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Implementation of TLAC Holdings Standard

HONG KONG MONETARY AUTHORITY
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I INTRODUCTION

1 Overview

1 In November 2015, the Financial Stability Board ("**FSB**") published a set of *Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution* together with a *Total Loss-absorbing Capacity (TLAC) Term Sheet* prescribing minimum TLAC requirements for global systemically important banks ("**G-SIBs**")[1]. For the purpose of preparing to implement this FSB standard in the context of the local resolution regime, the Hong Kong Monetary Authority ("**HKMA**") in turn issued, in January 2018, a consultation paper (CP 18.01) setting out proposals for the making of a set of rules under the Financial Institutions (Resolution) Ordinance (Cap. 628 of the Laws of Hong Kong) prescribing loss-absorbing capacity ("**LAC**") requirements for authorized institutions ("**AIs**") in Hong Kong ("**AI LAC Rules**")[2]. The consultation on CP 18.01 closed on 16 March 2018 and the HKMA will finalise the relevant policy proposals having regard to the comments received during the consultation.

2 As discussed in CP 18.01 (Part VIII), the Basel Committee on Banking Supervision ("**BCBS**") published in October 2016 a final standard on "*TLAC holdings*"[3] to specify the regulatory capital treatment of banks' holdings of TLAC instruments ("**the BCBS standard**"). The treatment builds on the corresponding deduction approach for regulatory capital instruments held by banks under Basel III.

3 The BCBS standard is scheduled to take effect at the same time as the minimum TLAC requirement for most G-SIBs becomes effective under the FSB standard, viz., 1 January 2019.

4 This consultation paper outlines the HKMA's proposals for implementing the BCBS standard locally in Hong Kong. It should be noted that in devising the proposals in this consultation paper, the HKMA has had regard to the related proposals in CP 18.01. Pending finalisation of the policy proposals in CP 18.01 therefore, some adjustments to the proposals in this consultation paper may be necessary. The

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[1] These documents can be accessed at http://www.fsb.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf

[2] See Consultation Paper on "Rules on Loss-Absorbing Capacity Requirements for Authorized Institutions" issued by the HKMA in January 2018, which can be accessed at http://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/resolution/LAC_CP_ENG.pdf

[3] The document can be accessed at https://www.bis.org/bcbs/publ/d387.pdf

HKMA will continue to engage with the industry in relation to any such future adjustments.

5 The HKMA invites comments on the proposals in this consultation paper by **28 May 2018**.

2 Structure of this Consultation Paper

6 The HKMA's proposals for the local implementation of the BCBS standard are set out in the following two sections of this consultation paper:

(i) Section II contains proposals on:

(a) the scope of application for the BCBS standard in terms of both (i) investing AIs and (ii) the instruments in which they invest;

(b) the deduction approach for TLAC holdings (together with the operation of exemption thresholds);

(c) the treatment of intragroup investments in TLAC within a banking group; and

(d) the interaction of TLAC requirements with capital buffers.

For each of these topics, the relevant requirements in the BCBS standard will first be outlined briefly before the corresponding local implementation proposals are set out.

(ii) Section III sets out the proposed timeline and step by step work plan for implementation.

II THE TLAC HOLDINGS DEDUCTION FRAMEWORK

1 Scope of application

1.1 BCBS standard

7 According to the BCBS standard, an investing bank (whether a G-SIB or a non-GSIB) must deduct its holdings of instruments issued by other G-SIBS that constitute TLAC holdings from its own Tier 2 capital. For the purpose of better limiting contagion in the banking system, the term "TLAC holdings" (also referred to as "other TLAC liabilities") is defined under the BCBS standard to encompass all direct, indirect and synthetic holdings, not only of instruments that are actively being recognised by the issuing G-SIB as external TLAC and are not in the form of regulatory capital instruments, but also of instruments ranking pari passu with those recognised instruments that meet the subordination criteria specified under the FSB TLAC Term Sheet[4]. The intended coverage of other TLAC liabilities for capital deduction is illustrated at **Annex**. For instruments recognised as external TLAC by virtue of the exemptions to the subordination criteria set out in the antepenultimate and penultimate paragraphs of Section 11 of the FSB TLAC Term Sheet, investing banks must determine the amount of their TLAC holding based on the latest disclosure made by the G-SIB issuing the relevant instrument. The exemptions to the subordination criteria allow G-SIBs to recognise, as external TLAC, "senior" liabilities ranking pari passu with "excluded liabilities"[5] and meeting the eligibility criteria for TLAC (other than subordination) on the following bases:

(i) for G-SIBs incorporated in jurisdictions in which all excluded liabilities are statutorily excluded from the scope of the bail-in resolution tool, all liabilities ranking pari passu with such excluded liabilities can be recognised as external TLAC, provided they are included within the scope of bail-in and otherwise meet the eligibility criteria for TLAC (other than subordination); and

[4] These refer to instruments that satisfy any one of the subordination criteria set out under the second paragraph or the "de minimis" criteria in the third paragraph (e.g. liabilities not exceeding 5% of the resolution entity's eligible external TLAC) of Section 11 of the FSB TLAC Term Sheet.

