



HONG KONG MONETARY AUTHORITY
香港金融管理局



Report on Loss-Absorbing Capacity Requirements Implementation in Hong Kong



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EXECUTIVE SUMMARY

The Hong Kong Monetary Authority (“HKMA”) conducted a review of the implementation of loss-absorbing capacity (“LAC”) requirements in Hong Kong over the past five years, from the commencement of the Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements—Banking Sector) Rules (Cap. 628B) (“LAC Rules”) in December 2018 to June 2023. This report provides an overview of the implementation programme, outlines the progress made and summarises the HKMA’s observations and related policy expectations.

Implementation programme and progress

LAC implementation is a key aspect of the bilateral resolution planning programmes between the HKMA Resolution Office and authorized institutions (“AIs”). Since the commencement of the LAC Rules, the HKMA has been working closely with each domestic systemically important AI (“D-SIB”) to drive the build-up of its LAC resources.

All D-SIBs have met their respective LAC requirements from 1 January 2023, representing a milestone in enhancing the resolvability of these banks and the resilience of the banking system in Hong Kong.

Furthermore, the HKMA has been extending the implementation of LAC requirements beyond D-SIBs to other locally incorporated AIs with total consolidated assets above HK\$300 billion. One of these AIs issued the first non-capital LAC debt instrument to market investors in the Asia ex-Japan bond markets.

Having regard to a range of factors, including international experiences and the approaches adopted by other jurisdictions, lessons learnt from the 2023 overseas banking turmoil, the size of Hong Kong’s economy, the landscape of banking sector, the LAC implementation experience and resolvability of AIs, as well as the HKMA’s approach to ex-ante resolution planning, this HK\$300 billion threshold for LAC implementation remains appropriate in the view of the HKMA.

It should be noted that the HK\$300 billion threshold is a planning assumption, which acts as an indicative benchmark rather than an automatic trigger point for the implementation of LAC requirements. Hence, it does not imply that an AI with HK\$300 billion or more in total consolidated assets will automatically be required to comply with LAC requirements.

The HKMA has been applying a proportionate, risk-based approach to commencing and advancing resolution planning programmes with relevant AIs, including identifying preferred resolution strategies and implementing LAC requirements. In addition to total consolidated assets, the HKMA takes into account other factors, such as the potential risks to financial stability in Hong Kong in the event of the failure of relevant AIs and other institution-specific factors, in determining the need for setting preferred resolution strategies and imposing LAC requirements.

The HKMA will keep the indicative threshold for LAC requirements implementation under review.

Observations and related policy expectations

The implementation of LAC requirements has driven the build-up of a significant layer of non-capital LAC resources at D-SIBs, amounting to HK\$352 billion or 5.9% of risk-weighted amounts (“RWAs”). As at end-June 2023, the total LAC resources (including capital and non-capital LAC resources) of D-SIBs stood at HK\$1,575 billion or 26.3% of RWAs, above the international minimum requirement of 18%.

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In terms of instrument class and currency mix, non-capital LAC debt instruments (69%) and USD (79%) contributed the largest proportions respectively based on the outstanding LAC debt instruments as at end-June 2023.

During the period from January 2019 to June 2023, relevant Als issued a gross total of HK\$511 billion of LAC debt instruments. The issuance structures follow their group structures and preferred resolution strategies. Als that are part of a G-SIB banking group typically issue on an intragroup basis and adopt a back-to-back model. The issuance activities generally coincide with those of their parent companies to a considerable extent, as demonstrated by changes in issuance volume during the COVID-19 pandemic and in the aftermath of the full write-down of all Credit Suisse's Additional Tier 1 ("AT1") capital instruments.

Pricing of LAC debt instruments is influenced by various market and institution-specific factors as well as the structure and terms of the instruments. Generally speaking, the pricing of LAC debt instruments moves in line with the interest rate benchmarks and is consistent with the ranking in the creditor hierarchy, with non-capital LAC debt instruments ranking above AT1 and Tier 2 ("T2") capital instruments.

The contractual maturities of outstanding non-capital LAC debt instruments vary from 2 years to 30 years. All of the instruments contain one or more call options which may be exercised at least 12 months earlier than their contractual maturity dates.

LAC debt instruments issued to market investors are typically structured as notes/securities, and those issued on an intragroup basis are structured either in the form of intragroup loans or notes/securities. Regardless of the documentation approach, all LAC debt instruments are contractually subordinated to depositors and general creditors of the issuing entity. Their terms and conditions also contain loss-absorption triggers and risk disclosures, in line with the LAC Rules requirements. All internal LAC debt instruments include only a write-down mechanism.

Majority of internal LAC debt instruments are governed by Hong Kong law, while all external LAC debt instruments issued to market investors are governed by English law, except for the provisions relating to the subordination of these instruments and also, in some cases, the provisions relating to set-off, loss absorption and/or the recognition of the exercise of powers under the Financial Institutions (Resolution) Ordinance (Cap. 628) ("FIRO").

All LAC-eligible T2 capital instruments and non-capital LAC debt instruments are classified as liabilities, whereas LAC-eligible AT1 capital instruments are typically classified as equity. The carrying value of LAC debt instruments measured at fair value has been impacted negatively by rising interest rates.

The self-assessment of LAC debt instruments is an effective process for a resolution entity or material subsidiary to identify potential enhancements to the terms of proposed instruments to meet the relevant qualifying criteria.

Resolution entities and material subsidiaries have been making quarterly and semi-annual disclosure on LAC and complying with the reporting requirements of the HKMA.

It is important to note that LAC requirements are institution-specific and take into account the preferred resolution strategy identified. Therefore, LAC requirements for different Als may not be directly comparable and a numerical comparison between the LAC ratios of any two Als may not be meaningful.

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Given the way in which regulatory capital buffers interact with the LAC and capital regimes in Hong Kong, in comparing between the total minimum resources needed to meet the minimum LAC risk-weighted ratio plus regulatory capital buffers and those needed to meet the minimum LAC leverage ratio, the required total minimum resources are usually greater on the RWA side.

The HKMA has been engaging with the relevant AIs on the design and implementation of approach to managing and deploying non-pre-positioned LAC within a resolution group in order to ensure their sufficiency and ready availability.

Next steps

Resolution planning, including actions to enhance resolvability, is an ongoing process. The HKMA will continue to work closely with relevant AIs on their build-up and maintenance of LAC resources in a prudent and proportionate manner.

1. INTRODUCTION

Resolution is a process to manage the likely failure of a financial institution (“FI”) in an orderly manner, with the purpose to promote and maintain the stability and effective working of the financial system, including continuity of critical financial functions by FIs, while seeking to protect public money. For resolution to be feasible and credible, FIs need to be organised and managed at all times in a way that facilitates the effective use of resolution powers by resolution authorities in the event of likely failure.

To this end, the Monetary Authority (“MA”), as the resolution authority for banking sector entities under the FIRO, sets resolution standards and conducts resolution planning for individual AIs well in advance of any actual failure. Through resolution planning process, the HKMA works with the relevant AIs to implement necessary changes to their legal structures, business operations and/or financial resources in order to address impediments to orderly resolution and enhance their resolvability.

One of the common impediments to orderly resolution is insufficient financial resources to absorb losses and

recapitalise a failing AI, which is crucial for stabilising the failing AI and restoring it to viability. To ensure adequate LAC resources of AIs for resolution purpose, the MA under the FIRO¹ made the LAC Rules², which came into effect on 14 December 2018. In addition, the MA issued on 20 March 2019 chapter LAC-1 “Resolution Planning – LAC Requirements” (“LAC-1”)³ of the FIRO Code of Practice to provide guidance on the operation of certain provisions of the LAC Rules

Under the LAC Rules, the MA may require AIs and other relevant entities⁴ to maintain a minimum level of LAC resources. Over the past five years, the HKMA has been working with relevant AIs including all D-SIBs in Hong Kong, as part of the resolution planning programmes, to build up and maintain a layer of LAC resources in line with the LAC Rules in order to enhance the resolvability of these AIs and strengthen the resilience of the banking system.

The purpose of this report is to provide an overview of the programme for implementing LAC requirements in Hong Kong, outline the progress made, and summarise the HKMA’s observations and related policy expectations.

¹ <https://www.elegislation.gov.hk/hk/cap628>

² <https://www.elegislation.gov.hk/hk/cap628B>. Unless otherwise stated, terms used in this report have the meanings given to them in the FIRO or the LAC Rules, as the case may be.

³ https://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/resolutions/LAC-1_Resolution_Planning-LAC_Requirements_ENG.pdf

⁴ Referring to HK holding companies and HK affiliated operational entities.

2. BACKGROUND

2.1 Purpose of LAC requirements

The FIRO establishes the legal basis for a cross-sectoral resolution regime in Hong Kong, and sets out various powers for resolution authorities, including five stabilization options that a resolution authority may apply, alone or in combination, when resolving a within scope FI. The stabilization options broadly fall into two categories: bail-in⁵ and transfer⁶.

Having sufficient LAC resources on the balance sheet of an AI allows losses to be imposed, by the MA as a resolution authority, on the shareholders and certain creditors (i.e. LAC holders) of the AI in the event of its failure and restore the AI's viability, thereby mitigating risks posed to the financial system. This ensures that LAC holders, rather than public funds, will be the first to absorb any losses, which is not only fairer than a bail-out by taxpayers, but also disincentivises excessive risk-taking by the AI.

LAC sufficiency is an essential prerequisite to the effective application of the bail-in stabilization option, which is typically envisaged under the preferred resolution strategy for AIs with large, complex and interconnected businesses. Under a bail-in resolution, LAC resources of a failing AI may be written down and/or converted into equity to absorb losses and support the recapitalisation of the AI as a whole.

LAC could also support the orderly resolution of a smaller and simpler AI, where a transfer stabilization option may be applied to move some or all of the assets, rights or

liabilities of, or securities issued by, the AI to a transferee. The write-down of LAC resources will reduce the liabilities, and increase the equity value, of the failing AI, thereby increasing the feasibility of transferring part or all of the failing AI to a private sector purchaser in such case.

For an AI that is part of a cross-border group, rather than the application of a stabilization option to the AI itself, its preferred resolution strategy would typically involve the application by its home resolution authority of resolution powers to its ultimate parent or holding company in its home jurisdiction. Under such preferred resolution strategy, should the AI become likely to fail, its viability would be restored by the transfer of its losses to the ultimate parent or holding company via the contractual write-down or conversion into equity⁷ of LAC instruments issued by the AI directly or indirectly to its parent or holding company ("contractual loss transfer"). Should contractual loss transfer not prove effective for any reason, the MA could apply the bail-in stabilization option to achieve the same economic effect.

2.2 Details of LAC requirements

Under the legislative framework in Hong Kong, LAC requirements are provided in the LAC Rules made pursuant to section 19(1) of the FIRO. LAC requirements complement regulatory capital requirements⁸ in maintaining financial stability by seeking to ensure that sufficient LAC resources are built up and maintained by the relevant AIs to facilitate an orderly resolution in the event of a failure.

⁵ A statutory write-off or conversion into equity of certain liabilities of a failing FI, in order to absorb losses and restore its capital position.

⁶ The transfer stabilization options consist of: (i) transfer to a purchaser; (ii) transfer to a bridge institution; (iii) transfer to an asset management vehicle; and (iv) transfer to a temporary public ownership company.

