

Appendix 1

Basel Committee Consultative Document: BCBS 164 *Strengthening the resilience of the banking sector*

1. Raising the quality, consistency and transparency of the capital base

We agree with the Basel Committee that clear and realistic grandfathering and transitional provisions must be defined to manage the impact of all the elements of any new capital requirements and ensure that economies are not adversely impacted while banks restructure their capital bases progressively in an orderly and cost effective manner.

Criteria for inclusion in common equity component of Tier 1 capital, Tier 1 additional going concern capital, and Tier 2 capital

Tier 1 Common Equity

Whilst we agree with the intent of the Committee's proposals, that banks should do "nothing to create an expectation that the instrument will be bought back, redeemed or cancelled", we believe that this restriction should be clarified such that it does not restrict normal market making activities in the Bank's own shares.

In addition, clear and separate disclosure in the notes to the financial statements should be considered acceptable to satisfy the requirement for separate disclosure on the Bank's balance sheet of common equity.

Tier 1 Additional Going Concern Capital

The Committee intends to set explicit minimum ratios for common equity, additional going concern capital and total capital. The Committee also notes that limits on Tier 2 (gone concern) capital are to be removed. In the same manner, it would be appropriate to remove limits on 'additional going concern capital' in relation to common equity, as such a limit is redundant if explicit minimum ratios are in place. As such, we do not consider it necessary to set a specific common equity 'predominance' level within tier 1, as this would serve only to limit the amount of additional going concern capital an institution could raise in relation to the common equity base. With minimum ratios in place for both measures, this appears unnecessary.

There is no compelling reason for instruments classified as liabilities to have either a conversion or a write-down mechanism which allocates losses to the instrument at pre-specified trigger points. It discriminates against instruments that are classified as equity, e.g. preference shares, where there is no similar requirement for a write-down. In particular:

- the requirement for a reduction in the claim of the instrument in liquidation is considered unnecessary by virtue of the criteria that the instrument cannot contribute to liabilities exceeding assets with respect to insolvency law,
- the requirement to reduce the amount repaid when a call is exercised generates a more penal result than for equity instruments;
- the requirement to reduce coupon/dividend payments on the instrument is considered unnecessary by virtue of the criteria regarding coupon discretion; and
- the requirement regarding instrument purchases should only apply at the time of issuance. Banks should not be restricted from undertaking underwriting or market making activities in their own instruments, indeed such activities are necessary to aid liquidity in such instruments, enhancing the size and depth of the market for bank capital instruments.

With respect to instruments issued via an SPV, we believe that the requirement that the on-lend of funds from the SPV must be “in a form which meets or exceeds” the criteria for inclusion in this tier of capital is unnecessarily restrictive. Differing tax laws across jurisdictions mean that in some, hybrid instruments can be issued from the operating company in tax-deductible format whereas in others, an SPV structure has been utilised to obtain this treatment. The impact of the proposed requirement would prevent a level playing field for bank capital across these jurisdictions. Where the economic substance of the different transaction structures is identical, differing only in legal form to satisfy local tax law, the regulatory treatment should be the same.

Tier 2 (gone concern capital)

Tier 2 instruments will be prevented from having any incentives to redeem. This requirement requires further clarification as to what is considered an incentive to redeem, i.e. any step-up features and/or call options. There is also a question as to whether the imposition of regulatory amortisation would be considered an incentive to redeem. The proposal provides protection to the capital base in that such instruments can only be called by issuers and further provides safeguards that the instrument can only be called and redeemed after a minimum of five years and only after prior supervisory approval. It is not clear, therefore, why a step-up feature may be considered a prohibited feature or unacceptable in light of the prior supervisory approval requirement.

As with tier 1 instruments, banks should not be restricted from undertaking underwriting or market making activities in the Bank’s own instruments issued.

