

# Developing rules on loss-absorbing capacity requirements for authorized institutions in Hong Kong

by the Resolution Office

As noted by the HKMA's Chief Executive, Norman Chan, recently,<sup>1</sup> the Financial Institutions (Resolution) Ordinance (FIRO) came into effect on 7 July 2017,<sup>2</sup> establishing the legal framework for a resolution regime for certain financial institutions in Hong Kong. This resolution regime is consistent with *the Key Attributes of Effective Resolution Regimes for Financial Institutions* published by the Financial Stability Board (FSB) in 2011, and re-issued in 2014.<sup>3</sup> Alongside a range of other resolution powers, it provides the resolution authorities with a bail-in power, which can be used to cancel or modify certain liabilities owed by a financial institution in resolution. However, some liabilities can be more easily bailed in than others. For the bail-in power to be effective in practice, it is therefore necessary to ensure a financial institution in resolution has a sufficient stock of liabilities that can be readily bailed in. Section 19 of the FIRO provides for resolution authorities to make rules setting out loss-absorbing capacity (LAC) requirements for certain financial institutions or their group companies.<sup>4</sup> The Monetary Authority (MA),<sup>5</sup> as resolution authority for authorized institutions (AIs), intends to make rules prescribing minimum LAC requirements for AIs. This article discusses some key questions related to LAC, and sets out the next steps in the development of LAC rules for AIs. The issues raised in this article are for the purposes of discussion only, and should not be taken as expressing any fixed policy intent of the MA at this time.

## 1. What is “loss-absorbing capacity”, and what is its purpose?

Loss-absorbing capacity, or LAC, refers to equity and certain liabilities of an AI that can be cancelled or modified (for example, by being written down or converted into equity) to reduce the AI's debt, thereby shoring up its balance sheet. LAC has two basic functions: it can absorb losses that are experienced by an AI on a going concern basis, and

it can be used to re-capitalise an AI on failure. More specifically, the FSB has issued guidance<sup>6</sup> (the FSB TLAC Principles) on what it terms “total loss-absorbing capacity” (TLAC), which sets out that loss-absorbing and re-capitalisation capacity can support an orderly resolution of a failing institution in a way that (i) minimises any impact on financial stability; (ii) ensures the continuity of critical functions; and (iii) with a high degree of confidence, avoids exposing public funds to loss.

<sup>1</sup> <http://www.hkma.gov.hk/eng/key-information/insight/20170810.shtml>

<sup>2</sup> Note that some provisions of the FIRO are not yet in operation, as set out in the Commencement Notice: <http://www.gld.gov.hk/egazette/pdf/20172119/es22017211977.pdf>

<sup>3</sup> As discussed in December 2015 issue of *HKMA Quarterly Bulletin*: <http://www.hkma.gov.hk/media/eng/publication-and-research/quarterly-bulletin/qb201512/fa1.pdf>

<sup>4</sup> Section 19 of the FIRO also allows for rules to be made for connected purposes to the setting of LAC requirements.

<sup>5</sup> The Monetary Authority is a public officer appointed by the Financial Secretary under section 5A of the Exchange Fund Ordinance, and is the Chief Executive of the HKMA.

<sup>6</sup> <http://www.fsb.org/2015/11/total-loss-absorbing-capacity-tlac-principles-and-term-sheet/>

LAC falls into one of two categories: (i) regulatory capital that is primarily designed to allow an AI to absorb losses on a *going concern* basis; and (ii) *gone concern* LAC that is designed to be available to support the re-capitalisation of an AI that has failed and has been put in resolution. Under the FIRO, an AI can only be put into resolution where its non-viability poses risks to the stability and effective working of the financial system of Hong Kong, including to the continued performance of critical financial functions (CFFs),<sup>7</sup> and where resolution will avoid or mitigate those risks. In other words, where an AI's non-viability would not pose such risks to the financial system of Hong Kong nor to the continued performance of such functions, it cannot be put into resolution (alternatives may include the use by the MA of his powers under the Banking Ordinance (BO),<sup>8</sup> and liquidation). In this latter case, no re-capitalisation in resolution of a gone concern would take place.<sup>9</sup>

## 2. How much loss-absorbing capacity should authorized institutions have?

It follows from the above that the amount of LAC an AI should be required to have will depend on how the AI would likely be dealt with on failure.

For an AI which because of its systemic significance would, on failure, be expected to be put into resolution under the FIRO, it is essential that the AI

(or its transferee)<sup>10</sup> is able to continue to perform its CFFs.<sup>11</sup> In order to achieve this, sufficient LAC would be required to allow for a re-capitalisation in resolution that enables the AI (or its transferee) to meet its authorization criteria, and to allow it to regain the confidence of market counterparties so that it could continue to operate.