⁷ See section 2.2 for more details.

⁸ Capital requirements are mainly prescribed in the Banking (Capital) Rules ("BCR") (Cap. 155L) issued under section 97C(1) of the Banking Ordinance (Cap. 155).

The LAC Rules impose LAC requirements on resolution entities and material subsidiaries. Under the LAC Rules, the MA may classify a classifiable entity as either a resolution entity or material subsidiary, in line with the preferred resolution strategy covering the entity identified by the MA. A resolution entity will be subject to external LAC requirements, pursuant to which it must maintain a minimum external LAC risk-weighted ratio and a minimum external LAC leverage ratio. A material subsidiary will be subject to internal LAC requirements, pursuant to which it must maintain a minimum internal LAC risk-weighted ratio and a minimum internal LAC leverage ratio.

LAC requirements under the LAC Rules for resolution entities and material subsidiaries are institution-specific and calibrated having regard to factors including the preferred resolution strategy identified for the specific entity. External LAC requirements for a resolution entity are generally calibrated at twice its regulatory capital requirements. Internal LAC requirements for a material subsidiary are equal to what its external LAC requirements would be if it were a resolution entity, and generally scaled down by its internal LAC scalar. Each resolution entity or material subsidiary is required to meet its LAC requirements on a consolidated basis with reference to its LAC consolidation group. Where the resolution entity or material subsidiary is an AI, it will also need to meet its LAC requirements on a solo or solo-consolidated basis scaled by its solo LAC scalar.

In addition to LAC requirements, a resolution entity or material subsidiary also needs to meet the minimum LAC debt requirement under the LAC Rules, meaning that no less than one-third of its minimum LAC ratios must be

met with external LAC debt instruments issued by the resolution entity or internal LAC debt instruments issued by the material subsidiary.

2.3 Components of LAC resources

Generally speaking, regulatory capital can count towards meeting LAC requirements, subject to meeting the relevant qualifying criteria and provisions under the LAC Rules. Non-capital debt instruments meeting the relevant qualifying criteria under the LAC Rules can also count towards meeting LAC requirements (i.e. non-capital LAC debt instruments). The qualifying criteria for LAC debt instruments, whether capital or non-capital in nature, are set out in Schedule 1 (for external LAC debt instruments) and Schedule 2 (for internal LAC debt instruments) to the LAC Rules, and are designed to help provide certainty that LAC resources remain available to facilitate an orderly resolution.

Among other qualifying criteria, a LAC debt instrument needs to have a remaining contractual maturity of at least 12 months or be perpetual, and its terms and conditions are required to contain a provision that the holder of the instrument acknowledges and agrees to be bound by any write-off, cancellation, conversion, modification or form change of the instrument in the exercise of powers under the FIRO, to help provide legal certainty in a resolution scenario. The instrument is also required to be either subordinated to the claims of an AI's general creditors and depositors, or issued by a clean HK holding company⁹, such that it is more readily bail-inable and there is a lower likelihood of "no creditor worse off than in liquidation" ("NCWOL") compensation¹⁰.

⁹ As defined in rule 2(1) of the LAC Rules.

¹⁰ NCWOL compensation refers to the safeguard under section 102 of the FIRO that provides for pre-resolution creditors and pre-resolution shareholders to receive compensation should they receive less favourable treatment in resolution than they would have had in insolvency.

BACKGROUND

A resolution entity is required to issue external LAC debt instruments¹¹ to an entity outside its resolution group to meet its external LAC requirements. On the other hand, a material subsidiary is required to issue internal LAC debt instruments¹² (either directly or indirectly) to a resolution entity¹³ within its resolution group to meet its internal LAC requirements. One of the key differences between an external LAC debt instrument and an internal LAC debt instrument is that the latter is designed to be written-down or converted into equity contractually in accordance with its terms and conditions without having to apply resolution powers to the issuing entity going into resolution.

It should be noted that, as regulatory capital buffers¹⁴ must compose only of Common Equity Tier 1 (“CET1”) capital and must be usable without entry into resolution, CET1 capital that counts towards LAC requirements calibrated with respect to RWAs cannot be double counted for regulatory capital buffers. This is in line with the Financial Stability Board (“FSB”)’s “Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs¹⁵ in Resolution: Total Loss-absorbing Capacity (TLAC) Term Sheet” (“TLAC Term Sheet” or “TLAC standard”)¹⁶, as well as the policy intent of LAC

requirements and regulatory capital buffers. This effectively means that an AI’s LAC resources should be sufficient to meet the sum of its LAC requirements and applicable regulatory capital buffers.

2.4 Implementation timeline of LAC requirements

All AIs are within the scope of the FIRO. However, it is neither practicable nor desirable that detailed ex-ante resolution planning be conducted for all such entities. The HKMA has been applying a proportionate, risk-based approach to prioritising AIs for resolution planning through bilateral resolution planning programmes. It is considered that where a Hong Kong incorporated AI’s total consolidated assets exceed HK\$150 billion, its failure would likely pose a risk to the stability and effective working of the financial system of Hong Kong, and therefore ex-ante resolution planning is prioritised for such an AI. Further, the planning assumption is that where a Hong Kong incorporated AI’s total consolidated assets exceed HK\$300 billion, the AI (and possibly any HK holding company and/or HK affiliated operational entities of the AI) should be subject to LAC requirements¹⁷.

¹¹ Section 1(1)(o) of Schedule 1 to the LAC Rules requires that an external LAC debt instrument is not funded or guaranteed directly or indirectly by the resolution entity or another entity that is in the same resolution group as the resolution entity, unless otherwise approved in writing by the resolution authority on being satisfied that the instrument being so funded or guaranteed is not inconsistent with the preferred resolution strategy covering the resolution entity.

¹² Section 1(1)(m) of Schedule 2 to the LAC Rules requires that an internal LAC debt instrument is not funded or guaranteed directly or indirectly by the material subsidiary or any subsidiary of the material subsidiary, unless otherwise approved in writing by the resolution authority on being satisfied that the instrument being so funded or guaranteed is not inconsistent with the preferred resolution strategy covering the material subsidiary.

¹³ This may refer to a Hong Kong resolution entity under the LAC Rules or a non-HK resolution entity, depending on the preferred resolution strategy.

¹⁴ Namely, capital conservation buffer, countercyclical capital buffer and higher loss absorbency buffer.

¹⁵ “G-SIBs” stand for global systemically important banks that are identified by the FSB.

¹⁶ <https://www.fsb.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf>

¹⁷ Paragraph 2.8 of LAC-1.

BACKGROUND

For an entity which has been classified as a resolution entity or material subsidiary by the MA in line with its preferred resolution strategy, the resolution entity or material subsidiary will have 24 months following its classification date to comply with its LAC requirements. The MA may extend the period after which the resolution entity or material subsidiary must meet a LAC requirement on a case-by-case basis, if satisfied that it is prudent to do so.

In considering whether it would be prudent to extend the period after which a resolution entity or material subsidiary must meet its LAC requirements, the MA may take into account evidence provided by the resolution entity or material subsidiary relating to any relevant factors, such as market conditions, investor appetite for LAC debt instruments, LAC implementation progress in the home jurisdiction of the resolution entity or material subsidiary, the funding structure of the resolution entity or material subsidiary, and impact on financial stability. The MA will continue to adopt a proportionate and prudent approach when determining the implementation timeline for individual resolution entities and material subsidiaries.

3. IMPLEMENTATION PROGRAMME AND PROGRESS

3.1 D-SIBs

Since the commencement of the LAC Rules in December 2018, the HKMA has been working closely with each D-SIB¹⁸ to drive the build-up of its LAC resources in line with its preferred resolution strategy determined by the MA and its classification under the LAC Rules as either a resolution entity or material subsidiary. All of the D-SIBs have been increasing their LAC resources by issuing capital and non-capital LAC debt instruments to facilitate loss absorption and recapitalisation in a resolution scenario.

LAC implementation is a key aspect of the bilateral resolution planning programmes between the HKMA Resolution Office and the relevant AIs. Typically, at the early stage of the resolution planning programme when the preferred resolution strategy is determined and well before LAC requirements need to be complied with, the relevant resolution entity or material subsidiary can expect to be notified of its applicable indicative LAC requirements by the MA, including the indicative implementation timeline, in line with its preferred resolution strategy. This would serve as a planning assumption and provide time for the resolution entity or material subsidiary to design its LAC and funding strategy.

The HKMA works closely with each resolution entity and material subsidiary on its LAC implementation. This would include the development and implementation of a credible strategy for building up LAC resources, in coordination with its parent company where applicable. Where any items are proposed for inclusion in a

resolution entity or material subsidiary's LAC resources, a self-assessment should be conducted by the resolution entity or material subsidiary to ensure that these items are eligible to be so included (see section 4.14 for more details). In addition, to facilitate LAC implementation, each resolution entity and material subsidiary reports to the MA regularly on its LAC information, including LAC positions and projections, as well as qualitative information such as its up-to-date approach to meeting LAC requirements, and key assumptions underpinning the projections and plans.

Currently, each D-SIB in Hong Kong is part of a G-SIB banking group. The HKMA has been adopting a coordinative approach with the relevant home and host resolution authorities in resolution planning for the D-SIBs. In identifying preferred resolution strategies and classifying resolution entities and material subsidiaries that are part of a cross-border banking group for the purpose of imposing LAC requirements, the HKMA co-ordinates with the home and other host resolution authorities through crisis management groups ("CMGs")¹⁹, resolution colleges and/or bilateral engagements, and adopts a group-wide resolution strategy where appropriate.

All D-SIBs have met their respective LAC requirements since 1 January 2023, representing a milestone in enhancing the resolvability of these banks and the resilience of the banking system in Hong Kong. In addition, all D-SIBs have been making periodic public disclosures of their LAC positions and instruments, promoting greater transparency and market discipline.

¹⁸ D-SIBs are designated on an annual basis. As of 1 January 2024, the following AIs (in alphabetical order) have been designated as D-SIBs: Bank of China (Hong Kong) Limited, Hang Seng Bank Limited, Industrial and Commercial Bank of China (Asia) Limited, Standard Chartered Bank (Hong Kong) Limited and The Hongkong and Shanghai Banking Corporation Limited.

¹⁹ For all G-SIBs, the FSB's Key Attributes of Effective Resolution Regimes for FIs ("Key Attributes") expect the establishment of CMGs with the objective of enhancing preparedness for, and facilitating the management and resolution of, a cross-border financial crisis affecting the FI (section 8). The Key Attributes also call for home and relevant host authority members of CMGs to put in place institution-specific cooperation agreements that define the roles and responsibilities of participating authorities and establish processes for coordination and information-sharing in developing recovery and resolution plans and carrying out resolvability assessments, and for coordination both in the run-up to and in a resolution (section 9 and Annex I).

IMPLEMENTATION PROGRAMME AND PROGRESS

3.2 Non-D-SIBs

The non-viability of AIs that are not D-SIBs could also pose risks to the stability and effective working of the financial system of Hong Kong. For instance, the failure of an AI could disrupt the provision of niche services or result in the liquidity and capital positions of other AIs coming under pressure due to direct exposure to the failed AI or indirect contagion risks due to similar business models. For this reason, the HKMA has been extending resolution planning beyond D-SIBs to other locally incorporated AIs with total consolidated assets above HK\$300 billion, including prioritising the identification of preferred resolution strategies for these AIs and the classification of these AIs as resolution entities or material subsidiaries under the LAC Rules. It is worth noting that in 2022, one of these AIs completed its issuance of an inaugural non-capital LAC debt instrument to market investors, representing the first such offering in the Asia ex-Japan bond markets.