Contingent capital

In advance of the proposals for contingent capital which have yet to be released, we should like to make the following points which may assist the Committee in formulating these proposals:

- Contingent capital issuances should not be mandatory;
- Triggers must be simple, transparent and predictable to investors;
- Triggers must be institution specific and not related to systemic or market risks;
- Write down or conversion triggers must be objective and not discretionary to the issuer or the banking supervisor;
- Conversion should not be limited to the predominant form of Tier 1 capital;
- Write down features should also permit a write-back feature when a bank's capital position improves.

Minority interests

The proposal to exclude minority interests from common equity is based on the premise that this capital is not available to support risks in the group as a whole. This proposal has a number of flaws:

- The minority interest is available to support the risks in the subsidiary to which it relates, which are included in full in the group as a whole. If the risks are fully consolidated in the regulatory balance sheet then the capital supporting such risks should also be fully consolidated;
- The treatment of minority interests in the manner proposed would introduce inconsistency with the treatment of associates (proportional consolidation) and may lead investors and analysts to believe that all remaining core equity capital is fungible across the group, which is unlikely to be the case;
- Minority interests are a feature of many emerging markets, where the legal or regulatory environments requires a local partner. The proposal risks damaging the development of banking systems in these markets by making inward investment more expensive;
- The proposal may therefore undermine expansion through locally incorporated subsidiaries and thereby provide an incentive to use instead a branch structure. This runs counter to other proposals on recovery and resolution where regulators seem to prefer locally incorporated subsidiaries. It is inconsistent to promote the subsidiary structure in one area of regulatory reform whilst penalising it in another.

Minority interests arise in many situations, from the use of local partners (either by regulatory diktat or the desire for local knowledge), the partial flotation of locally incorporated subsidiaries or through support frameworks for savings banks. All these are legitimate and longstanding practices that have not, to our knowledge, been the source of any problems during the recent crisis; nor do we believe is the impact of treating minority interests in the current regime misunderstood.

If regulators have a concern that the inclusion of minority interests flatters the capital ratio at group level in some circumstances (for example where a local partially owned subsidiary is ‘over capitalised’ or where a structure is consolidated under IFRS where there is minimal group equity ownership), this should be addressed through Pillar 2 to target the specific circumstances of an institution, rather than by introducing a blanket capital restriction with respect to all minority interests.

Under the current proposal, while minority interest is to be excluded from the common equity component of Tier 1 capital, there is no clarification as to whether it can be included as additional going concern capital or Tier 2 capital of the consolidated group; at a minimum we believe it must form part of the latter as it will respond in a ‘gone concern’ scenario.

Unrealised gains and losses on debt instruments and equities

The proposal primarily concerns instruments that are held in the IFRS category of Available for Sale (AFS). As the Committee is aware, proposed changes to IFRS 9 will remove the AFS category, such that these unrealised gains and losses will no longer exist. Rather than introduce unnecessary volatility through a change in regulatory treatment at this juncture, we believe it may be preferable for the Committee to await the finalisation and implementation of IFRS 9, when the perceived inadequacies of the current treatment will be resolved anyway.

Goodwill and other intangibles

While a deduction of goodwill is appropriate, the blanket deduction of intangible assets, other than those arising on acquisition, is not, particularly as many of those assets are recognised on the basis of contractual rights and are carried on balance sheet subject to recoverability tests. Other than as described above, HSBC sees no case to diverge from the accounting treatment in determining regulatory capital.

Deferred tax assets

A blanket deduction for all deferred tax assets would be unnecessarily harsh in our opinion. IAS 12 establishes the principle that deferred tax assets are recognised only where their recoverability is probable. In many cases, the recoverability of deferred tax assets will be subject to low levels of judgement and high degrees of probability, for example where loss carry backs are available, and will often not be particularly sensitive to levels of future profitability. In other cases greater judgement may be required. The recoverability of deferred tax assets is already considered according to a consistent framework such as the one provided by IAS 12. We also note that deferred tax assets tend to rise during economic downturns, and a blanket deduction of deferred tax assets irrespective of recoverability would have consequential procyclical effects on the measurement of capital. Accordingly, it is strongly recommended that the accounting approach is retained as the starting point for regulatory purposes, with consideration of limiting the time horizon over which such assets can be recognised for inclusion in the regulatory capital base.

