RESPONSE TO FSB CONSULTATION ON TOTAL LOSS ABSORBING CAPACITY

Calibration of the amount of TLAC required

1. *Is a common Pillar 1 Minimum TLAC requirement that is set within the range of 16 – 20% of risk-weighted assets (RWAs), and at a minimum twice the Basel III leverage requirement, adequate in the light of experiences from past failures to support the recapitalisation and resolution objectives set out in this proposal? What other factors should be taken into account in calibrating the Pillar 1 Minimum TLAC requirement?*

Minimum TLAC Requirement – RWAs

Overall, we believe that a minimum TLAC requirement of 16% of RWAs is more than adequate to ensure that there are sufficient resources to both absorb losses and recapitalise a failing bank. In particular, existing going-concern requirements are sufficient to absorb losses, and the recent trend towards a general increase in capital requirements should be taken into account. In terms of recapitalisation, the scale of resources needs to be sufficient to facilitate the resolution plan, not the resurrection of the entire Group.

There are a number of issues we considered in reaching this view:

(a) Systemic versus Idiosyncratic Failure

It is essential that there is clarity on the nature of the failure which the TLAC requirement is seeking to address: it is to support the resolution in the event of the idiosyncratic failure of any individual bank rather than a systemic failure of multiple banks within the same jurisdiction or across the global financial system.

If there is a systemic failure, we are unconvinced that the bail-in of any amount of TLAC would be able to deliver the stated objective of recapitalising the affected banks such that they are able to re-enter the public markets immediately after the restructuring. In this environment, we would anticipate: (i) a material loss of confidence in asset prices, (ii) significant doubts about the solvency of many, if not all, of the banks in the financial system, and (iii) considerable issues with the continued financing of banks from market sources, with the central bank needing to provide liquidity to avoid disorderly liquidation. In these circumstances, a bail-in of TLAC across the market could make a contribution to recapitalisation and address some questions of moral hazard but we are uncertain that it would be possible for banks to hold TLAC in sufficient quantities to restore confidence in a systemic crisis, stabilising asset prices and markets and restoring the private provision of funding to banks. Indeed, there may be much wider economic effects if there is a system-wide bail-in of TLAC which may compound uncertainties – we have explored this more in response to Question 14 below.

This is an important consideration when reviewing historical loss experiences. In our view, there are certain events which should be excluded as they do not represent an idiosyncratic failure which could have been addressed with TLAC but a systemic failure of bank managements and supervision which should have been addressed through proper macro-prudential policies and *ex ante* supervision decisions.

(b) Common Minimum Standard with Potential for Adjustment via Pillar 2

As an overarching principle, the level of requirements should be established in the context of the objectives of the resolution framework, i.e. to ensure that there are minimum resources to facilitate the resolution plan (continuation of critical functions and orderly resolution).

More generally, we believe that it would be unwarranted for the Financial Stability Board (FSB) to impose a high minimum Pillar 1 requirement globally if that was not appropriate for all countries. Some jurisdictions may have much lower loss expectations for their markets given their propensity for more significant macro-prudential interventions into the lending markets, supervisory restrictions on activities or the nature of the assets on bank balance sheets in these markets. This may be evident from their historic experience and/or their expectations of potential losses as considered through stress-tests and scenario planning. It would be inappropriate for the FSB to penalise these jurisdictions but, given the Multiple Point of Entry (MPE) approach, they could be countries in which Globally Systemically Important Banks (G-SIBs) have material operations.

It is up to the individual countries to balance their appetite for intervention in the financial system to prevent bank failures occurring as compared to the capacity for the private sector to absorb losses in all outcomes if a failure occurs.

Furthermore, TLAC is intended to facilitate resolution which by its very nature will be firm specific. As a result, it may be seen to be necessary to impose differing levels of TLAC depending on business and funding model, impact on financial system, cross border activities etc. This firm specific aspect is better addressed through the additional Pillar 2 requirement rather than imposing a general higher level of TLAC. Any Pillar 2 requirement would be determined and applied at the resolution entity level.

Given this analysis, we believe that the FSB should set the minimum Pillar 1 requirement for TLAC at the lower end of its range (ie at 16% of RWAs), recognising that countries have the ability to adjust for any perceived deficiencies both by jurisdiction and institution through Pillar 2 requirements, the calibration of which is clearly aligned with resolution objectives and agreed by the CMG.

(c) Potential Loss Analysis

The FSB is undertaking an historic loss analysis and, based on the points set out above, we believe that it will need to recognise (i) a distinction between systemic and idiosyncratic failure and (ii) the historic loss experiences in different markets given their structure and operation.

In addition, however, we believe that the FSB should pay close attention to the outcome of stress-tests which are undertaken in many jurisdictions. In particular, the degree to which it is possible for an individual institution to be specially affected by events before this becomes a much broader economic crisis which will require different policy measures to address, rather than relying on private sector balance sheets to deliver the necessary repairs.

Furthermore, we are observing an increasing trend for regulation which over-rides the risk sensitive analysis which was introduced in Basel II with simpler measures such as the leverage ratio and using standardised models as floors of Internal Risk-Based model outcomes. This has the effect of increasing overall capital levels for any given portfolio and, in our view, creating an increasing gap between the capital which might be allocated to address economic risks and the capital which banks are expected to hold for regulatory purposes. To the extent that conservatism is introduced in the going-concern capital requirements, this is at least doubled in TLAC terms because of the nature of the calculation

(d) Operating Levels of TLAC versus Minimum Requirements

The FSB should recognise that resolution entities will inevitably operate above this requirement given the penalties for breaching the minimum, giving further comfort on the actual levels of loss absorbency in the event of failure. We anticipate that banks will likely hold 2-3% more TLAC than the required minimum (as calculated in RWA terms) just because of its definition and calculation. Firstly, there will be TLAC instruments which have become ineligible for the calculation as they get closer to maturity and have a residual maturity of less than one year – these can still be bailed-in in the crisis and represent a buffer within the bank. Secondly, Boards will also want a buffer to ensure they retain freedom in the management of banks. Banks will therefore probably hold a buffer of, say, one year of TLAC issuance to avoid the risk of dropping below the TLAC threshold if markets are closed to new issuance. If banks had an average tenor of, say, 8 years, for TLAC debt instruments, that would mean that there would be at least 1% of RWAs for each of these categories. If the average tenor was shorter, these buffers would be higher.