3.3 Planning assumption for implementation

As explained in section 2.4, the HKMA has been prioritising AIs for resolution planning and advancing the implementation of LAC requirements based on a proportionate, risk-based approach, with priority given to D-SIBs and Hong Kong incorporated AIs with total consolidated assets exceeding HK\$300 billion, since the LAC Rules came into effect in December 2018.

Compared to 2018, Hong Kong records a modest growth in GDP of 1.4% based on annualised H1 2023 data. During the same period, the total assets and total deposits of the banking industry increased by 12.6% and 15.6% respectively. As at end-June 2023, AIs captured by

the HK\$300 billion threshold contributed to more than 60% of total assets and more than 70% of total customer deposits of all AIs.

The bank failures in the US and Europe during the first quarter of 2023 constituted the first real larger scale test of the international resolution framework established by the FSB's Key Attributes of Effective Resolution Regimes for Financial Institutions ("Key Attributes")²⁰ in the aftermath of the global financial crisis in 2008. The HKMA, together with other FSB member authorities, has been actively contributing to the FSB's review of the events and assessment of potential implications for the operation of the resolution framework, culminating in a report which was published in October 2023²¹. The review affirms the appropriateness and feasibility of the resolution framework, while identifying several areas for further analysis and improvement.

Among the lessons learnt is that although resolution was not used in the case of Credit Suisse, the TLAC standard and its implementation, along with the resolution planning that had been undertaken, provided a credible alternative option for the authorities. Should the resolution option be chosen, the availability of sufficient bail-inable debt would have supported the bank's post-stabilisation restructuring, which would be capital intensive. Also, the US bank failures showed that banks not identified as G-SIBs can still be systemically significant or critical upon failure, depending on prevailing circumstances, as well as the deposit and business structure of the banks. Therefore, it can be seen that having ex-ante resolution readiness at smaller banks, including a level of LAC resources, to facilitate authorities' potential resolution actions in order to maintain financial stability in times of banking crisis, would be important.

²⁰ https://www.fsb.org/wp-content/uploads/r_141015.pdf

²¹ See the FSB's report "2023 Bank Failures: Preliminary lessons learnt for resolution". <https://www.fsb.org/wp-content/uploads/P101023.pdf>

IMPLEMENTATION PROGRAMME AND PROGRESS

Approaches to implementing TLAC requirements in other major jurisdictions have been taken into account. The Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, and the Office of the Comptroller of the Currency jointly proposed in August 2023²², among other proposals in relation to resolution planning, to expand the scope of banks required to maintain a minimum amount of long-term debt to absorb losses and facilitate an orderly resolution to banks with total assets of US\$100 billion or more. In the UK, the Bank of England established indicative thresholds for guiding the setting of individual banks' preferred resolution strategies and therefore the minimum requirement for own funds and eligible liabilities ("MREL")²³. These thresholds are structured as ranges, namely 40,000 to 80,000 transactional accounts for partial transfer strategies, and total assets of GBP15 billion to GBP25 billion for bail-in strategies. The Bank of England reviewed its approach to setting MREL requirements in 2021 and maintained these thresholds.

The HKMA has reviewed the HK\$300 billion threshold for LAC requirements implementation, taking into account the size of Hong Kong's economy, the landscape of banking sector, the LAC implementation experience and resolvability of Als, lessons learnt from the 2023 overseas banking turmoil and approaches adopted by other jurisdictions. To strike a balance between: (i) achieving ex-ante resolvability of Als the non-viability of which would be likely to pose risks to the stability and effective working of the financial system of Hong Kong; and (ii) avoiding, insofar as is prudent, the imposition of potentially onerous requirements on smaller Als to issue LAC resources, including the potential challenges in issuing LAC debt instruments by these Als and the associated costs that may be passed on to their depositors and borrowers, the HKMA considers it

appropriate to continue to treat HK\$300 billion in total consolidated assets as the threshold for the planning assumption that LAC requirements should be imposed.

It should be noted that the HK\$300 billion threshold is a planning assumption, which acts as an indicative benchmark rather than an automatic trigger point for the implementation of LAC requirements. Hence, it does not imply that an AI with HK\$300 billion or more in total consolidated assets will automatically be required to comply with LAC requirements.

The HKMA has been applying a proportionate, risk-based approach to commencing and advancing resolution planning programmes with relevant Als, including identifying preferred resolution strategies and implementing LAC requirements. In addition to total consolidated assets, the HKMA takes into account other factors, such as the potential risks to financial stability in Hong Kong in the event of the failure of relevant Als and other institution-specific factors, in determining the need for setting preferred resolution strategies and imposing LAC requirements.

The HKMA will keep the indicative threshold for LAC requirements implementation under review.

²² <https://www.fdic.gov/news/press-releases/2023/pr23065.html>

²³ Under the UK resolution regime, MREL is the minimum amount of equity and subordinated debt a firm must maintain to support an effective resolution. See the Bank of England's approach to setting a MREL at <https://www.bankofengland.co.uk/-/media/boe/files/paper/2021/mrel-statement-of-policy-december-2021-updating-2018.pdf>

4. OBSERVATIONS AND RELATED POLICY EXPECTATIONS

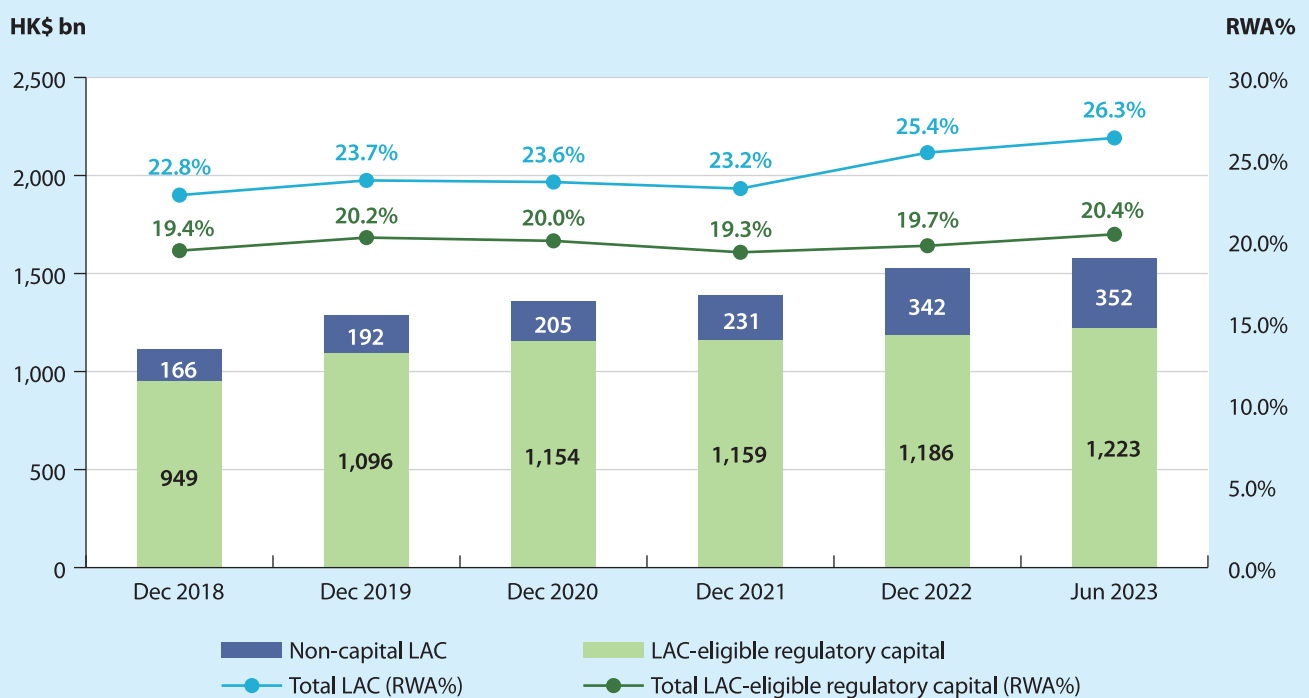


4.1 LAC position

Over the past five years, the implementation of LAC requirements has driven the build-up of a significant

layer of non-capital LAC resources at D-SIBs, amounting to HK\$352 billion or 5.9% of RWAs, on top of LAC-eligible regulatory capital of HK\$1,223 billion or 20.4% of RWAs. As at end-June 2023, the total LAC resources (including capital and non-capital LAC resources) of D-SIBs stood at HK\$1,575 billion or 26.3% of RWAs, above the international minimum requirement of 18%²⁴.

Chart 1 – Total LAC resources of D-SIBs



Notes for Chart 1:

- (1) The chart shows the total amount of LAC resources at period ends from end-December 2018 to end-June 2023, which is the sum of LAC-eligible regulatory capital and non-capital LAC resources, of all currently designated D-SIBs. Adjustments are made in arriving at the total amount of LAC resources of D-SIBs, taking into account their issuance structures and preferred resolution strategies.
- (2) LAC-eligible regulatory capital refers to regulatory capital (i.e. CET1 capital, AT1 capital and T2 capital) eligible for meeting LAC requirements.
- (3) The amount of non-capital LAC resources as at end-December 2018 (i.e. HK\$166 billion) represented non-capital financial resources already put in place by D-SIBs before the introduction of the LAC Rules in preparation of the implementation of LAC requirements.
- (4) Changes in total LAC resources were mainly driven by issuance/redemption of LAC debt instruments, changes in retained earnings as well as movements in other reserves during the period.

²⁴

For reference, in accordance with the TLAC Term Sheet, G-SIBs are required to maintain an end-state minimum TLAC level of 18% of RWAs and 6.75% of leverage ratio denominator.

OBSERVATIONS AND RELATED POLICY EXPECTATIONS



4.2 Composition

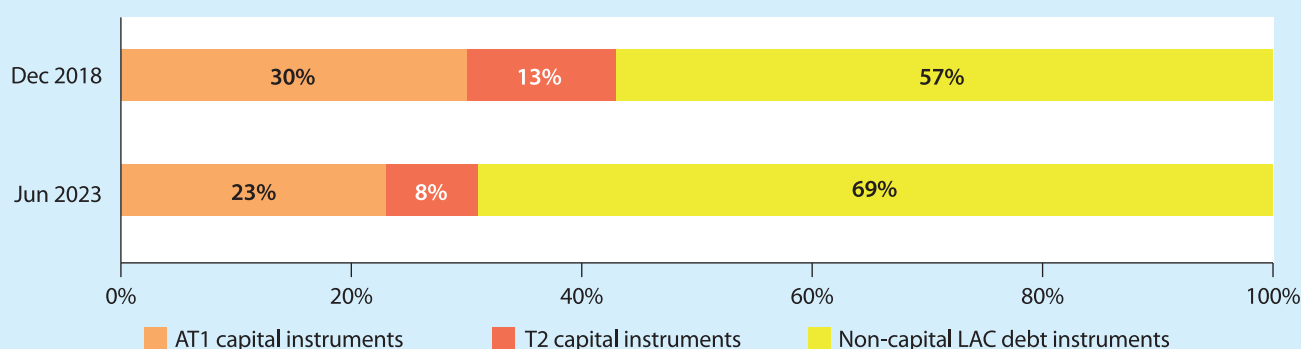
LAC resources include CET1 capital and various LAC debt instruments²⁵ meeting the relevant qualifying criteria under the LAC Rules. Focusing on LAC debt instruments, as at end-June 2023, AT1 capital instruments, T2 capital instruments, and non-capital LAC debt instruments accounted for 23%, 8% and 69% respectively of all outstanding LAC debt instruments issued by AIs which have been classified under the LAC Rules. Non-capital LAC debt instruments as a proportion of all outstanding LAC debt instruments increased by 12 percentage points during end-December 2018 to end-June 2023.

