AN EFFECTIVE RESOLUTION REGIME FOR FINANCIAL INSTITUTIONS IN HONG KONG

FINANCIAL INSTITUTIONS (RESOLUTION) ORDINANCE (Chapter 628)

RULES ON LOSS-ABSORBING CAPACITY REQUIREMENTS FOR AUTHORIZED INSTITUTIONS

CONSULTATION CONCLUSION

Hong Kong Monetary Authority

25 July 2018

Introduction

1. The Hong Kong Monetary Authority (**HKMA**) issued a consultation paper (**CP**)[1] on 17 January 2018 on its proposals for making rules under section 19 of the Financial Institutions (Resolution) Ordinance (Cap. 628) (**FIRO**) prescribing loss-absorbing capacity (**LAC**) requirements for authorized institutions (**AI LAC Rules**).

2. The CP also included proposals for a bill to make consequential amendments to the Inland Revenue Ordinance (Cap. 112) (**IRO**), to afford debt-like tax treatment to certain eligible LAC debt instruments (**IRO LAC Amendment Bill**).

3. This paper sets out the conclusions of the consultation on the approach to the AI LAC Rules and the IRO LAC Amendment Bill. It summarises the key comments received from respondents to the CP, the responses of the Monetary Authority (**MA**) to those comments, and proposals for taking forward the development of the AI LAC Rules and the IRO LAC Amendment Bill. Note that the proposals set out in this paper remain subject to modification and should not be taken to represent the MA's fixed, complete policy intent. Terms used in this paper that are defined in the CP have the same meaning in this paper.

4. The two-month consultation period on the AI LAC Rules ended on 16 March 2018. A total of ten submissions were received from a variety of sources including industry associations and professional bodies. The names of the respondents are listed in **Annex 1**. A summary of the major comments received and the MA's responses are discussed below, set out in a structure that follows that of the CP. A fuller consideration of comments received and the MA's responses is set out in **Annex 2** in tabular form for ease of reference.

General comments

5. No respondents to the CP challenged the basic principle that resolution entities and material subsidiaries should be required to meet LAC requirements in order to facilitate the orderly failure of such entities, should they reach the point of non-viability. A

[1] The CP can be found at the following link: http://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/resolution/LAC_CP_ENG.pdf

number of general comments on the proposals set out in the CP for implementing this principle, and the MA's responses to those comments, are set out in this section.

6. Several respondents sought more clarity on the details of the proposals in the CP. Generally speaking, entities want as much notice as possible of whether they will be classified as resolution entities or material subsidiaries, and if they are, what LAC requirements they will be required to meet, and by when. The MA understands that prolonged uncertainty is undesirable for business, but developing and implementing policy is inevitably an incremental process. More details on the MA's intended approach to LAC requirements are set out in this paper, and further clarity will be provided in the publication for industry consultation of (i) the draft text of the AI LAC Rules and the IRO LAC Amendment Bill, planned for July 2018; and (ii) a draft LAC code of practice chapter (**AI LAC COP**), planned for later in the year. However, ultimately, for each AI, which of the AI itself or its group companies (if any) will be classified as a resolution entity or a material subsidiary, and the LAC requirements that will apply to any entities that are so classified, will depend on the circumstances of that particular AI, in particular the preferred resolution strategy (if any) developed or adopted by the MA for that AI.

7. On the MA's current planning assumptions (which remain subject to change), classifications will be made in respect of domestic systemically-important banks (**D-SIBs**) that are part of non-EME[2] headquartered global systemically-important bank (**G-SIB**) groups in 2019 once the AI LAC Rules and IRO LAC Amendment Bill have come into operation. The intention is that such entities will be required to begin complying with LAC requirements that are consistent with the FSB minimum total loss-absorbing capacity (**TLAC**) requirements within three months of their classification as resolution entities or material subsidiaries (as applicable). For other relevant AIs, preferred resolution strategies will be finalised by the MA during 2019, with resolution entities and material subsidiaries being classified by 1 January 2020. On the basis of the implementation timeline proposed in the CP, those AIs will have to start meeting their LAC requirements by no later than 24 months after classification, i.e. by 1 January 2022.

8. A number of respondents said that AIs which are below a certain threshold for certain metrics – for example, percentage of total assets or total deposits in the Hong Kong market – would clearly not be systemically important and their non-viability would not pose a risk to financial stability in Hong Kong, so they should not have entities classified

[2] Emerging market economy

as resolution entities or material subsidiaries, and should not be subject to LAC requirements.

9. The MA's view is that where *ex ante* it is not evident, or not expected, that the failure 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, it is unlikely that a resolution strategy would need to be developed for such an entity, and it is therefore unlikely to be classified as a resolution entity or material subsidiary.[3] The MA is also of the view that assessing AIs against one or more metrics could prove useful in informing a determination as to whether a resolution strategy should be developed, and to whether an entity should be classified. As such, the MA's present intention is to develop a framework for making such assessments, and to include this in the AI LAC COP. However, as mentioned above, whether a resolution strategy should be developed, and whether an AI (or group company) should be classified as a resolution entity or a material subsidiary, will also need to be informed by the specific circumstances of that particular AI. So it is not the MA's expectation that an assessment framework based on key metrics could necessarily be applied mechanically in all situations to determine which entities should have resolution strategies and which should be classified. Instead, such a framework would help inform such determinations.

10. Several respondents said that the AI LAC Rules should be more closely aligned to the FSB's guidance on TLAC set out in its TLAC term sheet (the **FSB TS**[4]) than proposed in the CP. It was also suggested that the AI LAC Rules contain an explicit, binding commitment to international co-operation. This could, for example, constrain the MA to only classifying G-SIB entities as resolution entities or material subsidiaries where the agreement of the relevant crisis management group (**CMG**[5]) has been obtained.

11. Hong Kong is a pre-eminent global financial centre that plays host to 29 of the 30 G-SIBs without being the home jurisdiction for any of them, and the financial services industry makes a significant contribution to the Hong Kong economy. Having a robust regulatory framework that meets international standards supports financial stability and a level playing field, both of which are highly valued by the financial services industry. The

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[3] It is, however, possible that even where it is not expected that the failure of an AI would pose such a risk locally, a relevant subsidiary could meet one of the 5% tests set out in paragraph 78 of the CP and so be classified as a material subsidiary.

[4] Included here: Financial Stability Board, November 2015, *Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution and Total Loss-absorbing Capacity Term Sheet*

[5] The CMG for a G-SIB comprises the relevant authorities in (i) the home jurisdiction for that G-SIB; and (ii) the jurisdictions that are host to entities of the G-SIB that are material to its resolution.

proposals set out in the CP are generally closely aligned to the provisions set out in the FSB TS. But in light of Hong Kong's particular situation, the MA's view is that in implementing international best practice in Hong Kong, there are a few areas where adjustments are appropriate to ensure that the regulatory framework in Hong Kong is properly suited to local circumstances.

12. On the proposal that the AI LAC Rules limit the MA to only acting where international co-operation has been reached, the MA's intention is that when using powers under the AI LAC Rules – and indeed, in resolution planning more generally – the MA will act in close co-ordination with relevant authorities in other jurisdictions. Cross-border co-operation between resolution authorities is a pre-requisite for effective resolution planning for international banking groups, whether through CMGs or resolution colleges for G-SIBs, or on a bilateral basis for smaller banks. But it is not appropriate that the legislation in Hong Kong should constrain the MA by requiring consensus among the resolution authorities of other jurisdictions before the MA can exercise powers under the AI LAC Rules.

Part I: Introduction

The CP did not contain any consultation questions on Part I.

Part II: Capital and LAC

13. Several respondents sought more clarity on the circumstances in which the MA may propose a minimum loss-absorbing capacity requirement for an overseas subsidiary (in particular with reference to paragraph 25 and footnote 30 of the CP). For the avoidance of doubt, there is currently no suggestion that the MA will seek to require entities that are not incorporated in Hong Kong to meet LAC requirements. However, institution-specific resolution planning is an essential pre-requisite for the orderly resolution of failing institutions. For cross-border banks, this must include co-operation between the resolution authorities in home jurisdictions and host jurisdictions. For G-SIBs this may be conducted through CMGs or resolution colleges; for less complex cross-border institutions, bilateral engagement between authorities may be sufficient. These are the appropriate fora for discussing the appropriate calibration of loss-absorbing capacity requirements, and where relevant the HKMA would expect to be a party to such discussions. However, any requirements should be imposed by the relevant authorities in the jurisdiction in which an affected entity is based.

14. Clarity was also sought on the interaction between the regulatory capital buffer and LAC requirements. The MA's view is that Common Equity Tier 1 (**CET1**) that counts towards a LAC requirement that is calibrated with respect to risk-weighted assets (**RWAs**) cannot also count towards meeting the regulatory capital buffer, but that this restriction should not apply in relation to a LAC requirement that is calculated with respect to an entity's exposure measure. This is consistent with the approach taken under the Banking (Capital) Rules (Cap. 155L) (**BCRs**), which provide that CET1 that counts towards meeting capital requirements that are calculated with reference to RWAs (i.e. the restriction does not apply in relation to the leverage ratio) cannot count towards meeting the regulatory capital buffer.

15. More generally, Part II of the CP continues to reflect the MA's thinking on the issues set out in that Part. In particular, for the reasons set out in the CP (and discussed in more detail in Annex 2) the MA's view remains that the consequences of a breach of a LAC requirement could be considered a breach of an AI's minimum criteria for authorization (set out in Schedule 7 to the Banking Ordinance (Cap. 155)).

Part III: External LAC requirement

16. A number of respondents sought more clarity on how the MA would determine the classification of resolution entities and resolution groups, and it was submitted that the membership of a resolution group should correspond more closely to that set out in the FSB TS. But the observation was also made that difficulties can arise where the group with respect to which a LAC requirement needs to be met on a consolidated basis (**LAC consolidation group**) is different from the group (if any) with respect to which a capital requirement needs to be met on a consolidated basis (**capital consolidation group**).

17. In light of this, the MA would typically expect that for each resolution entity (and material subsidiary) that is an AI, the membership of its LAC consolidation group will be the same as the membership of its capital consolidation group under the BCRs. For a non-AI, the membership of its LAC consolidation group would typically be expected to be the same as the membership of the capital consolidation group under the BCRs of the non-AI's **principal authorized institution**, together with the non-AI. For a non-AI that is a Hong Kong incorporated holding company of an AI, the principal authorized institution will be a subsidiary AI, and for a non-AI that is an affiliated operational entity of an AI, the principal authorized institution will be an AI in relation to which it is an affiliated operational entity. However, the intention is that the MA will have the power to vary

the membership of a LAC consolidation group, having regard to relevant factors (more detail on this is set out in Annex 2).

18. On the question of which entities may be classified as a resolution entity and therefore subject to an external LAC requirement, it is only where the preferred resolution strategy contemplates the application of one or more stabilization options directly to it that an entity can be classified as a resolution entity. A stabilization option can only be applied under the FIRO if the three conditions set out in section 25 of the FIRO have been met. It follows from this that it is only where it is anticipated that these conditions will be met – including condition 3, which requires that the non-viability of a relevant financial institution (which may be the resolution entity itself, or an institution in the same corporate group as the resolution entity) poses risks to the stability and effective working of the financial system of Hong Kong, including to the continued performance of critical financial functions – that an external LAC requirement can be imposed.

19. More generally, it is intended that the AI LAC Rules will set out that in considering whether to classify an entity as a resolution entity, the MA may take into account the preferred resolution strategy covering the entity, and any other matters that the MA considers relevant. More guidance on this will be included in the AI LAC COP.

20. Note also that in order to simplify the implementation of LAC requirements, the MA's intention is to move away from the formulation set out in the CP whereby a resolution entity (or material subsidiary) is required to meet the higher of two requirements, one calibrated with reference to its RWAs and one calibrated with reference to its exposure measure. Instead, it is now intended that under the AI LAC Rules a resolution entity (or material subsidiary) will have to meet both requirements (as in the BCRs, where AIs are required to meet both risk-weighted capital adequacy ratios and a leverage ratio). Of course, at any one time the higher of these will be the more constraining (unless they are exactly equal), so the outcome will not change.

