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Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
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10 February 2016

Dear Sirs,

Total Loss Absorbing Capacity ('TLAC') Holdings - consultative document

HSBC welcomes the opportunity to respond to the Basel Committee on Banking Supervision's ('the Committee') consultation paper '*TLAC holdings*' ('the consultation'). We have summarised our key comments below and have provided detailed responses in the appendix to this letter.

We support the intent of the TLAC regime to facilitate loss absorption and bank recapitalisation and we are fully engaged with its UK implementation. However, we remain concerned with the apparent divergences in national implementation of the finalised FSB TLAC requirements, the inclusion of non-wholly owned entities and the challenging timetable for implementation. In our view, these concerns are further compounded when considering the proposed deduction for TLAC holdings.

As we noted in our response to the FSB TLAC consultation, we believe the existing regime for large exposures between banks should be utilised as the primary control on excessive holdings. It is also necessary to consider the position of non-regulatory capital TLAC within the creditor hierarchy, whereby Tier 2 instruments should absorb losses ahead of TLAC.

In spite of these arguments, we understand the Committee's preferred approach is to subject TLAC exposures to a deductions regime. In which case, it is vital that this is consistent with the corresponding deduction approach taken for holdings of regulatory capital under Basel III. This is further elaborated upon below with additional issues for consideration.

Firstly, the proposed asymmetric treatment is overly punitive and risks destabilising the funding market.

This approach contradicts the intentions of the FSB as set out in its finalised TLAC term sheet. This explicitly notes that where exposures correspond to items eligible for TLAC, they should be deducted from the relevant TLAC resources. In our view, it is disproportionate to impose stricter restrictions in respect of TLAC holdings than those already in place for capital instruments. Instead, a corresponding deductions approach

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should be taken, where TLAC holdings are deducted from the bank's TLAC resources rather than it's Tier 2 as proposed.

This would directly address both double-counting and contagion risk, whilst creating the correct incentives to issue long-term non-regulatory capital debt and ensure a liquid market in such instruments. Furthermore, the principle of deduction should apply to only TLAC eligible instruments and should not be expanded to include instruments that do not qualify as TLAC.

Secondly, a simple and effective approach to ensuring prudential considerations do not adversely affect liquidity would be to introduce a market-making exemption from deductions, both in respect of own issued TLAC and other banks' issued TLAC.

Without permitting a certain level of market making activity, there is a significant risk that the market for these instruments will lack the liquidity that is essential to attract the broad range of investors needed to deliver the substantial financial resources that are being sought to meet the new TLAC requirements. Consideration of an exemption would also be consistent with the Committee's views in the recently revised market risk framework.

Thirdly, whilst we support the intention to utilise thresholds for deductions of non-significant investments, we do not believe the existing regulatory thresholds in the capital framework would be appropriate for holdings of TLAC, and a separate threshold is necessary.

We propose instead, that a corresponding deductions regime should be underpinned by two simultaneous thresholds; a new, separate threshold in respect of non-regulatory capital TLAC holdings deductions, and an adjustment to the existing regulatory capital threshold for non-significant holdings. It is necessary that the calibration of such thresholds is informed by a dedicated and targeted impact assessment which could be achieved through a monitoring exercise. This would also allow for a transitional period during which the threshold for deductions would be monitored and calibrated, to take account of the significant levels of TLAC issuance anticipated in coming years.

In summary, whilst we appreciate the necessity to avoid contagion risk and double counting of TLAC across the financial system, this can and should be achieved through the deduction from the same class of TLAC resources rather than Tier 2. It is important that Tier 2 and non-regulatory capital TLAC continue to be regarded as separate classes of liabilities reflective of loss absorbing hierarchy. Any deviation from this would undermine both the Basel III capital regime and the FSB TLAC requirements. We therefore strongly urge the Committee to consider a corresponding ("like-for-like") deductions approach which is consistent with the overall principles of the existing capital deductions regime, rather than requiring deductions from Tier 2 regulatory capital which is a different class of instruments.

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Moreover, deductions should not apply to non-eligible TLAC liabilities, so as to ensure a clear and transparent market for investors. During a time when banks' debt issuance is expected to reach unprecedented levels, it is vital that market liquidity is created. This should be achieved through the use of market making exemptions and utilisation of appropriate thresholds, informed by a monitoring period. In this respect, it is vital that the Committee balances the objectives of constraining contagion risk against the need for creating a market for TLAC issuance. Furthermore flexibility should be introduced during this critical period of build-up in capacity, whilst allowing time to refine disclosures and operationalise identification of TLAC holdings.

Our full response is attached to this letter. Given the potential for far reaching implications of these proposals, if it is considered helpful to you and your colleagues, we would be pleased to meet to discuss any of our comments further.

