



March 16, 2018

By electronic submission to lacinfo@hkma.gov.hk

Consultation on AI LAC Rules Resolution Office Hong Kong Monetary Authority 55th Floor Two International Finance Centre 8 Finance Street, Central, Hong Kong

Re: Hong Kong Monetary Authority's Consultation Paper on Loss-Absorbing

Capacity Requirements for Authorized Institutions

Ladies and Gentlemen:

The Clearing House Association ("TCH")¹ and the Securities Industry and Financial Markets Association ("SIFMA")² welcome the opportunity to respond to the request of the Hong Kong Monetary Authority (the "MA") for comment on proposed rules on loss-absorbing capacity ("LAC") requirements for authorized institutions ("AIs") (the "AI LAC Proposal"). The AI LAC Proposal sets forth the MA's approach to setting requirements for LAC issued externally by a resolution entity ("external LAC") and internally within a resolution group ("internal LAC").³

The AI LAC Proposal states that it has been designed in light of relevant international standards, including the international total loss-absorbing capacity ("**TLAC**") standard established by the Financial Stability Board (the "**FSB**") and approaches taken in certain other jurisdictions that have adopted, or are in the process of adopting, LAC requirements for banking

_

The Clearing House is a banking association and payments company that is owned by the largest commercial banks and dates back to 1853. The Clearing House Association L.L.C. is a nonpartisan organization that engages in research, analysis, advocacy and litigation focused on financial regulation that supports a safe, sound and competitive banking system. Its affiliate, The Clearing House Payments Company L.L.C., owns and operates core payments system infrastructure in the United States and is currently working to modernize that infrastructure by launching a new, ubiquitous, real-time payment system. The Payments Company is the only private-sector ACH and wire operator in the United States, clearing and settling nearly \$2 trillion in U.S. dollar payments each day, representing half of all commercial ACH and wire volume.

SIFMA is the voice of the U.S. securities industry. We represent the broker-dealers, banks and asset managers whose nearly 1 million employees provide access to the capital markets, raising over \$2.5 trillion for businesses and municipalities in the U.S., serving clients with over \$18.5 trillion in assets and managing more than \$67 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit www.sifma.org.

Consultation paper on rules for loss-absorbing capacity requirements for authorized institutions (Jan. 2018), available at http://www.hkma.gov.hk/eng/key-functions/banking-stability/resolution/resolution-publications/.

groups.⁴ In issuing the AI LAC Proposal, the MA notes that "[a] new regime is needed that provides for the failure of a bank to be managed in an orderly way that allows for the functions of the bank to continue to be performed, avoids disruption to financial stability, and minimises the risk to public funds. An important element of such a regime is ensuring that, should a bank fail, it has sufficient financial resources of its own to absorb losses and be re-capitalised." The MA's AI LAC Proposal works to achieve this purpose, with external LAC representing the "financial resources external to a resolution group that are available to absorb losses and fund recapitalisations within a resolution group," and internal LAC enabling the passage of "losses up from the AI in which they first crystallise to a resolution entity, whose external LAC can then absorb the losses."

We support certain key components of the MA's AI LAC Proposal, which we believe make a significant positive contribution to the efforts undertaken in recent years by firms and regulators in many jurisdictions to achieve a durable end to the risk of "too big to fail" ("TBTF"). We believe that the MA should further consider those efforts, and particularly the progress made by the U.S. regulators and the U.S. global systemically important banking groups ("G-SIBs"), when adopting its final rules on AI LAC. As you know, the Board of Governors of the Federal Reserve System ("Federal Reserve"), the Federal Deposit Insurance Corporation ("FDIC") and the U.S. G-SIBs have taken a variety of legal, regulatory and practical steps to make the single-point-of-entry ("SPOE") resolution of the U.S. G-SIBs feasible. These actions include requiring the U.S. G-SIBs to comply with certain external TLAC and clean holding company requirements. Those requirements are designed to ensure that the U.S. G-SIBs have sufficient contributable assets at the top of the groups to recapitalize all their material subsidiaries, including any material Hong Kong subsidiaries, if the top-tier parent is put into a bankruptcy or special resolution proceeding.

We hope that certain key aspects of the AI LAC Proposal (as noted below) will serve as an example to other host jurisdictions as they set internal TLAC requirements. Part I of this letter expresses support for specific components of the AI LAC Proposal that we believe establish a promising foundation for international cooperation between home and host authorities. Part II of this letter describes the ways in which the AI LAC Proposal can be improved, including through

See AI LAC Proposal at ¶ 9 ("In developing policy on LAC requirements for AIs, the MA has reviewed relevant international standards, and the approaches taken in certain other jurisdictions that have adopted, or are in the process of adopting, rules on [LAC] requirements for banks. Particular regard has been given to the FSB's guidance on [TLAC] . . . and on internal TLAC . . . and also to the approaches taken under the EU's Bank Recovery and Resolution Directive . . . (including in the UK) and in the US").