While eligible AT1 capital instruments, T2 capital instruments and non-capital LAC debt instruments all

count towards LAC resources, it was observed that most resolution entities and material subsidiaries issued non-capital LAC debt instruments for meeting their LAC requirements and the minimum LAC debt requirement.

The significantly higher issuance volume of non-capital LAC debt instruments over the period may, in part, be attributed to their lower pricing compared with AT1 and T2 capital instruments (see section 4.6 for more details). Given that non-capital LAC debt instruments rank above AT1 and T2 capital instruments in the creditor hierarchy, it can be expected that the funding cost of issuing non-capital LAC debt instruments would be lower than that for AT1 and T2 capital instruments, in line with the different risk-return profile. If there is sufficient headroom above regulatory capital requirements (including regulatory capital buffers, where appropriate), resolution entities and material subsidiaries may choose to prioritise the issuance of non-capital LAC debt instruments to enhance their LAC debt resources in light of cost considerations.

Chart 2 – Composition of LAC debt instruments issued by relevant AIs



Notes for Chart 2:

- (1) The chart comprises data of AIs which have been classified as resolution entities or material subsidiaries under the LAC Rules, including D-SIBs and non-D-SIBs.
- (2) Data is based on the accounting value of outstanding LAC debt instruments at end-December 2018 and end-June 2023.

²⁵ Under the LAC Rules, LAC debt instruments refer to instruments meeting the qualifying criteria in Schedule 1 (for external LAC debt instruments) or Schedule 2 (for internal LAC debt instruments), namely eligible AT1 capital instruments, eligible T2 capital instruments and non-capital LAC debt instruments.

OBSERVATIONS AND RELATED POLICY EXPECTATIONS

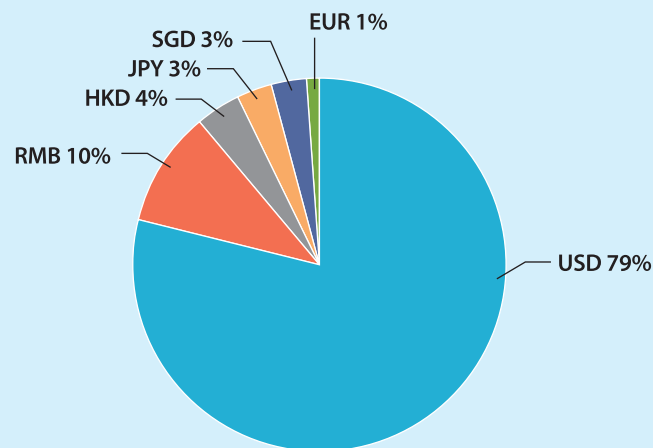


4.3 Currency mix

Resolution entities and material subsidiaries predominantly issued LAC debt instruments denominated in USD. At end-June 2023, LAC debt instruments denominated in USD accounted for 79% of their total outstanding issuances. The proportion of LAC debt instruments denominated in other currencies was relatively small. Specifically, Renminbi contributed 10%, Hong Kong dollar made up 4%, Japanese Yen and Singapore dollar each accounted for 3% and Euro represented 1%.

In determining the currency in which to issue their LAC debt instruments, AIs typically take into account their overall funding strategy, their deposit base, and the needs of their business operations, to align their funding structure with the currency risks inherent on their balance sheets and reduce potential currency mismatch risks. For LAC debt instruments funded by external issuances of its parent company, an AI's choice of currency may also be influenced by its parent company's target investor base. Some banks might also opt to issue LAC debt instruments in different currencies to diversify their investor base and reduce concentration risks associated with fewer currencies. Other factors, such as funding costs, liquidity and hedging considerations, would also be relevant.

Chart 3 – Currency mix of outstanding LAC debt instruments issued by relevant AIs



Notes for Chart 3:

- (1) The chart comprises data of AIs which have been classified as resolution entities or material subsidiaries under the LAC Rules, including D-SIBs and non-D-SIBs.
- (2) Data is based on the accounting value of outstanding LAC debt instruments at end-June 2023.

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4.4 Issuance volume

During the period from January 2019 to June 2023, AIs which have been classified under the LAC Rules issued a gross total of HK\$511 billion of LAC debt instruments, comprising HK\$104 billion of AT1 capital instruments, HK\$48 billion of T2 capital instruments and HK\$359 billion of non-capital LAC debt instruments. Taking into account early repayments/redemptions, the net issuance of LAC debt instruments by these AIs during such period amounted to HK\$284 billion, comprising HK\$37 billion of AT1 capital instruments, HK\$12 billion of T2 capital instruments and HK\$235 billion of non-capital LAC debt instruments.

Given all currently designated D-SIBs in Hong Kong are part of G-SIBs, the D-SIBs typically adopt a back-to-back model for issuing LAC debt instruments on an intragroup basis to their non-Hong Kong ultimate parent or holding companies (resolution entities), which in turn further issue TLAC²⁶ to market. Accordingly, it is observed that the issuance activities of D-SIBs generally coincide with those of their parent companies to a considerable extent, as demonstrated by changes in issuance volume during the COVID-19 pandemic and in the aftermath of the full write-down of all Credit Suisse's AT1 capital instruments.

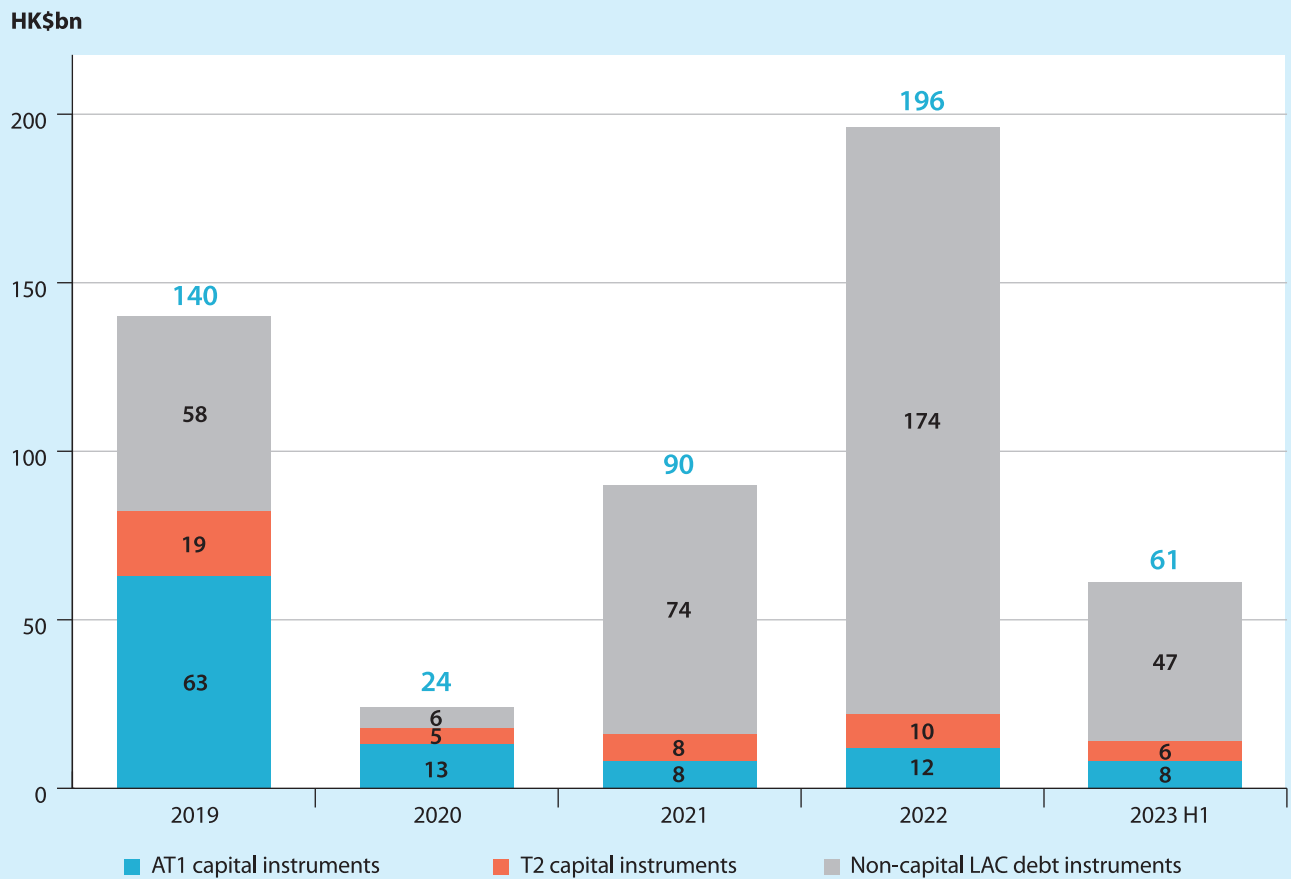
During the global outbreak of the COVID-19 pandemic in March 2020, TLAC issuance by G-SIBs was temporarily affected by significant volatility in various financial asset classes and elevated strain on funding markets, but gradually recovered and continued through the difficult pandemic environment on the back of large-scale monetary interventions by major central banks. As market volatility eased, the D-SIBs in Hong Kong continued their issuances of intragroup LAC debt instruments to their parent or holding companies, which issued TLAC to market investors, effectively leveraging the well-established diversified global investor network to facilitate issuances and build up LAC resources to enhance resolvability. This was reflected in the significantly higher issuance volume of LAC debt instruments by D-SIBs in 2021 and 2022 compared with 2020.

In the banking turmoil in the US and Europe in March 2023, the full write-down of all of Credit Suisse's AT1 capital instruments posed another market-wide impact to debt issuance activities by FIs, particularly on the primary and secondary markets for AT1 capital instruments. Coupled with other factors, including the elevated interest rate environment and the vast volume of LAC debt instruments issued in 2021 and 2022, a relatively lower gross issuance volume of LAC debt instruments by D-SIBs was observed in H1 2023.

²⁶ The term "TLAC" in this report refers to instruments and liabilities meeting the eligibility criteria set out in the TLAC Term Sheet.

OBSERVATIONS AND RELATED POLICY EXPECTATIONS

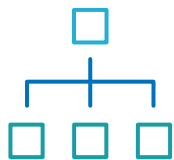
Chart 4 – Gross issuance volume of LAC debt instruments by relevant AIs



Note for Chart 4:

- The chart shows the total gross notional amount of LAC debt instruments issued by resolution entities and material subsidiaries since their classification under the LAC Rules.

