HSBC

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Chief Financial Officer
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16 April 2010

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Dear Sirs

Consultative document BCBS 164 – Strengthening the resilience of the banking sector

HSBC welcomes the opportunity to comment on the Basel Committee's proposals, and strongly supports the Committee's objectives of strengthening global bank capital rules in order to promote a more resilient banking sector. If the aims of the Committee are to be met then it is also imperative that a level playing field is created and that the proposals are implemented globally on a simultaneous and comparable basis, after taking into account relevant legal, tax and capital market differences across jurisdictions.

HSBC is one of the largest banking and financial services organisations in the world, with assets of US$2,364 billion at 31 December 2009. Headquartered in London, HSBC serves customers worldwide from more than 8,000 offices in 88 countries and territories in six geographical regions. HSBC's businesses encompass a very broad range of financial services and products, including personal financial services, commercial lending, global banking and markets, private banking, asset management and insurance.

At HSBC, inter alia, we strongly support the development of a robust, risk-based capital framework which will require the sector in aggregate to hold more core equity capital than in the past and which also promotes prudentially sound financial institutions and wider financial stability.

Maintaining undoubted financial strength is a top priority for HSBC. We therefore have always adopted a conservative approach to capital and risk management. As of 31 December 2009, our Tier 1 capital stood at 10.8% and our Core Tier 1 capital at 9.4%, both well in excess of regulatory requirements. This is not a recent phenomenon; HSBC has always believed in strong capital and over the last seventeen

years since moving HSBC's head office to the UK, HSBC's Tier 1 ratio has stood between 7.4 and 11.4 per cent and for the vast majority of the time has been in excess of 9 per cent, notwithstanding periods of intense shareholder pressure to leverage returns by reducing the equity component of the regulatory capital base. Our consolidated capital position is reinforced by a parallel local focus on capital and liquidity, which promotes financial stability in all our international markets. We believe this combination has enabled us to weather the recent downturn and many previous stress events from within our own resources and without recourse to any government funding or direct support.

Cumulative effect of the proposed measures

While we are supportive of reform, the potential for contradictory or overlapping measures, that in effect "double count" the capital that is required to address identified shortcomings, is clearly apparent, as is the potential for tightening measures to be introduced just as we start to see economic growth returning. Nor should the potential for over-burdening the industry with disproportionate cost be overlooked, since unintended consequences could be to channel lending activity into unregulated sectors of the market or to limit competition through high barriers to entry, both to the detriment of bank counterparties.

The cumulative impact of these and previously agreed proposals is currently being assessed through a Quantitative Impact Study (QIS). HSBC is pleased to be contributing to this QIS at Group level and believes it is critical that the results of this are taken in to account to inform both the timing and nature of any final proposals from the Committee. We believe it is essential that this assessment includes the likely impact of the proposals on the supply of credit and the cost of credit, together with the consequential impacts on employment and the economy in general. The Committee's Consultative Document states that a fully calibrated set of revised capital standards will be developed by the end of 2010 to be phased in as financial conditions improve and the economic recovery is assured. We would be interested to hear what criteria will be applied to determine when this has been achieved.

We are supportive of the focus of the Basel Committee on quantitative impact assessments; however, we would point out that these only measure the effect of the proposals on capital levels; they do not consider what each proposal, either separately or in aggregate, contributes to stability; and they do not consider the knock-on effects to business nor the feed through to the real economy.

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Our main comments on this consultation document are summarised below. Further detailed comments are set out in Appendix 1.

Raising the quality, consistency and transparency of the capital base

- **Minority interests.** We believe that this proposal introduces inconsistency in the capital calculation. Minority interest *is* available to support the risks in the subsidiary to which it relates and in so doing, it supports the Group as a whole. The fact that a highly capitalised subsidiary with a minority interest flatters the Group level capital ratio is no different from the mix effect of a wholly owned subsidiary with a large capital base where that capital may not be easily released to the rest of the Group. We believe that both of these impacts would be better addressed through Pillar 2. If the view is maintained that minority interest should be deducted from Core Tier 1 capital, then either so should the minority's share of RWAs or, alternatively, the minority interest should be included in Tier 2 capital as it will support creditors on a 'gone concern' basis.