Overall, we believe that these considerations will show that 16% is the more appropriate level (within the proposed range) to establish the Pillar 1 Minimum TLAC Requirement across all G-SIBs and their Material Subsidiaries and Resolution Entities in all countries.

Minimum TLAC Requirement – Leverage Ratio

We are concerned that banks which have genuinely low risk balance sheets may be prejudiced by the use of the leverage ratio as a metric to determine TLAC. These banks are often mortgage or commercial banks operating within a wider group which (a) invest in lower risk assets such as low loan-to-value mortgages and/or (b) hold significant portfolios of high quality liquid assets to provide liquidity for their deposit portfolio and repository for surplus deposit funds. The ring-fenced retail bank which HSBC is being required to create in the UK is an example of this but a number of other banks within the Group have similar characteristics.

These banks are already disadvantaged by the leverage regime which forces them to hold more capital than is economically warranted. They will suffer again under the TLAC regime. Often deposit-funded, they are required to raise capital and loss-absorbing capacity which they do not need for the underlying risks which they hold. In these cases, the proposed leverage ratio measure significantly increases any difficulties created of the leverage ratio for going-concern capital. And when these additional resources are deployed into liquid assets with negative spread discussed above, this exacerbates the leverage issue still further.

We believe that (i) FSB should consider further the position of local retail banks within the G-SIB TLAC regime, (ii) TLAC requirement should be based on the Basel 3 leverage standard, not

any local requirements, and (iii) it should be clarified whether the leverage metric covers the minimum requirements and the capital conservation buffer, to be consistent with the Basel approach.

Given the potential amplification of the effects of the leverage ratio through the TLAC mechanism, we believe that this should be specifically considered in any re-calibration of the leverage ratio.

2. *Does the initial exclusion of G-SIBs headquartered in emerging market economies (EMEs) from meeting the Common Pillar 1 Minimum TLAC requirement appropriately reflect the different market conditions affecting those G-SIBs? Under what circumstances should the exclusion end?*

Exclusion of EME Headquartered G-SIBs

We support policy initiatives which recognise that Emerging Market Economies (EMEs) have different characteristics and require different policy solutions. Many of our subsidiaries operate in EMEs and are both locally incorporated and locally funded, so we have a keen awareness of these differences which include:

(a) less participation in the banking system across the population as a whole;

(b) lower levels of household indebtedness (as measured in the banking system) relative to GDP;

(c) a much higher level of deposit funding for banks, potentially with excess deposits;

(d) less well developed capital markets in these countries;

(e) potentially smaller savings bases outside of the banking system, for example, in pension funds and long term savings products;

(f) a greater economic dependency on banks to fund both Governments and small and large corporates; and

(g) less sophisticated financial markets for the management of credit and counterparty risks.

Also, there are often differences in the ways in which EMEs are managed, sometimes with a greater degree of state intervention, both directly and indirectly.

- Direct measures include state ownership elements of the banking market which enables Governments to have an immediate impact on the customers of these institutions and secondary impacts on the customers of other firms through competitive pressure on the price and terms of banking services. It is noticeable that state ownership of elements of the banking system is common in all of the fast-growing BRIC economies.

- Indirect measures of intervention include regulatory policies on required lending (for example, to rural areas or unattractive business segments) and macro-prudential regulatory policies such as loan-to-value caps, loan-to-income requirements or simple rationing of credit.

This greater level of intervention represents a different relationship between the state and the private sector which needs to be taken into account in developing appropriate regulations.

In respect of the TLAC proposal, two of the most critical differences for EMEs are (i) a greater reliance on deposit funding, and (ii) the poor development of financial markets which might provide the TLAC required to satisfy the proposed requirements.

These market conditions apply not only to G-SIBs headquartered in EMEs but also to the local Resolution Entities of non-EME headquartered banks where these are essentially local operations, ie where they are separately incorporated local Resolution Entities which use local deposits and short term debt finance for their funding. Introducing a TLAC requirement on these local G-SIB subsidiaries could have distorting effects:

- If they seek to raise External TLAC from the local markets, capacity may be an issue and this could drain the funding capacity to the detriment of local banks. Furthermore, there will be a risk that the new TLAC instruments actually be held by retail investors, either directly or indirectly through pooled-investment vehicles such as Money Market Funds or Unit Trusts, with no overall improvement in the potential impact of bank failure on the 'ordinary population', either directly on in their indirect savings such as pension funds.

- Raising External TLAC from international markets would broaden the investor base with less risk of draining capacity and contagion into the local market. However, it brings its own issues. In resolution, it is the holders of TLAC who become the new owners of the Bank and some jurisdictions would simply not allow this or there may be sharply curtailed shareholder rights on conversion which might deter investors. In addition, cross-border demand for debt issuance is often more variable through the economic cycle due to lower inherent familiarity when compared to local bank issuers. Internal TLAC from an overseas parent may also be seen as an option which addresses these concerns. Internal TLAC is however inconsistent with MPE resolution strategies.

- In some respects, both of these options may be attractive for host supervisors giving them greater loss absorbency and the ability to 'export' losses to investors from another jurisdiction without affecting the domestic economy. But in both cases there are also issues of supervisory moral hazard, potential impact on profits which affects investment in a country and taxation effects which mean that these are not solutions which are free of consequences. These issues are discussed in more detail below.

As a result, we believe the EME Exemption must be applied more widely with the correct approach being for the TLAC requirements not to apply to Resolution Entities which are incorporated in EMEs, which operate predominantly in those EMEs and which are capable of being separately resolved in those markets. We have set out some possible definitions for Resolution Entities which are predominantly domestic entities below.

Issues with Cross-Border TLAC for EMEs

In the discussion about the provision of cross-border TLAC, it is important to distinguish between (a) entities which are not capable of being resolved separately from their parent because of business model, financial or operational dependencies – in these cases, the provision of Internal TLAC is the only way to address this issue; and (b) those entities which could be resolved separately but where there is a lack of TLAC capacity in the local market or other considerations which result in the need for cross-border TLAC.