OBSERVATIONS AND RELATED POLICY EXPECTATIONS



4.5 Issuance structure

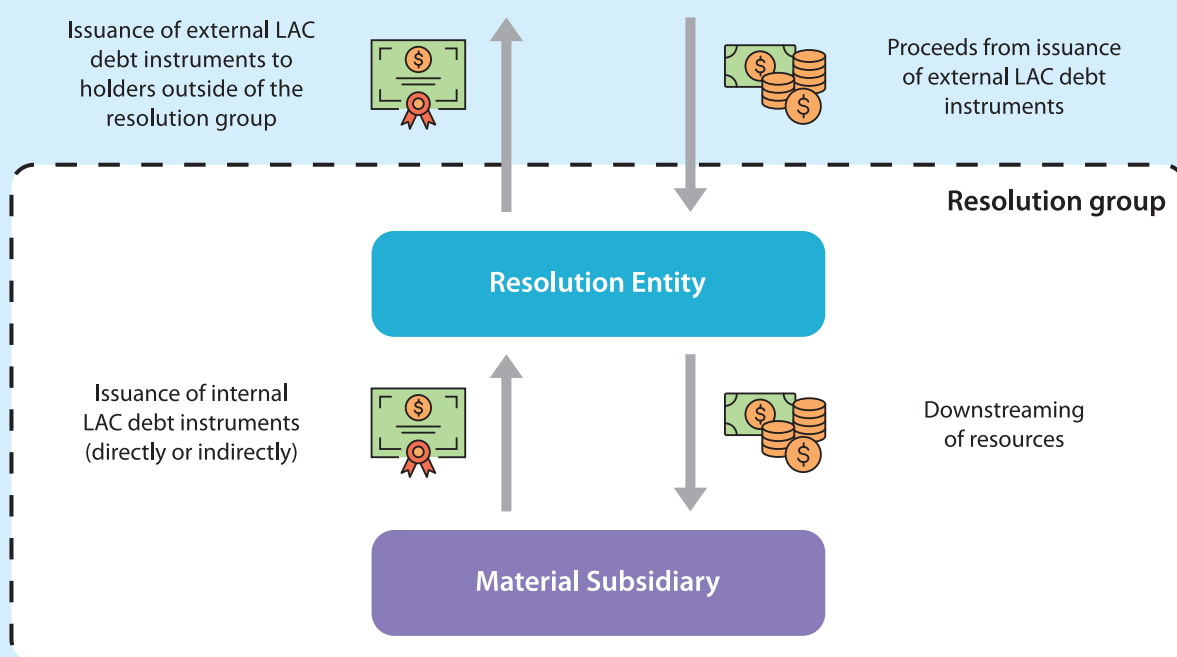
The issuance structure of LAC debt instruments of an AI follows its group structure and its preferred resolution strategy. For an AI that is part of a G-SIB banking group, the preferred resolution strategy would typically involve a contractual loss transfer from the AI (directly or indirectly) to its ultimate parent company (i.e. the resolution entity) incorporated in the relevant non-Hong Kong jurisdiction. To support the implementation of such resolution strategy, the AI, as a material subsidiary, would be expected to issue internal LAC debt instruments to the resolution entity (directly or indirectly), which may in turn fund these intragroup internal LAC debt instruments by the issuance of external LAC debt instruments or external TLAC, as the case may

be, to holders outside of the resolution group. In such circumstances, it could be that the issuance at the level of the resolution entity and the downstreaming of funds to the AI level would take place on a back-to-back basis (i.e. with identical commercial terms, including notional value, maturity, currency, etc.).

Given that the parent companies of G-SIBs would typically have ready access to a deep and active global debt capital market, a potential benefit of such an arrangement is that AIs can obtain funding for their internal LAC resources through the well-established issuance channels of their parent companies and diversify their funding sources, as compared to external issuances to the local market alone.

For an AI that is not part of an international banking group, the AI (or its clean HK holding company, if any) may be classified as a resolution entity. Consequently, the AI (or its clean HK holding company) would issue external LAC debt instruments directly to market.

Figure 1: Illustration of back-to-back issuance structure



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4.6 Pricing

The pricing of LAC debt instruments is influenced by various market and institution-specific factors as well as the structure and terms of the instruments. For LAC debt instruments issued to market, their pricing would generally depend on factors such as the AI's creditworthiness, yields offered by comparable outstanding instruments issued by peer banks, the AI's investor base and appetite, as well as prevailing market conditions.

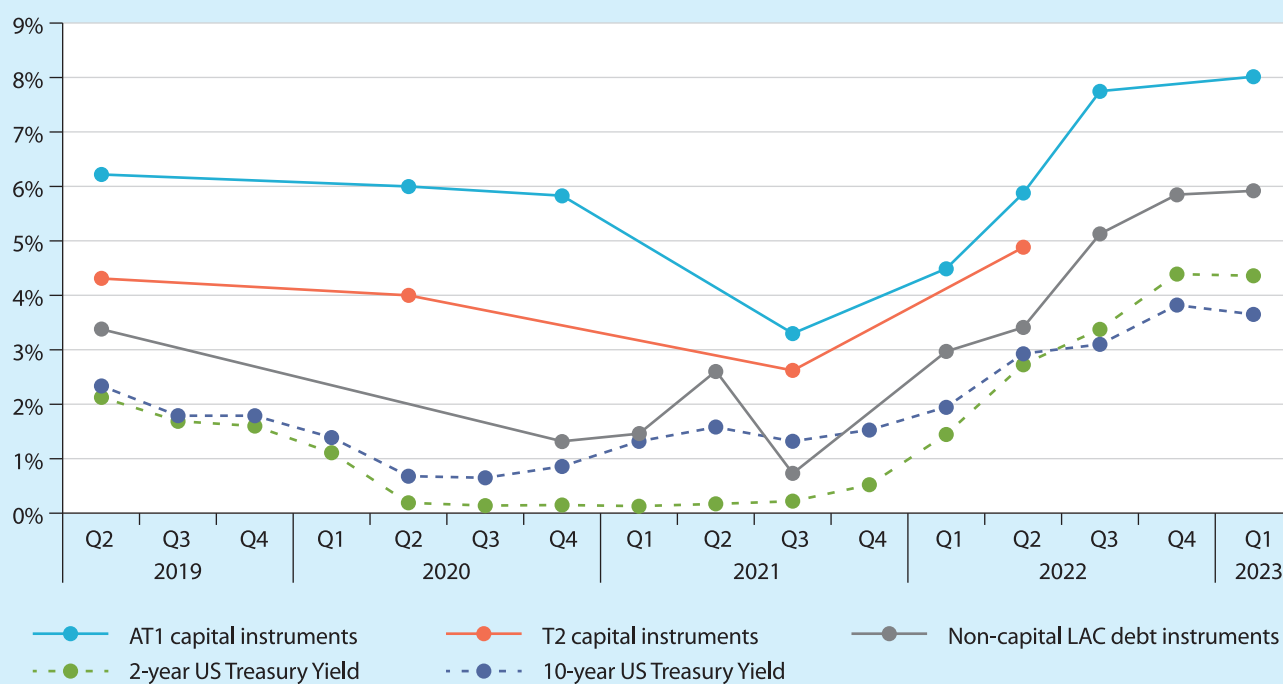
Where LAC debt instruments are issued on an intragroup basis, it is noted that a significant portion of such instruments is typically funded by the ultimate parent company of the group through external debt issuances on a back-to-back basis. In other words, the ultimate parent entity would usually downstream funding obtained through external debt issuances and pre-position such funding as LAC resources at the AI. Under such back-to-back intragroup issuance arrangement, the pricing of intragroup LAC debt instruments is typically determined on an arm's length basis and highly related to market conditions, including the prevailing interest rate environment. Hence, the cost of such intragroup LAC debt instruments would likely move in line with the pricing of external debt issuances, despite being issued on an intragroup basis and not directly to market.

For the purpose of analysis and illustration, the weighted-average interest rates at the time of issuance in respect of each type of LAC debt instruments denominated in USD are used to shed light on the general movement of the pricing of LAC debt instruments issued by resolution entities and material subsidiaries over time. As can be seen in Chart 5 below, the pricing largely moves in line with the benchmarks for medium to long term interest rates (2-year and 10-year US Treasury yields). The interest rates of LAC debt instruments at the time of issuance experienced a continued decrease in 2019, consistent with the federal funds rate cuts in the US. Following the global economic downturn caused by the COVID-19 pandemic and central banks' intervention to provide liquidity, the downward trend of the interest rates of LAC debt instruments bottomed out in Q3 2021 given the containment of COVID-19. Starting from 2022, amid monetary policy normalisation in the US, there has been an upward trajectory in the interest rates of LAC debt instruments at the time of their issuance.

Interest rates of LAC debt instruments are consistent with their ranking in the creditor hierarchy, with non-capital LAC debt instruments ranking above AT1 and T2 capital instruments. Broadly speaking, it is observed that AT1 capital instruments carry interest rates that exceed non-capital LAC debt instruments by 200 to 300 basis points on average during the review period, with a maximum observed difference of 450 basis points in Q4 2020.

OBSERVATIONS AND RELATED POLICY EXPECTATIONS

Chart 5 – Weighted-average interest rates of USD LAC debt instruments issued by relevant AIs at the time of issuance



Notes for Chart 5:

- (1) The chart comprises data of AIs which have been classified as resolution entities or material subsidiaries under the LAC Rules and includes issuances since their classification during January 2019 to June 2023.
- (2) Quarterly averages of the 2-year US Treasury yield and 10-year US Treasury yield are used as benchmarks.
- (3) The data point of T2 capital instruments for Q3 2021 represents the average yield observable in the secondary market, as no issuance of T2 capital instruments by relevant AIs took place in 2021.

OBSERVATIONS AND RELATED POLICY EXPECTATIONS

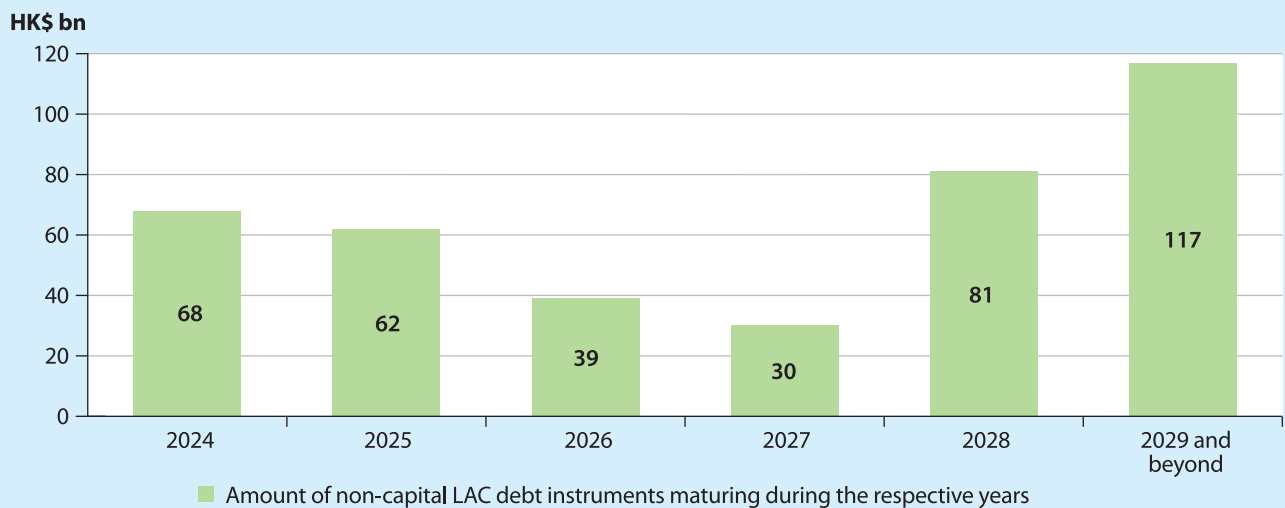


4.7 Maturity profile

It is observed that the contractual maturities of outstanding non-capital LAC debt instruments vary from 2 years to 30 years. Maturity profile of outstanding non-capital LAC debt instruments as at end-June 2023 is illustrated in Chart 6 below.

