BIS 79-014170
10.03.09

HSBC

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

27th February 2009

RE: PROPOSED REVISIONS TO THE BASEL II MARKET RISK FRAMEWORK

Dear Sirs/Madams,

We at HSBC welcome the consultation process on the proposed revisions to the Basel II market risk framework. We recognize the need to reformulate the way trading book capital is calculated and potentially make it less pro-cyclical.

The proposed revision may achieve this objective. However, we feel that, in some cases, this may make market-making activities undertaken by banks so capital intensive that it results in some institutions exiting the market all together or preferring to use standard charges rather than an internal model. This may not be the intended goal nor is it a desirable objective for the efficient workings of capital markets. Hence, we would urge the Committee to study the impact prior to finalization of these rules.

We believe that any proposed exclusion of securitized products from internal models for specific risk would be detrimental to the long-run viability of these products and their associated markets. Whilst a significant amount of losses in the past year have originated from these products, it is important to recognize that securitization technology can have inherent benefits when used appropriately in mitigating and customizing risks to meet investor needs. The boom in securitized markets has been driven as much by increased credit as by the desire for enhanced yield from investors who in some cases did not fully appreciate the risks arising from these products. The problems were further complicated by a misalignment of incentives and poor due diligence on the part of all stake holders. Whilst fixing these problems is essential, this must be addressed by enhancing controls and transparency rather than a *disproportionate increase in capital*, which would have the effect of further reducing the liquidity and market-making activity in these products. In fact, one of the key lessons from the current crisis is that market liquidity in a stressed environment varies more widely across products than was previously thought, and as such needs to be appropriately modelled in market risk measures.

HSBC Holdings plc
Group Risk, Level 40, 8 Canada Square, London E14 5HQ
Tel: 020-7991 8888 Fax: 020-7991 4603

HSBC

Rather than excluding securitized products from the internal VaR (and IRC) models, we would prefer that supervisors encourage development of more comprehensive risk measures which take account of important product characteristics such as liquidity. Potentially, more stringent criteria could be imposed prior to granting model recognition for these products. This would continue to provide an incentive for institutions to further develop and refine their internal models to appropriately capture all of the risks for this class of products, and for other esoteric products that may emerge in the future.

The used of a stressed VaR exposure in addition to the standard VaR exposure for capital calculations is an interesting proposal and one which we recognise may go some way towards addressing pro-cyclicality issues with the current VaR-based capital process. However, we are concerned at the extent of the double-counting of risks in following this approach, and at the quantum of the potential increase in capital irrespective of the dynamics of the underlying market. Based on this methodology, we would expect for the VaR-based capital to approximately double in the currnt market state. However, in more benign market conditions we anticipate the relative increase in VaR-based capital could be much higher. Based on an internal benchmarking exercise, if markets were to return to 2006/2007 levels in terms of volatility and market prices, the VaR-based Pillar 1 capital for a simple portfolio of foreign exchange spot, interest rate swaps, treasury bonds, and equity index positions would be about four times higher than that required under current rules. We do not believe this increase in capital is justified for a portfolio with no specific risk which has had generally good liquidity through the recent market turbulence.

We note that further guidance on the issue of stressed VaR model calibration would be required, as the current proposal leaves significant scope for institutions to optimize certain model choices, for example the length of the historical data period, in order to reduce the overall capital.

On the subject of prudent valuations, we would request that the Committee defer guidance to the International Accounting Standards Board, as any inconsistencies could lead to further confusion in valuations and potentially conflicting rules as the standards evolve.

In conclusion, whilst we appreciate the motivation behind the proposed changes and understand the need for expediency, we would request that the Committee try to ensure that the proposed changes provide the right incentives for market participants to further develop appropriate risk-sensitive models for capitalizing all risks in the trading book on a consistent basis. Before seeking further progress, we would strongly recommend and encourage the Committee to commission a quantitative impact study, in order to assess the likely impact of the proposed changes for market participants over the course of a full credit cycle. The results of such a study could then be used to help finalize the proposed changes.

Thank you for providing the opportunity to comment on this important issue.

Sincerely,

Mark Smith

Mark Smith
Global Head, Wholesale and Market Risk