[5] These are liabilities which are excluded from recognition as TLAC as specified in Section 10 of the FSB TLAC Term Sheet.

(ii) for G-SIBs incorporated in jurisdictions where the resolution authority may (under exceptional circumstances specified in the applicable resolution law) exclude, or partially exclude, all excluded liabilities from the scope of the bail-in resolution tool, a certain portion of the G-SIBs' liabilities[6], ranking pari passu alongside these excluded liabilities, may be permitted by the relevant authorities to be recognized as external TLAC.

8 Where issuing G-SIBs rely on the subordination exemptions in (i) or (ii) above in maintaining their external TLAC requirements, they must publicly disclose the relevant amount of external TLAC instruments issued thus exempted. Those applying the capped exemption described in (ii) must also disclose the percentage of their funding ranking pari passu with excluded liabilities that is eligible to be recognized as external TLAC under the exemption and the amount that is in fact being recognized as such. Where this capped exemption is used, an investing bank's holding of the issuing G-SIB's instruments will be subject to a proportionate deduction approach. The proportion to be deducted is calculated as (a) the amount of the issuing G-SIB's funding that ranks pari passu with excluded liabilities and that is actually recognized by the G-SIB as external TLAC divided by (b) the total amount of the funding issued by the G-SIB that ranks pari passu with excluded liabilities and that would be recognized as external TLAC if there were no subordination criteria.

9 The BCBS standard is scheduled to take effect from 1 January 2019 for banks' investments in G-SIBs' external TLAC except for those G-SIBs whose headquarters are in Emerging Market Economies ("**EME**") as referred to in Section 21 of the FSB TLAC Term Sheet. In relation to banks' investments in external TLAC issued by G-SIBs headquartered in EMEs, deduction of the investments under the BCBS standard will commence on a later date to coincide with the date upon which the minimum TLAC requirements for such EME G-SIBs take effect under the FSB TLAC Term Sheet[7].

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[6] According to Section 11 of the FSB TLAC Term Sheet, the recognition can be of a quantum equivalent to up to 2.5% of a bank's risk-weighted assets (RWA) when the bank's minimum TLAC requirement under the Term Sheet calculated by reference to its RWA is 16% and up to 3.5% RWA when the TLAC RWA minimum is 18%.

[7] Section 21 of the FSB TLAC Term Sheet provides for G-SIBs headquartered in EMEs, which are designated as G-SIBs by end-2015, to conform with minimum TLAC requirements beginning from 1 January 2025. This may, however, be accelerated depending upon developments in an EME's debt markets.

1.2 Proposed approach for local implementation

10 Reflecting the current local scope of application of the Basel III capital framework generally, it is proposed that "investing AIs" (i.e. those whose TLAC holdings are proposed to be deducted under the amendments to be made to the Banking (Capital) Rules ("**BCR**")) should encompass all locally-incorporated AIs, viz., not only those that are internationally active, and including those that are subsidiaries of G-SIBs incorporated in EMEs.

11 As to <u>what should constitute "TLAC holdings" for the purposes of deduction under the BCR</u>, it is proposed that not only "other TLAC liabilities" issued by G-SIBs, but also those issued by the following entities, should be subject to deduction:

(i) any locally-incorporated institution (whether an AI or not) as soon as it is classified by the Monetary Authority ("**MA**") as a resolution entity under the AI LAC Rules[8] (and hence may need to issue LAC instruments, which would be expected to include other TLAC liabilities, to satisfy its external LAC requirements even before the requirements under the AI LAC Rules become effective)[9] (in which case "other TLAC liabilities" will be those instruments that do not constitute or otherwise take the form of regulatory capital but that are eligible for recognition as external LAC under the AI LAC Rules); and

(ii) any overseas-incorporated institution which is not a G-SIB but which is classified as required to be subject to an external TLAC requirement imposed by a relevant competent authority (in which case "other TLAC liabilities" will be those non-regulatory capital instruments permitted by the relevant competent authority to be recognised as external TLAC in its jurisdiction, having regard to any exemption from subordination criteria (as described in paragraph 7(i) and (ii) above) adopted by the relevant jurisdiction in respect of instruments issued by non-G-SIB resolution entities).

