a material subsidiary, may require the material subsidiary to provide to the resolution authority, within the time specified in the notice, evidence of a kind specified by the resolution authority that the material subsidiary's internal loss-absorbing capacity, or items claimed by the material subsidiary to form part of its internal loss-absorbing capacity, meet the requirements of these Rules.*
- (3) *Without limiting the kinds of evidence the resolution authority may specify, the resolution authority may require a resolution entity or material subsidiary to obtain, and provide to the resolution authority, independent legal advice acceptable to the resolution authority.*

15.2 The inclusion of an item in a resolution entity's external loss-absorbing capacity or in a material subsidiary's internal loss-absorbing capacity is subject to the provisions of rule 37 or rule 39 (as applicable) of the LAC Rules. In order to ensure that a proposed item (including any item issued before the classification date of the resolution entity or material subsidiary) can be included within external loss-absorbing capacity or internal loss-absorbing capacity, the resolution entity or material



## Resolution Regime – Code of Practice

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

subsidiary will have to undertake a detailed self-assessment and will be expected to review and document:

- (a) whether the item falls within paragraph (a), (b) or (c) of rule 37 (if it is intended to constitute external loss-absorbing capacity) or rule 39 (if it is intended to constitute internal loss-absorbing capacity) of the LAC Rules; and
- (b) if the item is proposed to qualify as a LAC debt instrument, whether the criteria in Schedule 1 (if it is intended to constitute external loss-absorbing capacity) or Schedule 2 (if it is intended to constitute internal loss-absorbing capacity) of the LAC Rules are met.

15.3 As part of the self-assessment for any proposed LAC debt instrument, the resolution entity or material subsidiary should obtain a sufficiently independent legal opinion (preferably from an external legal firm) to ensure compliance of the proposed instrument from a legal perspective. The legal opinion should address:

- (a) the due incorporation and capacity of the issuer to issue the instrument and perform its obligations under it;
- (b) the due authorization of the instrument by the issuer, and the absence of conflict with (i) the issuer's constitutional documents and (ii) applicable law;
- (c) the instrument constituting legal, valid, binding and enforceable obligations of the issuer;
- (d) the legal effectiveness of any write-off/conversion provisions and the absence of legal impediments to such provisions operating in accordance with their terms;
- (e) the legal effectiveness of the acknowledgement or agreement of the instrument holder in relation to any exercise of powers under the FIRO;
- (f) the recognition of the governing law of the instrument; and
- (g) the compliance of the instrument with the qualifying criteria set out in Schedule 1 to the LAC Rules (for an external LAC debt



**Resolution Regime – Code of Practice**

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

instrument) or Schedule 2 to the LAC Rules (for an internal LAC debt instrument), including the degree of subordination.

15.4 In addition, where the proposed LAC debt instrument is subject to the law of a jurisdiction other than Hong Kong:

- (a) a legal opinion issued under such law should also be obtained, addressing the matters in paragraph 15.3 above (where applicable), as well as addressing the issue of whether such law could prevent the instrument from satisfying the criteria referenced in paragraph 15.3(g) above; and
- (b) section 1(1)(k) of Schedule 1 to the LAC Rules (for an external LAC debt instrument) or section 1(1)(j) of Schedule 2 to the LAC Rules (for an internal LAC debt instrument) must be complied with.

15.5 However, where a resolution entity or material subsidiary proposes to issue a new LAC debt instrument with identical features (save only for price, maturity, amount and dates) to instruments previously issued that meet all the criteria set out in Schedule 1 (for external LAC debt instruments) or Schedule 2 (for internal LAC debt instruments) to the LAC Rules, and for which an independent legal opinion was obtained, the resolution entity or material subsidiary may, instead of obtaining a fresh legal opinion, obtain a confirmation issued by its in-house legal counsel that there are no other terms or any intervening changes that will render the previous legal opinion “out-of-date”.