- **Deferred tax assets.** We believe that consistency with the accounting approach should be maintained. IAS 12 recognises deferred tax assets only where their recoverability is probable, so a blanket deduction for all deferred tax assets is excessive; and it might also be procyclical given that deferred tax assets tend to rise during a downturn. Should there be concern over the extent to which deferred tax assets depend upon profit generation well into the future, then a cut-off point for capital purposes could be adopted, say 2 years.

- **Defined benefit pension fund assets and liabilities.** While we agree that the accounting treatment in the financial statements should be the starting point for regulatory capital measurement, we also believe that adjustments may be justified when the accounting treatment is inappropriate for regulatory capital measurement. The proposal that no filter should be applied to defined benefit pension fund net liabilities would introduce an unjustified degree of volatility in regulatory capital and, worse, delegate capital calculation to accounting standard setters, who have no need to consider the impact on regulatory capital of changes to pension accounting. The accounting measurements of plan assets and defined benefit obligations at each balance sheet date, being sensitive to the risk-free rate and current asset price levels, can often result in large movements which impact shareholders' equity. However, such movements, through reported equity, can bear little relation to the actual funding requirements of the scheme from the sponsoring bank, which are agreed to fund essentially long term liabilities.

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> At a time of monetary easing to aid recovery from an economic downturn, when it is also likely that asset prices are depressed, the proposed alignment of the regulatory capital definition with the accounting model is potentially highly procyclical. For example, at a time of quantitative easing supported by low interest rates, it is likely that pension deficits on an accounting basis could rise. As a result of that incremental deficit hitting the capital base, the banking system would be withdrawing capital and, therefore, have reduced credit creation capacity at that time. We believe that a less procyclical solution could be found by allowing scheme specific valuation methodologies, prescribed in local regulation, with assessments undertaken every few years or even annually, to deliver a liability value more reflective of the expected return on a scheme's underlying assets, including having incorporated the impact of agreements reached on funding any disclosed deficit.
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> We would support recognising the quantum of agreed payments under such plans as a deduction from capital; this is similar to the current FSA approach. We do not support aligning in this area the regulatory capital definition with accounting measurement, given the potentially material impact from changes in the accounting standard without any change in underlying risk.

A number of proposals made by the Committee reflect the existing accounting or regulatory treatment followed in the UK, which we fully support. These include the treatment of stock surplus, investment in own shares, cash flow hedge reserve and gains and losses due to own credit risk. We are also supportive of the proposals that simplify the capital base by removing existing 50/50 deductions and either risk weighting or deducting in full from common equity.

Risk coverage

The Committee is proposing a completely new and untested approach to counterparty risk which includes an approach that does not appropriately reflect movements in Credit Valuation Adjustments (CVA). The approach proposed is procyclical, and not well aligned to risk.

The QIS exercise has highlighted technical shortcomings in the proposal as regards the structure of the hypothetical bond. The appendix provides more detail on our concerns, in particular around the assumptions made by the Committee.

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HSBC accepts that there is a risk of losses due to volatility in the CVAs taken by banks, and supports the introduction of regulatory capital requirements to reflect this risk.

The proposed approach is likely in most cases to produce requirements that are disproportionate to the risks involved. This could result in banks over-hedging corporate exposures with a consequential widening in funding (CDS) spreads and thereby increasing borrowing costs for the commercial sector. Given that the CVA capital charge can only be hedged where liquid CDS markets exist, banks are unlikely to be able to mitigate their capital costs with regard to SMEs, resulting in higher costs for smaller companies wishing to mitigate their risk. With banks being buyers of protection, sellers are likely to be concentrated amongst insurance companies and less regulated sectors such as hedge funds. Systemic risk could increase if protection sellers struggle to meet their obligations during the next crisis.

Further, banks make CVA adjustments using different methods according to their application of choices available within accounting standards and other factors. A one-size-fits-all approach to setting capital against counterparty risk is likely to produce requirements that are in some cases disproportionate to the risk.
We do not consider that the current proposal would have led to capital levels aligned to the actual CVA losses seen in the last couple of years, since the proposal is still driven by historical parameters, and also because many of the credits concerned were originally of the highest quality. Accordingly, the impact of recent events would not be captured as there would have been no equivalent historical credit variation within the VaR or Stressed VaR framework.