Supervisory Moral Hazard

In general, TLAC gives confidence that there are financial resources which can be bailed-in to restore solvency. Indeed, there are significant advantages for the host country in being able to impose losses on creditors in another foreign jurisdiction if there are domestic issues. We can see, however, that this may create a degree of regulatory 'moral hazard' – host supervisors could be more relaxed in their supervision, allowing riskier assets to be financed by banks than should otherwise be the case. This would offer economic benefits if those riskier investments are successful but the ability to offload the capital problems to another jurisdiction if they were to fail. Ultimately, it may be the case that home jurisdictions become concerned at the risks of contagion from foreign losses into their domestic investor markets through the bail-in of foreign TLAC.

Competitive Distortions

Only imposing TLAC on subsidiaries of foreign banks may introduce competitive distortions in the market. In particular, some creditors may feel more protected in a bank with a substantial TLAC tranche and so shift their activities in that direction. Overall, this could be 'a good thing' because it drives higher capital standards across the country but imposing TLAC on the Resolution Entities of G-SIBs in EMEs will increase the costs of undertaking business and potentially undermining the scale of international involvement in these economies. All loss-absorbency comes at a cost and this is an economic assessment which individual jurisdictions should make if there is no threat to the broader global financial system.

We see this as an important element of supporting economic development and raising general standards in banking and we are already concerned about the 'western' withdrawal from some EMEs markets and the consequences for the global economy. International companies want to deal with international banks which have deep local roots but global standards and connections. We do not believe that it would be helpful to discourage the establishment of local banking operations by global groups by making these operations less competitive and less profitable. This is important to maintain channels for global banking flows, supporting trade and development.

Effects on Profits and Investments

Imposing TLAC on deposit-funded banks in EMEs has effects on both profitability and the appetite for investment. These banks would need to raise new subordinated debt to satisfy the TLAC requirements at some considerable cost and with no opportunity to deploy the funds productively. It would be entirely inappropriate for those banks to extend their risk parameters merely because more cash was available but it is not possible for banks to 'push away' deposits without undermining their customer relationships.

There will be a material negative spread between the cost at which the funds are raised and the yield on the high quality assets into which it is deployed. This will depress profitability for the bank, reducing capital accumulation in these markets as well as both the capacity and appetite for investment.

In this respect, there is no difference whether this TLAC requirement is satisfied internally or externally; the ultimate effect on the underlying bank and the group is the same. If issued externally by the Resolution Entity, the profits are paid away at a local level. If issued internally,

the holding company will need to match any investment with issues to the market. This may satisfy capacity constraints and could marginally improve pricing, but most of the cost derives from the lack of investment opportunities for surplus funds and this remains unchanged.

These effects could be material, particularly for the affected banks and economies but also for the wider group, potentially with increases of greater than 50% in the capital and debt outstanding in many local subsidiaries. This in turn will have a material impact on local returns and the ability of subsidiaries of G-SIBs to operate competitively in these markets.

Effects on Taxation

These reductions in profitability have a direct impact on the taxes which the banks may pay and it may not be possible to recoup those taxes from the investors in the TLAC if (i), in the case of international investors, there is withholding tax payable in respect of the investors' jurisdiction and (ii) domestically, if the investors do not pay tax (as is the case for some funds) or do so at a lower tax rate, either as a corporate or in a personal capacity.

Effectively, the EME government is buying an insurance policy from foreign investors to address possible issues if their banks ever need to be resolved. The scale of the lost taxes is the premium which the government pays, in addition to the direct costs to the individual banks and their shareholders.

<u>Ending of the EME Exemption</u>

There is a danger that, as currently framed, the Exemption might be considered to be a political device which addresses the issues for particular countries within the G20, rather than an evidence-based policy which reflects the different economic and financial circumstances affecting Emerging Markets Economies. In these circumstances, we could not set out a framework for the Exemption to be wound down.

If the Exemption was reframed to address the circumstances of EMEs more generally (as we have suggested above), it might be more plausible to consider the circumstances in which the Exemption could be ended on a jurisdiction-by-jurisdiction basis.

In these circumstances, we believe that the key criteria to be considered would be the development of local capital markets which could provide a material portion of the TLAC required in the jurisdiction and avoid the cross-border issues highlighted above.

3. *What factors or considerations should be taken into account in calibrating any additional Pillar 2 requirements?*

We recognise supervisors' desire for Pillar 2 requirements above the universal minimum requirements of Pillar 1 given the different circumstances which may affect both jurisdictions and individual institutions. However, in implementing Pillar 2 requirements, it is important that sound principles are established to create consistency across banks and jurisdictions and through time. The scope of the Pillar 2 TLAC needs to be clearly defined, should not duplicate any of the risks that Pillar 2 going-concern capital requirements are intended to address, and should take into account the specificities of banks' recovery and resolution plans. Accordingly, a systematic framework should be developed which reflects factors such as:

(a) different experiences between countries given the nature of the financial systems and the degree to which macro-prudential tools are typically applied across the board to reduce systemic risks;

(b) the systemic importance of any entity and any underlying requirement that it remain operational, taking into account restrictions which may exist on the use of other resolution tools to ensure the continuity of activity;

(c) in the case of resolution entities which are not the ultimate holding company, recovery options such as the likelihood of group and/or other shareholder support given the potential economic effects of resolution;

(d) the potential scale of management buffers above the minimum requirements as outlined in Question 1 above; and

(e) the probability of an unpredictable outcome for losses as a result of specific risks which banks may be holding necessitating much wider TLAC requirements.

Both the FSB and local regulators should be encouraged to consult on potential Pillar 2 regimes so that the issues outlined above can be discussed in more detail.

Ensuring the availability of TLAC for loss absorption and recapitalization in the resolution of cross-border groups

4. *Should TLAC generally be distributed from the resolution entity to material subsidiaries in proportion to the size and risk of their exposures? Is this an appropriate means of supporting resolution under different resolution strategies? Which subsidiaries should be regarded as material for this purpose?*

Distribution to Material Subsidiaries

The distribution of TLAC from the Resolution Entity to Material Subsidiaries is focused on Single Point of Entry (SPE) groups where a single Resolution Entity (probably a holding company) invests in Internal TLAC issued by multiple operating banks as a mechanism for distributing both funding and loss-absorbing capacity within the Group. That Resolution Entity would then issue instruments to the markets, potentially on a back-to-back basis with the Internal TLAC.