⁵ *Id.* at Executive Summary.

⁶ *Id.* at ¶¶ 13-14.

See Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements for Systemically Important U.S. Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations, 82 Fed. Reg. 8266 (Jan. 24, 2017), available at https://www.gpo.gov/fdsys/granule/FR-2017-01-24/2017-00431 ("TLAC Rule").

Contributable assets include any assets that could be contributed to material subsidiaries, including intercompany receivables and HQLA.

changes designed to recognize international progress on TBTF. Because a number of the members of TCH and SIFMA are cross-border banking groups with operations in Hong Kong, but are based in other home jurisdictions, this letter will generally focus on the elements of the AI LAC Proposal dealing with internal LAC.

I. Support for Key Components of the MA's Internal LAC Proposal

A. TCH-SIFMA supports the calibration of internal LAC based on a starting point of 75% of external LAC.

TCH-SIFMA supports the MA's openness to calibrating internal LAC based on a starting point of 75% of external LAC—i.e., at the low end of the FSB's 75% to 90% range in the FSB Term Sheet. The AI LAC Proposal notes that any upward deviation from the 75% calibration will require a specific notice of determination to be issued by the MA to the material subsidiary, with the ability of the subsidiary to object to the notice and submit representations before a final form notice is served. We believe that adopting this starting point of 75% strikes an appropriate balance between the value of pre-positioning internal LAC and the value of maximizing the amount of available TLAC at the top of the group, which can be used to recapitalize material subsidiaries when, as and where needed.

As the MA is aware, any assets that are pre-positioned at material subsidiaries are likely to be trapped by host authorities and unable to be readily deployed to recapitalize other material subsidiaries during periods of material financial distress. As a result, excessive pre-positioning of assets is harmful in that it decreases the amount of available TLAC that can be relied upon to recapitalize any and all material subsidiaries, including material Hong Kong subsidiaries, when, as and where needed at the time of material financial distress. What the 2008 Financial Crisis and other crises have taught us is that both the source and depth of financial problems is inherently unpredictable. If it were otherwise, we would not have crises. Accordingly, a meaningful element of flexibility to deal with the unexpected is essential. By calibrating internal LAC starting at 75%, the MA will mitigate the risk of such excessive pre-positioning of assets and will permit G-SIBs to mitigate the risk that there will not be a sufficient amount of available TLAC in case the formulaic distribution of internal LAC does not match the distribution of losses in an actual financial distress scenario ("misallocation risk").

In addition to reducing misallocation risk, the presumptive 75% starting point for internal LAC calibration mitigates another key risk of excessive pre-positioning—the risk that other host authorities will, as a result of a collective action problem, set internal TLAC requirements above the optimal level. If host authority A believes that other host authorities will require an excessive amount of internal TLAC, trapping any corresponding pre-positioned assets in those other host jurisdictions, host authority A will have a strong incentive to also impose internal TLAC

_

See AI LAC Proposal at ¶ 88; FSB, Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution: Total Loss-absorbing Capacity (TLAC) Term Sheet (Nov. 9, 2015), available at http://www.fsb.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf ("FSB Term Sheet") at § 18.

AI LAC Proposal at ¶ 165.

requirements at excessive levels. If most, or all, host authorities were to act independently to require an excessive amount of internal TLAC for their own jurisdictions, this would deplete the available TLAC and the corresponding assets held at the top of the group, which would otherwise be available to recapitalize material Hong Kong subsidiaries, thereby creating misallocation risk.¹¹

The U.S. Department of the Treasury ("**Treasury**") made similar observations in a recent report dealing with the U.S. resolution regime. ¹² The Treasury report noted that, if an unduly high proportion of overall LAC is required to be "pre-positioned" in host jurisdictions, this "would constrain the flexibility of companies to allocate their resources across the firm as needed in the event of financial difficulty." ¹³ If host jurisdictions impose excessive calibrations of such requirements, "such restrictions could make firms more vulnerable to failure." ¹⁴

By acknowledging these concerns¹⁵ and opting to calibrate internal LAC starting from a presumptive baseline of 75% of external LAC unless certain aggravating circumstances are present, the MA has sent a responsible signal to other host jurisdictions, reducing their incentive to set unnecessarily high internal TLAC requirements. We further support the MA's inclusion of "the likely availability, or otherwise, of additional financial resources within the wider resolution group", among the factors that the MA will take into account when determining a material subsidiary's internal LAC scalar. We believe that this factor will enable the MA to appropriately take into account the scaling of internal TLAC requirements by other host jurisdictions in determining the scaling of a material Hong Kong subsidiary's internal LAC, which would align with the approach currently under consideration by the Bank of England. This approach also reinforces the AI LAC Proposal's call for international cooperation and coordination with respect to the setting of internal LAC levels.