Under the LAC Rules, an instrument that has a remaining contractual maturity of less than 12 months would no longer qualify as an external or internal LAC debt instrument, and therefore would no longer count towards LAC resources of a resolution entity or material subsidiary. While their maturities vary, all non-capital LAC debt instruments of the relevant AIs contain one or more call options which, with the prior consent of the MA under the LAC Rules, can be exercised at least 12 months earlier than their contractual maturity dates, so that the AIs may repay an instrument before it can no longer count towards its LAC resources and potentially issue a replacement instrument.

Chart 6 – Maturity profile of outstanding non-capital LAC debt instruments (i.e. excluding AT1 and T2 capital instruments) issued by relevant AIs



Notes for Chart 6:

- (1) The chart comprises data of AIs which have been classified as resolution entities or material subsidiaries under the LAC Rules.
- (2) Data is based on the notional value of outstanding non-capital LAC debt instruments at end-June 2023.

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4.8 Documentation

Als adopt different approaches to documenting the terms and conditions of their LAC debt instruments. LAC debt instruments issued to market investors are typically structured as notes/securities, and LAC debt instruments issued on an intragroup basis are structured either in the form of intragroup loans or notes/securities. Given the distinct legal forms between loans and notes/securities, different key documents may be involved in setting out the terms and conditions of LAC debt instruments.

It is observed that the key documents for LAC debt instruments issued in the form of intragroup loans may include a master loan agreement between the AI as borrower and its parent company or holding company as lender, which contains the master terms and conditions in respect of all intragroup loans (i.e. internal LAC debt instruments) to be made between the AI and its parent

company or holding company under the master loan agreement. Each such intragroup loan would usually be constituted by a short loan agreement setting out the specific terms of the loan, such as its principal amount, interest rate and maturity date, and would typically incorporate by reference the master terms and conditions set out in the master loan agreement.

LAC debt instruments may also be issued in the form of notes/securities, either intra-group or externally, with different documentation approaches. For example, the relevant key documents could include a deed poll made by the AI as an issuer, where the general terms and conditions of notes/securities issued under the programme are set out and incorporated by reference into the notes/securities. Another documentation approach would involve an offering circular, which may include detailed information about the issuer, its business and financial activities, general terms and conditions of the offering programme and required disclosures for complying with the relevant listing rules as applicable. In both cases, a pricing supplement would typically set out specific terms for each issue, such as the issuance size, coupon rate and issue/maturity date.

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4.9 Subordination

As set out in the Key Attributes, resolution powers should be exercised in a way that respects the hierarchy of claims²⁷. The Key Attributes also specify that equity should absorb losses first, and no loss should be imposed on senior debt holders until subordinated debt (including all regulatory capital instruments) has been written down entirely. This ensures that creditors bear losses in a resolution in the same order as in a liquidation process, reducing uncertainty about resolution outcomes. In addition, to provide further clarity and protection to investors, the Key Attributes provide that “[c]reditors should have a right to compensation where they do not receive at a minimum what they would have received in a liquidation of the firm under the applicable insolvency regime” (known as the NCWOL safeguard).

Building on the Key Attributes, a principle outlined in the TLAC Term Sheet is that in order for TLAC to absorb losses in a time of stress in the financial markets without spreading contagion and without necessitating the allocation of loss to liabilities where that would cause disruption to critical functions or significant financial instability, TLAC should not include operational liabilities on which the performance of critical functions depends and should be subordinated in some way to those operational liabilities²⁸. The requirement for TLAC-eligible liabilities (which could be written-down or converted into equity in a bail-in) to be subordinated results in these claims ranking junior to operational liabilities at all times in a transparent manner. This also helps lower the

likelihood of NCWOL compensation claims on the resolution authority and facilitate the continuity of critical financial functions in resolution.

Three different approaches to subordination for TLAC-eligible debt instruments are introduced under the TLAC Term Sheet, namely contractual subordination, structural subordination, and statutory subordination. Under the LAC Rules, the requirement for subordination is established as part of the qualifying criteria for external LAC debt instruments (Schedule 1 to the LAC Rules) and internal LAC debt instruments (Schedule 2 to the LAC Rules), which specify that the instrument must be either subordinated to depositors and general creditors of the issuing entity (i.e. contractual subordination) or issued by a clean HK holding company (i.e. structural subordination). The statutory creditor hierarchy in Hong Kong does not provide for the subordination of LAC debt instruments to the claims of depositors and general creditors.

It is observed that all LAC debt instruments issued in Hong Kong adopt the contractual subordination approach. The creditor ranking of claims, such as claims in respect of unsubordinated obligations (e.g. deposits, general senior creditors), non-capital LAC debt instruments, regulatory capital instruments and other junior obligations, in the event of a winding-up (or insolvency) is clearly delineated in the terms and conditions of LAC debt instruments, which enhances transparency and clarity. In one case, a clean HK holding company was established as the parent company of an AI to act as the resolution entity for its resolution group, which also achieved structural subordination of external LAC debt instruments issued by the clean HK holding company.

²⁷ See paragraph 5.1 of the Key Attributes.

²⁸ See principle (vii) of the TLAC Term Sheet.

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4.10 Loss-absorption trigger and features

The write-down or conversion into equity of internal non-capital LAC debt instruments issued by a material subsidiary is expected to be effected contractually in accordance with the terms and conditions of these instruments. To facilitate the effectiveness of such a contractual approach, the LAC Rules require the terms and conditions of internal non-capital LAC debt instruments to contain a provision requiring the material subsidiary to ensure that the instruments will be either written down or converted into ordinary shares, on the occurrence of a trigger event.

As set out in section 2(2) of Schedule 2 to the LAC Rules, the trigger event is the occurrence of: (a) the MA notifying the AI in writing that the MA is satisfied that the AI has ceased, or is likely to cease, to be viable and there is no reasonable prospect that private sector action (outside of resolution) would result in it again becoming viable within a reasonable period (in both cases, without taking into account the write-down or conversion into ordinary shares of any LAC debt instruments)²⁹; and (b) for an internal non-capital LAC debt instruments issued directly to a group company established or incorporated in a non-Hong Kong jurisdiction, the MA notifying the material subsidiary in

writing that: (i) the MA has notified its home resolution authority of the MA's intention to notify the material subsidiary under (a) above; and (ii) the home resolution authority has consented to the write-down or conversion of the internal non-capital LAC debt instruments issued by the material subsidiary, or has not, within 24 hours after receiving such notice from the MA, objected to the write-down or conversion of the internal non-capital LAC debt instruments issued by the material subsidiary.

Limb (b) of the trigger event reflects the principle that the imposition of losses on internal non-capital LAC debt instruments that are issued directly to a group company established or incorporated in a non-Hong Kong jurisdiction should involve both the home and host resolution authorities.

It is observed that the loss-absorption triggers of outstanding internal non-capital LAC debt instruments issued by material subsidiaries are aligned with the trigger language provided in the LAC Rules.

A material subsidiary may elect to include one or the other, or both, of write-down and conversion in the terms and conditions of its internal non-capital LAC debt instruments. Generally speaking, this is in common with the corresponding provisions in Schedules 4B and 4C to the BCR setting out the applicable qualifying criteria for AT1 and T2 capital instruments respectively. As it currently stands, the terms and conditions of all outstanding internal LAC debt instruments in Hong Kong include only a write-down mechanism.

²⁹

If the material subsidiary is instead an HK holding company or an HK affiliated operational entity, this aspect of the trigger event would be the MA notifying the material subsidiary in writing that the MA is satisfied that a relevant AI (i.e. any AI incorporated in Hong Kong of which the material subsidiary is a holding company or affiliated operational entity (as the case requires) and that is in the same resolution group as the material subsidiary) has ceased, or is likely to cease, to be viable and there is no reasonable prospect that private sector action (outside of resolution) would result in it again becoming viable within a reasonable period (in both cases, without taking into account the write-down or conversion into ordinary shares of any LAC debt instruments).

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4.11 Restrictions on sale and distribution

LAC debt instruments are expressly designed to bear loss to support loss-absorption and recapitalisation should an AI become non-viable. Where LAC debt instruments absorb losses, this is done via their outstanding amounts being written down or converted into equity depending on their terms and conditions. Such write-down or conversion could potentially result in substantial losses to investors. The hybrid features of LAC debt instruments – debt-like on issue, but with equity-like loss-absorbing characteristics – make them more complex than conventional bonds.

In view of the loss-absorption features and complex nature, for any external LAC debt instrument³⁰, the LAC Rules require its prospectus or offering document to adequately disclose the risks inherent in the holding of the instrument, and to state that the instrument is complex and high risk. Also, if issued in Hong Kong, the eligible instrument must be issued to a professional investor³¹. These provisions are complemented by other aspects of the investor protection regime in Hong Kong, including relevant circulars³² issued from time to time by the HKMA and the Securities and Futures Commission.



4.12 Governing law

The LAC Rules require external and internal LAC debt instruments to be subject to the law of Hong Kong, unless the issuer has obtained independent legal advice acceptable to the MA that, under the governing law of the instrument, the application of resolution powers under the FIRO, including the application of any stabilization option, in relation to the instrument or any liability constituted by the instrument, would be effective and enforceable on the basis of binding statutory provisions or legally enforceable contractual provisions³³. In this regard, the resolution entity or material subsidiary is expected to obtain a legal opinion issued under the relevant governing law addressing relevant matters such as the legal effectiveness of any write-off or conversion provisions and the absence of legal impediments to such provisions operating in accordance with their terms, the legal effectiveness of the acknowledgement or agreement of the instrument holder in relation to any exercise of powers under the FIRO, as well as the issue of whether the governing law of the instrument could prevent the instrument from satisfying the qualifying criteria set out in Schedule 1 to the LAC Rules (for an external LAC debt instrument) or Schedule 2 to the LAC Rules (for an internal LAC debt instrument), including the degree of subordination³⁴.

³⁰ Except for (a) AT1 capital instruments and T2 capital instruments that were issued before the LAC Rules came into operation; or (b) an instrument issued to and held by a group company of the issuer.

³¹ "Professional investor" is defined in section 1 of Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571).

³² For example, the updated circular "[Sale and Distribution of Debt Instruments with Loss-absorption Features and Related Products](#)", with [Annex 1](#) and [Annex 2](#), issued on 21 October 2022.