Regulatory capital requirements are calibrated to allow AIs to absorb losses on a going concern basis, but are not designed to also provide resources for a substantial re-capitalisation in resolution. Accordingly, to ensure an AI in resolution (or its transferee) is able to meet its authorization criteria without recourse to public funds, LAC that is additional to the minimum regulatory capital requirements<sup>12</sup> and that can be converted into equity and/or written down through bail-in (additional LAC) needs to be available once resolution is initiated. The amount of additional LAC required will vary from AI to AI, and specifically will depend on the strategy that the resolution authority would be likely to adopt in resolution to enable the continued performance of the AI's CFFs.

Identifying a *preferred resolution strategy* for an AI is a key stage in resolution planning, and involves the MA identifying, in advance, a strategy that reflects how the MA would expect to deal with the resolution of that AI, should it prove necessary.<sup>13</sup> Among other things, the preferred resolution strategy will involve identifying which one or more of the "stabilization options" set out in the FIRO are considered most

<sup>7</sup> This is one of the three conditions for initiating resolution set out in section 25 of the FIRO. The other two conditions are (i) that the AI has ceased, or is likely to cease, to be viable; and (ii) that there is no reasonable prospect that private sector actions (outside of resolution) would result in the AI again becoming viable within a reasonable period.

<sup>8</sup> Among other things, section 52 of the BO grants the MA a broad power to direct a failing AI to take such action as the MA may consider necessary in relation to its affairs, business and property, and to appoint a manager over an AI, subject to certain conditions being met as set out in that section.

<sup>9</sup> Note that in these circumstances, where an AI has not been put into resolution, the writing down or conversion into equity of Additional Tier 1 (AT1) and/or Tier 2 (T2) capital could nevertheless occur.

<sup>10</sup> Some or all of the AI's assets and liabilities, including those that are associated with the continued performance of a CFF, may be moved across to a transferee using certain of the stabilization options set out in the FIRO.

<sup>11</sup> The objects of the FIRO include establishing a regime for the orderly resolution of financial institutions with a view to avoiding or mitigating the risks otherwise posed by their non-viability to the stability and effective working of the financial system of Hong Kong, including to the continued performance of CFFs (section 4 of the FIRO).

<sup>12</sup> If the approach set out in the FSB TLAC Principles is adopted, "additional LAC" should also be in addition to capital buffers, so that capital buffers do not count towards LAC.

<sup>13</sup> This is discussed in more detail in *The HKMA's Approach to Resolution Planning*, a chapter in the Code of Practice issued by the MA pursuant to section 196 of the FIRO: [http://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/resolutions/RA-2\\_The\\_HKMA\\_approach\\_to\\_resolution\\_planning.pdf](http://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/resolutions/RA-2_The_HKMA_approach_to_resolution_planning.pdf)

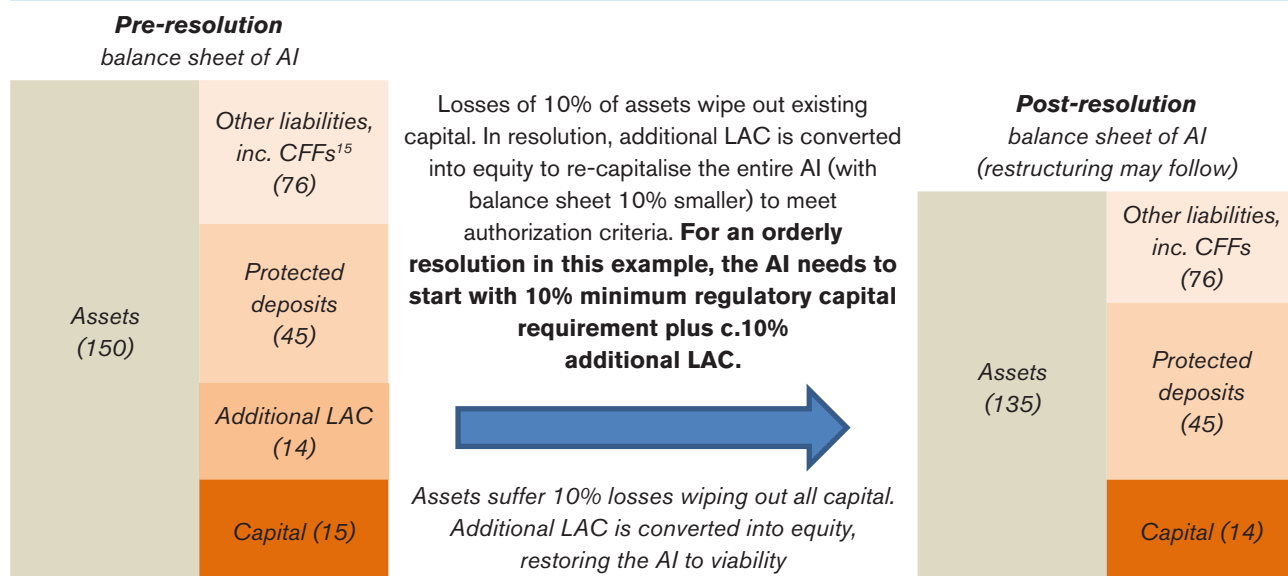
likely to be used in the resolution of the AI. A number of factors will influence the choice of the preferred strategy, including the nature of the activities conducted by the AI; the scale of its business; the nature of its funding arrangements; and the nature of any operational dependencies on intra-group entities and third parties.