21. Subject to the above, Part III of the CP continues to reflect the MA's thinking on the issues set out in that Part.

Part IV: Internal LAC requirement

22. A number of respondents sought more clarity on how the MA would determine the classification of material subsidiaries and material sub-groups. Further explanation was sought on why the CP proposal is for the materiality of a material subsidiary to be judged

with reference to its resolution group, rather than the wider banking group as proposed in the FSB TS. Another respondent sought more detail on how the determination of 'material to the provision of critical financial functions' (paragraph 78 of the CP) would be made.

23. The proposed criteria for classifying material subsidiaries to be set out in the AI LAC Rules are not identical to those set out in the FSB TS for identifying material sub-groups, in particular in that under the proposals set out in the CP the 5% tests are to be conducted with reference to the resolution group rather than the wider banking group. The intention is to tailor the international standard in this way for the domestic Hong Kong situation in particular to ensure that the appropriate classification of material subsidiaries can be effected for firms with a multiple point-of-entry (**MPE**) resolution strategy as well as those with a single point-of-entry (**SPE**) resolution strategy.

24. On the determination of 'material to the provision of critical financial functions', the MA's intention is again that the assessment framework described in paragraph 9 will be used to inform any assessment of this question.

25. On the question of material sub-groups, the MA's present intention is to revise the approach set out in the CP so that rather than being classified by the MA using powers under the AI LAC Rules, a material sub-group will instead be identified as a material subsidiary together with all its subsidiaries. Further, the intention is that (as for resolution entities), material subsidiaries will be required to meet their LAC requirements on a consolidated basis with respect to their LAC consolidation groups (not their material sub-groups). The LAC consolidation group for a material subsidiary would be identified in the same way as for a resolution entity (as described in Part III above).

26. Several respondents sought more clarity on how the MA would determine a material subsidiary's internal LAC scalar, with one respondent expressing the view that the calibration of the internal LAC scalar in relation to a G-SIB should be subject to the agreement of the CMG.

27. The MA has given further consideration to the question of which factors should be taken into consideration in any variation of an internal LAC scalar above 75%; more detail on this topic is set out in Annex 2. As discussed above, it is not appropriate that Hong Kong legislation should constrain the MA by requiring consensus among the resolution authorities of other jurisdictions, and so the MA does not intend that the AI LAC Rules

will specify that the calibration of the internal LAC scalar should be subject to CMG agreement as a matter of law.

28. Subject to the above, Part IV of the CP continues to reflect the MA's thinking on the issues set out in that Part.

Part V: Timeline for meeting LAC requirements

29. A number of respondents queried the proposed timeline for the introduction of LAC requirements, one respondent specifically submitting that AIs that were not G-SIBs or D-SIBs should not have to meet LAC requirements any earlier than 1 January 2022. The MA is mindful of the need to avoid requiring the issuance of a large volume of LAC in the Hong Kong market in a short period of time, and is therefore not intending to classify all relevant entities as resolution entities or material subsidiaries immediately after the AI LAC Rules come into force. As described in paragraph 7, the present intention is to classify resolution entities and material subsidiaries of non-EME G-SIBs on a timetable requiring them to meet the minimum FSB TLAC requirements in 2019. The expectation is that other relevant entities will be classified as resolution entities and material subsidiaries by 1 January 2020, and so will need to meet their respective LAC requirements by 1 January 2022 (i.e. within 24 months of classification).

30. Several respondents also queried the proposal set out in the CP that resolution entities and material subsidiaries should be required to meet their respective LAC requirements on a solo basis (as well as on a consolidated basis with respect to their LAC consolidation groups). The MA's view remains that this is appropriate, as AIs need to meet capital requirements on a solo basis and the calibration of LAC requirements is driven off the calibration of capital requirements. However, the MA acknowledges that in some circumstances requiring an AI to meet its LAC requirement on a solo basis may limit flexibility in the application of the proceeds of LAC issuance. The MA's present intention is therefore to allow for a LAC requirement to be scaled with reference to a **solo LAC scalar** which will be set at 100% unless scaled down by the MA. More details on this are set out in Annex 2.

31. Subject to the above, Part V of the CP continues to reflect the MA's thinking on the issues set out in that Part.

Part VI: LAC eligibility criteria

32. Respondents sought more clarity on a number of areas around LAC eligibility criteria, including on which features would lead to an instrument being characterised as derivative-linked.

33. The MA's present intention is that an instrument would be characterised as being derivative-linked where the value of the liability represented by the instrument fluctuates by reference to the value of, or any fluctuation in the value of, one or more than one underlying asset, index, financial instrument, rate or thing designated in the instrument, or the instrument otherwise has derivative-linked features, subject to an instrument not being so characterised only because a coupon on the instrument is calculated with reference to a reference rate.

34. Clarity was also sought on whether the existence of a call option would result in an instrument being characterised as derivative-linked. This is not the MA's intention, as the simple existence of such an option does not lead to the value of the liability being determined by reference to the price of something else. However, on further consideration, it is the MA's present intention that where a LAC debt instrument does contain a call option, the AI LAC Rules will require the consent of the MA to be obtained for the option to be exercised (modelled on the equivalent requirement in Schedule 4C to the BCRs).

35. More generally, Part VI of the CP continues to reflect the MA's thinking on the issues set out in that Part. In addition, the MA's present intention is that in order for debt instruments to be eligible as external LAC, the issuer will have to meet certain restrictions on the sale and distribution of those instruments, as set out in the following Part.

Part VII: Restrictions on sale and distribution of LAC debt instruments

36. Generally speaking, respondents accepted the proposal of restricting primary issuance of external LAC debt instruments to Professional Investors (**PIs**) only. However, the CP also raised the prospect of allowing primary issuance only to those PIs who are not 'retail banking customers'. There was a consensus among respondents who addressed this issue that primary issuance should be allowed to individuals who meet the criteria to qualify as PIs.

37. The MA's view is that appropriate investor protection measures need to be put in place to ensure that investment in external LAC debt instruments is restricted to those who understand the risks that such investments involve, and are able to bear those risks. But the MA also acknowledges that more onerous distribution restrictions could lead to a smaller investor base, and could have a negative impact on liquidity and pricing. On balance, the MA's existing judgement is that the issuance of external LAC debt instruments to all PIs can be permitted, subject to AIs meeting the relevant conduct requirements referred to in paragraph 38 below. It is the MA's intention that the AI LAC Rules will provide that instruments that are issued in Hong Kong must be issued to PIs in order to be eligible as external LAC.

38. More generally, the primary and secondary market sale or distribution in Hong Kong of (i) instruments that have LAC-like loss-absorption features (including Additional Tier 1 and Tier 2 capital instruments, other external LAC debt instruments, contingent convertible bonds, etc.); and (ii) investment products that primarily invest in, or whose returns are closely linked to the performance of, instruments that have such loss-absorption features ((i) and (ii) together being **restricted products**), should be restricted to PIs. The MA intends to provide guidance in the form of circulars on the sale and distribution of restricted products in the primary and secondary markets by AIs.

39. On the issue of a minimum denomination requirement for external LAC debt instruments, most respondents felt that in principle having such a requirement would be acceptable, but that the HKD 8 million level proposed in the CP was too high. In particular, respondents observed that current bond issuances typically have minimum denominations no higher than around USD 200,000 or EUR 100,000. The point was also made that the proposed level of HKD 8 million was just over USD 1 million, which could prove inconvenient when at least some issues of external LAC debt instruments are likely to be denominated in US dollars.

40. The MA's view is that these points have some merit, and so the MA's present intention is to revise the proposal set out in the CP so that external LAC debt instruments denominated in Hong Kong dollars, US dollars, Euros or another currency are required to meet minimum denomination requirements of HKD 2 million, USD 250,000, EUR 200,000 or the equivalent of HKD 2 million in another currency, respectively.

41. Respondents also expressed reservations about additional conduct measures proposed in the CP (paragraph 134). As with the other issues in this Part VII, the MA's existing view is that an appropriate balance needs to be struck between restricting the sale and

distribution of external LAC debt instruments to unsuitable investors, and limiting the negative liquidity and pricing impact that could potentially arise from the imposition of such restrictions.

42. In addition to the requirements set out above, the MA's present intention is therefore that the AI LAC Rules will also require relevant offering and product documents for external LAC debt instruments to contain appropriate risk disclosures and selling restrictions (CP paragraph 134(ii)). But on balance, the MA's current intention is not to restrict the sale or distribution of restricted products to PIs that are not retail banking customers only, nor to require written acknowledgements from investors (CP paragraphs 134 (i) and (iii)). The proposals set out in paragraphs 134 (iv), (v), (vi) and (vii) of the CP will apply as is already the case for certain complex and high risk products (subject to appropriate exemptions for dealings with Institutional or Corporate PIs).

43. Subject to the above, Part VII of the CP continues to reflect the MA's existing thinking on the issues set out in that Part. Note also that the intention is that the measures set out in this Part will also apply to regulatory capital debt instruments. In particular, the MA intends to revise the BCRs to provide that in order to be eligible as Additional Tier 1 capital or Tier 2 capital, instruments must either (i) be issued to an entity in the same banking group as the issuer; or (ii) meet the minimum denomination requirements set out in paragraph 40; if the instruments are issued in Hong Kong they must be issued to PIs; and the relevant offering and product documents of the instruments must contain appropriate risk disclosures and selling restrictions.

Part VIII: Treatment of LAC investments

44. Several respondents submitted that a less stringent approach to deductions of holdings of LAC investments be taken than proposed in the CP. However, the MA's existing view is that any material loosening of the proposals set out in the CP could lead to an increase in the risk of contagion should one or more AIs get into difficulties.

45. As proposed in the consultation paper CP18.03 'Implementation of TLAC Holdings Standard' published in April this year on this topic,[6] the MA's present intention is accordingly that where an AI holds **non-capital LAC liabilities**[7] – i.e. non-capital LAC debt

[6] http://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/consultations/CP18_03_Implementation_of_TLAC_Holdings_Standard.pdf

[7] These are analogous to G-SIBs' 'other TLAC liabilities' referred to in the Basel Committee on Banking

instruments, other non-capital instruments that are recognised as being eligible to count as loss-absorbing capacity under a regulatory regime in a non-Hong Kong jurisdiction, and certain other liabilities that rank equally with or junior to such instruments – issued by an entity in a different banking group, such instruments should be deducted from capital, subject to the materiality thresholds set out in that consultation paper.

46. The MA's view also remains that where an AI holds non-capital LAC liabilities issued by an entity in the same resolution group (i.e. internal LAC or the equivalent under a non-Hong Kong regulatory regime), such holdings should be deducted first from the holder's own non-capital LAC, and then from the holder's regulatory capital, with no deduction thresholds.

47. However, where an AI holds non-capital LAC liabilities issued by an entity in a different resolution group but in the same banking group as the holding AI, on further consideration the MA's view is that such instruments should be deducted in the same way as for internal LAC, i.e. first from the holder's own non-capital LAC, and then from the holder's regulatory capital, with no deduction thresholds.

48. Subject to the above, Part VIII of the CP continues to reflect the MA's thinking on the issues set out in that Part.

Part IX: Minimum debt requirement

49. Several respondents said that the minimum debt requirement was unnecessary, and that among other things it would limit AIs' flexibility in deciding how to fund their LAC, would incentivise the issuance of lower quality LAC, and depending on the prevailing capital position of an AI, could prove costly. Clarity was also sought on whether instruments that are legally in the form of debt but accounted for as equity would count towards the one-third debt requirement.