³³ For external LAC debt instruments, see sections 1(1)(k) and 1(4) of Schedule 1 to the LAC Rules. For internal LAC debt instruments, see sections 1(1)(j) and 1(4) of Schedule 2 to the LAC Rules.

³⁴ Paragraphs 15.3 and 15.4 of LAC-1.

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The majority of outstanding internal LAC debt instruments issued by material subsidiaries to their intragroup entities are governed by the law of Hong Kong. All outstanding external LAC debt instruments issued by resolution entities to market investors and a minority of internal LAC debt instruments are governed by English law, except for the provisions relating to the subordination of these instruments and also, in some cases, the provisions relating to set-off, loss absorption and/or the recognition of the exercise of FIRO powers, which are governed by Hong Kong law.



4.13 Accounting classification and measurement

Als may categorise LAC debt instruments as liabilities or as equity on their balance sheets in accordance with applicable accounting standards and their internal accounting policies. It is observed that, as at the date of this report, all LAC-eligible T2 capital instruments and non-capital LAC debt instruments of the relevant Als are classified as liabilities, while LAC-eligible AT1 capital instruments are typically classified as equity.

For T2 capital instruments and non-capital LAC debt instruments classified as liabilities, they are typically measured either at amortised cost or at fair value through profit or loss ("FVTPL"). When measured at amortised cost, LAC debt instruments are initially recognised at fair value less transaction costs and are thereafter measured at amortised cost using the effective interest method. The carrying values are relatively stable. In contrast, the fair value of LAC debt instruments measured at FVTPL would be influenced by a range of factors, including changes in market interest rates. In recent years, rising interest rates have had a negative impact on the fair values of LAC debt instruments issued by resolution entities or material subsidiaries in general, resulting in decreases in the value of those instruments counting towards LAC resources.

For AT1 capital instruments classified as equity, similar to the treatment of share capital, they are recognised upon issuance and subsequently measured at cost. As such, their carrying values tend to be more stable.

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4.14 Self-assessment

As set out in paragraph 15.2 of LAC-1, in order to ensure that a proposed item (including any existing item issued before the classification date of a resolution entity or material subsidiary) can be included within external or internal LAC resources, the resolution entity or material subsidiary will have to undertake a detailed self-assessment, and will be expected to review and document:

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

As part of the self-assessment for any proposed LAC debt instrument, a resolution entity or material subsidiary should obtain a sufficiently independent legal opinion to ensure compliance from a legal perspective. The completed self-assessment, together with any relevant legal opinions and a letter from the Chief Financial Officer (or another person with an equivalent role and seniority) confirming points (a) and (b) above, should be submitted to the HKMA.

Following the standing practice set out in paragraph 15.7 of LAC-1, a resolution entity or material subsidiary proposing to issue a LAC debt instrument for inclusion in its LAC is expected to, when in doubt, to discuss with the

resolution authority beforehand whether the proposed instrument complies with the necessary criteria, and provide the relevant supporting documents, which typically include drafts of the terms and conditions of the proposed instrument, self-assessment, confirmation letter and legal opinions, to the HKMA for discussion purposes.

The HKMA will communicate an acknowledgement based on confirmations by the resolution entity or material subsidiary once there are no further follow-up issues in respect of the proposed item for inclusion in LAC resources. In this regard, it should be noted that the acknowledgement by the HKMA does not constitute approval or confirmation of any kind that the relevant LAC debt instrument complies with all the criteria necessary for it to constitute LAC resources. The responsibility of ensuring such compliance rests at all times with the relevant resolution entity or material subsidiary.

For resolution entities or material subsidiaries conducting self-assessments for any LAC debt instruments for the first time, the process of refining the draft supporting documents is likely to be interactive and involves a certain amount of time. For example, enhancements may be needed regarding the language in the terms and conditions on the order of loss absorption between different classes of liabilities, and for consistency in the descriptions between different supporting documents.

In light of the detailed nature of the qualifying criteria of LAC debt instruments and the specifics required of the supporting documents for self-assessments, resolution entities and material subsidiaries are encouraged to commence the self-assessment process sufficiently early in advance of the proposed issuance of any LAC debt instruments or inclusion of any existing items in its LAC resources. Resolution entities and material subsidiaries should have a sufficient level of understanding of the qualifying criteria of LAC debt instruments and obtain professional advice where needed.

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Drawing from the HKMA's observation, the self-assessment is an effective process for the resolution entity or material subsidiary to ensure compliance of the terms of the proposed instrument to be issued with the applicable qualifying criteria of LAC debt instruments under the LAC Rules. By undertaking self-assessments, a resolution entity or material subsidiary can identify potential enhancements to the terms of the proposed instrument, where needed, to meet the relevant qualifying criteria, helping to ensure the ability of the instrument to absorb losses and support recapitalisation as contemplated by the preferred resolution strategy. As the confirmation by the resolution entity or material subsidiary referred to above is expected to be made by the Chief Financial Officer (or another person with an equivalent role and seniority), the self-assessment process also helps ensure sound governance and senior management oversight of the LAC issuance process and AIs' resolvability.

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4.15 Amendments for LIBOR transition

Over the past few years, the FSB has worked with regulatory authorities and international standard-setting bodies to develop and implement reform proposals to enhance the robustness of interest rate benchmarks. The end of June 2023 marked the final major milestone in the LIBOR transition with the end of the remaining USD LIBOR panel³⁵.

Some pre-existing LAC debt instruments of banks with floating rates or reset features had adopted USD LIBOR as a reference rate. In light of the cessation of USD LIBOR as a result of the interest rate benchmark reforms, some resolution entities and material subsidiaries have taken the initiative to amend the terms and conditions of their existing LAC debt instruments solely for the purpose of implementing the interest rate benchmark reforms, including amendments to transition away from LIBOR. It is observed some banks have used the Secured Overnight Financing Rate (i.e. SOFR) to replace USD LIBOR as an alternative reference rate for their LAC debt instruments.

Provided that an existing LAC debt instrument is amended solely for the purpose of effecting the reform of interest rate benchmarks, it may not be necessary for a resolution entity or material subsidiary to conduct a self-assessment of LAC eligibility described in section 4.14.

Nevertheless, the responsibility of ensuring ongoing compliance with the applicable LAC debt instrument qualifying criteria set out in the LAC Rules rests with the resolution entity or material subsidiary. The resolution entity or material subsidiary is encouraged to conduct analysis on whether, and if so how, the amendments would impact the LAC eligibility of the relevant instruments, and discuss with the HKMA if in doubt.

³⁵See the FSB's "Final Reflections on the LIBOR Transition". <https://www.fsb.org/2023/07/final-reflections-on-the-libor-transition/>

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4.16 Disclosures and reporting

Transparency of LAC, especially the order in which LAC will absorb losses in resolution, is relevant for investors, creditors, counterparties, depositors and other market participants. The TLAC Term Sheet stipulates that G-SIBs must disclose the amount, maturity and composition of external TLAC that is maintained by each resolution entity and internal TLAC that is held at each legal entity that forms part of a material sub-group. In line with the TLAC Term Sheet, the Basel Committee on Banking Supervision ("BCBS") introduced and enhanced certain disclosure templates³⁶, which have been integrated into the BCBS's Pillar 3 disclosure requirements³⁷.

Under the LAC Rules, similar requirements³⁸ apply to resolution entities and material subsidiaries for regular disclosures of the following information in relation to their LAC:

- Summary information on, and explanations of any material changes in, LAC
- Composition of, and explanations of any material changes in the composition of, LAC
- Creditor ranking at legal entity level
- Main features of regulatory capital instruments and non-capital LAC debt instruments

Resolution entities and material subsidiaries have been making quarterly and semi-annual disclosures, and lodging a copy of their disclosure statements with the HKMA before the publication of such statements in line with the LAC Rules. The disclosures made are usually contained in the banking disclosure statements published together with other regulatory disclosures required under the Banking (Disclosure) Rules (Cap. 155M). These statements can be accessed through the internet websites of the relevant entities or their group companies.

These disclosures enhance the credibility and feasibility of resolution, as they provide stakeholders with comprehensive data about an entity's LAC and the order in which losses may be absorbed in the event of a resolution, thereby increasing the understanding of the resolution process by these stakeholders and the likelihood of an orderly resolution. Also, such disclosures in turn encourage banks to manage their financial resources and business profiles in a prudent and sound manner, fostering market discipline.

In addition to disclosures, the relevant AIs regularly report information on their LAC resources, including LAC positions and projections, to the HKMA for monitoring the LAC implementation progress as part of bilateral resolution planning programmes.

³⁶ These include template KM2 (Key metrics – Total Loss-Absorbing Capacity (TLAC) requirements at resolution group level), table CCA (Main features of regulatory capital instruments and of other total loss-absorbing capacity (TLAC) - eligible instruments), template TLAC1 (TLAC composition for global systemically important banks (G-SIBs) (at resolution group level)), template TLAC2 (Material subgroup entity – creditor ranking at legal entity level) and template TLAC3 (Resolution entity – creditor ranking at legal entity level).

³⁷ https://www.bis.org/basel_framework/standard/DIS.htm

³⁸ The set of standard LAC disclosure templates with explanatory note is available at https://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/resolution/LAC_disclosure_template_eng.docx

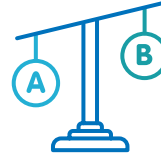
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4.17 Cross-holdings of TLAC

As losses arising from the failure of an AI may in resolution be imposed on its LAC debt instruments, any large-scale investment by other AIs in such instruments would have the potential to act as a vehicle for financial contagion. Building on the BCBS's "TLAC holdings" standard³⁹ and FSB's TLAC Term Sheet⁴⁰, to minimise possible contagion within the financial system, investments by an AI in the capital instruments or non-capital LAC liabilities issued by other banks are in general subject to deductions under the BCR when calculating regulatory capital. In addition, holdings of non-capital LAC liabilities issued by the AI itself or by a group company which is not in the same LAC consolidation group are in general deducted from the calculation of LAC resources under the LAC Rules⁴¹.

The HKMA monitors AIs' holdings of TLAC instruments to understand the impact of potential contagion. In addition, to provide transparency to the market, AIs are required to disclose the relevant deductions made under the BCR and, as applicable, the LAC Rules regularly, through template CC1 (Composition of regulatory capital), template TLAC1 (LAC composition of resolution entity (at LAC consolidation group level)) and template TLAC1(A) (LAC composition of material subsidiary (at LAC consolidation group level)).



4.18 Cross-bank comparison

It is important to note that LAC requirements are institution-specific and take into account the preferred resolution strategy identified for the relevant resolution entity or material subsidiary. For example, depending on the preferred resolution strategy, an AI incorporated in Hong Kong that is part of a wider banking group may be classified as a material subsidiary and be subject to internal LAC requirements that have been scaled down by an internal LAC scalar, whereas an AI incorporated in Hong Kong that is the parent company of a resolution group may be classified as a resolution entity and be subject to external LAC requirements without such scalar. In addition, the calibration of the different components and applicable scalars (internal LAC scalar and solo LAC scalar) of LAC requirements is institution-specific.