In order to achieve the objective of adequately setting capital against variations in CVA, there is a need for a framework which is more forward looking, and well calibrated to events equivalent to the recent extremely stressed moves. Although we remain uncertain as to whether any model is adequate to the task of capturing paradigm shifting events, nevertheless, in the attached Appendix we propose such an alternative forward-looking framework to compute a CVA Variability Charge ("CVC") which can be calibrated to an individual portfolio and which is not procyclical, is risk sensitive and uses existing tools already required by firms. We also suggest a form of language to permit this to be straightforwardly incorporated in the Basel document.

We also support the industry proposal to allow the deduction of CVA from the full CCR capital charge, not just from expected loss. This would generate a more level playing field for banks with different approaches of calculating CVA.

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Leverage ratio

We believe that the benefits of a leverage ratio as a regulatory tool are not clear-cut and it is certainly no panacea. Leverage ratios are not risk based, and as such they can provide both false comfort and inappropriate incentives, both by encouraging the use of off balance sheet vehicles and a move towards higher risk assets, especially when the leverage ratio, rather than a capital ratio, becomes a constraining factor. Perversely, they also penalise those financial institutions engaging in relatively low risk business and do nothing to constrain businesses that build the leverage into the product rather than on the balance sheet.

There is also a clear conflict between the leverage ratio and the requirements under the liquidity regime proposed in BCBS 165, which will require banks to hold more liquid securities including government bonds. Including such assets in the leverage ratio, as currently proposed, could undermine the role of banks in credit formation as the requirement to hold more liquidity and work within a leverage ratio constraint could well encourage banks to reduce RWAs and leverage, with the most vulnerable portfolios being those of SMEs as mortgage lending and large corporate lending is very difficult to adjust in the short term.

We are, additionally, concerned that overcoming fundamental differences in accounting globally, a difficulty which is recognised by the Committee, will prove a formidable challenge. In particular, we note the more generous off-balance sheet treatment and netting of derivatives positions permitted under US GAAP compared to IFRS. Even if the accounting issues can be solved, level playing field issues will still arise to the extent that banks are able to offload risk from the balance sheet, for example to government sponsored entities, in some markets but not in others.

We agree that a leverage ratio may well have a role to play as an early warning indicator in the prudential regulator's Pillar 2 toolkit. HSBC believes that consideration should be given to a flexible approach agreed bilaterally between the bank and the regulator, based on business model and risk, rather than a prescriptive one-size-fits-all measure. We are concerned that, if the leverage ratio were set at a level which obstructs the ordinary course of business, it would foster perverse incentives and may have unforeseen consequences. HSBC would therefore encourage the Committee to give further consideration to both the role and structure of a leverage ratio.

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Procyclicality

HSBC supports the introduction of measures that aim to lessen the procyclical effects of the current Basel framework.

We believe that such measures must have strong and consistent links with bank internal risk management. For HSBC, this means in particular that we strongly favour measures building on Through-the-Cycle PDs, which we have used for many years and which have been proven to avoid procyclicality in our capital requirements. We strongly caution against any new measures that would have to be developed for capital buffer purposes only, and otherwise serve no useful internal purpose.

HSBC agrees that both capital measures and provisioning should be considered to address procyclicality. However, we believe that there is a limited amount that can be achieved by making changes to provisioning methodology in the financial statements; the largest contribution needs to come from a careful review of regulatory capital methodology.

HSBC agrees that it should be possible to achieve more forward looking provisioning in financial statements by using a broader range of credit information. HSBC also believes that the introduction of excessive subjectivity into provisioning methodology, or approaches that seek to accumulate a prudential 'buffer' during benign periods in order to stabilise reported earnings during times of stress, will reduce the objectivity of financial reports and damage market confidence. HSBC also believes that, by reducing the emphasis on provisioning when seeking solutions to procyclicality, this will reduce the serious risk of double counting capital to support expected losses in applying the capital and accounting frameworks.