We assume that, in many cases, these Material Subsidiaries are not generally capable of being resolved separately from the Resolution Entity given the integration of the business model, customer bases, systems and operations. In this scenario, we see the distribution of Internal TLAC to Material Subsidiaries as an essential requirement to create a mechanism by which losses can be transmitted within a Group under the SPE model. Without this in place *ex ante*, it is difficult to see how a bail-in at the holding company level can assist the troubled subsidiary. Transforming debt instruments into equity, or writing off these liabilities at the holding company level, does not itself generate the funds which it would otherwise be necessary for the holding company to inject if there are no pre-existing intra-group liabilities.

To be clear, however, HSBC does not operate on this basis for the majority of its operations and our major banking subsidiaries are established to be Resolution Entities. Our preference is for

separate legal entities with local funding which can be resolved locally if the Group is no longer able, or willing, to provide further support. We also believe this is the preference of many jurisdictions in which we operate where the local authorities wish to have clear control over all aspects of the resolution process.

We understand that, for an MPE group such as HSBC which has a holding company which is not a resolution entity itself, there would be no TLAC requirements imposed at the level of the G-SIB consolidated group; instead, TLAC requirements would be set at the level of each Resolution Entity, under the local Pillar 1 implementation of the agreed FSB proposals including any local adjustments. This is based on discussions with FSB officials and considering the QIS and particularly the footnote on Page 1 which states:

> *"TLAC minimum requirements will be applied to each resolution entity within a G-SIB. For MPE, this may not necessarily include meeting TLAC at the G-SIB consolidated group level if this is not itself a resolution entity"*

We believe that this is entirely appropriate and necessary given the local nature of resolution. Furthermore, we do not believe that it would be appropriate for a 'Group add-on' of additional resources at a higher level to be imposed if the local regime is does not fully reflect the FSB's G-SIB regime, perhaps focusing instead on local approaches to resolution and/or the structure for D-SIBs as defined in local terms or where there are differences of opinion as to the Pillar 2 Requirements. This is particularly the case if there are no material cross-border risks to be addressed.

Since resolution is local, it is difficult to envisage what a 'Group add-on' would achieve – it would not change the probability of failure which is determined by the capital levels and the recovery plan and, once there is a resolution event, it is difficult to envisage why a consolidating supervisor would release additional funds to assist with loss-absorbency, or indeed the mechanism by which this might be achieved. The concept of a 'Group add-on' does not appear to be consistent with and may at its extreme interfere with the MPE resolution strategies. There is a risk that group resources might act as a signal that the Group could step in to support failing subsidiaries rather than allowing local intervention for local resolution. This would not only present risks to the credibility of the MPE resolution plan, but would also reduce the incentives for local jurisdictions to put in place an appropriate resolution regime.

<u>Definitions of Material Subsidiaries</u>

The FSB has four criteria for the assessment of Material Subsidiaries. Three of these are based on the scale of the entity relative to the Group and one on the importance of the entity in terms of criticality to the financial system as assessed by the Crisis Management Group (CMG). We believe that the emphasis given to the scale within the Group could be reduced and the 5% recommendation in respect of profits, RWAs and leverage could potentially be relaxed in specific instances.

Conversely, however, we believe that more emphasis should be placed upon the role that the entity plays in the economies in which it operates and that the decision to require Internal TLAC should be a decision of relevant supervisory and resolution authority, made after due consultation with the CMG and the firm itself. It is the country which will suffer the consequences if the TLAC is not properly distributed and, therefore, it must be the ultimate judge of these requirements having considered its own circumstances and risk appetite. Additional factors such as magnitude of cross border activities, whether the entity carries out critical activities for the

local economy and possible impact on financial stability if the entity was to fail should all be considered when determining if it is a material entity.

We note that there is no materiality threshold for Resolution Entities, all of which would be required to issue TLAC (externally on some reading of the Proposals). And yet, we believe that resolution at a subsidiary level will become more common within most financial groups. In line with our comment above, perhaps the defining criteria for materiality is the dependency of the local economy on the operations of that subsidiary.

Exclusion of Certain Entities

We do believe that there are a number of entities which should not be subject to TLAC requirements, either within an SPE structure, where they should be excluded from the consolidated metrics on which TLAC is calculated, or by not being considered to be a Resolution Entity within an MPE approach. These include:

(a) non-bank entities such as asset management and insurance companies, which would not be resolved under a bank resolution regime, or non-financial sector entities such as ancillary service entities which are part of the regulatory consolidation group and could be put through normal insolvency processes; and

(b) banking entities for which the Group would not have responsibility on resolution including,

  (i) associate companies which are proportionally consolidated for regulatory purposes but not consolidated under IFRS - within the HSBC Group, over 12% of our risk-weight assets are represented by our minority investments in associated banks, largely in China but also including Saudi British Bank;

  (ii) entities which are separately listed or which have material minority shareholders where the loss-absorbing capacity issues must be addressed at the entity level to avoid economic distortions between shareholders – this would include entities such as Hang Seng Bank; and

(c) special purpose entities which may be associated with the financing of specific asset pools where there is a clear *ex-ante* distribution of losses to the creditors without recourse to the parent company.

5. *To what extent would pre-positioning of internal TLAC in material subsidiaries support the confidence of both home and host authorities that a G-SIB can be resolved in an orderly manner and diminish incentives to ring-fence assets? Is a requirement to pre-position internal TLAC in the range of 75 - 90% of the TLAC requirement that would be applicable on a stand-alone basis, as set out in the term sheet (Section 22), appropriate to satisfy the goals of the proposal and ensure that TLAC is readily and reliably available to recapitalize subsidiaries as necessary to support resolution? Can this pre-positioning be achieved through other means such as collateralized guarantees?*

Does pre-positioning increase confidence in orderly resolution?

As discussed above, we assume that Material Subsidiaries which require Internal TLAC are operations which cannot be readily resolved separately from the parent Resolution Entity. We

should also assume that these entities contain economic functions which are critical to the host country – if this is not the case, they should not be resolved through bail-in but via a simple bankruptcy process. In these circumstances, we can see that pre-positioning Internal TLAC will give host countries more confidence that the financial aspects of resolution can be addressed and the likelihood of a disorderly resolution of that subsidiary, with the associated financial instability in the host country, is reduced.