Investments in the capital of certain banking, financial and insurance entities

The proposal is in line with the requirements of the existing Basel Accord, paragraphs 28-30, the Capital Requirements Directive in the European Union and existing regulatory practice in most jurisdictions. The proposal is, however, more specific about the tier of capital against which the deduction for such holdings should be made, to ensure that deductions are made on a corresponding basis.

The basis of the proposal recognises that, in the absence of such a deduction, regulatory capital would be double counted within the system.

While HSBC is supportive of the intention to avoid double counting of bank capital we do have concerns that the inclusion of the assets held in the trading book within the aggregate 10% limit will have significant unintended consequences. Trading books are used to provide liquidity for the equity market and should not be materially constrained in this function. This is particularly the case where a large number of financial institution holdings are traded as part of equity indices (e.g., bank equities make up 15% of the FTSE 100). These holdings provide liquidity and arbitrage free prices in exchange traded derivative markets as, in order for a bank to hedge the market risk of selling futures, it needs to hold the physical equities in the index as a hedge.

Imposing a restriction on ordinary market-making activity within the trading book may well drive the business to less regulated sectors of the market, increasing costs and reducing both liquidity and price transparency.

We would propose that, as currently under FSA regulations, the aggregate holding restriction of 10% of a firm's capital is limited to the banking book, and the trading book deductions apply only at the individual equity level.

Defined benefit pension fund assets and liabilities

The proposal to apply no filter to defined benefit pension fund net liabilities raises the question as to whether the accounting treatment under IAS 19 (or indeed any other accounting standard) is an appropriate method under which to consider the impact of defined benefit pension scheme obligations on regulatory capital adequacy. While there are two permitted treatments within the current IAS 19, the 'corridor approach' which serves to partially dampen the volatility of the accounting treatment of gains and losses is not universally adopted by IFRS reporters, and is proposed to be removed in future. Accordingly, this response considers the other approach, whereby actuarial gains and losses are recognised in full in the period they occur within Other Comprehensive Income. Under IAS 19, the measurement of plan assets and defined benefit obligations at each balance sheet date are highly volatile, being sensitive to point-in-time fair values of plan assets, and point-in-time corporate bond yields, respectively. These movements do not necessarily bear any relation to the actual funding requirements from the sponsor Bank, which are agreed to fund what are essentially long term liabilities, and which we believe have far greater relevance in the context of measuring capital adequacy. In considering the proposed deduction of any

net defined benefit pension fund asset, we note that recognition of such an asset would require that the asset is recoverable by the company, although it is acknowledged that recovery may be over a long period of time depending on the scheme rules and circumstances, and that the measurement of the asset under IAS 19 is beset by the same issue of sensitivity to point-in-time fair values of plan assets and bond yields.

The above accounting treatment for pension scheme losses would have procyclical results when used in the regulatory capital adequacy context, for example during the onset of a financial crisis when the fair values of plan assets typically fall, and interest rates in general would tend to fall, increasing the present value of the defined benefit obligations as reported under IAS 19. When economic conditions improve, large reported net liabilities can reduce substantially in a relatively short period of time. It would seem perverse that credit capacity would be withdrawn in a downturn through the impact of marking pension schemes to market under IAS 19 just as governments were seeking to stimulate the economy through the lower interest rates that caused the deficit to rise.

The volatility associated with the IFRS methodology and assumptions would argue for a more stable and scheme specific valuation methodology, which in many instances is in fact prescribed by local regulation or statute. The basis used in discussion between the fund and the bank when agreeing contribution levels, including any additional contributions to make good foreseeable deficits would be more appropriate. Such assessments, undertaken every year or at the least every three years, deliver a liability value that is reflective of the expected return on the scheme's underlying assets and includes agreement on funding of any disclosed deficit. We would be supportive of recognising the quantum of agreed payments under such plans, currently limited to a 5 year rolling period, as a deduction from Tier 1 capital. This would deliver a more realistic deduction, capable of review/adjustment at successive assessments and reflective of actual scheme experience. This would also better reflect the actual economic obligation of the bank to its pension plan in the foreseeable future, rather than the plan lifetime which may be 40 or 50 years as the pensioners draw their pensions over their lives.