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[8] As discussed in footnote 19 of CP 18.01, a locally incorporated resolution entity will be an AI, a holding company of an AI or an affiliated operational entity of an AI.

[9] See CP 18.01 Section III for a discussion of the classification of entities as resolution entities.

Q1. Do you agree with the above scope of application for the purposes of implementing the BCBS standard locally in terms of:

(i) investing AIs;

(ii) constituents of TLAC holdings; and

(iii) timing for other TLAC liabilities issued by any locally-incorporated AI or overseas bank that is not a G-SIB to be subject to deduction (e.g. should deduction be applied even earlier than the time when the issuing AI / bank is classified as required to be subject to an external TLAC requirement)?

2 Deduction approach

2.1 BCBS standard

12 According to the BCBS standard, where a bank invests in other TLAC liabilities issued by another bank (i.e. a G-SIB for the purposes of the standard), the investment should be deducted from the investing bank's regulatory capital. To minimize possible contagion within the banking system, the prudential capital treatments set out in the BCBS standard incorporate the following key aspects:

Tier 2 deduction

(i) An investing bank's holdings of other TLAC liabilities must be deducted from its own Tier 2 capital. Where the bank does not have sufficient Tier 2 capital for the deduction, the holdings should be deducted from its upper tier(s) of capital. This builds upon, and dovetails into, the corresponding deduction approach under the original Basel III framework.

Thresholds for exemption from deduction

(ii) The **existing 10% threshold** under the Basel III framework for a bank's "non-significant" investments[10] in unconsolidated financial institutions[11] will

[10] i.e. investments in the capital (and, in future, in other TLAC liabilities) of banking, financial and insurance entities where the investing bank does not own more than 10% of the issued common share capital of the issuing entity.

[11] As set out in paragraph 81 of the original Basel III text.

cover not only capital instruments, but also other TLAC liabilities issued by these institutions, measured on a net long basis.

(iii) In addition to the 10% threshold, a **further 5% threshold for TLAC holdings** is introduced (primarily to facilitate market-making activities) that allows a bank to risk-weight (instead of deducting from capital) its TLAC holdings which are categorized as "non-significant" investments in unconsolidated financial institutions, measured on a gross long basis, up to 5% of the investing bank's common equity. Where the investing bank is a G-SIB, the application of the threshold will be subject to additional conditions (i.e. the holding is in the bank's trading book for not more than 30 days after acquisition and, once designated for inclusion within the 5% threshold, cannot subsequently be included within the 10 % threshold)[12].

(iv) As in the Basel III deduction framework, the above thresholds will not be available to a G-SIB's holdings of its own other TLAC liabilities, any reciprocal cross-holdings[13], and "significant" investments[14] in other TLAC liabilities issued by other banks, which must be fully deducted from the investing G-SIB's TLAC resources or regulatory capital as follows:

(a) the G-SIB's holdings of its own other TLAC liabilities must be excluded from being recognised as part of its TLAC resources; and

(b) the G-SIB's reciprocal cross-holdings and holdings of other banks' other TLAC liabilities which are categorized as "significant" investments must be deducted from its Tier 2 capital, and to the extent there is insufficient Tier 2 capital, from its upper tiers of capital in line with the corresponding deduction approach under Basel III.

(v) For any investment in other TLAC liabilities that is within the deduction thresholds, the investing G-SIB must subject the investment to an appropriate risk-weighting treatment.

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[12] As the BCBS standard is an international minimum standard, it is (as always) open to national authorities to elect to apply these stricter conditions to all, or a subset of, banks in their jurisdictions.

[13] i.e. cross holdings that are designed to artificially inflate the capital (and, in future, TLAC) position of banks.

[14] i.e. investments in the capital (or, in future, in other TLAC liabilities) of banking, financial and insurance entities where the investing bank owns more than 10% of the issued common share capital of the issuing entity (or where the entity is an affiliate of the bank).

2.2 *Proposed approach for local implementation*

13 As indicated in paragraph 10, it is proposed that the above deduction approach be applied to all locally incorporated AIs in respect of their holdings of other TLAC liabilities issued by the entities described in items (i) and (ii) of that paragraph (as well as those issued by G-SIBs).