For our prior comments to the FSB on this collective action problem, please see Section I.B. of our February 17, 2017 comment letter to the FSB on its Proposed Guiding Principles on Internal TLAC, available at http://www.fsb.org/wp-content/uploads/TCH-SIFMA-ABA-FSR-and-IIB.pdf. See also Oxford Business Law Blog, FSB's Final Guiding Principles on Internal TLAC (July 18, 2017), available at https://www.law.ox.ac.uk/business-law-blog/blog/2017/07/fsbs-final-guiding-principles-internal-tlac.

Treasury, Orderly Liquidation Authority and Bankruptcy Reform (Feb. 21, 2018), available at https://home.treasury.gov/sites/default/files/2018-02/OLA REPORT.pdf.

¹³ *Id.* at 23.

¹⁴ *Id*.

¹⁵ AI LAC Proposal at ¶ 75.

¹⁶ *Id.* at ¶ 89.

Consultation on a proposed updated Statement of Policy: Internal MREL – The Bank of England's approach to setting a minimum requirement for own funds and eligible liabilities (MREL) within groups, and further issues (Oct. 2017), available at https://www.bankofengland.co.uk/-/media/boe/files/financial-stability/resolution/internal-mrel-consultation-october-2017.pdf?la=en&hash=33594C3FB3C7F1D129033AFE4E3A2BF20A4F9AA8 ("BOE Internal MREL

Proposal") at 15.

Although we support the MA's proposal to calibrate internal LAC based on a starting point of 75% of external LAC, we note that the internal LAC requirement in practice ultimately will depend on the external LAC requirement to which the 75% (or higher) scaling is applied. Under the AI LAC Proposal, the MA's fully phased-in external LAC requirement for Hong Kong-headquartered resolution entities based on a risk-weighted assets ("RWA") measure will generally equal 2x(Pillar 1 + Pillar 2A). ¹⁸ Because Pillar 2A is firm-specific, the internal LAC requirement for each material Hong Kong subsidiary will vary based on its Pillar 2A requirement. For illustrative purposes, we assume that relevant Pillar 2A requirements range between approximately 1% and 4%. Assuming the application of a 75% scalar, the internal LAC requirement would be calculated as 75% of 2x(8% + [Pillar 2A]%), meaning that the internal LAC requirement would equal 13.5% of RWAs for a firm with a Pillar 2A requirement of 1% and 18% of RWAs for a firm with a Pillar 2A requirement of 4%. By contrast, the FSB-specified internal TLAC requirement would be equal to the very bottom number of this range—13.5% of RWAs—if calibrated at 75% of the FSB's external TLAC requirement of 18% and would rise to just 16.2% if the calibration were set at 90% of the FSB's external TLAC requirement. Thus, for firms with Pillar 2A requirements above 1%, the effective internal LAC requirement would be higher than the corresponding FSB-specified internal TLAC requirement applying the same scalar, and the difference would be greater the higher the Pillar 2A requirement. Please see Annex 1 for an illustration of the calibration of the MA's internal LAC requirements as compared to the FSB-specified internal TLAC requirements, which shows that, although the MA calibrated its internal LAC requirement at the low end of the 75% to 90% range when measured against the MA's external LAC requirement, the actual internal LAC requirement may for many firms be at the FSB's high end or even higher when measured against the FSB's calibration for external TLAC at 18% of RWAs.

In addition, the requirement for material Hong Kong subsidiaries to calculate their LAC requirements at the subsidiary level, which includes in RWA intragroup exposures that would net out at the group level, results in double counting of intragroup exposures among affiliates in RWA and therefore a higher internal LAC calibration across the firm than would be warranted by the group's external LAC requirement, which nets out those exposures. The inclusion of intragroup exposures in the RWA requirement that would be multiplied by 75% likewise, therefore, skews the internal LAC calibration.

As a result, although we support the MA's proposal to calibrate internal LAC at a presumptive starting point of 75% of external LAC, we recommend that the MA apply this scalar against the FSB's external TLAC requirement of 18% instead of the MA's external LAC requirement of 2x(Pillar 1 + Pillar 2A). Further, we urge the MA to add the determination of the internal LAC scalar to the list of determinations that are reviewable by the Resolvability Review

_

Under the AI LAC Proposal, external LAC would be comprised of (1) a capital component calibrated to absorb losses before resolution and (2) a resolution component calibrated to support the orderly resolution of a failing resolution entity. See ¶¶ 42, 46. The capital component would generally be equal to Pillar 1 plus Pillar 2A regulatory capital, while the resolution component would in turn generally be set at a level that is equal to the capital component, subject to any variation made by the MA. See id. at ¶¶ 43, 54, 59.