15.6 After completing the self-assessment, the resolution entity or material subsidiary should submit to the resolution authority:

- (a) a letter confirming that based on its assessment, the proposed item falls within paragraph (a), (b) or (c) of rule 37 or rule 39 (as applicable), and (for any proposed LAC debt instrument) meets the criteria in Schedule 1 or Schedule 2 (as applicable), such confirmations to be made by its Chief Financial Officer or another person with an equivalent role and seniority within the institution;





## Resolution Regime – Code of Practice

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

and

- (b) the resolution entity's or material subsidiary's self-assessment of whether the item falls within paragraph (a), (b) or (c) of rule 37 or rule 39 (as applicable), and (for any proposed LAC debt instrument) meets the criteria in Schedule 1 or Schedule 2 (as applicable), including any relevant legal opinions referenced in paragraphs 15.3 and 15.4 above.

15.7 As a standing practice, a resolution entity or material subsidiary proposing to issue an instrument for inclusion in its loss-absorbing capacity is expected, when in doubt, to discuss with the resolution authority beforehand whether the instrument complies with the necessary criteria. For this purpose, the resolution entity or material subsidiary is expected to submit to the resolution authority the relevant supporting documents (including a summary of the main features of, and a draft term sheet for, the instrument, together with drafts of the confirmation letter, self-assessment and legal opinions referred to in the preceding paragraph) demonstrating that the instrument falls within paragraph (a), (b) or (c) of rule 37 or rule 39 (as applicable), and (for any proposed LAC debt instrument) meets the criteria in Schedule 1 or Schedule 2 (as applicable), for the resolution authority's review.

15.8 Note that should a LAC debt instrument either:

- (a) bear loss in accordance with its terms; or
- (b) be written off, cancelled, converted, modified, or have its form changed, in the exercise of powers under the FIRO,

this should not trigger any cross-default or acceleration rights in any other financial contracts to which the issuer is a party. Were it to do so, this could increase the financial pressure on the issuer, and could potentially undermine the issuer's viability. The resolution authority therefore expects that the terms and conditions of any LAC debt instrument should specifically set out that the occurrence of any event included in (a) or (b) above does not constitute an event of default.



**Resolution Regime – Code of Practice**

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

However, whether such an event could trigger cross-default or acceleration rights in any other financial contracts of the issuer will ultimately depend on the wording of any such rights in those other contracts. The resolution authority therefore expects each resolution entity and material subsidiary to ensure that the wording of any cross-default or acceleration rights in any financial contracts it enters into in the future does not allow for any such rights to be triggered following the occurrence of any event included in (a) or (b) above.

15.9 The resolution authority will, once no further follow-up issues need to be raised with a resolution entity or material subsidiary in respect of its proposed item, communicate its acknowledgement to the resolution entity or material subsidiary based on the confirmations by the resolution entity or material subsidiary referred to in paragraph 15.6(a) above. Such an acknowledgement should not be taken as confirmation by the resolution authority that the relevant item complies with all the criteria necessary for it to constitute external loss-absorbing capacity or internal loss-absorbing capacity (as applicable). Such compliance remains at all times the responsibility of the resolution entity or material subsidiary.

15.10 Generally speaking, it is to be expected that the process described in paragraphs 15.2-15.9 above would provide sufficient evidence on the eligibility of an item to be included within a resolution entity's external loss-absorbing capacity or material subsidiary's internal loss-absorbing capacity. Where the resolution authority requires additional evidence, it would be open to the resolution authority to use the powers under rule 41(1) or rule 41(2) to require that such additional evidence be provided.



**Resolution Regime – Code of Practice**

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

**16. Requirement not to include, or to discontinue inclusion of, items in external or internal loss-absorbing capacity (rule 42)**

16.1 Rule 42 provides as follows:

- (1) *If the resolution authority is satisfied that it is prudent to do so, the resolution authority may, in accordance with rule 43—*
- (a) *require a resolution entity—*
    - (i) *not to include an item in the calculation of its external loss-absorbing capacity; or*
    - (ii) *to discontinue the inclusion of an item in the calculation of its external loss-absorbing capacity; or*
  - (b) *require a material subsidiary—*
    - (i) *not to include an item in the calculation of its internal loss-absorbing capacity; or*
    - (ii) *to discontinue the inclusion of an item in the calculation of its internal loss-absorbing capacity.*
- (2) *In determining whether it is prudent to require a resolution entity or material subsidiary not to include, or to discontinue the inclusion of, an item, the resolution authority may take into account—*
- (a) *any matters that, in the opinion of the resolution authority, may undermine the ability of the item to absorb losses or otherwise contribute to an orderly resolution as contemplated by the preferred resolution strategy covering the resolution entity or material subsidiary; and*
  - (b) *any other matters the resolution authority considers relevant.*