Yours faithfully,



cc. Mark Carney (Governor of the Bank of England and Chair of Financial Stability Board),
Andrew Bailey (Chief Executive Officer of the Prudential Regulation Authority)

Appendix

Promotion of market making to support investor demand and liquidity

We urge the Committee to consider the adverse impact of the proposed deduction approach. In particular, the proposed rules will strongly discourage market making in TLAC issued by 3rd party banks, which will drastically reduce liquidity as the stock of TLAC increases. Secondary market making of TLAC may become concentrated principally in the hands of the issuer themselves which will manifest itself through wider bid-offer spreads and consequently distort the market relative to other asset classes, especially in times of stress. This may also create the potential for conflict of interest with a G-SIB bank effectively being the only material supplier of liquidity in its own paper.

In order to ensure that there is a liquid market for newly issued instruments intended to meet TLAC requirements, it is necessary that underwriting and market making in both own TLAC instruments and 3rd party issued TLAC instruments are subject to an exemption. Without permitting a certain level of market making activity, there is a significant risk that the markets for these instruments will lack the liquidity that is essential to attract the broad range of investors necessary to deliver the financial resources that are being sought to meet the new TLAC requirements.

An exemption will be particularly pertinent for market making in own issued instruments. For example, during 2015, annual turnover in our own issued EUR debt instruments by percentage of notional was approximately three times that for 3rd party issued securities, and it is reasonable to assume that outright issuance will increase over the coming years.

It is also important to note that the Committee's revised approach for market risk issued in January, under the Fundamental Review of the Trading Book, sets out that where a bank demonstrates that it is an active market-maker, a national supervisor may establish a dealer exception for holdings of capital instruments in the trading book. While at this stage there is insufficient clarity as to its implementation, we would agree that such an exemption should be applied for market making in TLAC instruments. In our view, however, this should not be left for national supervisors to consider, but that a common global policy, consistently implemented across banks is more appropriate. Otherwise there is a risk this creates level playing field issues and divergent treatment.

Importantly, beyond any exemption, deductions for TLAC holdings for market making purposes should be based on actual holdings rather than on any pre-approved limit, contrary to the implementation of market making deductions in the EU under the Capital Requirements Regulation ('CRR'). This will ensure that banks do not have any incentives to retain any positions beyond the period necessary nor retain holdings up to the pre-approved limit since the capital costs will be incurred in any event.

Corresponding Deduction

The corresponding deductions approach that is already in place for regulatory capital should be adopted for investments in TLAC eligible instruments; whereby TLAC would be deducted from the bank's relevant category within own TLAC and not from Tier 2

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capital as proposed. The desire to reduce risks associated with double counting of TLAC and contagion can be addressed by requiring banks to deduct TLAC holdings from their TLAC resources.

We strongly disagree with the proposed asymmetric treatment to deduct from Tier 2 capital. In our view, it is inappropriate to impose stricter restrictions in respect of TLAC holdings than those already in place for capital instruments. Furthermore, a deduction from Tier 2 capital would not directly address the risk of double counting TLAC, and would create incentives (if not an indirect requirement) for banks to meet TLAC requirements via Tier 2 issuance. Not only would this undermine the requirements in the finalised FSB TLAC term sheet to meet requirements through issuance of non-regulatory capital instruments, but would result in significant incremental costs associated with TLAC issuance.

Moreover, it is unclear why the overall policy is being driven by a need to accommodate non-G-SIBs, which are by definition not intended to be in scope of the TLAC regime. It is important to recognise that in certain major jurisdictions additional loss absorbency regimes will apply to non-G-SIBs, particularly in the EU via the implementation of minimum requirements for own funds and eligible liabilities ('MREL').

A corresponding deduction approach should be applied to all banks. Banks which are not subject to TLAC requirements can similarly deduct TLAC holdings from their TLAC resources since they are not precluded from issuing bail-in-able debt to create a necessary buffer for such holdings. In contrast, banks and non-banks which are not subject to TLAC requirements, should be subject to existing prudential requirements such as the application of risk weights on exposures to TLAC and limits on large exposures.

A corresponding deduction approach applied to banks subject to TLAC requirements, would allow TLAC to be deducted from a bank's own TLAC resources and any excess could be deducted from higher tiers of capital. This approach directly addresses double gearing whilst creating the appropriate incentives to issue long-term non-regulatory capital debt and ensure a liquid market in such instruments. A holistic approach to TLAC deductions would allow for a more coherent framework, better aligned with the existing capital regime, whilst addressing contagion risk in a targeted way across the banking sector.