However, for host countries, the concern must always be that the funds are insufficient for resolution and no further funds are forthcoming from the parent Resolution Entity. In this scenario, with a significant entity which cannot be resolved separately, the host country would face difficult choices about how it can implement an orderly resolution without becoming embroiled in the wider problems of the Group. Given these limitations, we could see a scenario where, in the short term, host countries demand levels of TLAC at the higher end of the proposed levels which has been suggested if this is the host country's only line of defence. It will be important to build trust so that this level can be reduced.

The host country will also appreciate that they will have little control on the operation of the Material Subsidiary after the bail-in of Internal TLAC. The new shareholders (previously the TLAC holders) or potentially the home resolution authority under some form of conservatorship will be in charge of the Resolution Entity and may not have the same commitment to this Material Subsidiary as either the previous shareholders or the host country. That places the host country at risk of economic harm if they are unable to manage the adjustments in the Bank at a pace which suits their economy. It may also be that local resolution authorities will want and need to take additional steps beyond bail-in in order to restore the effective operation of that Material Subsidiary.

Given their mandates are to ensure the financial stability of their own jurisdiction, we believe resolution authorities are likely want to have more control over the resolution process for entities under their mandate. Over time, therefore, we expect such host countries to seek to develop more resolution options – effectively, improving separability and creating Resolution Entities. We see this trend across a number of jurisdictions in which HSBC has subsidiaries and we hope that some of these concerns will be addressed through the operational subsidiarisation project currently under way in the HSBC Group.

Is this the right level of pre-positioning?

As discussed above, we see it as quite possible that countries tend towards the upper end of the pre-positioning requirements where (a) the subsidiary represents a critical element of the economic system of the host country and (b) it has limited legal and technical ability to take alternative resolution actions in extreme circumstances. Ultimately, it will be host jurisdictions which determine if the minimum requirements outlined by the FSB will be sufficient, particularly where Internal TLAC bail-in represents the only realistic resolution option, or if a further Pillar 2 requirement is needed.

A technical issue is that pre-positioning requires '75 - 90% of the TLAC requirement that would be applicable on a stand-alone basis', however it is unclear what the stand-alone requirement would be – is the TLAC requirement calculated with reference to what applies at the home jurisdiction, or the host/local TLAC requirement?

Are there other means of pre-positioning?

We believe that it is right that regulators and banks should explore the options for different solutions to pre-positioning, provided that the overall goals of Internal TLAC can be achieved. In particular, financial resources must to be clearly committed to a foreign jurisdiction so that they can be used to recapitalise a bank in that country if local supervisors require this. At present, however, it is not clear that an alternative solution can be developed which has the same effect in terms of, *inter alia*, the unconditional commitment of resources to a single entity whilst delivering this at a lower economic cost.

Determination of instruments eligible for inclusion in external TLAC

6. *Are the eligibility criteria for TLAC as set out in the term sheet (Sections 8-17) appropriate?*

Structured Notes

There has been considerable discussion on the eligibility of structured notes as TLAC instruments and we understand that the principle objections are (a) the ability to value these notes at the point of resolution and (b) the volume of individual notes which may be in issue and therefore the logistical issues with ensuring an equitable bail-in, with the distribution of new instruments or rights post-conversion.

We believe that structured notes should not be excluded from TLAC, as long as they satisfy the key criteria of TLAC. Structured notes do not differ conceptually from vanilla instruments that are hedged. What is crucial is that it is demonstrable that they can be bailed-in without undue complexity for the resolution process.

Variations in TLAC Criteria

In the case of MPE Groups, as discussed elsewhere, we understand that TLAC will be calculated at the level of each resolution entity, with no consolidated group measure where the holding company is not itself a resolution entity. We also know that there will be minor adjustments in the loss-absorbency regimes across jurisdictions to reflect specific national laws or regulations and there is always the danger that instruments which are considered to be TLAC eligible in a particular jurisdiction do not conform to the final FSB rules.

We believe that where the subsidiary in question is predominantly a domestic bank, the local regime should be accepted as the relevant standard. It is the Resolution Authority in that country which will face the practical issues of bail-in and which will need to account to higher authorities if the regime is flawed. The FSB may comment on any flaws through a peer review but, where the consequences are predominantly local, the bank and its wider group should not need to change its issuance programme or hold additional TLAC at a group level to address these deficiencies.

Calls for TLAC eligible instruments

There is a cliff effect in TLAC eligibility created by the criteria that instruments must have a remaining duration of at least one year. In these circumstances, it may be efficient for banks to

have an option to call the instrument immediately after it passes this threshold. We see no risks in this if the Bank continues to comply with the TLAC requirements placed upon it after the call.

It is for management to determine how much of a buffer they wish to hold above the minimum requirement. Supervisors will have credible and effective sanctions which can be imposed if that requirement is breached and the call of any one instrument should not threaten the immediate viability of the entity before those sanctions have time to take effect. In these circumstances, since the call is optional, the assessment of remaining maturity for callable securities should be based on the contractual maturity date and not the first possible call date.

7. *What considerations bear on the desirability of an expectation that a certain proportion of the common minimum Pillar 1 TLAC requirement consists of (i) tier 1 and tier 2 capital instruments in the form of debt plus (ii) other eligible TLAC that is not regulatory capital?*

We understand that this guideline rests on the assumption that all of the existing common equity will have been exhausted in the period prior to resolution and that it is necessary to have certain resources 'held in reserve' so that it is available at the time of crisis.

We do not agree with this analysis. Firstly, we believe that it is quite possible that there will be residual equity capital, at the point of resolution. This is in part because of the growing divergence between capital requirements as calculated for regulatory purposes and the underlying economic risks and also because stress-tests are further raising equity requirements above Basel 3 minimums, with the specific intention that banks should have residual equity capital after the stress event.

Whilst we do not believe that banks should be required to fulfil their TLAC requirements with equity capital, we can see the advantages of having clear access to loss-absorbing capacity without decisions and events which introduce transaction risk. Furthermore it seems perverse to impose constraints on a bank that wishes to meet TLAC with equity capital since this is the most loss absorbing form of capital.