2. Risk coverage

CVA charge: limitations of the current proposal

In our opinion the current proposal does not achieve the aim of appropriately capturing the volatility of CVA charges. In our opinion this is due to limitations in the methodology. Specific examples are given below

- The concept that the counterparty spread reflects the spread risk of CVA is true only where CVA is computed from market spreads. For banks such as HSBC which largely use through the cycle PDs, the use of credit spreads for the calculation of capital charges introduces volatility to the capital position. Further the direct use of counterparty spread is limited to counterparties for which CDS prices actually exist. In respect of the remaining exposures proxies would have to be established
- In using an EAD concept, the exposure generated for the bond amount will already be larger than any current risk because the EAD factors in some adverse future variations.
- The portfolio on which the capital charge is calculated is “lop-sided” with respect to counterparty positions as all the positions are positive. This results in all the hypothetical bonds being long credit risk, when in reality there may be many offsetting positions.
- The statement that “risks are similar” between the hypothetical bonds and the CVA charge is not accurate where exposure to a counterparty has a mixed maturity profile. This is particularly true where exposures are highly market dependant where historical PDs are applied..

We have additional concerns. The methodology requires the use of both VaR and Stressed VaR. We have commented already to our lead regulator that in respect of risk capital, we generally do not believe it to be coherent to apply both VaR and Stressed VaR (rather the maximum of the two). Further we do not believe that the multiplication up to 1 year for stressed VaR only is likely to be robust. We are also surprised that no basis has been set out for calibration of multipliers for the VaR figures, nor any statement as to whether this would be regularly recalibrated.

The allowance of an offset from CDS seemed initially helpful, but the clarification that the maturity of the bond is not to be Effective Maturity capped at 5 years, but either uncapped or the actual nominal maturity of the longest netting set will almost certainly invalidate most liquid and tradeable CDS.

The limitations in our opinion give rise to a significant overstatement in the capital charges resulting from the proposal when compared to the economic risk. As a result, institutions are likely to make every effort to hedge the overstated risk with the following potential consequences:

- General increase in risk within the financial system: as banks are encouraged to over-hedge their credit risk exposures. Even at high spread levels it will be cost effective for banks to try to buy protection
- Increased systemic stress: as all banks will be purchasers of protection, the sellers of such protection are likely to come from the less regulated sectors such as hedge funds, which might in turn increase systemic risk if protection sellers struggle to meet their obligations during the next crisis.
- Unfair treatment of SMEs: the CVA capital charge can be hedged only for counterparties where liquid CDS markets exist – in other words only for large companies. Since in the case of SMEs banks would not be able to mitigate their capital costs, these would most likely be passed on, making it more expensive for smaller companies to mitigate their risk.
- Increased Procyclicality: in stressed market conditions, the CVA would be made more volatile, and the suggested capital charge will likely increase in addition to this. Further an increase in CDS spreads – a likely consequence of increased demand to hedge – could also feed through to the real economy, making it more difficult for large corporates to obtain finance.

The OTC derivatives market is also likely to be fragmented:

- The proposals are intended to encourage migration away from bilateral OTC derivatives arrangements towards central clearing. Bespoke OTC derivatives are currently used by the commercial sector to mitigate their financial risks. The use of central counterparties requires marking to market and collateral posting, but many commercial enterprises do not have cash management systems or working capital headroom to do so. Unintended consequences of these proposals would be that corporates may choose on cost grounds not to mitigate their market-related risk, increasing the economic risk in the commercial sector; or that the risk would be assumed by the unregulated sector.
- These are particularly a concern because, as the IOSCO guidelines for central counterparties (“CCP”) have not yet been agreed, there is no certainty that CCP trades would be exempt from this treatment.