Deduction thresholds

We support the Committee's intention to utilise a threshold approach to deductions of TLAC, namely to create a distinction between significant and non-significant investments, with the utilisation of appropriate thresholds. However, in our view the deductions approach under the capital regime should be augmented, to take into account, that by definition, regulatory capital will form part of a bank's overall TLAC resources. It is also necessary to avoid the risk that any adjustments to existing thresholds is utilised to create more headroom for holdings of regulatory capital instruments of other banks beyond TLAC.

Specifically, we propose that a corresponding deductions regime should be underpinned by two simultaneous thresholds:

The first should be in respect of non-regulatory capital TLAC holdings deductions only, and the second should be in respect of the existing regulatory capital threshold for non-significant holdings. The first TLAC dedicated threshold, takes into account the fact that banks may invest in other banks TLAC, and avoids the risk of potentially creating considerable headroom within the existing capital threshold which could be used for holdings of regulatory capital of financial sector entities.

The second threshold would be the existing regulatory capital threshold which should be increased to take into account the fact that banks may wish to meet TLAC requirements through additional regulatory capital issuance, and may also need to deduct excess TLAC holdings from higher tiers of capital under a corresponding deductions approach (i.e. where their own TLAC would be insufficient to absorb those deductions). The marginal increase in this threshold should be informed through an impact assessment, and the final calibration should be determined once a monitoring period has been conducted. We would not expect the increase in the second threshold for regulatory capital to be as high as would be necessary if there was only one threshold for all instruments, including TLAC.

We agree that the application of the deductions should occur once long and short positions have been netted. An effective long position should be reduced first without restriction as to maturity or counterparty risk and only resulting net long positions being deducted, subject to the thresholds. If the intention is to deduct from Tier 2, we believe it would be necessary to permit the ability to net long and short positions across TLAC and Tier 2 instruments.

We also believe that it would be timely for the Committee to reconsider the overall principle for netting. Specifically, this is to assist the management of market making books to allow market liquidity in one segment to be permitted to facilitate liquidity in another, whereby short positions in high tier capital instruments would be permitted to be applied to reduce long positions of TLAC. For example, a short equity position from the highest tier should be permitted to offset an excessive (and otherwise TLAC reducing) long position in the lower tiered TLAC. This could be achieved relatively easily. In general, the upward movement of deductions with excess deductions made against higher tiers of capital should also be mirrored for netting purposes.

Identification of TLAC holdings to be deducted

The overarching principle for a deductions regime should be that only TLAC eligible liabilities are deducted. The pool of investments to be deducted should directly correspond with the pool of eligible instruments that banks' are required to maintain in order to meet TLAC requirements. Eligibility criteria for deductions should therefore be based on the eligibility criteria set out in the finalised TLAC term sheet, both in terms of the issued instrument and the issuing entity. In both respects, the scope for deductions should not be expanded further. If the boundaries are blurred, it will be difficult to identify what constitutes TLAC, thus rendering the regime inoperable. It may also result in aggregate

TLAC levels demanded across the system being vastly inflated relative to the shortfalls estimated from the 2014 quantitative impact study ('QIS').

The FSB finalised TLAC term sheet clearly states that resolution entities will be required to issue TLAC externally. We would therefore expect that deductions should only be made in respect of instruments that have been issued by resolution entities. Such an approach rests on the clarity created by the legal/regulatory environment in respect of the risks related to bank securities and hence their status as bail-in-able debt. This should be supplemented through comprehensive disclosures, given TLAC eligible liabilities are not readily identifiable.

These operational complexities around identification are further compounded, if the deductions coverage is extended to instruments which rank *pari-passu* with TLAC liabilities (i.e. those which are subordinated to excluded liabilities), or those which rank *pari-passu* with excluded liabilities. It is also necessary to take into account the apparent divergent implementation of TLAC, whereby certain jurisdictions have chosen to introduce statutory subordination. Whilst certain types of liabilities may rank *pari-passu* with TLAC and therefore be subject to losses alongside TLAC instruments, the risk weighted regime should adequately deal with losses imposed on the investor. Furthermore, given these are no longer being used by the issuing bank to meet its TLAC requirement, the risk of double counting is no longer prevalent.

If however, the Committee decides to require deductions of instruments which rank *pari-passu* with TLAC, it is necessary that deductions should be permitted to be made against the bank's own TLAC resources that are no longer eligible e.g. where remaining maturity is less than a year. It should be recognised that this stock of liabilities will continue to be loss absorbing despite no longer meeting the eligibility criteria and should therefore be used for offsetting and netting purposes and against which deductions can be made.