Tribunal.¹⁹ We note that variation of the resolution component ratio, which is similarly a ratio that is subject to variation by the MA and that has a significant impact on the calculation of the required amount of LAC, is already one of the areas proposed to be reviewable by the Resolvability Review Tribunal. We believe that it would make sense to apply the same treatment to the internal LAC scalar. At a minimum, we urge the MA to provide, in its initial notice of an internal LAC scalar determination, its rationale for the upward deviation from the baseline 75% calibration of such scalar so as to facilitate engagement with the affected entity before the final form notice is served.

B. TCH-SIFMA supports the MA's proposal not to impose internal LAC requirements on Hong Kong branches of foreign banks.

Under the AI LAC Proposal, the MA states that only entities incorporated in Hong Kong will be required to meet LAC requirements; entities incorporated outside Hong Kong, including any branch in Hong Kong of such entities, will generally not be required to meet an external or internal LAC requirement. We support the MA's proposed approach, as it appropriately recognizes the responsibility of the home authority to oversee a bank chartered in its jurisdiction, including any Hong Kong branches of a bank. ²¹

As the MA has observed in the foundational document setting forth its approach to resolution planning, where an AI is part of a cross-border group, consultation and cooperation with the AI's home resolution authority (including, in the case of G-SIBs, the cross-border group's Crisis Management Group ("CMG")) is key. ²² In this context, the MA has recognized that close cooperation with relevant home and host resolution authorities of cross-border groups in preparation for resolution, and recognition of resolution actions at the group level taken by home resolution authorities outside Hong Kong, will facilitate smoother resolutions of relevant AIs. The determination in the AI LAC Proposal not to impose an internal LAC requirement on Hong Kong branches of foreign banks is consistent with the overall collaborative and consultative approach that has been previously articulated by the MA as well as with the stated requirements of the FSB Term Sheet. ²³

As a general matter, we encourage the MA to allow determinations made with respect to the remaining matters listed in paragraph 165 of the AI LAC Proposal to be reviewable by the Resolvability Review Tribunal as well, including particularly the designation of material subsidiaries, material sub-groups and resolution entities.

AI LAC Proposal at \P 21, 25.

In addition, while we consider the AI LAC Proposal clear in its statement that internal LAC requirements will not apply to Hong Kong branches of foreign banks, we believe that the proposal could be made even clearer by moving the content of footnote 30 elsewhere in the document to make evident that it does not relate to the treatment of branches.

The HKMA's Approach to Resolution Planning (July 2017), available at: http://www.hkma.gov.hk/eng/key-functions/banking-stability/resolution/resolution-publications/, at ¶ 7.1.

See FSB Term Sheet at § 18 ("Branches are not subject to internal TLAC requirements separate from any external or internal TLAC requirement applied to the legal entity of which they are a part.").

C. TCH-SIFMA supports the MA's decision to allow internal LAC instruments to be issued directly to the parent resolution entity or indirectly via other entities in the same resolution group.

Under the AI LAC Proposal, the MA recognizes that in order for the issuance of internal LAC to credibly support resolution and the passing of losses to the parent resolution entity, internal LAC instruments, including internal LAC debt, must be able to be issued either directly to the parent resolution entity or indirectly via other entities in the resolution group. We strongly support the MA's decision to provide firms the flexibility to issue internal LAC instruments directly or indirectly to the parent resolution entity, and in some cases outside of the chain of ownership, which will allow firms to structure their internal LAC in a manner that is consistent with their global resolution strategy and the efficient funding of their operations.

II. Recommended Improvements to the MA's Internal LAC Proposal

A. With respect to G-SIBs, the MA should bring the criteria for designating material subsidiaries into closer alignment with the FSB Term Sheet.

Both the AI LAC Proposal and the FSB Term Sheet articulate a set of "5 percent tests" that are meant to be the principal, objective gauge of whether a G-SIB's subsidiary operations in a host jurisdiction rise to a level that justifies the imposition of a local internal TLAC requirement on the hosted subsidiary or sub-group. The MA's specification of these quantitative tests for designating a Hong Kong subsidiary as material, though formulated slightly differently from the language used in the FSB Term Sheet, is consistent with the principle underlying this element of the FSB Term Sheet. This principle is that the misallocation risks inherent in the required prepositioning of LAC resources are so significant that they should only be judged as acceptable by home and host regulators when the subsidiary operations of a G-SIB in a particular host jurisdiction are so substantial that they are critical to the successful resolution of the G-SIB resolution group as a whole.