Please note that our suggested drafting in Appendix 2 which includes the introduction of a short risk-free bond, reflects the amended instructions issued with QIS5. For consistency, we have also made appropriate amendments to exclude the general market risk element from the CVA charge.



It is unfortunate that the early release of this proposal has not allowed financial institutions to contribute perhaps better alternative technical proposals which could have been included in the testing as part of QIS5.

HSBC supports the comment that “the Committee will review other internal approaches that more accurately reflect the risk from changes in exposure”.

Application of Proposed Method

HSBC uses a variety of CVA computation methods to adjust to fair values of derivatives to take account of counterparty likelihood of default. We have examined the annualised volatility of our CVA charges and compared this to the level of the counterparty risk RWAs. Even during the stressed period, the volatility of the CVA charges was substantially less than the capital level implied from the level of counterparty risk RWAs.

However, using the proposed method, based on application of the same regulatory multipliers as normal position VaR (but with scaling to 1 year for Stressed VaR) we estimate increases in RWAs to be in the order of 7 times current counterparty risk RWAs.

Calibration is critical in all cases, but as the proposed method is neither proportionate to the risk, nor risk sensitive, the calibration is unlikely to be effective through time if a fixed multiplier is applied to the result of the calculations.

Alternative proposal

In order to capture the CVA variation within a regulatory calculation, we propose a forward looking framework to compute a CVA Variability Charge (“CVC”) which can be calibrated to an individual portfolio. It is not procyclical, is risk sensitive and uses existing tools already required by firms.

Firstly, CVC is defined as the potential change in value in the CVA at a specific soundness standard over a defined horizon for given expected exposure. Our proposal is to use a 99.9 percentile 1 year soundness standard, which is in line with banking book IRB soundness standards for capital.

The CVC approach then defines a discrete set of credit states between which counterparties can migrate. In the case where CVA charges are calculated using a historical probability based transition matrix, the credit states are already well defined and correspond to rating agency categories (AAA, AA, etc). For CVA calculated using market implied probabilities, credit states which correspond to ranges of CDS spreads could be defined.



For all counterparties, the change in CVA caused by counterparty migration across credit states (ie. moving from one rating category to another) is then calculated. The CVA will increase as the credit states worsen, and will reduce when credit states improve. This process generates by counterparty the change in CVA corresponding to the pre defined credit states.

For a single counterparty the change in CVA relating to the worst credit state would probably best represent the CVC, because of the extreme nature of the confidence interval. However, for a portfolio the correlation between the counterparties will be critical to assessing the CVC, because the change in CVA in a given scenario could be different for each counterparty.

To account for this correlation, a Monte-Carlo approach is proposed such that, in each trial, the credit states for all counterparties are selected in a correlated fashion. The banking book approach often uses a single factor with correlation calibration in the range of 12%-24% depending on rating. The more granular the correlation for the set of counterparties the larger the number of correlation factors required.

To create these correlation factors, counterparties can be grouped by for example, sector, rating, region, and country and then the correlations between the groupings are computed. At the end of each trial, the sum of change in CVA due to the migration of credit state for all counterparties is computed. The process is then repeated until enough trials have been performed to yield a stable distribution from which losses can be determined for a required confidence interval to form the CVC measure.

HSBC have computed the RWA requirement using this approach (which uses a number of the features of the IRC computation) and emerge with a figure of a little over 90% of the counterparty risk RWA, which although higher than the variance experienced in practice would generate a more appropriate capital requirement than the Basel proposal. Further the method would have captured the full CVA move experienced.

The CVC framework is not the only alternative which is more risk sensitive. For example, an alternative proposal, particularly appropriate for banks which mark their credit spreads to the CDS market, would be to include the CVA generating exposure in trading book VaR itself. This would work well provided the models were acceptable to regulators, but the models are no more complex than many of those currently applied. It would however create significant overlap with the existing counterparty risk methodologies which would need to be carefully considered in any calibration.