50. The MA's view is that, as set out in the CP, LAC that is in the form of debt can help facilitate the orderly resolution of a failing AI, thereby contributing towards financial stability. The MA considers that calibrating the minimum debt requirement at one third of the overall LAC requirement (consistent with the FSB TS) strikes the right balance between enhancing financial stability and limiting the regulatory burden on AIs.

Supervision (**BCBS**) TLAC holdings standard published in October 2016: http://www.bis.org/bcbs/publ/d387.htm.

51. The MA therefore intends that the AI LAC Rules will require one third of LAC requirements to be met with debt. It is proposed that in order to count towards this one-third requirement, instruments must meet the relevant LAC eligibility criteria and must evidence indebtedness. For the avoidance of doubt, this will include Additional Tier 1 and Tier 2 capital instruments that meet these conditions, and it is not intended that instruments need to be accounted for as liabilities (rather than equity) in order to count towards the minimum debt requirement. The MA intends to retain the power to vary down the minimum debt requirement proposed in the CP, for the reasons set out in the CP. But the MA would expect to use this flexibility only in limited circumstances. More detail on this is set out in Annex 2.

52. More generally, Part IX of the CP continues to reflect the MA's thinking on the issues set out in that Part.

Part X: Reporting, disclosure, procedure and reviews

53. On disclosure, respondents sought more information on the frequency with which disclosures would be required to be made, with one respondent advocating alignment with the current requirement for capital disclosures. In addition, one respondent said that disclosure should be required on a consolidated basis only, not also on a solo basis.

54. In light of this feedback, and in order to ensure that the disclosure requirements are well aligned with international standards, the MA intends to revise the proposed approach on disclosures set out in the CP. In particular, the MA intends to insert provisions in the AI LAC Rules modelled on sections 6, 8, 9, 10 and 15 of the Banking (Disclosure) Rules (Cap. 155M) (**BDRs**). These include a provision (section 6(1)(ab) of the BDRs) for the details of required disclosures to be set out in templates or tables developed by the MA. The MA intends that the AI LAC Rules will describe at a high level the nature and frequency of disclosure that will be required, modelled on the five relevant templates from the BCBS's March 2017 publication on *Pillar 3 disclosure requirements – consolidated and enhanced framework*.[8] The MA then intends to develop (with industry consultation) templates setting out the details of the required disclosures, with the templates under the AI LAC Rules modelled on those five BCBS templates. The MA's current intention is that under the AI LAC Rules, resolution entities and material subsidiaries will have to start making required disclosures three months after their classification.

[8] https://www.bis.org/bcbs/publ/d400.htm The five relevant templates are KM2, CCA, TLAC1, TLAC2 and TLAC3.

55. In addition, a number of respondents said that more of the determinations that the CP proposed the MA should have the power to make (in particular, the calibration of the internal LAC scalar) should be subject to review by the Resolvability Review Tribunal (**RRT**). The MA's view is that as the impact of the various determinations differs, the right to apply for review by the RRT should be reserved for the more important, far-reaching determinations. Accordingly, the MA continues to hold the view that of the determinations discussed in the CP, those that should be subject to review by the RRT are any variation of the resolution component ratio, and any direction to take remedial action. However, on further consideration, the MA's current view is that following classification as a resolution entity or material subsidiary, or where an increase in a Pillar 2A requirement leads to an increased resolution component ratio, an affected entity should have the opportunity to request a reduction in its resolution component ratio. It is proposed that a decision by the MA not to accede to such a request should also be subject to review by the RRT.

Part XI: Tax treatment of LAC debt instruments

56. Respondents were broadly supportive of the proposal to extend debt-like tax treatment to LAC debt instruments, but also raised a number of comments in relation to the proposals set out in the CP. These included a submission to the effect that the amendments to the IRO should be retrospectively effective, to ensure that where AIs start issuing LAC debt instruments ahead of any implementation deadline, those instruments also benefit from debt-like tax treatment, and that debt-like tax treatment should also apply to LAC debt instruments issued by affiliated operational entities.

57. On the first of these points, it is acknowledged that AIs will need to start issuing LAC debt instruments ahead of any implementation deadline. In taking forward the AI LAC Rules and the IRO LAC Amendment Bill, the intention is to reduce the chance of any sequencing issues leading to increased tax liabilities for issuers. In order to achieve this, the MA's current intention (which remains subject to change) is that no classifications of resolution entities or material subsidiaries will be made until both the AI LAC Rules and the IRO LAC Amendment Bill have come into operation.

58. On the second point, the MA acknowledges that it is desirable to avoid disadvantaging affiliated operational entities who may be required to issue LAC debt instruments. It is proposed that debt-like tax treatment would be afforded to affiliated operational entities which are classified by the MA as a resolution entity or a material subsidiary and thus

subject to a LAC requirement, while interests, gains or profits derived from LAC debt instruments made by such affiliated operational entities would be assessed as trading receipts and hence be brought into the scope of chargeable profits, on the same basis as for clean holding companies.

Part XII: Impact of LAC requirements

The CP did not contain any consultation questions on Part XII.

Next steps

59. The MA's present intention is to issue the draft text of the AI LAC Rules and the IRO LAC Amendment Bill for industry consultation in July 2018, and to issue the AI LAC COP for industry consultation later in the year. The current target is to table the draft AI LAC Rules and the IRO LAC Amendment Bill in the Legislative Council in Q4 2018. Subject to completion of the negative vetting procedure, it is expected that the AI LAC Rules would come into operation around the end of 2018.

Annex 1 – List of respondents

1. Asia Securities Industry & Financial Markets Association (ASIFMA)
2. Chong Hing Bank Limited, Dah Sing Bank Limited, Fubon Bank (Hong Kong) Limited, Public Bank (Hong Kong) Limited and Shanghai Commercial Bank Limited
3. Hang Seng Bank Limited
4. Hong Kong Deposit Protection Board
5. Hong Kong Interbank Clearing Limited
6. OCBC Wing Hang Bank Limited
7. Private Wealth Management Association
8. The Clearing House Association and the Securities Industry and Financial Markets Association
9. The DTC Association
10. The Hong Kong Association of Banks

Annex 2 – Summary of comments and MA's responses

PART II CAPITAL AND LAC	
Respondents' comments	**MA's response**
1. One respondent disagreed with the proposal set out in the CP that CET1 that counts towards meeting a LAC requirement cannot also count towards meeting the regulatory capital buffer. Another respondent sought clarification on how this would work if a LAC requirement based on the exposure measure was the binding constraint (rather than a LAC requirement based on RWAs).	Where an AI meets its regulatory capital buffer, that buffer provides additional going-concern loss-absorbing capacity that can be utilised without the AI breaching its regulatory capital requirements. If CET1 that counts towards meeting a LAC requirement could also count towards meeting the regulatory capital buffer, this would mean that the amount of going-concern loss-absorbing capacity that could be utilised before the AI breached its LAC requirements would be **less** than the amount that could be utilised before the AI breached its capital requirements. This is not the policy intention, not least as the MA's existing view (as discussed further below) is that a breach of a LAC requirement should be regarded as comparable to a breach of a regulatory capital requirement. This is consistent with section 6 of the FSB TS, which provides that CET1 used to meet minimum TLAC requirements must not be used to also meet a regulatory capital buffer. Accordingly, the MA's view remains that CET1 that counts towards a LAC requirement cannot also contribute to a regulatory capital buffer. However, consistent with the approach taken in the BCRs, the MA's view is that this should only apply with respect to LAC requirements that are calibrated with respect to RWAs. This restriction should not apply in relation to a LAC requirement that is calculated with respect to an entity's exposure measure.

PART II CAPITAL AND LAC Respondents' comments	MA's response
	The MA's intention is accordingly to revise the definition of 'net CET1 capital' in section 3E of the BCRs so that it excludes not only CET1 capital that the institution requires for complying with any of the minimum CET1 capital ratio, Tier 1 capital ratio, or Total capital ratio under the BCRs, but also any CET1 capital that the institution counts towards meeting any LAC requirement under the AI LAC Rules that is calibrated with respect to RWAs.
2. Several respondents sought more clarity on the circumstances in which the MA may propose a minimum loss-absorbing capacity requirement for an overseas subsidiary (in particular with reference to paragraph 25 and footnote 30 of the CP).	Where the MA is of the view that the absence of a local loss-absorbing capacity requirement for an overseas subsidiary of a Hong Kong entity (where both are in the same resolution group) constitutes an impediment to resolvability, the MA may, in consultation with the relevant authorities in that jurisdiction, propose that such a requirement be imposed. However, the imposition of any such requirement would be a matter for the local authorities. It is not the intention that this issue be reflected in the AI LAC Rules.
3. One respondent submitted that breaching a LAC requirement should not be regarded as comparable to breaching a capital requirement. Another respondent said that regarding a breach of a LAC requirement as comparable to a breach of a regulatory capital requirement was	An external LAC requirement will only be imposed where the non-viability of an AI is expected to pose risks to financial stability, including to the continued performance of critical financial functions. An internal LAC requirement will only be imposed where the relevant entity is in a resolution group, and meets one or more of the materiality conditions. In either case, maintaining adequate LAC is likely to be a fundamental aspect of ensuring resolvability. It follows that a breach of LAC requirements undermines resolvability, thereby increasing the

PART II CAPITAL AND LAC	
Respondents' comments	**MA's response**
acceptable, but remedial actions should be distinguished.	likelihood that the non-viability of an AI would threaten financial stability. The MA's existing view – consistent with section 7 of the FSB TS – is accordingly that a breach of a LAC requirement should be regarded as comparable to a breach of a regulatory capital requirement. The details of any response by the MA to a breach of a LAC requirement would depend on the circumstances of any particular case.

PART III EXTERNAL LAC REQUIREMENT	
Respondents' comments	**MA's response**
1. Two respondents sought more clarity on how the MA would determine the classification of resolution entities and resolution groups, and submitted that for G-SIBs the agreement of the relevant crisis management group (**CMG**) would be required for such classifications to be made.	It is intended that the AI LAC Rules will set out that in considering whether to classify an entity as a resolution entity, the MA may take into account the preferred resolution strategy covering the entity, and any other matters that the MA considers relevant. As described in paragraph 9, the MA's present intention is to develop a framework which will go towards addressing which entities should have resolution strategies, and which should be classified. More guidance on this will be included in the AI LAC COP. In addition, the present intention is to revise the approach originally proposed in the CP to resolution groups so that rather than being classified by the MA using powers under the AI LAC Rules they will instead be identified in resolution strategies. Under this revised approach, resolution entities will need to meet their external LAC requirements on a consolidated basis with

PART III EXTERNAL LAC REQUIREMENT Respondents' comments	MA's response
	respect to their LAC consolidation groups, not their resolution groups – see the next row in this table. As described in the CP, it is proposed that the MA will have the power to classify resolution entities under the AI LAC Rules. But it is not appropriate that such powers be limited in the AI LAC Rules with explicit reference to the agreement of CMGs; Hong Kong legislation should not seek to constrain the MA by requiring consensus among the resolution authorities of other jurisdictions before the MA can exercise powers under the AI LAC Rules. However, for G-SIBs, the MA fully expects that in exercising its power to make these classifications it will act in close co-ordination with CMGs.
2. One respondent submitted that the membership of a resolution group should correspond more closely to that set out in the FSB TS, but also noted that where a resolution group is different from a capital consolidation group, this can cause operational complexities and costs. Another respondent made the related point that the calculation of RWAs and exposure measures for resolution entities and material subsidiaries on a	The MA acknowledges that complications can arise where the denominator for a LAC requirement needs to be determined with reference to assets held by an entity that is not an AI. In developing the AI LAC Rules, the MA therefore proposes to introduce a new concept of **LAC consolidation group**, which for a resolution entity or material subsidiary will be the group of companies with reference to which that resolution entity or material subsidiary needs to meet any relevant LAC requirement on a consolidated basis. The LAC consolidation group for any resolution entity or material subsidiary that is an AI will be that AI's capital consolidation group (unless varied by the MA; see next paragraph). The LAC

PART III EXTERNAL LAC REQUIREMENT	
Respondents' comments	**MA's response**
consolidated basis can be burdensome where not all the members of the relevant consolidation groups are subject to prudential regulation.	consolidation group for any Hong Kong incorporated AI holding company will be that holding company together with the capital consolidation group of its largest Hong Kong incorporated AI subsidiary, and the LAC consolidation group for any Hong Kong incorporated affiliated operational entity will be that entity together with the capital consolidation group of the largest Hong Kong incorporated AI in relation to which it is an affiliated operational entity (in each case as varied by the MA). It is proposed that the MA will have the flexibility to add members to, or remove members from, a LAC consolidation group. The present intention is that in considering whether to add entities to or remove entities from a LAC consolidation group, the AI LAC Rules will set out that the MA may take into account: (i) 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; (ii) the preferred resolution strategy covering the resolution entity or material subsidiary; and (iii) any other matters the MA considers relevant.
3. Several respondents said that smaller banks[9] were not systemically important and their	In order for an entity to be classified as a resolution entity or a material subsidiary and therefore be subject to LAC requirements, there needs to be a resolution strategy in respect of that entity

[9] Respondents proposed various criteria for classifying 'smaller banks', such as (i) no more than a certain percentage of total assets in the Hong Kong market; or (ii) a quantitative threshold for performing critical financial functions in the Hong Kong market, such as no more than 2-3% of deposits.