To implement this principle, the FSB Term Sheet supplements the "5 percent tests" with a further provision which states that, even where these quantitative tests are not met, a material sub-group requiring application of a minimum internal TLAC requirement may be found to exist where the entities that make up such a sub-group "have been identified by the firm's CMG as

the total operating income of the G-SIB group; or (3) has a total leverage exposure measure larger than 5% of the G-SIB group's consolidated leverage exposure measure. *See* § 17. Although the AI LAC Proposal refers to resolution groups and the FSB Term Sheet refers to G-SIB groups, the two categories are essentially equivalent in the case of G-SIBs with SPOE resolution plans.

AI LAC Proposal at ¶ 92.

The AI LAC Proposal defines a material subsidiary to include any entity that (1) contains more than 5% of the consolidated RWAs of its resolution group; (2) generates more than 5% of the total operating income of its resolution group; or (3) has total exposure measure of greater than 5% of the consolidated exposure measure of its resolution group. *See* ¶ 78. Similarly, the FSB Term Sheet defines a material sub-group to include any subgroup that (1) has more than 5% of the consolidated RWAs of the G-SIB group; (2) generates more than 5% of

material to the exercise of the firm's critical functions."²⁶ The AI LAC Proposal, by contrast, provides that where the MA, in its sole discretion, concludes that a given Hong Kong subsidiary is "material to the provision of [critical financial functions] in Hong Kong,"²⁷ it may designate that subsidiary as material and subject it to a minimum internal LAC requirement.

In the context of resolution planning for G-SIBs, this approach would appear to give the MA a degree of discretion and latitude to unilaterally designate entities as material subsidiaries that is contrary to the agreement among home and host authorities embodied in the FSB Term Sheet. To resolve this conflict with internationally agreed principles, we urge the MA to revise the AI LAC Proposal to specify that—in the case of G-SIBs—the standard for designating a Hong Kong material subsidiary will correspond, in both process and substance, to the standard specified by the FSB Term Sheet.

We note that the FSB Term Sheet recommends that "the list of material sub-groups and their composition . . . be reviewed by the home and host authorities within the CMG on an annual basis and, if necessary, revised by the relevant host authorities." Thus, revising the proposed criteria for designating material subsidiaries to conform to the FSB Term Sheet would still appropriately acknowledge the importance of the MA's oversight of the Hong Kong operations of cross-border groups, while recognizing that the resolution of such operations would necessarily be part of wider-ranging resolution proceedings that require cross-border cooperation.

B. TCH-SIFMA recommends that the MA not impose a separate minimum internal debt requirement.

The AI LAC Proposal stipulates that any entity that is subject to a LAC requirement, including an internal LAC requirement, will be "required to meet at least one-third of that requirement with LAC debt instruments," subject to variation by the MA in certain instances. Although we strongly support the goal of establishing appropriate and reasonable LAC requirements, we believe that the separate debt requirement is unnecessary to ensure that material Hong Kong subsidiaries have enough LAC at the point of non-viability ("**PONV**") to be recapitalized.

We also consider a minimum debt requirement to be unnecessary in the case of internal LAC since internal LAC does not serve a market discipline purpose. Instead, we believe that material Hong Kong subsidiaries should be permitted to satisfy their minimum LAC requirements by freely substituting equity for debt and vice-versa, subject to applicable regulatory capital requirements. From a practical standpoint, it is unlikely that any material Hong Kong subsidiary would choose to satisfy its entire LAC requirement with equity rather than debt, because debt is a less expensive form of loss-absorbing capacity. In addition, it would be

FSB Term Sheet at § 17.

AI LAC Proposal at ¶ 78.

FSB Term Sheet at § 17.

²⁹ AI LAC Proposal at ¶ 152.

counterintuitive to prohibit the substitution of equity for debt since equity can function as both going-concern and gone-concern capital. In contrast, debt generally functions only as gone-concern capital. For these reasons, we recommend that the MA adopt an approach similar to that proposed by the Bank of England, which has independently arrived at the decision not to impose a separate minimum internal debt requirement.

At a minimum, we urge the MA to take a more consultative approach to internal TLAC composition, tailored to each material sub-group. For instance, the FSB Guiding Principles state that host authorities may "in consultation with the home authority" consider the inclusion of a minimum internal debt requirement. The FSB Guiding Principles further explain that, in applying such an expectation, host authorities should "take into account the composition of the material sub-group's existing internal TLAC instruments and the practicality of making changes to it, with a view to ensuring that the material sub-group is not required to issue additional internal TLAC beyond the requirement set by the host authority." Although the AI LAC Proposal does contemplate the possibility of the MA varying the internal debt requirement based on an entity's capital situation and resolvability assessments, it does not contemplate consultation with home authorities nor taking into consideration home authority TLAC requirements. Introducing these elements into the determination of internal LAC composition would further reinforce the MA's approach of consultation and cooperation with AIs' home resolution authorities.