For convenience we enclose some proposed text which could replace the existing section VIII as Appendix 2.

Effective Expected Potential Exposure (EEPE) with stressed parameters to address general wrong-way risk

In 2009, an exercise was run to compare EEPE estimated by our models with the actual realised current exposures. This analysis included EEPE spanning the worst period of the credit crisis. The result of this analysis was that on average EEPE was overestimating current exposure by some margin. In our opinion, EEPE based on the current calibration is sufficiently conservative.

If a stressed calibration for EEPE was mandated, what calibration should be used for credit risk exposure. There is a risk that in using a stressed calibration, users would be tempted to discount the calculated exposure, knowing that the exposures calculated are based on a stressed calibration and risk limits could be increased to accommodate the higher utilisation. Were a “normal” calibration chosen for credit risk exposures, there would be problems with the use test, as capital calculations would use a stressed calibration. In this case the already considerable processing capacity requirements would double as simulations using the normal and the stressed calibration have to be run in parallel.

As CVA is calculated using the same simulation results as for EEPE, the problem would be similar to credit risk exposure calculation. Especially if we used the “normal” calibration to calculate CVA, but have to use EAD on a stressed basis for the CVA capital charge, the CVA charge would be even less aligned with actual risk.

We also do not see the rationale for allowing hedges to be included in the new CVA charge, but not for the calculation of EEPE. We suggest allowing the notional of single name CDS to be deducted from each valuation in every path when simulating EEPE. A more detailed explanation can be found in the ISDA/AFME industry proposal.

We do not believe this charge measures general wrong-way risk, other than increasing exposure estimates in general. This change also disadvantages IMM banks in comparison to banks with similar amounts of general wrong-way risk, but who utilise a less sophisticated model.

A multiplier for the asset value correlation for large financial institutions

We accept that correlation between financial counterparties increased during the crisis. However, we also note that in general exposures between large financial institutions were covered by risk mitigation arrangements such as netting and collateral agreements. Further, financial counterparties are already subject to central clearing processes for areas of their business. In light of these factors, in our opinion there is no clear case for the multiplier.

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It is also not clear to us how the multiplier has been calibrated, and whether this calibration has been derived only from CCR exposures, or also other credit risk exposures. HSBC would like industry and regulators to work together to review the basis for the calibration of the 1.25 multiplier and to understand the actual risk to be expected in a future crisis.

Collateralised counterparties and margin period of risk

In the last few years, firms have invested heavily in their collateral management units, processes and systems, and have worked with industry and regulators to strengthen collateral management throughout the industry. Examples are the dispute resolution protocol, standardized electronic messaging for margin calls and reconciliation requirements imposed by regulators (Fed reconciliation).

With this in mind, we welcome the proposed rules to strengthen collateral management units, as the majority of the proposed changes have already been implemented by industry. However, we do not agree with all circumstances where the margin period of risk is to be increased.

Large netting sets: Counterparties with large portfolios are usually counterparties with large credit lines, ie. counterparties with good credit quality. Since the credit crisis, regulators have imposed reconciliation requirements on the “Fed 14” counterparties – daily reconciliation for all Fed 14 counterparties with more than 500 transactions and monthly reconciliation for all counterparties with more than 1000 trades. This is complemented by extensive regular reporting. These reconciliation requirements improve data quality, significantly reduce the risk of disputes, make sure that the portfolios are tightly managed and would enable a quick closing out of such positions.

An arbitrary threshold defining a large netting set will only lead to firms splitting these netting sets into smaller ones, actually reducing the netting effect and increasing risk. We therefore suggest removing the proposals for increased margin periods of risk for large netting sets.

Disputes: The financial industry, led by ISDA, is currently implementing the Dispute Resolution Protocol. This protocol should considerably reduce the time for resolution of a dispute, ie. there should be fewer instances where a doubled margin period of risk needs to be triggered.