16.2 Rule 42(1) empowers the resolution authority to exclude from external loss-absorbing capacity or internal loss-absorbing capacity items that would otherwise be eligible. It is not the intention of the resolution authority to use this provision to expand the eligibility criteria that



**Resolution Regime – Code of Practice**

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

(external or internal) LAC debt instruments are required to meet as a matter of course. This rule is instead designed to act as a safeguard, so that should there be any matters in relation to an item that would undermine its ability to bear loss and contribute to an orderly resolution as intended, the resolution authority would be able to exclude it from counting towards (external or internal) loss-absorbing capacity.

- 16.3 Should the resolution authority determine that an item should be excluded from (external or internal) loss-absorbing capacity, the affected resolution entity or material subsidiary would have the opportunity to make representations on the matter to the resolution authority (see rule 43).



**Resolution Regime – Code of Practice**

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

**17. Key metrics – loss-absorbing capacity – quarterly disclosures (rule 47)**

17.1 Rule 47(1) and (2) provides as follows:

- (1) *A disclosure entity must disclose, for each quarterly reporting period—*
  - (a) *summary information on its loss-absorbing capacity; and*
  - (b) *an explanation of any material changes to its loss-absorbing capacity during the period, including the key drivers of those changes.*
  
- (2) *In addition to subrule (1), a disclosure entity that is a material subsidiary in a resolution group a member of which is a non-HK resolution entity must disclose, for each quarterly reporting period, to the extent to which the disclosure entity can reasonably obtain the necessary information—*
  - (a) *summary information on the loss-absorbing capacity of the non-HK resolution entity; and*
  - (b) *an explanation of any material changes to the loss-absorbing capacity of the non-HK resolution entity during the period, including the key drivers of those changes.*

17.2 Rule 52(1) provides as follows:

- (1) *If a disclosure entity is required under these Rules to disclose information, it must make that disclosure by—*
  - (a) *preparing, in the Chinese and English languages, a statement—*
    - (i) *that, subject to subrule (2) and rule 56, is in the form exclusively of a standalone document or a discrete section of the disclosure entity's financial statements (**discrete section**); and*



**Resolution Regime – Code of Practice**

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

- (ii) *in which the information required to be disclosed is readily identifiable;*
- (b) *subject to subrule (2) and rule 56, presenting the information required to be disclosed in the format, and using the standard disclosure templates or tables, specified by the resolution authority; and*
- (c) *complying with the other provisions of this rule applicable to or in relation to the statement.*

17.3 The disclosure requirements contained in rule 47(1) and (2) have been developed from (but are not necessarily limited to) those set out in Template KM2 included in *Standards Pillar 3 disclosure requirements – consolidated and enhanced framework*<sup>23</sup> published in March 2017 by the Basel Committee on Banking Supervision. The resolution authority will specify one or more standard templates or tables for the purpose of the disclosure requirements contained in rule 47(1) and (2). The intention is that those templates or tables will enable:

- (a) under rule 47(1), (i) each resolution entity to disclose its external loss-absorbing capacity on a consolidated basis; and (ii) each material subsidiary to disclose its internal loss-absorbing capacity on a consolidated basis; and
- (b) under rule 47(2), each applicable material subsidiary to disclose the loss-absorbing capacity at resolution group level of the non-Hong Kong resolution entity in its resolution group.