C. The MA should clarify the scope of its contractual write-down/conversion requirement.

As will be discussed below, a qualified secured support agreement should be treated by the MA as an alternative to a contractual write-down/conversion right. But to the extent the MA requires a contractual write-down/conversion provision, the MA should clarify that it would be consistent with that requirement for the MA to be provided with the flexibility to write down or convert to equity only the portion of LAC debt instruments that is needed for the subsidiary to satisfy the MA and the market that it has sufficient going-concern capital to continue to be viable. For example, if a contractual conversion provision were triggered, the MA should have the option to write down/convert only the portion of internal LAC necessary to recapitalize the Hong Kong entity. For example, it should have the option to convert only 50% of the internal LAC if that is all the Hong Kong entity needs to be recapitalized. The MA under such a contractual write-down/conversion provision would still have the authority to write down or convert all of the LAC debt instruments if it considered that action to be necessary at the time it exercised its contractual right.

FSB, Guiding Principles on Internal Total Loss-absorbing Capacity of G-SIBs ('Internal TLAC') at 20 (July 6, 2017), available at http://www.fsb.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf ("FSB Guiding Principles") at 10-11.

³¹ *Id.* at 11.

D. The MA should clarify the contractual trigger requirements.

The AI LAC Proposal requires that internal LAC debt include a contractual trigger that would provide the MA with the right to write down or convert to equity an internal LAC debt instrument "upon notification from the MA at the PONV, as determined by the MA." The Proposal states that these contractual provisions "should also specify that such write-down and/or conversion by the MA should be conditional on the relevant home authority, if any, not objecting." The Proposal explains that, should the home authority object "within a specified period, say 24-48 hours, it would be open to the MA to initiate resolution in respect of the issuer, and then impose losses on the internal LAC in resolution." We request that the MA clarify this set of trigger requirements to further provide that:

- (i) the MA's contractual right to write down or convert to equity any internal LAC debt is conditioned on the MA providing the issuer and holder of such internal LAC debt and each home resolution authority identified in the relevant internal LAC debt instrument (e.g., both the Federal Reserve and the FDIC in the case of a U.S. G-SIB) with written notice of the MA's intention to exercise such contractual right and the amount of such internal LAC debt that it proposes to write down or convert to equity,
- (ii) if within 24 hours of receiving such notice, the holder of such internal LAC debt contributes an amount of assets to the issuer of such internal LAC debt (including in the form of forgiving or converting to equity such internal LAC debt) equal to the amount of such internal LAC debt that the MA had proposed to write down or convert to equity in its notice, then the MA's contractual rights would be automatically terminated with respect to such amount of internal LAC debt, and
- (iii) if in the absence of such a contribution of assets, any such home resolution authority voices any objection within 24 hours of receiving such written notice, then one of the essential conditions for exercising the contractual right will not have been satisfied and therefore the MA would be limited to using its statutory bail-in powers to write down or convert to equity such internal LAC debt after placing the issuer of such internal LAC debt in a statutory resolution proceeding.

E. A qualified secured support agreement should be accepted as an alternative to the contractual write-down/conversion requirement.

Under the AI LAC Proposal, debt must include a contractual provision allowing the MA to write it down or convert it to equity without placing the issuer in a resolution proceeding.³⁵ This provision ensures that, when necessary, internal LAC "can be written down or converted

³² AI LAC Proposal at ¶ 115.

³³ *Id.*

³⁴ *Id.* at fn. 103.

³⁵ *Id.* at ¶ 115.

into equity, thereby passing losses up to the resolution entity and restoring the material subsidiary to viability without it having to go into resolution itself."³⁶ We believe that qualified secured support agreements would accomplish the same goal. Each U.S. G-SIB has put in place or is in the process of putting in place a legally binding secured support agreement. Each of these agreements imposes secured obligations on the top-tier parent and certain other affiliates (the "Support Entities") to use the group's contributable assets to recapitalize its material subsidiaries, including its material Hong Kong subsidiaries, as part of the U.S. G-SIB's SPOE resolution in order to keep them out of their own insolvency or special resolution proceedings.³⁷

We urge the MA to revise the AI LAC Proposal to permit debt to qualify as internal LAC if the issuer of the debt is the secured beneficiary of a qualified secured support agreement, even if the debt instrument itself does not contain a contractual write-down/conversion provision. Moreover, depending on the terms of the secured support agreement, such an arrangement might be less likely than a contractual write-down/conversion provision to cause recharacterization of the internal LAC debt as equity for U.S. federal income tax purposes.