PART III EXTERNAL LAC REQUIREMENT	
Respondents' comments	**MA's response**
non-viability would not pose a risk to financial stability in Hong Kong, so they should not have entities classified as resolution entities or material subsidiaries, and should not be subject to LAC requirements. Further, LAC funding costs for smaller banks would be higher than for larger banks, putting the smaller banks at a competitive disadvantage and forcing more market share on to the larger, predominantly non-Hong Kong headquartered, banks in Hong Kong. Two respondents also said that imposing LAC requirements on smaller banks would require them to replace some of their existing deposits with (higher cost) debt, undermining profitability, weakening competition and the provision of services to customers. Imposing a LAC regime in Hong Kong when others in the region are not planning to do the same, or may be planning to	that envisages the application of stabilization options under the FIRO (or resolution tools in another jurisdiction) to it or to another group company. Under the FIRO, the initiation of resolution and the application of stabilization options to an entity is subject to the three conditions set out in section 25 of the FIRO being met, the third of which is that the non-viability of the entity (or if the entity is not an AI, a relevant 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.[10] Accordingly, any AI whose non-viability would not be expected to pose such risks will not typically[11] be subject to LAC requirements, as it would not be expected that should such AI reach the point of non-viability (**PONV**) it would be put into resolution. For other AIs, the non-viability of which may pose risks to financial stability in Hong Kong, requiring them to meet LAC requirements may well involve some additional costs. However, to the extent that (i) those costs arise from the internalising of risks inherent to an AI's business; and (ii) requiring an AI to meet LAC requirements mitigates risk to financial stability and/or public funds, the result is a net benefit to Hong Kong and the wider economy. The balance of costs and benefits of imposing LAC requirements on AIs in Hong Kong is considered in more detail in Part XII of the CP.

[10] This third condition also requires that putting the entity into resolution would mitigate that risk.

[11] It is possible that even where it is not expected *ex ante* that the failure of an AI would pose such risks, a relevant subsidiary could meet one of the 5% tests set out in paragraph 78 of the CP and so be classified as a material subsidiary.

PART III EXTERNAL LAC REQUIREMENT	
Respondents' comments	**MA's response**
do so but on a slower timetable, could put banks in Hong Kong at a competitive disadvantage. In a similar vein, several respondents asked for more clarity on which entities would be considered small enough not to be subject to LAC requirements, and/or proposed that only G-SIBs / D-SIBs should be covered.	
4. A number of respondents sought more clarity on the details of how an external LAC requirement would be calibrated. These included asking for more detail on how the relevant legal entities will be determined for the purposes of paragraph 45(iv) in the CP (and it was submitted that such determination should be subject to the review by the RRT) which impacts on the determination of the capital component ratio, and on how the resolution component ratio would be varied by the MA.	The MA's intention remains that a resolution entity's external LAC requirement will be calibrated with reference to its capital component ratio and its resolution component ratio, as proposed in the CP. On the capital component ratio, as a revision to the proposals set out in the CP, it is the intention that this will be determined with reference to a resolution entity's capital consolidation group, or the capital consolidation group of its principal authorized institution if the resolution entity is not itself an AI. On the resolution component ratio, as proposed in the CP, the intention is that the AI LAC Rules will provide for it to be equal to the capital component ratio, subject to the MA having a power to vary it. Specifically, the MA intends that the AI LAC Rules will set out the following factors which

PART III EXTERNAL LAC REQUIREMENT Respondents' comments	MA's response
	the MA may take into account in considering whether it is prudent to vary a resolution component ratio: (i) any stabilization options expected to be applied under the preferred resolution strategy; (ii) 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 calibrating LAC requirements; and (iii) any other matters the MA considers relevant. More guidance on this will be set out in the AI LAC COP. As described above, it is proposed that the AI LAC Rules will provide for a LAC consolidation group to be defined for each resolution entity or material subsidiary. The mechanism proposed in paragraph 45 of the CP will therefore no longer be needed.
5. Two respondents submitted that the resolution component ratio for entities that are not G-SIBs or D-SIBs should be no more than 50% of the capital component ratio.	The basic principle underpinning the calibration of external LAC is that the resolution component ratio should be equal to the capital component ratio, so that an AI can experience losses that wipe out its regulatory capital requirement and have sufficient remaining LAC to allow it to be fully recapitalised in resolution and restored to viability. But as discussed in the CP, there may be circumstances in which less LAC would be sufficient – for example, where the resolution strategy for an AI envisages a partial transfer of assets and liabilities to another entity, with the result that the balance sheet that needs to be recapitalised in resolution is smaller than the AI's original balance sheet, and so requires fewer recapitalisation resources (i.e. less LAC).

PART III EXTERNAL LAC REQUIREMENT Respondents' comments	MA's response
	However, automatically reducing the resolution component ratio for any resolution entity or material subsidiary that is not in a G-SIB or D-SIB group without taking into account its specific circumstances – in particular, the relevant preferred resolution strategy – would not be appropriate. This could result in a situation where the LAC requirement that an entity is required to maintain is insufficient to implement its resolution strategy. For the factors that the MA is proposing should be taken into account in any variation of the resolution component ratio, see the preceding row in this table.
6. One respondent made the point that the policy on LAC requirements should take into account other related regulatory workstreams, including revised standards for RWAs. This respondent also considered that annual reviews of an entity's resolution component ratio would be too frequent – an entity would not have time to implement any changes from an earlier review before the next one took place. It was submitted that reviews should not take place more often than every two years.	The goal of setting an AI's resolution component ratio equal to its capital component ratio (prior to any variation by the MA) is to ensure that should the AI fail it can be recapitalised in resolution and restored to viability. Other regulatory workstreams – such as revised standards for RWAs – are therefore automatically taken into account in the calibration. The MA acknowledges that implementing annual changes to LAC requirements following a review of the resolution component ratio may be burdensome for a resolution entity or material subsidiary. However, if changes are required, they should be identified and implemented in a timely fashion – and if they are not required, they will not be made. A requirement for annual reviews does not imply annual changes.

PART III EXTERNAL LAC REQUIREMENT Respondents' comments	MA's response
7. One respondent raised the concern that the proposals set out in the CP may require G-SIBs to meet a LAC requirement that is above 16% (the minimum TLAC requirement for G-SIBs set out in the FSB TS) earlier than 1 January 2022. This respondent also submitted that non-CET1 capital issued by the subsidiaries of a resolution entity should be able to count as LAC up to 1 January 2022, as set out in the FSB TS.	Under the MA's current planning assumptions (i) non-EME G-SIBs will not be required to meet external LAC requirements that are higher than 16% of RWAs / 6% of the exposure measure before 1 January 2022; and (ii) no other relevant entities will be required to meet LAC requirements before 1 January 2022. See 'MA's response' in Part V below. In addition, the MA does not expect that the proposal in the CP that non-CET1 capital issued by the subsidiaries of a resolution entity should not be able to count as LAC during a transitional period to have a material impact.
8. One respondent said that imposing temporary LAC requirements on subsidiaries in Hong Kong of EME G-SIBs to a shorter timeline than that proposed by the FSB (i) would create uncertainty, as they would be temporary in nature; (ii) would be difficult to do in consultation with the relevant home authority; and (iii) might distort competition. Relatedly, another respondent considered that such subsidiaries should not be subject to LAC requirements until 2025.	The timelines set out in the FSB TS for EME (and non-EME) G-SIBs to meet minimum TLAC requirements constitute backstop timelines; there is no suggestion that jurisdictions should not move more quickly should that be appropriate in light of local circumstances. As described in 'MA's response' in Part V below, the MA's present intention is to classify resolution entities and material subsidiaries of non-G-SIBs by 1 January 2020, with the result that they will need to meet their respective LAC requirements by 1 January 2022. For non-EME G-SIBs, a timeline will be adopted that is largely consistent with the FSB TS, which will result in such entities being required to meet LAC requirements ahead of the 1 January 2022 deadline that will apply to non-G-SIBs (see preceding paragraph). But there is no justification for

PART III EXTERNAL LAC REQUIREMENT	
Respondents' comments	**MA's response**
	adopting a timeline for EME G-SIBs so that they do not have to meet LAC requirements under the AI LAC Rules until a date *later* than the 1 January 2022 deadline that will apply to non-G-SIBs, in particular as some of the largest and most significant AIs in Hong Kong are EME G-SIBs. It is therefore the intention to classify the resolution entities and material subsidiaries of EME G-SIBs to the same timeline as non-G-SIBs, i.e. by 1 January 2020, with LAC requirements to be met within 24 months, so by 1 January 2022. It is the intention that the classifications would be co-ordinated with the relevant CMGs; the resulting LAC requirements would not be temporary, although they could be revised upwards in due course to meet applicable minimum TLAC requirements under the FSB TS, if higher; and treating EME G-SIBs the same as other non-G-SIBs, rather than more favourably, will support, not distort, competition.

PART IV INTERNAL LAC REQUIREMENT	
Respondents' comments	**MA's response**
1. Respondents sought more clarity on how the MA would determine the classification of material subsidiaries and/or material sub-groups. One respondent expressed concern that non-Hong Kong subsidiaries could be included in a material sub-group; another sought more detail on how	As set out in the CP, the MA's intention remains that in order to classify an entity as a material subsidiary it must be in a resolution group (and not be a resolution entity) and in addition it (taken on its own or together with any of its subsidiaries in its resolution group) must (a) contain more than 5% of the risk-weighted assets of the resolution group; (b) generate more than 5% of the total operating income of the resolution group; (c) contain more than 5% of the unweighted assets of the resolution group; or (d) be material to the provision of critical financial functions.