14 However, it is proposed that, for the purposes of the local implementation of the deduction regime, AIs that are classified by the MA under the AI LAC Rules as resolution entities, and therefore subject to an external LAC requirement, should be treated as if they were G-SIBs for the application of the deduction mechanism starting from the time when an AI is classified by the MA as a resolution entity under the Rules. Accordingly, where such resolution entities are investing AIs holding other TLAC liabilities, the additional conditions described in paragraph 12(iii) and the treatment of holdings of own instruments and reciprocal cross-holdings will also apply. Other AIs (i.e. those not classified as resolution entities under the AI LAC Rules) will not be subject to the additional conditions for use of the 5% threshold when they invest in other TLAC liabilities.

15 For an AI's investments in other TLAC liabilities that are within the AI's deduction thresholds, the same risk-weight shall apply to those investments as in the case of any within threshold investment in the Tier 2 capital issued by the same issuer.

Q2. Do you have any comments on the above proposals regarding:

(i) the application of the additional conditions described in paragraph 12(iii) only to G-SIBs and AIs that are classified by the MA as resolution entities?

(ii) the risk-weighting treatment of an AI's investments in other TLAC liabilities that are within the deduction threshold?

3 Treatment of intragroup holdings

3.1 *BCBS standard*

16 The focus of the BCBS standard is on the capital treatment of banks' holdings of other TLAC liabilities issued by other G-SIBs and does not explicitly cover the following intragroup holdings of other TLAC liabilities issued as:

(i) **external TLAC by a resolution entity in another resolution group but within the same banking group** (in the case of a banking group subject to a "multiple-point-of-entry" ("**MPE**") strategy in resolution). In this regard, the

note to Template TLAC1 in the *Pillar 3 disclosure requirements – consolidated and enhancement framework* published by the BCBS in March 2017 currently allows for the deduction of the holdings to be made either from the investing bank's regulatory capital or from its total TLAC resources (i.e. including both TLAC instruments and regulatory capital); and

(ii) **internal TLAC by a material subsidiary**[15] **within a resolution group**. In this regard, the FSB document *Guiding Principles on the Internal Total Loss-absorbing Capacity of G-SIBs ('Internal TLAC')* issued in July 2017 observes that "[t]*o avoid possible double counting, authorities should consider applying an internal TLAC deduction approach or an equivalently robust supervisory approach"*[16].

3.2 Proposed approach for local implementation

17 Having regard to the discussion under section VIII "Treatment of LAC investments" of CP 18.01, it is proposed that:

(i) for the situation set out in paragraph 16(i) above, the same deduction treatment as described in Section 2 of Part II of this paper should be applied. In other words, any investments by an AI in other TLAC liabilities issued by a resolution entity in another resolution group but within the same banking group will be treated in the same way as investments in other TLAC liabilities issued by an entity outside the banking group. The HKMA considers that this approach is consistent with the assumptions underlying an MPE strategy where contagion between resolution groups within the same banking group should be kept to a minimum; and

(ii) for the situation set out in paragraph 16(ii) above, which is relevant to any AI within a resolution group having to calculate its capital position on a solo basis, such holdings of "internal" TLAC issued by a material subsidiary within the same resolution group will be deducted:

(a) firstly from other TLAC liabilities issued by the investing AI; and

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[15] Under the FSB TLAC Term Sheet (Section 16 & 17), subsidiaries of a resolution entity satisfying certain materiality criteria (broadly signifying their materiality in any resolution of the resolution entity) are to be subject to internal TLAC requirements which in effect require resolution entities to commit loss-absorbing capacity to such material subsidiaries.

[16] Guiding Principle 10 of the FSB document, which can be accessed at: http://www.fsb.org/wp-content/uploads/P060717-1.pdf

(b) secondly, where that is not sufficient, from the investing AI's regulatory capital beginning with its Tier 2 capital and, if that is insufficient, from its upper tiers of capital in line with the corresponding deduction approach under Basel III.

18 The proposed treatment described in paragraph 17(ii) takes into account comments received from the industry (when the BCBS standard was being developed), that it would be excessive to require holdings of internal TLAC, in the form of other TLAC liabilities, to be subject to the same deduction treatment as external TLAC in the form of other TLAC liabilities (i.e. deduction directly from Tier 2 capital of the investing bank).