A secured support agreement should constitute a qualified secured support agreement if it grants the material Hong Kong subsidiary a legally enforceable, secured right to require a Support Entity to contribute sufficient assets to (including in the form of the forgiveness, or a conversion to equity, of a sufficient portion of any debt issued by) the Hong Kong subsidiary. The MA could rely on its supervisory powers to require the Hong Kong subsidiary to exercise that right when it was otherwise failing or likely to fail. We note that the Financial Institutions (Resolution) Ordinance ("FIRO") defines LAC, in relation to an entity, to include a financial resource "that the entity maintains or to which it has unconstrained access," which appears to describe secured support agreements. To enable the most effective application of the proposed LAC eligibility criteria in the case of G-SIBs that have adopted secured support agreements covering Hong Kong subsidiaries that were deemed material for home country resolution planning purposes, we urge the MA to clarify that a qualified secured support agreement can substitute for the contractual write-down/conversion provision that would otherwise be required in an instrument eligible as internal LAC.³⁹

³⁶ *Id.* at Executive Summary.

The resolution strategies of each of the U.S. G-SIBs are set forth in the public summaries of their 2017 Resolution Plans submitted under Title I of the Dodd-Frank Act. *See* Resolution Plans, available at: https://www.federalreserve.gov/supervisionreg/resolution-plans-search.htm.

FIRO, available at: http://www.hkma.gov.hk/eng/key-functions/banking-stability/resolution/resolution-publications/, at A2589.

³⁹ In addition, if, based on the factors set out in paragraph 89 of the AI LAC Proposal, a material subsidiary would be subject to an internal LAC requirement higher than 75% of external LAC, we believe the final updated AI LAC rules should allow the material subsidiary to satisfy any portion of the required internal LAC amount above 75% with a qualified secured support agreement.

F. The MA should approach the deadline for non-EME G-SIBs to meet internal LAC requirements with appropriate flexibility.

Paragraph 102 of the AI LAC Proposal indicates that non-Emerging Market Economy ("EME") G-SIBs may be required, after written notice by the MA, to meet their LAC requirements by January 1, 2019. Given the time that will be required for the MA to finalize the AI LAC Rules, issue the supplemental Code of Practice that we understand the MA plans to publish this summer and undertake the specific designation, where appropriate, of resolution entities, material subsidiaries, material sub-groups and internal LAC scalars, the MA should approach this deadline with appropriate flexibility to avoid the precipitous imposition of new internal LAC requirements where the subject firm has not had sufficient time to prepare for an orderly transition to meeting the requirement.

G. The MA should consider the U.S. tax consequences of the proposed contractual triggers.

TCH-SIFMA supports the MA's proposal that amendments be made to legislation in Hong Kong so that LAC debt instruments are generally given debt-like tax treatment by Hong Kong's Inland Revenue Department. As the AI LAC Proposal notes, this proposal would provide beneficial certainty on tax treatment under Hong Kong law. The Proposal points out that Hong Kong previously determined in 2016 to grant debt-like tax treatment to other capital instruments that are hybrid in nature, with debt-like legal forms and equity-like loss-absorbing features, and we agree that it makes sense to put LAC debt instruments on the same footing as such instruments, including the exemption of transfers from stamp duty. We also support the proposals by the MA that are directed at ensuring that the tax treatment of interest expense associated with LAC debt instruments issued by a clean holding company of an AI is made appropriately equivalent to that associated with instruments issued by an AI.

Notwithstanding the proposed confirmation that internal LAC debt will be treated as debt for purposes of Hong Kong tax law, the contractual trigger elements envisioned by the Proposal could nevertheless cause it to be treated as equity for *U.S.* federal income tax purposes, with potentially adverse tax consequences to the U.S. group. The following consequences could result from such recharacterization:

• <u>Treatment of payments as dividends</u>. Payments of interest made by the Hong Kong subsidiary to its U.S. parent would be non-deductible dividends for U.S. tax purposes, resulting in greater income and earnings by the Hong Kong subsidiary for purposes of determining the amount ultimately included in income by its U.S.

⁴⁰ See AI LAC Proposal at ¶ 172.

⁴¹ *Id.* at ¶ 168.

⁴² *Id.* at ¶¶ 166-67.

⁴³ See id. at ¶ 171.