<sup>23</sup> <https://www.bis.org/bcbs/publ/d400.pdf>



## Resolution Regime – Code of Practice

LAC-1

Resolution Planning – LAC  
Requirements

20.03.2019

### 18. Composition of loss-absorbing capacity – semi-annual disclosures (rule 48)

18.1 Rule 48 provides as follows:

*A disclosure entity must disclose, for each semi-annual reporting period—*

- (a) a detailed breakdown of its loss-absorbing capacity; and*
- (b) an explanation of any material changes to the composition of its loss-absorbing capacity during the period, including the key drivers of those changes.*

18.2 Rule 52(1) provides as follows:

*(1) If a disclosure entity is required under these Rules to disclose information, it must make that disclosure by—*

- (a) preparing, in the Chinese and English languages, a statement—*
  - (i) that, subject to subrule (2) and rule 56, is in the form exclusively of a standalone document or a discrete section of the disclosure entity's financial statements (**discrete section**); and*
  - (ii) in which the information required to be disclosed is readily identifiable;*
- (b) subject to subrule (2) and rule 56, presenting the information required to be disclosed in the format, and using the standard disclosure templates or tables, specified by the resolution authority; and*
- (c) complying with the other provisions of this rule applicable to or in relation to the statement.*

18.3 The disclosure requirements contained in rule 48 have been developed from (but are not necessarily limited to) those set out in Template



## Resolution Regime – Code of Practice

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

TLAC1 included in *Standards Pillar 3 disclosure requirements – consolidated and enhanced framework*<sup>24</sup> published in March 2017 by the Basel Committee on Banking Supervision. The resolution authority will specify one or more standard templates or tables for the purpose of the disclosure requirements contained in rule 48. The intention is that those templates or tables will enable:

- (a) each resolution entity to disclose a detailed breakdown of its external loss-absorbing capacity (both capital and non-capital) on a consolidated basis; and
- (b) each material subsidiary to disclose a detailed breakdown of its internal loss-absorbing capacity (both capital and non-capital) on a consolidated basis.

<sup>24</sup> <https://www.bis.org/bcbs/publ/d400.pdf>





**Resolution Regime – Code of Practice**

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

**19. Resolution entity – creditor ranking at legal entity level – semi-annual disclosures (rule 49)**

19.1 Rule 49 provides as follows:

*A disclosure entity that is a resolution entity must disclose, for each semi-annual reporting period—*

- (a) information on the priority that creditors would enjoy on a winding up of the disclosure entity; and*
- (b) where appropriate, institution-specific or jurisdiction-specific information relating to creditor hierarchies on a winding up of the disclosure entity.*

19.2 Rule 52(1) provides as follows:

*(1) If a disclosure entity is required under these Rules to disclose information, it must make that disclosure by—*

- (a) preparing, in the Chinese and English languages, a statement—*
  - (i) that, subject to subrule (2) and rule 56, is in the form exclusively of a standalone document or a discrete section of the disclosure entity's financial statements (**discrete section**); and*
  - (ii) in which the information required to be disclosed is readily identifiable;*
- (b) subject to subrule (2) and rule 56, presenting the information required to be disclosed in the format, and using the standard disclosure templates or tables, specified by the resolution authority; and*
- (c) complying with the other provisions of this rule applicable to or in relation to the statement.*



**Resolution Regime – Code of Practice**

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

19.3 The disclosure requirements contained in rule 49 have been developed from (but are not necessarily limited to) those set out in Template TLAC3 included in *Standards Pillar 3 disclosure requirements – consolidated and enhanced framework*<sup>25</sup> published in March 2017 by the Basel Committee on Banking Supervision. The resolution authority will specify one or more standard templates or tables for the purpose of the disclosure requirements contained in rule 49.

<sup>25</sup> <https://www.bis.org/bcbs/publ/d400.pdf>



**Resolution Regime – Code of Practice**

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

**20. Material subsidiary – creditor ranking at legal entity level  
– semi-annual disclosures (rule 50)**

20.1 Rule 50 provides as follows:

*A disclosure entity that is a material subsidiary must disclose, for each semi-annual reporting period—*

- (a) information on the priority that creditors would enjoy on a winding up of the disclosure entity; and*
- (b) where appropriate, institution-specific or jurisdiction-specific information relating to creditor hierarchies on a winding up of the disclosure entity.*

20.2 Rule 52(1) provides as follows:

*(1) If a disclosure entity is required under these Rules to disclose information, it must make that disclosure by—*