19 Additionally, for the situation described in paragraph 16(ii):

(i) it should be noted that, similar to the current treatment of an AI's investments in any capital instruments issued by another AI within the same consolidated banking group, (which is applied when calculating the AI's capital adequacy ratio on a solo basis), the internal TLAC holdings will be subject to full deduction without the application of the deduction thresholds described in Section 2 of Part II of this consultation paper; and

(ii) the application of the treatment described in paragraph 17(ii) should start from the time when an entity within the resolution group is classified by the MA as a material subsidiary under the AI LAC Rules.

Q3. Do you agree with the above proposals for the treatment of an AI's holdings of other TLAC liabilities issued:

(i) as external TLAC by a resolution entity in another resolution group but within the same banking group when the AI calculates its capital adequacy ratios on a solo and a consolidated basis; and

(ii) as internal TLAC by a subsidiary which is a material subsidiary within the same resolution group when the AI calculates its capital adequacy ratio on a solo basis?

4 Interaction with capital buffers

4.1 BCBS standard

20 The BCBS standard specifies that G-SIBs must take into account their minimum TLAC requirement when calculating the amount of their CET1 capital available to meet

their capital buffers. In this regard, CET1 capital must first be used to meet the minimum capital and TLAC requirements before the remainder can contribute to capital buffers.

4.2 Proposed approach for local implementation

21 The HKMA intends to follow the BCBS standard and proposes to apply this hierarchy for allocation of CET1 capital to all locally incorporated AIs that are subject to minimum external/internal LAC requirements under the AI LAC Rules[17]. In this connection, AIs are also required to take account of the potential impacts of the proposed capital treatment of their TLAC holdings in conducting internal capital adequacy assessment and determining internal capital targets.

Q4. Do you have any comments on the above proposal regarding the interaction of the minimum LAC requirements with an AI's capital buffers?

III TIMELINE & WORK PLAN FOR IMPLEMENTATION

22 The HKMA proposes to implement the BCBS standard locally as described in this consultation paper with effect from 1 January 2019, in line with the BCBS scheduled timeline as well as the proposed effective date of the AI LAC Rules.

23 Implementation of the relevant requirements will require amendments to be made to the BCR, viz.:

(i) Part 1B will be amended such that in calculating the amount of "net CET1 capital", an AI must take into account the amount of CET1 capital required to meet, not only its minimum CET1 capital ratio, Tier 1 capital ratio and Total capital ratio, but also it minimum LAC requirement (where applicable);

(ii) Part 3 will be amended to incorporate an AI's holdings of other TLAC liabilities into the deduction framework;

(iii) Schedule 4E will be amended to set out the deduction treatment of an AI's holdings of its own other TLAC liabilities; and

[17] Please refer to Section III "External LAC Requirement" and Section IV "Internal LAC Requirement" of CP18.01 for the relevant proposals.

(iv) Parts 4, 5 and 6, and Schedules 4F and 4G will be amended to set out the treatment of an AI's investments in other TLAC liabilities which are exempted from deduction by the operation of the relevant thresholds.

24 Where necessary, the HKMA will conduct an impact study based on AIs' holding of other TLAC liabilities in order to assess how the policy proposals described in this consultation paper will affect AIs' capital positions.

25 Some alignment changes to the existing Return of Capital Adequacy Ratio (Form MA(BS)3) and its accompanying completion instructions will also be required.

26 The proposed implementation timeline is summarised as follows:

Date	Events
April 2018	Consultation with industry on implementation proposals
July / August 2018	[Conduct of impact study]
August / September 2018	Statutory consultation on draft BCR amendment rules
Q3 2018	Consultation with industry on the amendments to the CAR Return and accompanying completion instructions
October 2018	Finalisation of BCR amendment rules taking into account comments received in consultation Gazette BCR amendment rules and submit to the Legislative Council for negative vetting
1 January 2019	BCR amendment rules come into effect
By 31 Mar 2019	Launch of revised CAR Return

Q5. Do you have any comments on the proposed timeline and work plan for implementing the BCBS standard locally in Hong Kong?

Annex

Intended coverage of "other TLAC liabilities" for capital deduction

Instruments eligible for recognition as TLAC not in the form of regulatory capital	**Pari Passu ranking instruments**
Type 1 instruments – instruments that fall within the subordination criteria set out in first 3 paragraphs in Section 11 of FSB TLAC Term Sheet (including those that satisfy the four "de minimis" criteria set out in the 3rd paragraph)	Instruments pari passu to Type 1 instruments
Type 2 instruments – instruments that fall within the exemption conditions set out in the antepenultimate paragraph in Section 11 of FSB TLA Term Sheet	
Type 3 instruments – instruments that fall within the exemption conditions set out in the penultimate paragraph in Section 11 of FSB TLAC Term sheet	