In the FSB's TLAC term sheet, the affirmation is made that there is an exact symmetry between treatment of a breach of buffer requirements due to Tier 2 instruments maturing (and not being replaced) and one arising as a result of TLAC debt maturing. We do not agree with this as in the situation where a firm has surplus CET1 over the going concern minimum CET1 requirements (including buffers), a shortage of Tier 2 would be met with CET1 whereas the same shortage of TLAC requirements may not be able to be filled in with CET1 capital if the entity is already at the 33% limit. Under the FSB proposals, this results in a solvent entity with surplus CET1 capital facing possible restrictions on distributions which seems disproportionate.

Given these factors, we believe that there should not be a minimum level of non-equity capital and debt. Alternatively, if a limit is to be imposed, there should not be automatic restrictions on distributions if a shortfall of TLAC occurs – in such circumstances, a plan to replenish the shortfall could be submitted to the regulators to ensure timely correction.

Furthermore, it is unclear what the condition 'in the form of debt' is aiming to achieve as eligibility of Additional Tier 1 instruments should not depend on the accounting treatment.

8. *Are the conditions specified in the term sheet (Section 8) under which pre-funded commitments from industry-financed resolution funds to provide resolution funding contribute to TLAC appropriate?*

On the potential contribution from Resolution Funds, we would make the following comments:

- We believe that the definition of Resolution Funds should be extended to include Deposit Guarantee Schemes where these are able to make a contribution to resolution funding. One of the questions which arises from the TLAC proposals is the continuing role of Deposit Guarantee Schemes (DGS) where TLAC is the primary source of resolution funding. In these scenario, it might not be appropriate for these larger firms to continue to contribute to these DGS schemes on the same basis as they do at present since they will be significantly less likely to use such schemes. Where contributions are calculated on a risk-adjusted basis, this would suggest a major reduction in contributions from larger firms and a shift in the costs across the industry.

- We do not understand the logic which underlies the cap on resolution funds at 2.5% of RWAs. It could be that the FSB was concerned about the potential burden for recapitalisation relative to the size of the resolution fund. But there is no reference to the size of the resolution fund in Section 8 and it is also proposed that the cap could be increased if the minimum Pillar 1 TLAC requirement is raised above 16% (although the portion by which it would be raised is not set out). Further details should be set out underpinning the basis of the 2.5% proportion of TLAC which can be covered by Resolution Funds.

9. *Is the manner in which subordination of TLAC-eligible instruments to excluded liabilities is defined in the term sheet (Section 13) sufficient to provide certainty regarding the order in which creditors bear loss in resolution, and to avoid potentially successful legal challenges or compensation claims? Where there is scope for liabilities which are not subordinated to excluded liabilities to qualify for TLAC, are the transparency and disclosure requirements set out in section 13 and 24 sufficient to ensure that holders of these instruments would be aware of the risk that they will absorb losses prior to other equally ranking but excluded liabilities? If not, what additional requirements should be adopted?*

We understand the FSB's desire to have no potential for legal dispute on the bail-in of TLAC. However, at present, we do not believe that it will be possible to create a structural subordination which is entirely clear, not least because of tax liabilities. This will need to be addressed in the FSB's revised proposals.

Interaction with regulatory capital requirements and consequence of breaches of TLAC

10. *Do you agree that the TLAC requirement for G-SIBs should be integrated with Basel III such that the minimum TLAC requirement should be met first, and only after TLAC is met should any surplus common equity tier 1 (CET1) be available to meet the Basel III buffers?*

It would be helpful to have a much clearer understanding of how the TLAC and capital requirements, both buffers and minimum requirements, might work together. The current intention appears to be that buffers "sit on top of" TLAC, meaning that a bank would have to maintain TLAC at all times, but usage of buffers would not cause a violation of TLAC requirements.

However, this would imply that a breach of the TLAC requirements is considered more severely than a breach of any buffers. This in turn could be taken as meaning the potential resolution of a Bank which had significant capital resources and no immediate solvency issues simply because it had insufficient loss absorbency for a theoretical resolution event. It is not clear why this would be the case and what benefit might be derived from such drastic action.

One of the key issues in this respect is the imposition of the 33% limit for CET1 capital to meet the TLAC requirements (see our response to question 7 above).

It is also unclear from the proposals how the different scopes of application of the capital requirements and TLAC will be reconciled. For example, the Basel capital framework contemplates application to groups on a consolidated level but within an MPE group the TLAC requirements would apply at resolution entity level, with no consolidation adjustment. Over time, we believe that there will need to be material adjustments to the supervisory and regulatory frameworks to reflect this renewed focus on requirements at subsidiary levels.

Transparency

11. *What disclosures (in particular in terms of the amount, nature and maturity of liabilities within each rank of the insolvency creditor hierarchy) should be required by resolution entities and material subsidiaries to ensure that the order and quantum of loss absorption in insolvency and resolution is clear to investors and other market participants?*

We agree that there will need to be much greater disclosure of the creditor hierarchy for banks, not only with the introduction of TLAC but also because of issues of depositor preference and other regulatory changes. However, we see limited benefit in narrow development in the disclosures of loss absorbency data on its own. There also needs to be improved disclosures of the assets of the bank so that investors can make an informed decision on their overall risks, not just their ranking in resolution and insolvency.

HSBC has been a participant in the FSB's Enhanced Disclosure Task Force and believe that this is the correct forum to develop a comprehensive disclosure package to address these and other regulatory changes. This needs to be applied consistently so that investors have a more intuitive understanding of the risks and rewards without the need for excessive analysis on individual circumstances.

We would note that, if there is no consolidated requirement for MPE Groups, there should be no publication of aggregate TLAC across the Group. This may give the false impression when compared to consolidated data and give an implication that TLAC was in some way fungible across the Group when this is not the case.

Limitation of contagion

12. *What restrictions on the holdings of TLAC are appropriate to avoid the risk of contagion should those liabilities be exposed to loss in resolution?*

There is an existing regime for large exposures between banks and it is difficult to see why TLAC holdings should not be covered by this. To the extent that TLAC is seen as a first-loss risk, this should be considered in how TLAC instruments are included in the large exposure limits but, if this is the case, there should also be a compensating adjustment for instruments which are lower in the bail-in hierarchy (or indeed are excluded from the scope of bail-in).

Furthermore, we believe the FSB should be concerned about the potential effects of any bail-in beyond the narrow banking system as the shadow banking system, or non-bank financial institutions become increasingly important to the financial system. We have already commented that we believe that the bail-in approach could create financial instability if used for a wide range of firms at the same time. This should be considered as part of the QIS but it will be for regulators of these portions of the financial system to adopt prudential controls, not for banks to impose them on investors acquiring instruments issued by banks.