Accordingly, the minimum LAC requirement that should apply to an AI will depend on the preferred resolution strategy for that AI.<sup>14</sup>

For a large and complex financial group performing extensive CFFs and whose assets and liabilities associated with those functions are not readily separable from other assets and liabilities, its preferred resolution strategy may require significant additional capital resources to absorb losses and to re-capitalise the entire group. These can be provided using the bail-in stabilization option, but the AI must have sufficient bail-inable liabilities. In these circumstances, substantial additional LAC would be needed.

### **Stylised example of the resolution of a complex AI**

*Multiple factors contribute towards systemic importance and the AI performs various CFFs. Preferred resolution strategy involves re-capitalisation of the entire AI. (For simplicity, we assume capital requirements of 10% of assets and ignore capital buffers.)*



<sup>14</sup> The FSB TLAC Principles set out that in calibrating the individual TLAC requirement for specific firms, authorities should take into account the firm's recovery and resolution plans, systemic footprint, business model, risk profile and organisational structure.

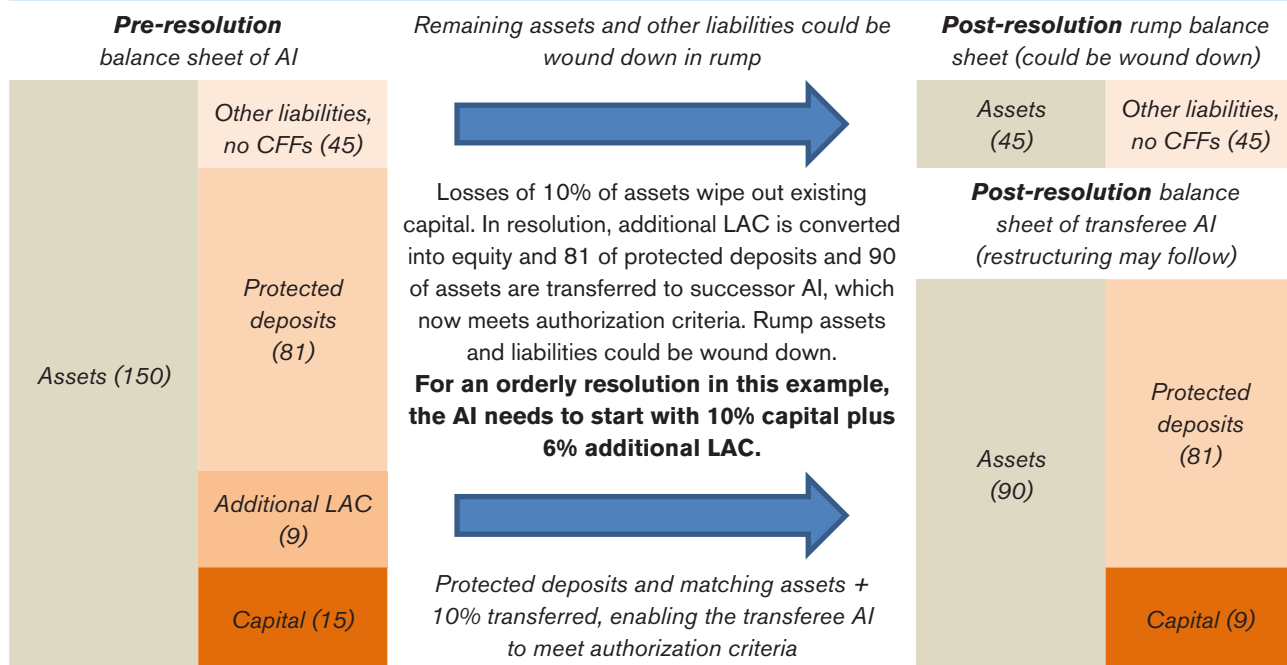
<sup>15</sup> For simplicity, these examples only reference CFFs that are associated with liabilities. There could also be CFFs associated with assets.