PART IV INTERNAL LAC REQUIREMENT	
Respondents' comments	**MA's response**
this might happen. Several respondents considered that for G-SIBs the agreement of the relevant CMG should be required for such classifications to be made. Further explanation was also sought on why the CP proposal is for the materiality of a material subsidiary to be judged with reference to its resolution group, rather than the wider banking group as proposed in the FSB TS (and as supported by one respondent). One respondent said that the fourth limb of the test for classifying a material subsidiary – materiality to the provision of critical financial functions – should mirror the FSB TS; the wording proposed in the CP is too broad. Another respondent sought more detail on how the determination of 'material to the provision of critical financial functions in Hong Kong' (paragraph 78 of the CP) would be made.	These criteria are not identical to those set out in the FSB TS for identifying material sub-groups, in particular in that the 5% tests are to be conducted with reference to the resolution group rather than the wider banking group, and the test on the provision of critical functions is to be determined by the MA, rather than the CMG. On the 5% tests, the intention is to tailor the international standard to the domestic Hong Kong situation as described above, in particular to ensure that the appropriate classification of material subsidiaries can be effected for firms with an MPE strategy as well as those with an SPE strategy. On the determination of critical functions, it is not appropriate that powers set out in Hong Kong legislation be constrained with explicit reference to the agreement of CMGs. However, for G-SIBs, the MA fully expects that in making such determinations, and more generally in classifying material subsidiaries, it will act in close co-ordination with CMGs. Note also that on the determination of 'material to the provision of critical financial functions', the MA proposes that the definition of critical financial functions in the AI LAC Rules will be the same as in the FIRO, and the MA's intention is that the framework described in paragraph 9 will be used to inform any assessment of this issue. Note further that the present intention is to revise the approach to material sub-groups so that rather than being classified by the MA using powers under the AI LAC Rules, a material sub-group will instead be defined as a material subsidiary together with all its subsidiaries. Among other things, this may result in the inclusion of non-Hong Kong subsidiaries within a material sub-group.

PART IV INTERNAL LAC REQUIREMENT Respondents' comments	MA's response
	However, under the revised approach, a material subsidiary will have to meet its LAC requirement on a consolidated basis with reference to its LAC consolidation group, not its material sub-group. The LAC consolidation group for a material subsidiary will be constituted in a similar way as for a resolution entity.
2. Several respondents sought more clarity on how the MA would determine a material subsidiary's internal LAC scalar, with one expressing the view that the calibration of the internal LAC scalar in relation to a G-SIB should be subject to the agreement of the CMG. One respondent considered that material subsidiaries of EME G-SIBs should have their internal LAC scalars set at 75%, as they are less globalised, less complex, and have lower contagion risk. Another respondent held the view that the internal LAC scalar should be applied to the 18% minimum TLAC requirement in the FSB TS, not to a modelled external LAC requirement, which could be higher. A submission was also made that the calibration	The MA has given further consideration to the question of which factors should be taken into consideration in any variation of an internal LAC scalar above 75%. The MA's present intention is that the AI LAC Rules will set out the following factors that the MA may take into consideration: (i) the preferred resolution strategy covering the material subsidiary; (ii) the likely availability of additional financial resources within the material subsidiary's resolution group which could be expected to be deployed to restore to viability any authorized institution in the material subsidiary's material sub-group; and (iii) any other matters the MA considers relevant. However, the intention remains that unless explicitly varied by the MA, a material subsidiary's internal LAC scalar will be 75%. This will apply to EME G-SIBs as well as to other AIs (including non-EME G-SIBs). As is the case for other AIs, an EME G-SIB's internal LAC scalar will only increase above 75% if there are specific factors indicating it should be – but if such factors are present, the fact that a material subsidiary is within an EME G-SIB group should not prevent the internal LAC scalar from increasing. The suggestion that the internal LAC scalar be applied to the 18% minimum TLAC requirement

PART IV INTERNAL LAC REQUIREMENT	
Respondents' comments	**MA's response**
of the internal LAC scalar should be made subject to review by the RRT. On the internal LAC scalar, clarification was sought on why this could be up to 100% for a group with a simple organisational structure, and on what was meant by 'simple organisational structure' in this context (paragraph 84 of the CP). One respondent considered that the same range for the internal LAC scalar should apply regardless of whether the internal LAC was issued cross-border. And one respondent said that the agreement of any relevant CMG and/or home authority should also be required in the calibration of an internal LAC scalar.	specified in the FSB TS is not consistent with the principle underpinning the way in which the LAC requirements are calibrated, nor is it consistent with the FSB TS which specifies that internal TLAC should be calculated with reference to the minimum TLAC requirement that would have applied had the material sub-group been a resolution group. As defined in the FSB TS, the minimum TLAC requirement must (after a transition period) be *at least* 18%, not *equal to* 18%. The MA does not agree that the calibration of the internal LAC scalar should be subject to review by the RRT. The calibration of the internal LAC scalar is a highly technical matter, and the range within which the MA can increase the scalar is in any case narrowly prescribed. The reason that with a very simple organisational structure – for example, a holding company with a single direct AI subsidiary – it may be preferable to have an internal LAC scalar of 100% is that in such circumstances there may be no resolvability benefit to retaining any 'surplus' or 'non-pre-positioned' LAC (referred to below as **non-pre-positioned LAC**) at the holding company level. If there is only one entity that is conducting banking activity, that is the only entity that can incur losses on such activity – accordingly, there is no loss of efficiency in pre-positioning all LAC on that entity's balance sheet. In addition, setting the internal LAC scalar at 100% in these circumstances would ensure that all the LAC resources raised at the holding company level were downstreamed as LAC – rather than in non-LAC form – thus maximising the resolvability benefit.

PART IV INTERNAL LAC REQUIREMENT Respondents' comments	MA's response
	On the submission that the agreement of any relevant home authority or CMG be required for the calibration of the internal LAC scalar, it is not appropriate that powers set out in Hong Kong legislation be constrained in this way. However, in calibrating the internal LAC scalar, the MA fully expects to act in close co-ordination with any relevant home authority and/or CMG.
3. One respondent submitted that in assessing whether the material subsidiary of a non-EME G-SIB should be subject to a LAC requirement, consideration should be given to whether, were it a standalone entity, it would have a LAC requirement. And one respondent submitted that if a D-SIB would not be required to comply with a LAC requirement, there should be a presumption that a similarly-sized G-SIB subsidiary should not be required to meet an internal LAC requirement, in the interests of maintaining a level playing field.	The principle underpinning the proposals on LAC requirements set out in the CP is that LAC requirements should only be imposed (i) where they are necessary to improve resolvability where the non-viability of a relevant AI could pose a risk to the stability and effective working of the financial system in Hong Kong; or (ii) on a material subsidiary that is in a resolution group, to support the implementation of a resolution strategy. The MA's existing view is that neither of the two submissions put forward here would lead to a more efficient imposition of LAC requirements, but they would lead to increased complexity. The MA does not therefore intend to implement either of them.
4. Several respondents raised questions on the issue of non-pre-positioned LAC (see footnote 73 of the	The MA is not proposing to set out detailed requirements in the AI LAC Rules on either the management of non-pre-positioned LAC or the treatment of any mismatches between internal

PART IV INTERNAL LAC REQUIREMENT	
Respondents' comments	**MA's response**
CP), suggesting that it should be made available for commercial purposes, and asking whether the MA was considering introducing requirements on the management of non-pre-positioned LAC. One respondent also sought clarification on the treatment of any mismatches between internal and external LAC, proposing that AIs should be given flexibility to manage their funding efficiently. Another respondent sought examples of such mismatches.	and external LAC. However, this does not mean that AIs will be able to deploy any non-pre-positioned LAC as they see fit, without consideration as to the impact on resolvability. The MA intends to issue further guidance in due course on the approach that AIs will be expected to take in the management of non-pre-positioned LAC. (Note also that the intention is that the AI LAC Rules will set out that the quantity and availability of non-pre-positioned LAC is one of the factors that the MA may take into account in considering whether to reduce the solo LAC scalar to below 100%.) An example of how such mismatches could arise and prove problematic is set out in paragraph 123 of the CP.
5. More clarity was sought on the way in which PONV triggers would be designed and then activated. In particular, more detail was requested on the circumstances in which internal LAC may be required to be written-down only or converted only (and the justification for this), and on the criteria that the MA would use in making a PONV determination. One respondent sought confirmation that the home authority would take	The MA's existing view is that the design and activation of PONV triggers in LAC debt instruments should be modelled on the approach in Schedules 4B and 4C to the BCRs for Additional Tier 1 and Tier 2 capital instruments, subject to appropriate adjustments. Taking this approach will have the advantage of using an existing mechanism with which AIs are already familiar. Detailed provisions will be set out in the AI LAC Rules when they are published for industry consultation. Note that in making a PONV determination for non-capital internal LAC debt instruments, however, the MA would expect to refer to section 5 of the FIRO which sets out when an AI ceases to be viable.

PART IV INTERNAL LAC REQUIREMENT	
Respondents' comments	**MA's response**
the lead in matters of cross-border co-ordination, and respondents also suggested a longer timeframe (two respondents proposed 48 hours) than that set out in the CP (paragraph 95, footnote 83). One respondent suggested that at PONV, the MA should have the flexibility to write down / convert into equity only a portion of an entity's LAC debt instruments, if partial write-down / conversion would provide sufficient loss-absorbency and recapitalisation resources. This respondent also suggested that the MA should provide advance notice to the issuer and holder of internal LAC debt (as well as to any relevant home authority) of the MA's intention to trigger, and that if within 24 hours of such notice the holder contributes sufficient assets to the issuer, the MA would not be able to trigger the internal LAC debt.	The MA proposes that the AI LAC Rules will allow 24 hours for a response from a home authority in respect of a proposed trigger activation for internal LAC debt instruments. This reflects that fact that as the financial condition of an AI deteriorates, the need for rapid action may not allow for a longer timeline. However, should a cross-border AI for which the MA was host authority come under stress and the possibility of there being a need to trigger internal LAC increase, the MA would fully expect to be co-ordinating closely with the relevant home authority. Notwithstanding the identification of a minimum specified timeframe in the AI LAC Rules, should time allow, the MA would in any case aim to notify the home resolution authority in advance of formally providing notice of the intention to trigger internal LAC debt instruments. On the suggestion that the MA provide advance notice to the issuer and holder of internal LAC debt before triggering, the MA's existing view is that this should not be provided for in the AI LAC Rules. As the financial position of an issuer of internal LAC debt deteriorates, the MA would in any case expect any holder of such debt to be co-ordinating with the issuer, the MA and any relevant home authority to attempt to recover the position of the issuer without the need for the internal LAC debt to be triggered.
6. One respondent submitted that internal LAC	Making provision in the AI LAC Rules for internal LAC requirements for entities classified as

PART IV INTERNAL LAC REQUIREMENT	
Respondents' comments	**MA's response**
requirements (and minimum debt requirements) did not make sense for service companies – instead, operational continuity or other alternative arrangements should be developed in detail for such companies.	material subsidiaries, which could include affiliated operational entities such as service companies, does not imply that such companies would necessarily be classified as material subsidiaries (leading to them being required to comply with a minimum LAC requirement). Each case will be judged on its merits; where such a classification and attendant LAC requirement are unwarranted, the classification will not be made.
7. Two respondents submitted that internal LAC should be allowed to be issued outside the chain of ownership, or outside of the resolution group, to allow for more efficient funding.	Requiring internal LAC to be issued (directly or indirectly) within a resolution group up to the resolution entity is fundamental to the mechanism through which losses are passed up to the entity within a resolution group that has issued external LAC (i.e. the resolution entity), and so out of the group. Where a banking group determines that it is more efficient to issue external LAC from multiple entities, then in principle it is open to that group to organise its structure and its businesses in such a way that it is resolvable under an MPE resolution strategy.