Arrangements also need to be put in place to support both underwriting and market making in TLAC by G-SIBs. Unless this is the case, the markets for these instruments will lack the liquidity which is essential to attract the broad range of investors necessary to deliver the financial resources which are being sought.

Conformance period

13. *Should G-SIBs be required to conform with these requirements from 1 January 2019? Why or why not? What, within the range of 12 to 36 months following the identification as a G-SIB, should be the conformance period for banks identified as G-SIBs at a future date?*

Conformance Period

We believe that the FSB needs to be realistic on the conformance timetable, for the reasons set out below.

Rule-making Timetable

The FSB's proposals on TLAC will not be finalised until the G20 Summit towards the end of 2015 and these rules will then need to be translated into local regulations. In some cases, these will require additional primary legislation as the regulations would impose rules in areas which have already been considered in primary legislation – to do otherwise would undermine crucial democratic processes and, potentially, the rules themselves. Effectively, the final regulations on which issuance can be based will not be in place before mid-2016 at the earliest.

Short Term Effects

It is in the interests of both regulators and the industry for these rules to be settled as soon as possible. Until this is done, firms will be concerned that they may issue instruments which might not be eligible – these would then need to be restructured at some cost or they could ‘block’ capacity until they run-off. This scenario might lead firms to either (a) delay issues or (b) issue instruments with a shorter tenor than normal, all of which is to the detriment of both the bank and the economy.

Longer Term Adjustments

From the time rules are available, banks will need to restructure their balance sheets. Most capital instruments should qualify under their current terms but changes are likely to be required for substantial tranches of senior debt, either to re-issue them from different legal entities to effect structural subordination or for them to be re-issued with the requisite contractual subordination and disclosures. Furthermore, the investor base to which these securities will be issued will have changed as a result of the different terms and risks and there will need to be a process of education, the adjustment of investment mandates, etc.

With such a substantial debt re-issuance programme in a number of banks, it is difficult to believe that this could be completed within a three year window without imposing material financial costs on banks in respect of the terms for TLAC issuance. In particular, they may be forced to:

- redeem and re-issue securities with revised terms or execute some form of exchange offer; or

- issue excess amounts of securities in order to meet the TLAC requirements without redeeming existing, non-eligible instruments, with this burden diminishing as existing instruments run-off; or

- pay a premium to investors beyond what would be expected long term market price for these instruments in order to be able to meet the short deadline.

Furthermore, this burden of re-issuance may fall disproportionately on certain banks and jurisdictions. Firms based in some countries may have little structural adjustment for existing debt to be eligible. This is probably true for US banks which have an existing holding company structure and, indeed, we have already seen US banks disclose their expected TLAC positions as part of their 2014 reporting. US banks also benefit from one of the largest investor bases into which to issue new securities, whereas banks from other economies may have a much more constrained investor bases given the size of their local market and the limits of investor appetite for cross-border investment.

As a result, it is critical the funding requirement and market capacity in the QIS and market survey are examined both at a global basis but, more importantly, at a local level since this may prove to be the binding constraint for some economies. In addition, the local market surveys will need to take into account other demands on investors with a parallel timeframe, such as the requirements for D-SIBs to meet loss absorbency thresholds under local rules.

Structural Changes

The timetable should also reflect any structural changes in the local industry such as the ring-fencing of retail banks in the UK and the potential structural changes for banks in the EU. These changes in structure will further complicate the issuing process as banks will not have the legal entities in place for which issuance will be required in the long term. Legal separation in the UK may not be in place until some time during 2019 which would seem to conflict with the current conformance timetable.

International Timetable

Against this background, it is important that a common long-stop timetable is established which does not overtly disadvantage certain corporate structures or business models or indeed countries (and in doing so favour others). We believe that will probably mean an extension of the conformance date so there is at least five years from the date at which rules can be realistically expected to be available.

Conformance for a New G-SIB

It is inevitable that a parallel version of these rules will be applied to banks which are D-SIBs, particularly if they are near G-SIBs. If it is otherwise, this would create too great a discontinuity within the financial system. Unlike the initial tranche, any bank which becomes a G-SIB once this programme has reached steady state will (a) already have clear rules for TLAC at a global and local level and(b) almost certainly already have issued TLAC which is eligible. These banks are also unlikely to enter directly into the highest requirements.

As a result, a timeframe of up to 36 months for new G-SIBs may well be appropriate.

Market impact and other aspects

14. *How far is the TLAC proposal, if implemented as proposed, likely to achieve the objective of providing sufficient loss-absorbing and recapitalization capacity to promote the orderly resolution of G-SIBs?*

The orderly resolution of a G-SIB will rely on stability in markets and the wider financial system to enable participants in the resolution to have a clear understanding of the appropriate valuations which can be applied to assets, the value of any ongoing franchise and, ultimately, the risks they face in dealing with the firm.

If there is a bank failure which is idiosyncratic, we can see how these conditions of market stability could be achieved whilst TLAC is bailed-in and, in these cases, TLAC may achieve the objective of promoting an orderly resolution.

Unfortunately, if a failure is not demonstrably idiosyncratic, there is a considerable risk that the problems become systemic and the issues are much wider. Furthermore, systemic crises can arise in entities other than either G-SIBs or D-SIBs since, in the majority of cases, systemic crises are not triggered by the failure of individual banks but by concerns about the asset classes in which they are invested. This was the situation which operated in the case of the former building societies in the UK (Northern Rock, Bradford and Bingley and Alliance + Leicester) and, in the case of Spain, the caxias which have now been consolidate into Bankia.

In these cases, bailing TLAC may actually compound the systemic issues given the scale of losses to be absorbed and overall issues of investor confidence. Alternative mechanisms need to be in place to deal with these systemic events.

15. *What will be the impact on G-SIB's overall funding costs of the adoption of a Pillar 1 Minimum TLAC requirement?*

There are a number of factors which will affect G-SIBs funding costs as a result of the adoption of a Pillar 1 Minimum TLAC requirement.

(a) Existing TLAC Instruments

Firms may have instruments in issue which satisfy the TLAC requirements, probably because they are either (i) capital instruments or (ii) senior debt which is structurally subordinated as they have been issued from a holding company. We expect that US firms will be better placed in this regard than their international counterparties. In respect of this tranche of the TLAC requirements, there will be no additional cost.