- (a) preparing, in the Chinese and English languages, a statement—
  - (i) that, subject to subrule (2) and rule 56, is in the form exclusively of a standalone document or a discrete section of the disclosure entity's financial statements (**discrete section**); and*
  - (ii) in which the information required to be disclosed is readily identifiable;**
- (b) subject to subrule (2) and rule 56, presenting the information required to be disclosed in the format, and using the standard disclosure templates or tables, specified by the resolution authority; and*
- (c) complying with the other provisions of this rule applicable to or in relation to the statement.*



**Resolution Regime – Code of Practice**

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

20.3 The disclosure requirements contained in rule 50 have been developed from (but are not necessarily limited to) those set out in Template TLAC2 included in *Standards Pillar 3 disclosure requirements – consolidated and enhanced framework*<sup>26</sup> published in March 2017 by the Basel Committee on Banking Supervision. The resolution authority will specify one or more standard templates or tables for the purpose of the disclosure requirements contained in rule 50.

<sup>26</sup> <https://www.bis.org/bcbs/publ/d400.pdf>



## Resolution Regime – Code of Practice

LAC-1

Resolution Planning – LAC  
Requirements

20.03.2019

### 21. Main features of regulatory capital instruments and of other non-capital LAC debt instruments – semi-annual disclosures (rule 51)

21.1 Rule 51(1) provides as follows:

- (1) *A disclosure entity must disclose, for each semi-annual reporting period—*
- (a) *the main features of its CET1 capital instruments, Additional Tier 1 capital instruments, Tier 2 capital instruments and non-capital LAC debt instruments (each referred to in this rule as a **relevant instrument**); and*
  - (b) *a direct link to the relevant section of its internet website where the full terms and conditions of all relevant instruments can be found.*

21.2 Rule 52(1) provides as follows:

- (1) *If a disclosure entity is required under these Rules to disclose information, it must make that disclosure by—*
- (a) *preparing, in the Chinese and English languages, a statement—*
    - (i) *that, subject to subrule (2) and rule 56, is in the form exclusively of a standalone document or a discrete section of the disclosure entity's financial statements (**discrete section**); and*
    - (ii) *in which the information required to be disclosed is readily identifiable;*
  - (b) *subject to subrule (2) and rule 56, presenting the information required to be disclosed in the format, and using the standard disclosure templates or tables, specified by the resolution authority; and*



**Resolution Regime – Code of Practice**

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

(c) *complying with the other provisions of this rule applicable to or in relation to the statement.*

21.3 The disclosure requirements contained in rule 51 have been developed from (but are not necessarily limited to) those set out in Table CCA included in *Standards Pillar 3 disclosure requirements – consolidated and enhanced framework*<sup>27</sup> published in March 2017 by the Basel Committee on Banking Supervision. The resolution authority will specify one or more standard templates or tables for the purpose of the disclosure requirements contained in rule 51.

<sup>27</sup> <https://www.bis.org/bcbs/publ/d400.pdf>



## Resolution Regime – Code of Practice

LAC-1

Resolution Planning – LAC  
Requirements

20.03.2019

## 22. Group disclosures and internet websites (rule 56)

22.1 Rule 56(1) provides as follows:

- (1) *A disclosure entity may treat disclosures made by a group company of the disclosure entity (**group disclosures**) as being part of the disclosures the disclosure entity is required to make under these Rules (**entity disclosures**) if the disclosure entity demonstrates to the satisfaction of the resolution authority that—*
- (a) the group disclosures are not materially different from the entity disclosures;*
  - (b) if the group company is established or incorporated in a non-Hong Kong jurisdiction—the group disclosures are prepared in accordance with the prevailing banking supervisory standards relating to disclosure issued by the Basel Committee and adopted by the relevant banking supervisory authority of that group company (if any);*
  - (c) the group disclosures provide a sufficient level of detail to permit third parties to form a considered view of the relevant aspects of the disclosure entity’s loss-absorbing capacity;*
  - (d) the disclosure statement of the disclosure entity contains a statement of the location where all the group disclosures can be found;*
  - (e) the group disclosures are set out on an internet website of the group company that is accessible by the general public; and*
  - (f) the disclosure entity has an internet website (or a section of an internet website) that—*
    - (i) is specifically intended to be accessible by the general public in Hong Kong; and*
    - (ii) contains a link to the section of the internet website setting out the group disclosures as referred to in paragraph (e).*