We would however suggest introducing a materiality threshold, removing the situation where a doubling of the margin period arises as a result of a few minor past disputes. The industry will be proposing a consistent framework for dispute reporting to regulators by May 31st, which will include such thresholds. We would suggest using these thresholds when determining whether the margin period of risk should be doubled.

Illiquid contracts or collateral: we accept that there is a possibility that such positions cannot be closed out quickly and that an increased margin period of risk is

appropriate in these cases. However, similar to netting sets with disputes, we would suggest introducing a materiality threshold.

3. Leverage Ratio

The benefits of a leverage ratio as a regulatory tool are not clear. However HSBC considers that whilst leverage ratios are not risk based, they might 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, rather than a prescriptive one-size-fits-all measure. If the ratio were set at any level which obstructs the ordinary course of business, it would foster perverse incentives and may have unforeseen consequences.

We are concerned about the effects that differences in accounting, which seem to be recognised by the Committee, would have on leverage ratio calculations. US GAAP allows off balance sheet treatment for many of the vehicles which must be consolidated under the much stricter rules of IFRS, as well as allowing much greater use of netting for derivative exposures. Overcoming these fundamental differences is a formidable challenge in making the leverage ratio a useful metric for regulators or investors to use that would be comparable across jurisdictions.

HSBC would encourage the Committee to give further consideration to both the role and structure of a leverage ratio. The first step, in our view, is to define what it is that the leverage ratio is intended to achieve, as a basis for detailed design of numerator and denominator; thus clarifying what it is not expected to achieve, which ought to be addressed through other measures. Moreover, we consider it more important that the outputs of such a tool be evaluated as trends over time against other indicators for the same firm, rather than in benchmarking against other institutions.

The leverage ratio is seen to be a risk insensitive measure that the Committee envisaged to be a backstop safeguard to supplement capital adequacy requirements. However, such a constraint can also provide inappropriate incentives, both by encouraging the use of structured products and off balance sheet vehicles and a move towards higher risk assets, especially when it, rather than the capital ratio, becomes a constraining factor.

Exclusion of assets related to liquidity requirements

Banks will likely going forward be required to hold more liquid securities including government bonds in order to comply with the revised liquidity regime. Given the clear conflict between requirements under the liquidity proposals to increase the amount of liquid assets held and the impact of including these assets in the leverage ratio, we believe it is appropriate that such assets be excluded from the exposure measure.

Netting and other forms of credit risk mitigation

It is important that in constructing the leverage ratio there is no attempt to ignore legally enforceable netting and other forms of credit risk mitigation which gives a distorted view of the actual exposure, and which is not related to the economic substance. When designing an appropriate leverage measure it is important to distinguish between assessing actual exposures and risk-weighting those exposures. The desire for a 'risk-insensitive' measure is aimed at not using risk-weighting as this is not reflective of leverage. It should however not be extended to cover measures of actual exposure by disregarding legally enforceable netting agreements and collateral held. Nor should it be extended to apply 100% conversion factors to off balance sheet products, which again do not reflect actual or potential exposure. This is discussed further below.

While harmonising accounting treatment may be desirable, reaching the lowest common denominator is unlikely to be meaningful. HSBC would suggest allowing banks to apply legally enforceable netting and other forms of credit risk mitigation that they would apply while calculating exposure values for risk-weighting. A leverage ratio calculated on this basis would also provide more useful information to regulators and would also encourage stronger risk management practices.

The Committee's recent paper 'Recommendations for strengthening cross-border bank resolution frameworks' promotes the use of collateral and netting arrangements to help limit the impact of a bank failure, which we fully support. To disregard such arrangements in other proposals is inconsistent.

Exposures to central counterparties

All OTC exposures to central counterparties should be exempt from leverage ratio requirements, because of the strong risk management and governance in place and proposed for such trades. There are separate regulatory work-streams in progress to make central counterparties yet safer.