HSBC believes, however, that the IASB's proposal for an Expected Cash Flow model has serious conceptual and practical flaws. In particular, as has been widely commented, the proposal to spread the initial expectation of loss over the lives of financial assets yet take the effect of any changes in those expectations immediately to profit or loss account lacks a conceptual basis and is likely to introduce additional unwarranted procyclicality. Furthermore, such a methodology is likely to be impracticable to implement and prohibitive in cost due to heavy additional data requirements.

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HSBC is currently assessing the merits of alternative provisioning models. HSBC would be content to retain the incurred loss model for financial reporting purposes, but would also be supportive of using a broader range of credit information than is currently used, in order to ensure earlier provisioning.

A macroprudential policy mechanism for management of the supply of credit

Perhaps a better way of tackling procyclicality would be to design a macro-prudential policy mechanism for managing the supply of credit. HSBC has been working on some ideas for a policy mechanism to plug the gaps in the pre-crisis regulatory framework which contributed to the crisis. These ideas focus on:

- the 'disarticulation' of the price of credit from the supply of credit, a feature of the crisis which rendered the monetary lever ineffective;
- the disconnect between micro-prudential supervision and macro-economic and systemic analysis, a feature of the crisis which rendered supervision less effective;
- over-reliance on historic data for the purpose of calibrating risk, whether for the purpose of regulation or for complex securitisation algorithms;
- the inherent shortcomings of relying on a "fixed point" capital ratio when real levels of risk in the system move dynamically.

We do not believe that "Basel III" yet addresses any of these issues in a coherent way; and if they remain unaddressed, current proposals for regulatory reform may prove no more than an attempt to make the next crisis affordable, rather than an attempt to prevent it.

To complement the monetary mechanism, which manages the price of credit, we would propose a separate policy mechanism for the management of the supply of credit. The principal lever would be the flexing of capital requirements, targeted on areas of concern. Under this mechanism, an independent 'Financial Stability Authority' would monitor macro-economic and systemic indicators and would issue guidance on the range of core tier 1 capital which should be held in the banking sector. It would also be responsible for identifying potential "areas of exuberance". The Authority could be similar to a monetary policy committee, but would probably not need to meet as often. Monitoring could take place at the national level, or more widely. This process should be transparent, with published minutes of meetings.

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The national prudential supervisor would be responsible for implementing the range of risk weights, institution by institution, through an enhanced Pillar II process, on the basis of the distribution of risk within a given business. When the need arises to increase capital requirements, the supervisor would focus on the degree of exposure to the identified "areas of exuberance". This should not preclude the use, if necessary, of other administrative tools – such as LTV caps.

The FSB, the European Systemic Risk Board, once up and running, and national financial stability authorities should be encouraged to monitor equivalent macroeconomic data and compare notes. Both the first Turner Review[1] and the recent Bank of England Discussion Paper[2] list appropriate indicators. Supervisory colleges could be the medium for ensuring that the principal regulators of overseas banks avert arbitrage when the exuberance of domestic banks is being targeted, thereby managing "leakage".

This form of management of the supply of credit should provide for a reduction of capital requirements as well as an increase, ie. it would help to calibrate the level of capital in the sector to match the level of risk more accurately – a feature missing from the Basel regime in the period 1988-2008. Although we believe the concept of "buffers" to be helpful, there needs to be the ability to reduce capital requirements to answer the question about how capital buffers would be "released in a recession" to meet the purpose for which they were notionally conceived. This mechanism could, in effect, subsume many of the ideas about capital and liquidity which are now under discussion. We have also characterised the real time data feedback mechanisms necessary to ensure that capital levels track real levels of risk during periods of stress. A period of reductions in capital requirements – ie the release of credit into a recovering economy – would carry incentives for coordinated introduction across different jurisdictions.

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1 FSA, *The Turner Review: A regulatory response to the global banking crisis*, March 2009
2 Bank of England, *The role of macroprudential policy: A Discussion Paper*, November 2009

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As part of our overall efforts to work in partnership with governments and regulators in improving the financial system for the future, we should be very pleased to discuss or develop the ideas in this response with you.

Yours faithfully

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