PART V TIMELINE FOR MEETING LAC REQUIREMENTS	
Respondents' comments	**MA's response**
1. On timing of implementation of LAC requirements, a number of respondents mentioned that the MA should consider phasing in the requirements to avoid a glut of LAC debt	The MA's present intention is to classify resolution entities and material subsidiaries of non-EME G-SIBs on a timetable requiring them to meet the minimum FSB TLAC requirements in 2019. The expectation is that other relevant entities will be classified as resolution entities and material subsidiaries by 1 January 2020, and so will need to meet their respective LAC requirements by 1

PART V TIMELINE FOR MEETING LAC REQUIREMENTS	
Respondents' comments	**MA's response**
instruments coming to the market within a short period of time.	January 2022 (i.e within 24 months of classification). See paragraph 7 above. However, ahead of formal classification, the MA expects to provide AIs with indications of which entities will be classified, and indications of the MA's thinking on key determinations that will affect LAC calibration (for example, variations to the resolution component ratio or the internal LAC scalar). The MA's existing view is that this timeline will provide issuers with sufficient flexibility to allow them to issue LAC to a timetable that would not strain market capacity.
2. More generally, the point was made that requirements should not be imposed too quickly – one respondent submitted that AIs that were not G-SIBs or D-SIBs should have 48 months to meet their requirements (rather than the 24 months proposed in the CP), or should not have to meet requirements any earlier than 1 January 2022. One respondent said that for G-SIBs, implementation timelines should be agreed with CMGs, and two respondents said that the FSB's	The MA's thinking on the implementation timeline for LAC requirements is set out in paragraph 7 above. Note that on this timeline, apart from non-EME G-SIBs, no AIs would be required to meet any LAC requirements before 1 January 2022. The MA acknowledges that in light of the fact that the AI LAC Rules will not be in force any earlier than around the end of this year, meeting the FSB's deadline of 1 January 2019 may present challenges for the affected non-EME G-SIBs, which is why the current planning assumption is that relevant entities will not be required to begin complying with LAC requirements until three months after their classification as resolution entities or material subsidiaries (as applicable).

PART V TIMELINE FOR MEETING LAC REQUIREMENTS	
Respondents' comments	**MA's response**
timeline of 1 January 2019 for non-EME G-SIBs would be challenging.	
3. Several respondents questioned the proposal that resolution entities and material subsidiaries that were AIs should also be required to meet their respective LAC requirements on a solo basis (as well as on a consolidated basis).	Resolution entities and material subsidiaries that are AIs need to meet regulatory capital requirements on a solo (or solo-consolidated) basis. It follows from this that they should also be required to meet LAC requirements on the same basis, so that should they suffer losses that wipe out their regulatory capital requirements, they have sufficient remaining LAC to be recapitalised, allowing them to again meet their regulatory capital requirements on a solo basis in resolution. However, the MA acknowledges that in some circumstances requiring an AI to meet its LAC requirement on a solo basis may limit flexibility in the application of the proceeds of LAC issuance. The MA therefore proposes that while the AI LAC Rules should require AIs to meet LAC requirements on a solo basis, the MA should have the power to vary down the solo requirement, should the MA consider it prudent to do so in the circumstances, by reducing the solo LAC scalar to less than 100%. The MA's present intention is that the AI LAC Rules will set out the following factors that the MA may take into consideration in the calibration of the solo LAC scalar: (i) the extent to which setting the scalar at 100% would result in the entity having to maintain a higher level of loss-absorbing capacity than that required to meet its LAC requirements on a consolidated basis; (ii) the extent to which setting the scalar at 100% would impact on the quantity and availability of non-pre-positioned LAC; and (iii) any other matters the

PART V TIMELINE FOR MEETING LAC REQUIREMENTS	
Respondents' comments	**MA's response**
	MA considers relevant.
4. Differing views were expressed on the period within which AIs should be required to respond to an increase in LAC requirements – one respondent thought the proposed 12 months may be workable, another said the period should be 24 months, to be consistent with the proposed grace period for rectifying breaches of LAC requirements.	The MA's existing view is that requiring any increase that arises as a result of the exercise by the MA of a power of variation under the AI LAC Rules to be met within 12 months is appropriate, as it could be anticipated that increases are likely to be relatively small in comparison to the overall LAC requirement. It is intended that this conformance period will be effected by requiring the MA to give 12 months' notice of any such increase. Where the MA thought necessary, the MA would be able to provide a longer notice period.
5. Two respondents asked how AIs would be able to observe LAC requirements on an ongoing basis, when RWAs and the exposure measure are constantly changing. Clarity was also sought on whether an exemption would be allowed for when RWAs / exposure measure increased significantly in relation to, for example, an IPO financing.	The issues AIs face in complying with LAC requirements on an ongoing basis when RWAs and the exposure measure are constantly changing are comparable to those faced in complying with regulatory capital requirements on an ongoing basis. Accordingly, the MA's expectation is that resolution entities and material subsidiaries should be able to manage the issue for LAC requirements as they do for regulatory capital requirements. Consistent with the TLAC holding standard issued by the Basel Committee on Banking Supervision in October 2016, the HKMA's consultation paper CP18.03 'Implementation of TLAC Holdings Standard' proposed to make available an additional 5% exemption for a bank's 'TLAC holdings',

PART V TIMELINE FOR MEETING LAC REQUIREMENTS	
Respondents' comments	**MA's response**
	primarily in order to facilitate market-making activities. Under the proposal, any amount of TLAC holdings that is within the threshold is allowed to be risk-weighted (instead of being deducted from capital).

PART VI LAC ELIGIBILITY CRITERIA	
Respondents' comments	**MA's response**
1. Two respondents sought more detail on exactly what features would lead to an instrument being characterised as derivative-linked. In particular, clarity was sought that debt instruments with early holder redemption options, early issuer call options or variable interest rates would not be so considered.	The MA's proposal is that an instrument would be characterised as being derivative-linked where the value of the liability represented by the instrument fluctuates by reference to the value of, or any fluctuation in the value of, one or more than one underlying asset, index, financial instrument, rate or thing designated in the instrument, or the instrument otherwise has derivative-linked features, subject to an instrument not being so characterised only because a coupon on the instrument is calculated with reference to a reference rate. The MA's existing view is that on this approach, an instrument could not be characterised as being derivative-linked simply as a result of having a holder redemption option or an issuer call option. However, as set out in the CP, it is the MA's intention that for the purposes of determining eligibility, the maturity of an instrument which includes a holder redemption option would be determined by reference to the earliest possible date on which redemption can be sought. In addition, it is the MA's present intention that (following Schedule 4C to the BCRs) if

PART VI LAC ELIGIBILITY CRITERIA Respondents' comments	MA's response
	an instrument includes a call option, in order for the instrument to be eligible as LAC the option can only be exercised with the prior consent of the MA, and the issuer must not have done anything to create an expectation at issuance that the call option will be exercised.
2. One respondent submitted that the statutory creditor hierarchy be amended to rank LAC debt instruments below other liabilities, and sought clarity on the purpose of paragraph 113(iii)(k) in the CP (and whether it would apply to internal LAC, and if so, why), which proposes that LAC debt instruments contain language recognising the FIRO's statutory bail-in power.	The FSB TS discusses three categories of subordination, namely contractual, statutory and structural. The CP proposes (paragraph 113(iii)(h)) that non-capital LAC debt instruments must be either contractually subordinated or structurally subordinated. As such, there is no need for them to also be statutorily subordinated by amending the statutory creditor hierarchy. The primary purpose of the proposal in paragraph 113(iii)(k) is to promote disclosure and transparency. There are benefits to simplifying the identification of both internal LAC instruments and external LAC instruments, hence this proposal applies to both.
3. One respondent asked for further clarity on what additional criteria the MA might require for eligibility, in addition to those listed in the CP (paragraphs 118 and 119).	The primary purpose of the proposals raised in paragraphs 118 and 119 of the CP is not to impose additional eligibility criteria on LAC debt instruments, but rather to allow the MA to call for evidence of eligibility, and, if necessary, to determine that an instrument is ineligible because the imposition of losses on it may undermine orderly resolution.
4. Two respondents said that as contemplated in the FSB TS, provision should be made for substitution	The FSB TS does not *require* that internal LAC can be substituted with collateralised guarantees, but rather notes that home and host authorities may jointly agree to substitute on-balance sheet

PART VI LAC ELIGIBILITY CRITERIA	
Respondents' comments	**MA's response**
of internal LAC with collateralised guarantees. This would alleviate the problem faced by primarily deposit-funded banks who would otherwise have to add more assets (and so more risks). One respondent submitted that it should be acceptable for internal LAC debt instruments to not have contractual write-down / conversion provisions where they are supported by a qualified secured support agreement.	internal TLAC with internal TLAC in the form of collateralised guarantees, subject to various conditions. These conditions include that the collateral backing any such guarantee needs to be sufficient to fully cover the amount involved (including following appropriately conservative haircuts), it needs to be unencumbered, and there can be no barriers to transferring the collateral to the material subsidiary. The MA's existing view is that bearing in mind the nature of these conditions, the potential efficiencies that may arise from allowing such substitution are likely to be modest, and in any case are likely to be outweighed by the complexity and risks involved in having assets on the balance sheet of the resolution entity, rather than pre-positioned on the balance sheet of the material subsidiary. As such, the MA does not intend to provide for internal LAC to be substituted with collateralised guarantees or qualified secured support agreements.
5. One respondent requested that the MA consider (i) the interplay of fair value accounting applicable to internal LAC instruments with write-down/conversion clauses; (ii) the accounting which applies to external LAC instruments; and (iii) adverse accounting and fiscal implications. This respondent also suggested that the MA consider the compatibility	The MA's approach is to set out the minimum criteria with which external LAC and internal LAC need to comply (which will be developed from those set out in paragraphs 113 and 115 of the CP). Subject to meeting those criteria, AIs are free to arrange the issuance of LAC instruments to take account of other potential accounting and regulatory treatments as they see fit.

PART VI LAC ELIGIBILITY CRITERIA Respondents' comments	MA's response
of internal LAC with other regulatory requirements, such as the Hong Kong Listing Rules and the Inland Revenue Ordinance.	
6. One respondent thought that paragraph 115(iii)(a) of the CP was potentially counter-productive, as it could allow for internal LAC to be funded by a subsidiary of the issuer – this should not be permissible.	The MA proposes to revise the eligibility criteria in relation to restrictions on funding by the issuer or its affiliates for external LAC debt instruments and internal LAC debt instruments so that (i) for external LAC debt instruments, the instrument cannot be funded or guaranteed directly or indirectly by the issuer or another entity that is in the same resolution group as the issuer, unless the MA has agreed in writing that the instrument being so funded or guaranteed is not inconsistent with the relevant preferred resolution strategy; and (ii) for internal LAC debt instruments, the instrument cannot be funded or guaranteed directly or indirectly by the issuer or any subsidiary of the issuer, unless the MA has agreed in writing that the instrument being so funded or guaranteed is not inconsistent with the relevant preferred resolution strategy. The difference between (i) and (ii) reflects the fact that internal LAC is designed to be funded by another entity in the same resolution group as the issuer.
7. It was acknowledged that having a clean holding company for an AI may increase resolvability, but that this would likely depend on the specific resolution strategy. One respondent asked for more detail on what constitutes a clean holding	Drawing in part on section 11 of the FSB TS, the intention is that a 'clean holding company' will be defined as one: (i) the activities of which are limited to (a) issuing funding instruments; (b) holding funding instruments issued by its subsidiaries; and (c) any related ancillary activities; and (ii) the liabilities of which that do not constitute LAC and that rank equally with or junior to

PART VI LAC ELIGIBILITY CRITERIA	
Respondents' comments	**MA's response**
company.	any items that do constitute LAC, do not exceed 5% of its LAC. Note that a holding company will also need to meet these conditions in order to benefit from debt-like tax treatment of LAC debt instruments as proposed in Part XI of the CP.
8. One respondent sought more detail on exactly what would and would not count as LAC, in particular asking for confirmation of whether items like cumulative fair value gains in Tier 2 capital would count as LAC, and if so whether they would constitute LAC debt for the purposes of the minimum debt requirement. Two respondents asked for clarity on whether instruments that are legally in the form of debt but accounted for as equity would count towards the one-third debt requirement.	It is proposed that the items that will constitute LAC are (i) non-capital debt instruments that meet certain eligibility criteria, including having a remaining contractual maturity of at least 12 months (**LAC eligibility criteria**); and (ii) the total capital of the relevant entity, less any contribution thereto from Additional Tier 1 and Tier 2 capital instruments that do not meet the LAC eligibility criteria. Cumulative fair value gains in Tier 2 capital would therefore constitute LAC. However, the MA intends that LAC liabilities will count towards the minimum debt requirement if and only if the instruments by which they are constituted evidence indebtedness.