(b) Substitutional TLAC Instruments

Firms will also have instruments in issue which can be restructured to create TLAC instruments. The clearest example of this is existing senior debt which is not currently subject to statutory, structural or contractual subordination. There will be costs involved in this process, both on a transitional and an ongoing basis.

The transitional costs of redeeming and re-issuing existing instruments could be considerable but these could be mitigated by adjustments to the Conformance Period to reflect the normal maturity profiles of banks. Seeking to achieve conformance in a three year window to January 2019 would represent a 'bonus' to current instrument holders who would be able to force better terms against such a short deadline.

Determining the ongoing costs is more problematic. The transition from senior debt to subordinated debt increases the probability of default for the instrument and probably increases the loss-given default since it would be part of a narrower pool of affected instruments. Furthermore, the existence of a new class of subordinated debt specifically designed for resolution purposes may lead to a heightened expectation that the TLAC instruments will be subject to write-downs and/or conversion. Pricing differentials already exist in some markets between debt issued at holding company and operating company level, and some might consider that to be a proxy for the costs of subordination outlined above. We do not believe that this is the case for the following reasons:

- the probability of bail-in and the potential loss-given default has not been absorbed fully into the pricing of the holding company debt instruments; and
- these prices do not reflect an expected squeeze on supply when the requirements for TLAC instruments are implemented fully.

We believe that disclosures and discussion will improve institutions' understanding of capital instruments over time and the pricing should move to reflect this.

We are, however, particularly concerned about issues of supply. Although we have seen investors adapt to new instruments, we do not believe that pools of funds are freely fungible, either between classes of shares, sectors and jurisdictions. There is a serious risk that the requirements for TLAC will need to materially increase pricing in order to attract finance to overcome:

(i) a natural aversion to instruments which are much more likely to be subject to capital losses from institutions which were typically holders of senior debt from banks;

(ii) real limitations on institutional appetite to increase their overall exposure to the banking system, as compared to other sectors of the economy; and

(iii) in some jurisdictions, particularly EMEs, a shallow pool of investible funds for which banks will need to compete.

(c) Additional TLAC Instruments

Locally incorporated, deposit-funded banks within a G-SIB will be most severely affected by this proposal. The greatest impact of TLAC will come where Resolution Entities have insufficient existing TLAC instruments or opportunities to substitute existing debt instruments for new TLAC eligible instruments. We believe that these are likely to be deposit-funded entities where new TLAC requirements will require the bank to raise financing for the local entity, either internally or externally, beyond that for which it has a requirement. This has consequences if the cash from such TLAC debt could not be deployed profitably and deposits cannot be pushed away without damaging customer relationships.

The result is that surplus cash is invested in high quality liquid assets with a large negative spread between the cost of the TLAC funding and revenues that the cash will generate. This will have a negative effect on both HSBC and the local market. Reduced local profits will erode the capital resources available to the local entity and affect the willingness of the Group to invest in these entities or jurisdictions. Even if the TLAC is provided by a group holding company, this does not restore the equilibrium – internal TLAC needs to be matched to external TLAC to avoid double leverage so, in the end, there is a cost to the Group.

Moreover, the additional requirements could be material for certain smaller entities even if the absolute levels were relatively low in Group terms. Potentially, these entities could require with increases of greater than 50% in the capital and debt outstanding even at the lowest level of the TLAC range. This in turn will have a material impact on local returns and the ability of subsidiaries of G-SIBs to operate competitively in these markets.

Lower profits also mean lower taxes. This might be acceptable if the investors in TLAC are located in the same jurisdiction and pay the same tax rate but that is often not the case, particularly in emerging markets where the investors may well be overseas in more developed markets, effectively 'exporting' both profit and taxes to other countries.

Overall, we believe that the issues arising from the transition from existing debt to TLAC are probably manageable if the rules are available as soon as possible, reducing the period of uncertainty, and there is a longer timetable to achieve conformance.

However, we can see much more systemic issues where banks are largely deposit-funded and the costs and market issues are much more significant. Because these effects will be concentrated into local banks, whether resolved by internal or external TLAC, there will be an economic impact for these banks and the economies in which they operate.

16. What will be the impact on the financial system and its ability to provide financing to the real economy?

As set out above, there will be a financial cost of TLAC both for banks directly but also indirectly for other banks and all bank shareholders.

In the case of the substitution of existing debt for TLAC eligible instruments at an additional cost, it could be argued that this is likely to be a marginal cost. But this may not be the case if the transformation from senior debt to TLAC materially changes the investor base, for example, through the exclusion of bank holdings or investors unwilling to accept the higher risks of bail-in.

For additional TLAC required by deposit-funded entities, this will have a much larger direct impact on these institutions, on the profitability of the financial system in those jurisdictions (and therefore the willingness to invest) and on the taxes paid to the Government. Even if the absolute costs appear to be relatively modest in a global context or in the context of a G-SIB, they may be considerable for the country involved or the investment case for that subsidiary. Close consideration therefore needs to be given to the QIS and the impact on particular economies.

17. Do you have any comments on any other aspects of the proposals?

It is necessary for the proposals better distinguish between issues of cross-border resolution for inter-dependent subsidiaries (which we believe should be the focus of these proposals) and the local resolution of predominantly domestic banks which are members of a G-SIB group. We would see the former as a core function for the FSB in promoting cross-border resolution and the stability of the global financial system. In the case of the latter, however, this would seem to be more of a local matter which needs to be considered in a different context, particularly since some of the countries affected are not represented at either the Basel Committee or the FSB.

Overall, we also see an inadequate development of the proposal in respect of MPE groups. It is not clear that there is a proper understanding of the degree to which groups will be split into many entry points at a relatively low level within the group and the implications of this for TLAC policy. Noticeably, there is no concept of materiality for Resolution Entities although this is clearly defined for Material Subsidiaries which are subject to a SPE approach.

There is also an inadequate consideration of deposits and deposit-funded banks. The word ‘deposit’ appears only three times in the proposals and one of these references is in the definition of the Federal Deposit Insurance Corporation. There needs to be considerable more attention paid to this model which has proved remarkably resilient in many countries and over many years.