On the other hand, for a smaller, simpler AI whose CFFs are concentrated in a readily-separable business unit (e.g. deposit-funded mortgage lending), the preferred resolution strategy might require a more modest bail-in to re-capitalise that business unit as opposed to the AI as a whole. Under such a strategy, the liabilities and assets associated with that unit could be moved out of the AI using one of the stabilization options set out in the FIRO that provides for a transfer of assets and liabilities to another entity (e.g. to a purchaser), and any remaining rump of the AI could then be wound up using normal insolvency proceedings. In these circumstances, less additional LAC would be required to ensure that the AI's critical deposit-taking functions continue and that the AI's resolution is orderly.

By extension, the failure of a small AI, that does not perform any CFFs and the non-viability of which would not pose a risk to the stability and effective working of the financial system of Hong Kong, would not result in it being put into resolution. In these circumstances, there would be no requirement for additional LAC as no re-capitalisation through a bail-in under the FIRO would take place.<sup>16</sup> Instead, such small AIs could enter into a winding up on failure, whereupon protected deposits would be paid out under the Deposit Protection Scheme<sup>17</sup> (subject to the compensation limit set out in the Deposit Protection Scheme Ordinance).

**Stylised example of the resolution of a simpler AI**

The AI's only CFF is taking protected deposits.<sup>18</sup> Preferred resolution strategy involves transfer of liabilities associated with CFFs (i.e. protected deposits) to, for example, a private sector purchaser or a temporary bridge institution. Rump could be wound down (although it could remain as an AI for a while to allow BO and FIRO powers to continue to be exercised). (For simplicity, we assume capital requirements of 10% of assets and ignore capital buffers.)



<sup>16</sup> Note that in these circumstances, where an AI has not been put into resolution, the writing down or conversion into equity of AT1 and/or T2 capital could nevertheless occur.

<sup>18</sup> For simplicity, these examples only reference CFFs that are associated with liabilities. There could also be CFFs associated with assets.

<sup>17</sup> <http://www.dps.org.hk/en/coverage.html>



- *not include derivative-linked features*: where the value of a liability is linked to derivatives, valuing that liability quickly and accurately in resolution is likely to be difficult. This would in turn make bailing in that liability more of a challenge. Fluctuations in the value of the instrument over time could also lead to undesirable volatility in the amount of LAC an AI holds.
- *be subject to the same governing law as the law of the jurisdiction in which the issuer is incorporated*: this will provide legal certainty on the use of bail-in powers. If the governing law is of a different jurisdiction, the same purpose may be achieved by including suitably robust language in the LAC instrument's contractual terms and conditions recognising Hong Kong's resolution powers, and specifically the bail-in stabilization option.

#### 4. Is there a risk that imposing losses on loss-absorbing capacity could put further stress on the financial system in a time of crisis?

LAC is designed so that it is available to absorb losses, should that prove necessary when an AI fails. Where LAC does take losses, this will lead to a reduction (possibly to zero) in the value of the LAC – be it regulatory capital or other LAC instruments – in the hands of investors. Resolution is designed to mitigate risks to the financial system that the disorderly collapse of an AI may produce. It is therefore critical that where the resolution strategy of an AI may involve imposing losses on LAC investors, the crystallisation of losses does not itself give rise to, or exacerbate, material systemic risk or contagion.

Two important points follow from this. The first is that all investors in LAC must properly understand the risks that come with such investments, and be equipped to bear those risks. Should the issuing AI run into difficulties, those investments could be written down or converted into equity, handing the investors a substantial loss. The second is that investment by AIs in the LAC instruments of other AIs needs to be carefully monitored, and subject to restrictions or deductions. The central purpose of the FIRO is to provide for the orderly resolution of financial institutions with a view to avoiding or mitigating the risks otherwise posed by their non-viability to the stability and effective working of the financial system of Hong Kong, including to the continued performance of CFFs.<sup>24</sup> Large-scale investment by AIs in LAC issued by other AIs risks undermining this by – far from mitigating systemic risks – acting as a vehicle for financial contagion, spreading losses from one AI to another.