PART VII RESTRICTIONS ON THE SALE AND DISTRIBUTION OF LAC DEBT INSTRUMENTS	
Respondents' comments	**MA's response**
1. Generally speaking respondents were fine with the proposal to restrict primary issuance to PIs only. However, the CP also raised the prospect of allowing primary issuance only to those PIs who are not 'retail banking customers'. There was a consensus among respondents who addressed this issue that primary issuance should be allowed to individuals who meet the criteria to qualify as PIs. Respondents commented that prohibiting issuance to 'retail banking customers' that meet the PI criteria would go beyond restrictions in other key financial centres (and anything in the existing regime in Hong Kong), and it would have a negative impact on liquidity and marketability, leading to higher costs and putting Hong Kong AIs at competitive disadvantage. One respondent pointed out that there is no statutory definition of 'retail banking customers', and suggested that no such reference be made.	The MA's view is that appropriate investor protection measures need to be put in place to ensure that investment in external LAC debt instruments is restricted to those who understand the risks that such investments involve, and are able to bear those risks. But the MA also acknowledges that more onerous distribution restrictions could lead to a smaller investor base, and could have a negative impact on liquidity and pricing. On balance, the MA's existing judgement is that the issuance of external LAC debt instruments to all PIs can be permitted, subject to AIs meeting relevant conduct requirements referred to in the following rows of this Part. The MA therefore intends that the AI LAC Rules will set out that in order to be eligible as external LAC, a debt instrument issued in Hong Kong will need to be issued to a PI as defined in section 1 of Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571).

PART VII RESTRICTIONS ON THE SALE AND DISTRIBUTION OF LAC DEBT INSTRUMENTS	
Respondents' comments	**MA's response**
2. Broadly speaking, respondents commented that in principle having a minimum denomination requirement for LAC debt instruments would be acceptable, but all respondents on this question said that HKD 8 million was too high, and would have a negative impact on liquidity and marketability, leading to higher costs and reducing the investor base. Respondents pointed out that it would only apply to Hong Kong issuers, disadvantaging them in both Hong Kong and global markets. Two respondents said that orders below USD 1 million are often placed for these types of instruments, and that internationally comparable minimum denominations are USD 200,000 / EUR 100,000, i.e. around HKD 1-1.5 million. Current market practice among Institutional PIs is to use small denominations to improve transferability, liquidity, and pricing. One respondent made the point that in Hong Kong, the closest comparator	As for the preceding row in this table, in setting a minimum denomination requirement for LAC debt instruments there is a balance that needs to be struck between ensuring that investment in LAC debt instruments is in practice limited to those who understand and are able to bear the risks, and imposing unduly onerous regulatory requirements. On further consideration of this issue, and in light of respondents' feedback, the MA's present intention is to revise the proposal set out in the CP so that external LAC debt instruments denominated in Hong Kong dollars, US dollars, Euros or another currency are required to meet minimum denomination requirements of HKD 2 million, USD 250,000, EUR 200,000 or the equivalent of HKD 2 million in another currency, respectively. The MA therefore intends that the AI LAC Rules will set out that in order to be eligible as external LAC, a debt instrument will need to meet these minimum denomination requirements.

PART VII RESTRICTIONS ON THE SALE AND DISTRIBUTION OF LAC DEBT INSTRUMENTS	
Respondents' comments	**MA's response**
under the existing regime is the minimum denomination of HKD 500,000 needed to gain an exemption from complying with the prospectus requirement specified in the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32). Two respondents said that if a minimum denomination was required, it should not be higher than the equivalent of USD 200,000.	
3. Several respondents expressed the view that further restrictions of the type set out in paragraph 134 of the CP (such as requiring written acknowledgement of risk from every investor, and setting minimum risk ratings for LAC debt instruments) are too onerous, in particular for secondary distribution and for sophisticated customers such as PIs, and would be inconsistent with the approaches followed in other financial centres. (And several respondents said that if written communications on risk with investors	In light of respondents' feedback, and on further consideration of this topic, the MA intends to revise the proposed measures set out in paragraph 134 of the CP so that: (i) offering and product documents for external LAC debt instruments must contain disclosure in respect of (1) risks (including that the instruments are complex and high risk); and (2) selling restrictions, i.e. issuance is permitted to PIs only; (ii) primary and secondary market sale or distribution in Hong Kong of restricted products must be to PIs only; (iii) AIs are required to make adequate disclosure by directing potential investors in any restricted products to the selling restrictions in the offering and product documents, and explaining to them relevant information such as the structure, features and risks of any restricted products;

PART VII RESTRICTIONS ON THE SALE AND DISTRIBUTION OF LAC DEBT INSTRUMENTS	
Respondents' comments	**MA's response**
was to be mandated, it should be one-way only, and on a one-off basis, i.e. not required for every transaction.) It was submitted that the regime for LAC debt instruments should not be any stricter than that currently in place for regulatory capital instruments. Stricter requirements may have a significant negative impact on liquidity and pricing, for very little benefit. Respondents commented that licensed corporations and relevant AIs need to abide by the SFC's Code of Conduct, which provides a robust regime which works well. One respondent proposed that if it was felt that more action was required in respect of LAC debt instruments, the MA / SFC could require relevant AIs / licensed corporations to provide enhanced training to their staff and ensure appropriate risk suitability disclosures, while also conducting detailed monitoring to ensure that proper due diligence is being conducted and that governance frameworks are	(iv) AIs are required to assure themselves that customers who wish to invest in restricted products have adequate knowledge or experience in products with bail-in, contingent convertible or convertible features; (v) AIs who offer non-leveraged investment opportunities in restricted products are required to treat them as of at least high risk, with any leveraged opportunities being treated as of the highest risk, and to assign appropriate product risk ratings accordingly; and (vi) a strong justification would be needed for any risk mis-match transactions. The MA intends that the AI LAC Rules will set out that in order to be eligible as external LAC, the offering and product documents for an instrument must contain the disclosure referred to in (i) above. More generally, it is intended that the investor protection measures set out above will be implemented through the issuance of circulars. It is intended that certain exemptions will be available for transactions involving Institutional or Corporate PIs (see below). For the avoidance of doubt, the MA does not currently intend to restrict the sale or distribution of restricted products in either the primary or secondary markets to PIs who are not retail banking customers, nor to require a written statement from every investor acknowledging that the investor understands and accepts the risks associated with the investment.

PART VII RESTRICTIONS ON THE SALE AND DISTRIBUTION OF LAC DEBT INSTRUMENTS	
Respondents' comments	**MA's response**
being adhered to.	
4. Several respondents said that the proposed description of 'restricted products' could prove problematic, as it would not always be clear what was and was not included. It was suggested that the MA should provide more clarity on which products would and would not count as 'restricted products', and/or that the MA maintain a list of all such products, to provide certainty.	The MA acknowledges that in imposing restrictions on the distribution of restricted products, it is important that market participants are able to clearly identify which products are in scope. The intention is that the AI LAC Rules, and relevant circulars, will clearly identify which products are affected, and the relevant investor protection measures that apply.
5. One respondent sought clarity on the extent to which the requirements proposed in paragraph 134 of the CP – in particular, the provision of offering and product documents, should they not be available – could be waived for transactions involving Institutional or Corporate PIs, and/or in execution only transactions.	The MA's intention is that intermediaries should, where available, provide each client with recommended investment products' up-to-date prospectuses or offering circulars and other up-to-date documents relevant to the investments. Following on from the proposal in paragraph 136 of the CP, it is the MA's present intention that AIs dealing with Institutional PIs be automatically exempt from the requirements set out in (iii), (iv), (v) and (vi) above, while AIs dealing with Corporate PIs could be exempted from the same requirements if they have complied with the procedures required under the SFC's Code of Conduct. In other words, AIs may conduct execution-only transactions for Institutional PIs, and under the aforesaid conditions for Corporate PIs, but not for Individual PIs.

PART VII RESTRICTIONS ON THE SALE AND DISTRIBUTION OF LAC DEBT INSTRUMENTS	
Respondents' comments	**MA's response**
6. Several respondents suggested that the proposals to automatically classify restricted products as 'high risk' or 'highest risk' may not be appropriate, as it would remove the ability to take into account the features of a particular product in determining its risk rating.	The MA regards restricted products as complex and high risk. In addition, the MA's understanding is that AIs already typically classify debts with loss-absorption features as 'high risk'. As such, the MA's view remains that AIs who offer non-leveraged investment opportunities in restricted products should treat them as of at least high risk, with any leveraged opportunities being treated as of the highest risk.
7. One respondent said that any additional restrictions should not apply to instruments that are already in issue, as the risks are already understood.	The MA does not accept the view that simply because instruments are in issue, it can be assumed that the risks are already fully understood. However, the MA does accept that the requirements above that it is intended will be included in the eligibility criteria for external LAC instruments (i.e. issuance in Hong Kong must be to PIs, they must meet minimum denomination requirements, and their offering and product documents must contain certain disclosures) should not apply to instruments already in issue when the AI LAC Rules come into operation. Were these requirements not to be disapplied, there would be no way for AIs to make such instruments compliant (short of redeeming them and issuing new instruments). However, the investor protection measures described above (including sale and distribution to PIs only) should apply to any future secondary market sale or distribution of restricted products that are already in issue when the AI LAC Rules come into operation.

PART VIII TREATMENT OF LAC INVESTMENTS	
Respondents' comments	**MA's response**
1. One respondent said that notwithstanding the BCBS TLAC holdings standard, external LAC and internal LAC should both be deducted from LAC (not capital). Another respondent made the general point that deducting LAC holdings from regulatory capital is unnecessary and difficult to calculate; the risk is already adequately addressed by risk-weighting.	Generally speaking, the MA does not agree that holdings of external LAC should be deducted from LAC, rather than from capital. This could lead to increased contagion risk, and would be inconsistent with the BCBS TLAC holdings standard. See consultation paper CP18.03 'Implementation of TLAC Holdings Standard' issued by the HKMA in April this year. The MA agrees, however, that holdings of internal LAC should be deducted from LAC, but with no materiality thresholds.
2. One respondent said that at the very least deductions from LAC rather than capital should apply for intragroup external LAC (issued between resolution groups within one banking group) and internal LAC. One respondent also said there should be a material holdings threshold below which deductions would not be made, that long and short positions should be netted out, with only the net amount being subject to deduction, and that there should be an exception for	On further consideration, where an AI holds non-capital LAC liabilities issued by an entity in a different resolution group but in the same banking group as the holding AI, the MA's view is that such instruments should be deducted in the same way as for internal LAC, i.e. first from the holder's own non-capital LAC, and then from the holder's regulatory capital, with no deduction thresholds.

PART VIII TREATMENT OF LAC INVESTMENTS	
Respondents' comments	**MA's response**
market-making.	

PART IX MINIMUM DEBT REQUIREMENT	
Respondents' comments	**MA's response**
1. Several respondents said that the minimum debt requirement was unnecessary, and that among other things it would limit AIs' flexibility in deciding how to fund their LAC, would incentivise the issuance of lower quality LAC and, depending on the prevailing capital position of an AI, could prove costly.	The advantage of LAC that is in the form of debt as opposed to equity is that LAC in the form of debt is not at risk of depletion before failure, and provides a known quantity of loss-absorbency and recapitalisation resource in excess of going concern capital. As debt is typically cheaper to raise than equity, and in addition has a tax advantage over equity, meeting LAC requirements with debt rather than equity will often prove less expensive for an AI. The MA acknowledges that this will not invariably be the case, depending on an AI's initial capital structure, but the MA's current view is that AIs should be able to mitigate additional costs, in particular in light of the long lead-in time described above. Where this requirement does impose some additional costs on issuers, the MA's view is that by improving the resolvability of AIs, there are net benefits to financial stability and the wider economy.
2. One respondent said that while a minimum debt requirement may be acceptable for external LAC requirements, it should not be transposed to internal LAC requirements. Unlike for external	The MA's existing view is that the rationale set out above on the benefits of a minimum debt requirement applies to internal LAC as well as to external LAC.