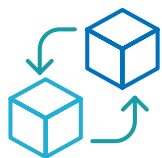
Therefore, LAC requirements for different AIs may not be directly comparable. Given that AIs typically maintain their level of LAC with reference to their applicable LAC and other regulatory requirements, this also means that a numerical comparison between the LAC ratios of any two AIs may not be meaningful. Considerations should be given to the complexity involved when assessing the LAC positions across multiple AIs.

³⁹ <https://www.bis.org/bcbs/publ/d387.pdf>

⁴⁰ Section 15 of the TLAC Term Sheet, providing for the regulation of investors, stipulates that in order to reduce the risk of contagion, G-SIBs must deduct from their own TLAC or regulatory capital exposures to eligible external TLAC instruments and liabilities issued by other G-SIBs in a manner generally parallel to the existing provisions in Basel III that require a bank to deduct from its own regulatory capital certain investments in the regulatory capital of other banks.

⁴¹ For resolution entities and material subsidiaries that are AIs: (a) for the purpose of meeting the minimum external or internal LAC requirements on a solo basis, holdings of non-capital LAC liabilities issued by entities in its LAC consolidation group are also required to be deducted from the calculation of the AI's LAC; and (b) for the purpose of meeting the minimum external or internal LAC requirements on a solo-consolidated basis, holdings of non-capital LAC liabilities issued by entities in its LAC consolidation group that are not solo-consolidated subsidiaries of the AI, are also required to be deducted from the calculation of the AI's LAC. See rules 38(1)(c), 38(1)(d), 40(1)(c) and 40(1)(d) of the LAC Rules for details.

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4.19 Interaction between LAC requirements and the capital regime

Consistent with the principle in the TLAC Term Sheet and the approach taken under the BCR, CET1 capital that counts towards the minimum LAC risk-weighted ratio cannot also count towards meeting regulatory capital buffers (this restriction does not apply in relation to the minimum LAC leverage ratio). Given the way in which regulatory capital buffers interact with the LAC and capital regimes in Hong Kong, in comparing between the total minimum resources needed to meet the minimum LAC risk-weighted ratio plus regulatory capital buffers and those needed to meet the minimum LAC leverage ratio, it is observed that the required total minimum resources are usually greater on the RWA side.

In addition, while resolution entities and material subsidiaries can meet their LAC requirements with LAC debt instruments as well as resources which are not LAC debt instruments (e.g. retained earnings and other disclosed reserves which count towards CET1, or ordinary shares), the minimum LAC debt requirement can only be met with LAC debt instruments. For an AI with an existing capital structure composed mainly of CET1 capital and with relatively less LAC debt resources (i.e. AT1 or T2 capital instruments which meet the relevant qualifying criteria under LAC Rules requirements to count as LAC resources), the minimum LAC debt requirement may be the key driver of its LAC debt issuances. Therefore, as part of its LAC planning and when designing LAC issuance plans, an AI would typically need to take into account its pre-existing and projected composition of LAC resources (i.e. its level of CET1 capital and LAC debt instruments), as well as the projections of its RWA and exposure measures, so as to maintain the desired level of LAC resources for meeting all relevant requirements.

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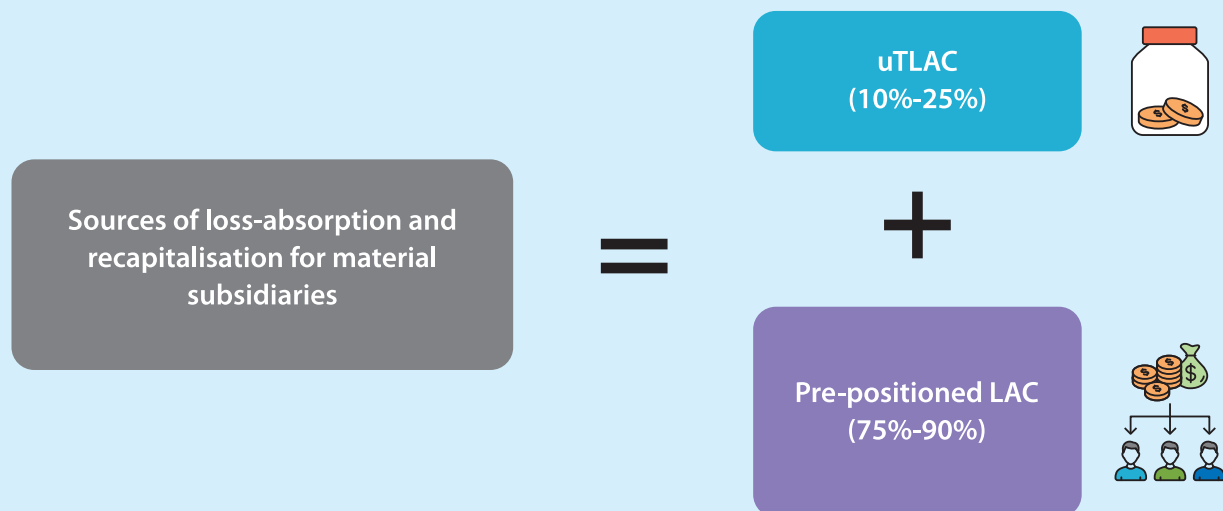


4.20 Non-pre-positioned LAC or unallocated TLAC

Non-pre-positioned LAC, or unallocated TLAC (“uTLAC”), refers to the TLAC resources of a banking group that are not distributed to material sub-groups and that are in excess of those needed to cover risks on the resolution

entity’s⁴² solo balance sheet. According to the TLAC Term Sheet, uTLAC should be made readily available to recapitalise any direct or indirect subsidiary of the resolution entity as necessary to support a resolution. Given that internal LAC requirements set by host resolution authorities for subsidiaries within a cross-border banking group have typically been scaled down by an internal LAC scalar, having sufficient and readily available uTLAC would be an important element to support the recapitalisation needs of such subsidiaries in a resolution and the effective implementation of the group-wide resolution strategy.

Figure 2: Sources of loss-absorption and recapitalisation for material subsidiaries



Note for Figure 2:

- Percentages are for illustrative purpose only and represent percentages of external LAC requirements that would apply had the material subsidiary been a resolution entity in the preferred resolution strategy

⁴²

A “resolution entity” referred to in this paragraph is not limited to those defined under the LAC Rules. It refers to an entity to which resolution tools will be applied in accordance with the preferred resolution strategy for its banking group in general.

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As a member of the FSB's uTLAC Technical Experts Group, the HKMA has been actively contributing to the policy development on uTLAC resources at the international level, which reached a milestone with the publication of a report by the FSB entitled "Deployment of Unallocated Total Loss-Absorbing Capacity (uTLAC): Considerations for Crisis Management Groups (CMGs)"⁴³ ("FSB CMG considerations report") in July 2023. The report lists a set of considerations to facilitate the operationalisation of uTLAC arrangements as part of G-SIB resolution planning among home and host resolution authorities. The considerations focus on the identification of corresponding assets in which uTLAC is held, the location of such assets, the arrangement for their deployment, in particular in a cross-border context, as well as the potential legal, regulatory and operational challenges that may arise. CMGs for G-SIBs are asked to inform the FSB, in 2023 and 2024, of their experiences with discussions based on the set of considerations described in the report.

Under the HKMA's LAC policy, the availability and sufficiency of non-pre-positioned LAC within a resolution group is one of the key factors in the determination of internal LAC scalar for a material subsidiary. Setting a lower internal LAC scalar would reduce the amount of internal LAC required to be pre-positioned at the material subsidiary and therefore increase the reliance on non-pre-positioned LAC resources in times of crisis should the material subsidiary run into difficulties and require financial resources to restore its viability.

The HKMA has been engaging with the relevant AIs on the design and implementation of the framework for

non-pre-positioned LAC resources through the bilateral resolution planning programmes. Where relevant, AIs have been working with their parent companies to develop an approach to the management and deployment of non-pre-positioned LAC resources, to ensure they are sufficient and readily available to support recapitalisation in a resolution. Amongst other things and consistent with the CMG considerations set out in the FSB CMG considerations report, the factors that AIs may take into account when developing their non-pre-positioned LAC framework would include: (i) the sufficiency of non-pre-positioned LAC resources compared to the loss-absorption and recapitalisation needs of the material subsidiaries; (ii) the liquidity of the assets corresponding to non-pre-positioned LAC; (iii) the ability of the assets corresponding to non-pre-positioned LAC to retain value in crisis times; (iv) the extent to which there is a clear and enforceable agreement between entities within the resolution group or governance arrangements among home and host resolution authorities, as the case may be, with defined triggers and calibration for the deployment of uTLAC in resolution; (v) the existence of regular and robust monitoring and reporting on the values of the corresponding assets in normal times; and (vi) the identification and mitigation of any legal, regulatory or operational obstacles to the deployment of non-pre-positioned LAC resources to a material subsidiary under financial stress.

Resolution entities and material subsidiaries may wish to take the above factors into account in taking forward their work on the design and implementation of the framework for non-pre-positioned LAC resources as applicable.

⁴³ <https://www.fsb.org/2023/07/deployment-of-unallocated-total-loss-absorbing-capacity-utlac-considerations-for-crisis-management-groups-cmgs/>

5. NEXT STEPS

Resolution planning, including actions to enhance resolvability, is an ongoing process. Establishing sufficient LAC resources is an important aspect to enhance the resolvability of AIs and strengthen the resilience of the banking system. The banking turmoil in the US and Europe in March 2023 highlighted the importance of LAC resources to support the use of resolution tools and to provide optionality for authorities in handling the failure of FIs and maintaining financial stability. The HKMA will continue to work closely with relevant AIs on their build-up and maintenance of LAC resources in a prudent and proportionate manner, taking into account international experiences, as well as evolving economic and market conditions. AIs and their stakeholders are encouraged to make reference to the observations identified in this report as appropriate.

ANNEX: GLOSSARY

Term	Definition
AI	Authorized institution
AT1	Additional Tier 1
BCBS	Basel Committee on Banking Supervision
BCR	Banking (Capital) Rules (Cap. 155L)
CET1	Common Equity Tier 1
CMG	Crisis management group
D-SIB	Domestic systemically important authorized institution
FI	Financial institution
FIRO	Financial Institutions (Resolution) Ordinance (Cap. 628)
FSB	Financial Stability Board
FSB CMG considerations report	Financial Stability Board's report "Deployment of Unallocated Total Loss-Absorbing Capacity (uTLAC): Considerations for Crisis Management Groups (CMGs)"
FVTPL	Fair value through profit or loss
G-SIB	Global systemically important bank
HKMA	Hong Kong Monetary Authority
Key Attributes	Financial Stability Board's "Key Attributes of Effective Resolution Regimes for Financial Institutions"
LAC	Loss-absorbing capacity
LAC Rules	Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements — Banking Sector) Rules (Cap. 628B)
LAC-1	Code of Practice chapter LAC-1 "Resolution Planning – LAC Requirements"
LIBOR	London Interbank Offered Rate
MA	Monetary Authority as resolution authority
MREL	Minimum requirement for own funds and eligible liabilities
NCWOL	No creditor worse off than in liquidation
RWA	Risk-weighted amount
TLAC	Total loss-absorbing capacity
TLAC Term Sheet or TLAC standard	Financial Stability Board's "Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution: Total Loss-absorbing Capacity (TLAC) Term Sheet"
T2	Tier 2
uTLAC	Unallocated Total Loss-absorbing Capacity



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