⁴⁴ *Id.* at ¶¶ 159-70, 172.

parent under relevant U.S. tax regimes—e.g., for purposes of global intangible low-taxed income ("GILTI") and Subpart F. Notwithstanding the above, the U.S. parent would be fully taxable on the dividends it was deemed to receive, under relevant U.S. hybrid rules. Moreover, repayment of the recharacterized debt might be treated as a taxable dividend to the U.S. entity holding the internal LAC debt, rather than as a tax-free return of principal, to the extent of the Hong Kong subsidiary's accumulated earnings and profit.

• Tax credits. Depending on the circumstances (including whether the U.S. entity holding the internal LAC is a direct parent of the Hong Kong subsidiary), recharacterization of the internal LAC debt as nonvoting equity could have an adverse effect on the U.S. group's ability to claim U.S. tax credits for Hong Kong taxes that it otherwise would be entitled to take with respect to equity interests in the Hong Kong subsidiary. This could have the effect that economic income earned by the Hong Kong subsidiary is subject to tax by both Hong Kong and the United States without offset.

We therefore believe that concerns arising from the potential recharacterization of internal LAC debt as equity for U.S. federal income tax purposes should be considered by the MA in formulating its requirements for internal LAC debt.

Notably, in the case of the Federal Reserve's TLAC Rule, the Federal Reserve worked with the U.S. Treasury Department and the Internal Revenue Service (the "IRS") to ensure that internal TLAC issued by a U.S. subsidiary of a non-U.S. banking group would be respected as debt, unless and until the internal TLAC was subject to conversion to equity by the Federal Reserve. The resulting IRS guidance⁴⁵ expressly limits this treatment to instruments issued pursuant to the Federal Reserve's regulations setting forth requirements for internal TLAC debt. In particular, while the IRS did not explain its reasoning, it appears to have taken comfort from the limited circumstances in which a conversion order could occur: a determination by the Federal Reserve that (i) the issuer is considered to be in default or in danger of default (pursuant to rules prescribed by the Federal Reserve) and (ii) one of three specified circumstances applies (such as the home country supervisor of the non-U.S. G-SIB consenting or not promptly objecting after notification of the conversion or exchange). Moreover, the IRS guidance appears to rely in part on the Federal Reserve's acknowledgment that its regulations do not restrict an issuer's ability to include certain traditional debt terms in internal TLAC debt, including (i) that, upon conversion to equity, existing equity would be transferred by the holder to the issuer and canceled upon transfer and (ii) debt covenants on the same terms permissible for covered bank holding companies, such as covenants providing for acceleration rights based upon the issuer's insolvency or payment default.⁴⁶

The IRS guidance applies only to internal TLAC debt and would not be authority regarding the U.S. tax treatment of internal LAC debt instruments. As a result, tax advisers may

⁴⁵ Rev. Proc. 2017-12, 2017-3 I.R.B. 424.

⁴⁶ *Id.* at 425-26.

have difficulty reaching affirmative conclusions that internal LAC debt instruments would be treated as debt for U.S. federal tax purposes in the absence of such authority. However, we believe that if the MA were to permit internal MA debt instruments to include similar provisions, it would be helpful to persuading the IRS to determine that internal LAC debt should be treated in the same manner as internal TLAC debt for U.S. federal tax purposes.

* * *

We thank the Monetary Authority for its consideration of our comments. If you have any questions, please do not hesitate to contact John Court at +1-202-649-4628 or Carter McDowell at +1-202-962-7327.

Sincerely,

John Court

Managing Director and Deputy General Counsel

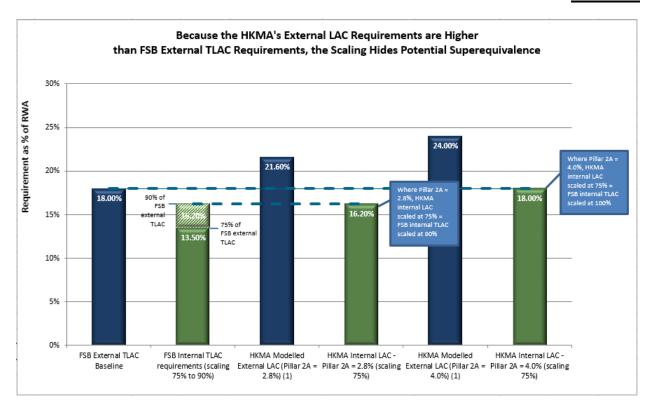
The Clearing House Association L.L.C.

Carter McDowell

Managing Director and Associate General Counsel

Cartes ME Dowell

Securities Industry and Financial Markets Association



(1) The MA's proposal would require material Hong Kong subsidiaries to calculate their LAC requirements at the subsidiary level, which includes in RWA intragroup exposures that would net out at the group level. This may result in double counting of intragroup exposures among affiliates in RWA, as discussed in further detail in Section I.A of this letter.