PART IX MINIMUM DEBT REQUIREMENT Respondents' comments	MA's response
LAC, the equity and debt holder of internal LAC may be the same entity, minimising the need for a minimum debt requirement.	
3. One respondent said that at a minimum the factors that should be taken into account when considering whether to vary down the minimum debt requirement for internal LAC should include any home authority TLAC requirements, and considerations of the imposition of any minimum debt requirement should be conducted in consultation with any relevant home authority. Another respondent was doubtful about the need for the one-third minimum debt requirement, and sought more clarity on the circumstances in which it would be varied down.	The MA's view is that the one-third minimum debt requirement is a valuable element of the proposed LAC regime, which should only be varied down in limited circumstances. The MA's present intention is that the AI LAC Rules will set out the following factors that the MA may take into account in any consideration of whether to vary down the minimum debt requirement: (i) the total capital of the resolution entity or material subsidiary; (ii) the preferred resolution strategy covering the resolution entity or material subsidiary; and (iii) any other matters the MA considers relevant. More guidance on this will also be included in the AI LAC COP.
4. Two respondents said that a minimum debt requirement would be particularly onerous for	The MA acknowledges that in certain limited circumstances imposing a one-third minimum debt requirement on smaller AIs may be more onerous than for larger AIs that may in any case choose

PART IX MINIMUM DEBT REQUIREMENT	
Respondents' comments	**MA's response**
small AIs as it would require them to issue debt even though they may not be recognised names in the market, implying a higher cost. Further, it would force smaller banks to increase their reliance on wholesale debt funding at the expense of deposits, weakening the deposit franchise of already small banks.	to fund a portion of their balance sheet with debt. However, LAC debt can make an important contribution to improving the resolvability of smaller AIs, as it can for larger AIs. The requirement that one third of LAC requirements be met with LAC debt strikes a balance between on the one hand AIs' capital requirements and the importance of AIs having significant going concern capital on their balance sheets, and on the other hand the benefits of LAC debt, as described above.

PART X REPORTING, DISCLOSURE, PROCEDURE AND REVIEWS	
Respondents' comments	**MA's response**
1. Two respondents sought more information on the frequency with which disclosures would be required to be made, with one respondent proposing alignment with the current requirement for capital disclosures.	In light of this feedback, and in order to ensure that the disclosure requirements are well aligned with international standards, the MA intends to revise the proposed approach on disclosures set out in the CP. In particular, the MA intends to insert provisions in the AI LAC Rules modelled on sections 6, 8, 9, 10 and 15 of the BDRs. These include a provision (section 6(1)(ab) of the BDRs) for the details of required disclosures to be set out in templates or tables specified by the MA. The MA therefore intends that the AI LAC Rules will describe at a high level the nature and frequency of disclosure that will be required, modelled on five relevant templates from the BCBS's March 2017 publication on *Pillar 3 disclosure requirements – consolidated and enhanced*

PART X REPORTING, DISCLOSURE, PROCEDURE AND REVIEWS	
Respondents' comments	MA's response
	framework.[12] The MA then intends to develop (with industry consultation) templates setting out the details of the required disclosures, with the templates under the AI LAC Rules modelled on those five templates published by the BCBS.
2. One respondent said that disclosure should be required on a consolidated basis only, not also on a solo basis.	Following the approach described in the preceding row in this table, the MA intends that the basis on which disclosure should be required should broadly follow that set out in the relevant templates published by the BCBS.
3. One respondent said that all the determinations listed in paragraph 165 – in particular the calibration of the internal LAC scalar (this point was supported by another respondent) – should be subject to review by the RRT. Two respondents submitted that an opportunity to make representations should be made available in respect of determinations of relevant legal entities as contemplated in paragraphs 45(ii) and 45(iv) of the CP.	The MA's view is that it is not appropriate for all of the determinations listed in paragraph 165 in the CP to be subject to review by the RRT. The impact of the various determinations differs, and adopting a similar approach to that used in connection with the BCRs, the right to apply for review by the RRT is intended to be reserved for the more important, far-reaching determinations. Affected entities will in any case be given the opportunity to make representations in respect of all of the determinations. Accordingly, the MA continues to hold the view that of the determinations discussed in the CP, those that should be subject to review by the RRT are any variation of the resolution component ratio, and any direction to take remedial action.

[12] https://www.bis.org/bcbs/publ/d400.htm The five relevant templates are KM2, CCA, TLAC1, TLAC2 and TLAC3.

PART X REPORTING, DISCLOSURE, PROCEDURE AND REVIEWS	
Respondents' comments	**MA's response**
	However, on further consideration, the MA's current view is that following classification as a resolution entity or material subsidiary, or where an increase in a Pillar 2A requirement leads to an increased resolution component ratio, an affected entity should have the opportunity to request a reduction in its resolution component ratio. It is proposed that a decision by the MA not to accede to such a request should also be subject to review by the RRT. Note that as described above, the MA is proposing to revise the approach described in paragraph 45 of the CP so that each resolution entity and material subsidiary now has a LAC consolidation group, which is based on its capital consolidation group, subject to variation by the MA. The MA's present intention is that where the MA intends to use the power to vary a LAC consolidation group, the affected entity should have the opportunity to make representations, as described in paragraph 165 of the CP.

PART XI TAX TREATMENT OF LAC DEBT INSTRUMENTS	
Respondents' comments	**MA's response**
1. Two respondents said that the loan and interest tracing requirements set out in sections 17F(2) and 17F(3) of the IRO can present difficulties for global banking groups which channel funding	Section 17F of the IRO is a specific anti-avoidance rule under which interest deduction will be allowed if the money paid for the issue of a regulatory capital security (**RCS**) held by specified connected persons is funded by an external issuance of RCS, debenture or debt instrument. The rule would not be applied to deny deduction of payments made in relation to an RCS for genuine

PART XI TAX TREATMENT OF LAC DEBT INSTRUMENTS	
Respondents' comments	**MA's response**
from a group holding company to multiple operating banks in different jurisdictions, due to the fungibility of funds and other market and regulatory considerations. It was suggested that these requirements be eliminated, or that the relevant Departmental Interpretation and Practice Note (**DIPN**) of the Inland Revenue Department (**IRD**), namely DIPN 53, be amended to address this issue.	commercial reasons. Whether the money paid for the issue of an RCS is funded through an external issuance is a question of fact, determined on a case-by-case basis. Accordingly, it is considered that no amendments to sections 17F(2) and 17F(3) are needed at this stage.
2. Three respondents also submitted that the amendments to the IRO should be retrospectively effective, to ensure that where AIs start issuing LAC debt instruments ahead of any implementation deadline, those instruments also benefit from debt-like tax treatment.	It is acknowledged that AIs will need to start issuing LAC debt instruments ahead of any implementation deadline. In taking forward the AI LAC Rules and the IRO LAC Amendment Bill, the present intention is to reduce the chance of any sequencing issues leading to increased tax liabilities for issuers. On the MA's current planning assumptions (which remain subject to change), no classifications of resolution entities or material subsidiaries will be made until both the AI LAC Rules and IRO LAC Amendment Bill have come into operation.
3. Two respondents sought confirmation that should losses be suffered on investments in LAC debt instruments, provision would be made for	For profits tax purposes, pursuant to section 19D of the IRO, assessable profits and losses are computed and treated in the same manner. Therefore, profits or losses arising from LAC debt instruments are treated as taxable profits or allowable losses if they fall within the ambit of the

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tax deductions to be claimed. And clarification was sought on whether profits and losses on LAC debt instruments would be assessed on a marked-to-market basis for profits tax purposes.	relevant provisions. Consistent with the IRD's current interim administrative measure for accepting computation of profits tax in respect of financial instruments for recent years of assessment on a fair value basis, the intention is that a marked-to-market profit or loss (as the case may be) derived by a taxpayer (except for certain connected persons of the issuer of a LAC debt instrument) from a LAC debt instrument will be taxed or allowed (as the case may be) for profits tax purposes as for other financial instruments. Regarding section 17D(2) of the IRO, the legislative intent is that fair value accounting is not applicable in relation to RCS held by certain connected persons of the issuer including those who are chargeable to profits tax in Hong Kong.
4. Two respondents submitted that the provisions for LAC debt instruments in the IRO should be separate from the existing provisions for RCS, and not overlapping.	The drafting of the IRO LAC Amendment Bill will reflect the policy intent.
5. Two respondents emphasised the need to have a workable definition of 'clean holding	As set out in the responses to Part VI above, the intention is that a 'clean holding company' will be defined as one:

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company'.	(i) the activities of which are limited to (a) issuing funding instruments; (b) holding funding instruments issued by its subsidiaries; and (c) any related ancillary activities; and (ii) the liabilities of which that do not constitute LAC and that rank equally with or junior to any items that do constitute LAC, do not exceed 5% of its LAC.
6. Two respondents sought clarification that section 17D(2) of the IRO – which disregards accounting fair value changes for RCS/LAC debt instruments issued to a 'specified connected person' of the issuer – would also apply to a 'connected person' of the issuer, in order to avoid a tax mismatch between the 'connected person' and the issuer, given that any fair value change of the issuer is disregarded under section 17C(2) of the IRO.	The policy intent is that section 17D(2) of the IRO which disregards accounting fair value changes on RCS/LAC debt instruments will also apply to a 'connected person' of the issuer who is chargeable to profits tax in Hong Kong to avoid a tax mismatch between the 'connected person' and the issuer of the RCS/LAC debt instruments. Similarly, sections 17D(3) and (4) are also intended to apply to such a connected person.
7. Two respondents submitted that debt-like tax treatment should also apply to LAC debt instruments issued by affiliated operational entities. This is because under the proposals set	It is acknowledged that where affiliated operational entities are required to meet LAC requirements, they may be disadvantaged from a tax perspective if LAC debt instruments they issue are not afforded debt-like tax treatment on the same basis as AIs and clean holding companies. It is therefore proposed that in such circumstances, debt-like tax treatment would be

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out in the CP such entities can be classified as resolution entities or material subsidiaries, and they can therefore be required to meet LAC requirements.	afforded in relation to LAC debt instruments issued by affiliated operational entities which are classified by the MA as a resolution entity or a material subsidiary and thus subject to a LAC requirement while interests, gains or profits derived from LAC debt instruments made by such affiliated operational entities would be assessed as trading receipts and hence be brought into the scope of chargeable profits, on the same basis as for clean holding companies. Given that the proposed tax treatment with respect to LAC debt instruments for clean holding companies and affiliated operational entities, in each case subject to a LAC requirement, are the same as the treatments for "financial institutions" (defined under the IRO), as a consequential amendment, the intention is that such clean holding companies and affiliated operational entities will be carved out from the corporate treasury centre regime in the same way as for financial institutions. In addition, it is acknowledged that an AI which is incorporated outside Hong Kong may be required to issue instruments under a LAC-equivalent requirement of a non-Hong Kong jurisdiction. In such circumstances, the intention is to also afford debt-like tax treatment for those LAC-equivalent instruments.
8. One respondent suggested that issuers of internal LAC debt instruments should be allowed	The LAC eligibility criteria are proposed with a view to ensuring that LAC debt instruments are capable of absorbing losses at the PONV of the resolution entity or material subsidiary (or if such

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to tailor the terms and conditions to ensure favourable treatment for US federal tax purposes.	an entity is not an AI, the relevant AI). An example of the terms and conditions suggested by the respondent, namely covenants providing for acceleration rights based upon the issuer's insolvency or payment default for 30 days or more, could undermine the loss-absorbing characteristic of LAC debt instruments (and would be inconsistent with the approach taken in section 1(f) of Schedule 4C to the BCRs, in relation to Tier 2 capital instruments). Therefore, the MA does not intend to allow LAC debt instruments, be they internal or external, to contain terms and conditions in this regard. More generally, the appropriate US tax treatment of instruments held by persons subject to US tax is a matter for the US tax authorities.