Imposing restrictions on who can invest in LAC instruments would reduce the risk of LAC instruments ending up in the hands of those who do not fully understand the risks they entail. In particular, bearing in mind the risky nature of these investments, they are less likely to be suitable for retail investors.<sup>25</sup>

The risk of LAC instruments being a vehicle for financial contagion between AIs can be mitigated by imposing restrictions on the extent to which AIs can invest in each other's instruments. A straightforward way of doing this may be to deduct from an AI's own LAC, which is counting towards meeting its minimum LAC requirements, an amount equal to its holding of any LAC instruments issued by other AIs. More stringently, LAC holdings could be required to be deducted from regulatory capital.<sup>26</sup>

<sup>24</sup> Section 4(a) of the FIRO.

<sup>25</sup> Similar concerns have led authorities in some jurisdictions to impose restrictions and/or strict risk disclosure requirements on the sale of certain regulatory capital instruments.

<sup>26</sup> The Basel Committee on Banking Supervision "TLAC holding standard" requires that holdings of external TLAC instruments be deducted from regulatory capital: <http://www.bis.org/bcbs/publ/d387.htm>. Relevant policy proposals on this will be developed in Hong Kong for consultation with industry, with a view to local rules taking effect from 1 January 2019, in accordance with the FSB's timeline.

## 5. What are the next steps in the development of loss-absorbing capacity rules for authorized institutions?

The discussion in this article should not be taken as expressing any fixed policy intent of the MA on the issues raised. Rather, this article is designed to provide a brief summary of some of the key issues that are relevant to the development of minimum LAC requirements for AIs, and to provide an indication of some of the MA's preliminary thinking. Over the coming months, the MA's thinking on these issues, including the areas discussed above, will continue to develop. Other important issues, not directly addressed in this article, include the application of LAC requirements within *cross-border financial groups*, whether there should be a LAC *minimum debt requirement*,<sup>27</sup> and a consideration of the relative *costs and benefits* of different formulations of LAC policy.

Given the international nature of the financial sector in Hong Kong, the application of LAC rules to local operations of banks that are headquartered in other jurisdictions will be an important issue. While Hong Kong is not the home authority for any of the 30 institutions identified by the FSB as "global systemically-important banks" (G-SIBs), 29 of them have operations here. And more generally, the majority of licensed banks that are incorporated in Hong Kong are (direct or indirect) subsidiaries of foreign parent companies. The effective resolution of cross-border financial institutions requires close co-operation between supervisory and resolution authorities in different jurisdictions, not only at resolution execution, but also throughout the earlier resolution planning stage. This extends to the setting of minimum LAC requirements. For example, under the FSB's rules, LAC that is issued externally by a G-SIB in its home jurisdiction should be distributed internally to group subsidiaries or sub-groups, including to those that are located in host

jurisdictions and deemed material for the resolution of the group as a whole.<sup>28</sup> In this, as in the rest of its work on resolution, the approach taken by the MA is that the regime in Hong Kong should align with international best practice, focused on making co-ordinated cross-border resolution feasible, while being appropriately tailored for the local context.

By enhancing the stability and effective working of the financial system in Hong Kong, LAC requirements will reduce the probability and impact of future financial crises. They will also reduce the likelihood that in the future public funds would be put at risk should the authorities be forced to bail-out a failing AI in order to avoid the adverse consequences for depositors, financial stability and the wider economy that might otherwise be caused by its disorderly collapse. Enhancing the resilience of the financial system by aligning our resolution regime to international standards will also contribute to strengthening Hong Kong's role as an international financial centre. But fair and proportionate regulation, and a level playing field for market participants, also support this objective. In developing LAC policy, the MA will accordingly take into consideration costs as well as benefits, to ensure that where possible any unintended adverse consequences can be minimised. This will include considering how imposing LAC requirements on AIs may lead to increased costs, which could be passed on to consumers and businesses in the form of more expensive banking services. Consideration will be given to how any such costs can be minimised without undermining the policy objective, including through an appropriate transitional timeline for implementation.

The MA is planning to set out a policy proposal for prescribing minimum LAC requirements for AIs in a consultation paper expected to be published in late 2017 or early 2018. The consultation paper will address and expand on the areas discussed in this article, and other relevant issues.

<sup>27</sup> The FSB TLAC Principles propose that long-term debt (including debt capital) constitute at least 33% of minimum TLAC requirements.

<sup>28</sup> In July 2017 the FSB published its *Guiding Principles on the Internal Total Loss-Absorbing Capacity of G-SIBs*: <http://www.fsb.org/2017/07/guiding-principles-on-the-internal-total-loss-absorbing-capacity-of-g-sibs-internal-tlac-2/>