**Resolution Regime – Code of Practice**

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

- 22.2 The purpose of rule 56(1) is to avoid requiring duplicative disclosure by allowing a disclosure entity to treat disclosures made by a group company of the disclosure entity as being part of the disclosures the disclosure entity is required to make under the LAC Rules, provided that the specified conditions are met.
- 22.3 Note that where a disclosure entity that is an AI has met disclosure requirements under the Banking (Disclosure) Rules (Cap. 155M) (“Disclosure Rules”) that overlap with disclosure requirements under the LAC Rules, as a question of fact it may be that disclosure made under the Disclosure Rules also complies with the requirements under the LAC Rules. To the extent that this is the case, duplicative disclosure is not required.
- 22.4 Note further that where a disclosure entity is required to make disclosures under the Disclosure Rules and under the LAC Rules, the intention is for all such disclosures to be located together in a standalone document or discrete section of the entity’s financial statements. It is not intended that disclosures by a disclosure entity under the LAC Rules be located in a separate standalone document, or separate discrete section of the entity’s financial statements, to the document or section in which disclosures by that entity under the Disclosure Rules are located.





**Resolution Regime – Code of Practice**

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

**23. Requirement to notify resolution authority of failure or likely failure to comply (rule 60)**

23.1 Rule 60 provides as follows:

*If an entity that is subject to a requirement under these Rules fails to comply, or becomes aware that it is likely to fail to comply, with the requirement, the entity must—*

- (a) as soon as practicable notify the resolution authority; and*
- (b) provide particulars to the resolution authority on request.*

23.2 The resolution authority understands that any assessment of whether an entity is “likely to fail to comply” with a requirement involves a degree of judgement. Where a resolution entity or material subsidiary is uncertain as to whether it is likely to fail to comply with a requirement under the LAC Rules, it should bring the matter to the attention of the resolution authority.

23.3 Note that section 19(4) of the FIRO provides that an entity that, without reasonable excuse, fails to comply with a requirement applicable to it under the LAC Rules to notify, or to provide particulars to, the resolution authority about a notifiable matter, commits an offence. Section 19(6) of the FIRO provides that if an entity commits an offence under section 19(4), an officer of the entity also commits an offence under that subsection if the officer (a) authorized or permitted the commission of the offence by the entity; or (b) was knowingly concerned in any way (whether by act or omission) in the commission of the offence by the entity.



## Resolution Regime – Code of Practice

LAC-1

Resolution Planning – LAC  
Requirements

20.03.2019

### 24. Requirement to take remedial action (rule 61)

24.1 Rule 61(1) provides as follows:

*(1) If an entity contravenes these Rules, the resolution authority may, in accordance with rule 62, require the entity to take remedial action specified by the resolution authority, within the period specified by the resolution authority, to remedy the contravention.*

24.2 Should an AI fail to meet a LAC requirement, and more generally should a resolution entity or material subsidiary fail to meet a requirement to which it is subject under the LAC Rules, before requiring remedial action under rule 61, the resolution authority would expect to discuss the necessity for such action with the entity concerned and give the entity an opportunity to present a remediation plan.

24.3 If the plan meets with the resolution authority's approval and seems reasonable and practically achievable, the resolution authority may then serve a written notice on the relevant entity under rule 61 requiring the entity to implement the remediation plan if satisfied, on reasonable grounds, that it is prudent to so require.

24.4 Note that section 19(5) of the FIRO provides that an entity that, without reasonable excuse, fails to comply with a requirement applicable to it under the LAC Rules to take remedial action in the event of the entity contravening those rules, commits an offence. Section 19(6) of the FIRO provides that if an entity commits an offence under section 19(5), an officer of the entity also commits an offence under that subsection if the officer (a) authorized or permitted the commission of the offence by the entity; or (b) was knowingly concerned in any way (whether by act or omission) in the commission of the offence by the entity.



**Resolution Regime – Code of Practice**

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

24.5 Note further that under paragraph 2 of the Eighth Schedule to the Banking Ordinance (Cap. 155), the failure of an AI to meet the criterion set out in paragraph 6 of the Seventh Schedule to that Ordinance, that is, to maintain adequate financial resources to the satisfaction of the MA, would be a ground for the MA to revoke the AI's authorization. Depending on the circumstances of the case, the MA could take the view that in order to maintain adequate financial resources an AI would have to meet any LAC requirements to which it was subject. Consequently, a breach of any such requirement might call into question whether the AI was continuing to maintain adequate financial resources.