With respect to instruments that rank *pari-passu* with excluded liabilities, we recognise that in certain cases senior debt may be issued by banks to meet their TLAC requirements; as such issuance is subject to a limit permitted in the finalised FSB TLAC term sheet. Whilst the consultation recognises that not all senior debt investments should be deducted, we do not think this proposal goes sufficiently far. In our view, it would be wholly inappropriate to deduct senior holdings or any other type of instrument which ranks *pari-passu* with excluded liabilities, irrespective of maturity.

The alternate deduction approach suggests that senior debt investments could be subject to first loss, bail-in risk. In practice this is not the case, given banks will have a stock of liabilities which rank *pari-passu* with TLAC (e.g. TLAC which has a remaining maturity of less than a year, which will by definition be bailed-in and absorb losses before senior debt). The FSB term sheet recognises that senior debt should largely not be included as TLAC and we similarly believe that senior debt should not be included in the TLAC deductions regime. The alternative approach set out in the consultation, in our view is inoperable due to the practical challenges in identifying which banks are meeting their TLAC requirements through senior debt. The proposed deduction of senior debt also calls

into question whether a bank which chooses to meet its TLAC requirement through senior debt, should be able to use this against which to make deductions.

Indirect or synthetic holdings

We agree that the rationale underpinning the capital regime should be adopted for TLAC. However, it is necessary that final requirements set out additional detail and specific definitions as to what is intended to constitute indirect and synthetic holdings. It is vital to understand the extent to which banks will need to look through exposures to underlying investments which may include TLAC instruments or indices which reference TLAC instruments. As part of this, it is necessary to undertake a proportionate approach to ensure that banks are not required to look through multiple layers through to the underlying exposures. In respect of synthetic holdings, it is also necessary to set out the extent to which market indices would be captured, for example indices which contain exposures in relation to both regulatory capital and TLAC debt.

The scope of TLAC instruments which need to be deducted will clearly have ramifications on the extent to which indirect and synthetic holdings are identified. For example indices and investments in funds will include senior and/or subordinated debt.

Disclosures of TLAC

In practice, the above complexities will mean that the deductions regime will rely strongly on robust Pillar 3 disclosures. This could be delivered through banks' disclosures of TLAC issuances to meet their requirements and details as to the designated resolution entity/entities. We note that this is intended to form part of the second phase of Basel Pillar 3 revisions which has not yet been published. However, without such a proposal for disclosures, it is difficult to comment on how accurate identification of TLAC holdings can be achieved in practice. Furthermore, in respect of indirect holdings, if a look through approach is adopted, it will be necessary to consider disclosures of non-banks' holdings of TLAC, which are not within the scope of Pillar 3 requirements.

Scope of application

We support the need to introduce deductions for investments in own instruments and reciprocal cross holdings which are designed to inflate the TLAC position of banks. However, we believe a nuanced approach is needed for intra-group TLAC holdings. The consultation is silent in this regard, and any finalised proposals should explicitly note that internal TLAC does not constitute 'own TLAC'.

Intra-group treatment of TLAC holdings may be considered to fall outside the purview of the Committee, however we believe finalised requirements for TLAC holdings should explicitly state that deductions are not intended to apply to internal TLAC. Application of deductions treatment to internal holdings would not be consistent with the principle of down streaming internal TLAC to material entities, and if introduced will create obstacles to the 75-90% levels of internal TLAC mandated in the FSB finalised term sheet. In particular, it would be inappropriate to require internal TLAC to be deducted from Tier 2

as it would compel resolution entities i.e. issuing holding companies, to issue Tier 2 externally, which would be inconsistent with the FSB finalised requirements.

Impact assessment and monitoring period

Given the expected significant impact if deductions were applied to Tier 2 resources and the proposed extension of coverage to instruments which are not TLAC eligible, we strongly urge the Committee to undertake a targeted impact assessment and finalise the calibration of deduction thresholds and their operation once a monitoring period has been undertaken. The QIS carried out as part of the development of the FSB TLAC requirements should be treated with caution, as it was undertaken on a best efforts basis and the scenarios that were provided do not correlate with the proposals in this consultation. In particular, the information requested as part of the QIS did not include assessment of holdings in instruments which ranked *pari-passu* with excluded liabilities.

Use of transitional phased-in approach

It is our strong view that given the lack of grandfathering treatment within the finalised FSB TLAC term sheet, and the potentially significant magnitude of deductions, a phased-in approach should be adopted during a transitional period. This would allow time for investor appetite to be developed around demand for newly issued TLAC instruments. Market capacity for these instruments will need to greatly expand in order to accommodate the full implementation of the new regime by 2022. A transitional phased in approach would also allow time for banks to refine disclosures, and operationalise identification of TLAC holdings.