**Resolution Regime – Code of Practice**

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

**25. Qualifying criteria to be met to be an external LAC debt instrument (section 1(1) of Schedule 1)**

25.1 Section 1(1)(m)(ii) of Schedule 1 provides, as a qualifying criterion for an instrument to be eligible as an external LAC debt instrument, as follows:

*(ii) any prospectus or offering document prepared by or for the issuer in relation to the instrument—*

*(A) adequately discloses the risks inherent in the holding of the instrument, including the risks in relation to its subordination and the circumstances in which the holder may suffer loss as a result of the holding;*

*(B) contains a statement that the instrument is complex and high risk; and*

*(C) contains a statement that, if issued in Hong Kong, the instrument must be issued to a professional investor;*

25.2 The risks associated with external LAC debt instruments are complex, in particular because of their loss-absorbency features. These instruments are expressly designed to bear loss should an AI become non-viable. As such, proper risk disclosure in relation to such instruments is of particular importance.

25.3 The provisions of section 1(1)(m)(ii) of Schedule 1 are designed to ensure that the risks associated with an investment in external LAC debt instruments are adequately disclosed. These provisions are complemented by other aspects of the investor protection regime in Hong Kong, including relevant circulars issued from time to time by the HKMA and the Securities and Futures Commission.

25.4 In order to ensure that prospective holders of external LAC debt instruments are clearly on notice of the risks, statements complying with



**Resolution Regime – Code of Practice**

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

the requirements set out in section 1(1)(m)(ii)(B) and (C) of Schedule 1 should appear on the front page of any prospectus or offering document. The resolution authority does not have the current intention of setting out further detailed guidelines in relation to information that needs to be disclosed in order for the requirements set out in section 1(1)(m)(ii) of Schedule 1 to be met. However, any disclosure should be capable of being read with ease by anyone scanning the material, and should not be presented in a style that is designed to reduce its impact.



## Resolution Regime – Code of Practice

LAC-1

Resolution Planning – LAC  
Requirements

20.03.2019

### 26. Additional requirements for internal non-capital LAC debt instruments (section 2(3) of Schedule 2)

26.1 Section 2(3) of Schedule 2 provides as follows:

(3) *The resolution authority may serve a written notice on a material subsidiary requiring that the terms and conditions of any or all instruments that are intended to be internal LAC debt instruments must specify which one only of writing down or conversion into ordinary shares will take place on the occurrence of the trigger event.*

26.2 The LAC Rules require that the terms and conditions of internal non-capital LAC debt instruments contain a provision requiring the relevant material subsidiary to ensure that the instrument will be written down, or converted into ordinary shares, on the occurrence of a trigger event (section 2(1)(a)(i) of Schedule 2). Generally speaking, and in common with the corresponding provisions set out in Schedules 4B and 4C to the Capital Rules, the requirements under the LAC Rules are no more specific than this. This allows the material subsidiary to elect whether to include one or the other, or both, of write-down and conversion in the terms and conditions.

26.3 However, in certain circumstances it may be that the terms and conditions of internal non-capital LAC debt instruments which are proposed to be issued should specifically provide on the occurrence of a trigger event for the instruments to be either written down or converted into equity, in order to avoid any potential undermining of the ability of the instruments to absorb losses or otherwise contribute to an orderly resolution as contemplated by the preferred resolution strategy covering the material subsidiary.



**Resolution Regime – Code of Practice**

**LAC-1**

**Resolution Planning – LAC  
Requirements**

**20.03.2019**

26.4 For example, where all the ordinary shares and all the internal non-capital LAC debt instruments issued by a material subsidiary are not held by the same person, it may be that should the non-capital internal loss-absorbing capacity be converted into equity rather than being written down, the result may be a change in control of the material subsidiary. This could complicate – and potentially frustrate – orderly resolution. In such circumstances, the resolution authority may consider it appropriate to require that the terms and conditions of such instruments provide for write-down only.