Credit derivatives

When the sold CDS protection positions arise as a result of market making activity, we believe they should be excluded from the leverage ratio. Including all sold positions indiscriminately would be likely to have adverse market impacts such as reduced liquidity and increased spreads, thereby increasing the cost of funds in the commercial sector. There are cases when counterparties require products which don't match the available liquid contracts. Perhaps as an alternative, more representative approach for the trading book, simply the 'Jump to Default' amount should be included in the asset base.

Trade finance

If a leverage ratio is to be adopted, it should be amended to allow trade finance products to adopt the CCFs used in the exposure calculations when being assessed for the leverage ratio. Trade finance products are contingent liabilities that arise from trade-related obligations underpinned by the movement of goods or the provision of services and evidenced by commercial contracts that document the arrangement between buyer and seller. The “conversion” of these off balance sheet exposures to on balance sheet exposures is not automatic and in all cases is detached from an event of default. It is difficult to classify these exposures as “a source of leverage” given that they are supported by an underlying transaction that involves either movement of goods or the provision of a service. The transactions are initiated by the customer and must meet set criteria that ensure that the exposure becomes on balance sheet due to an event that is not default related. Banks undertaking trade finance activities have no mechanism to “shift items off the balance sheet to avoid the leverage ratio constraint” which is the Committee’s stated concern. Trade finance products should not be mistaken as risky asset classes. These products actually provide a cheaper form of financing, risk mitigation and structure for the international trade of goods and services.

It is difficult to estimate the exact impact of the proposed changes in the consultative document, as this will be unique to each bank's current position with respect to the proposed leverage ratio constraint. However, for banks that are constrained by a leverage ratio, it is likely these banks will change the way facilities are provided to customers and/or lead to an increase in the pricing of these facilities. This may lead to a decrease in the demand for trade finance and an increase in the cost of international trade, at a time when international trade is essential to foster a global recovery.

Trade finance products constitute a small portion of HSBC's total lending portfolio (representing less than 2% of HSBC’s total assets) and allowing the CCF values used in a bank's exposure calculations when determining the leverage ratio will ensure that banks continue to provide an essential service to facilitate international trade, without increasing risk in the banking system.

4. Procyclicality

Cyclicality of the minimum requirement

HSBC supports measures that aim to lessen the procyclical effects of the Basel framework. Countercyclical measures in the minimum capital requirements seem to offer theoretical solutions to this problem.

On the technical implementation level, we believe that any measure 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 multiple years now and which in fact have proven to dampen procyclicality in our capital requirements significantly. These PDs are also used for internal risk management, limit setting, loan pricing and many other applications, making the rating process robust, well governed and lined up with bank internal as well as regulatory interest.

We would strongly caution against any new measures that would have to be developed for capital buffer purposes only. Such measures would have limited or no link with internal risk management processes, and their credibility would pose a constant challenge. Moreover, they would significantly increase costs while yielding very specific and limited benefit only. Both strict point-in-time PDs for the proposed IASB Expected Loss accounting approach and regulatory downturn PDs would fall into this category.

Forward-looking provisioning

HSBC agrees that both capital and provisioning solutions are needed to address procyclicality, but believes that there is a limited amount that can be achieved by making changes to provisioning methodology in the financial statements. The largest contribution should 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, but believes that it is vital to market confidence that the financial statements provide objective and verifiable information to all market participants about the true state of the company's financial position at the balance sheet date. 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.

An additional factor to consider is the lack of data on procyclicality which makes it virtually impossible to come up with the right calibration of a solution to procyclicality. HSBC observes that accounting standards for financial reporting are intended to establish consistent principles for all forms of commercial activity, not just banking, and it would be impossible to devise an accounting approach that both addresses procyclicality in the banking context and operates consistently for all types of commercial activity. Different accounting standards for banks and other types of



commercial enterprises would be likely to further damage investor confidence in financial reporting.

HSBC believes that convergence in international accounting standards must remain an overarching goal. International convergence means convergence towards a high quality set of accounting standards. Accordingly, a converged accounting standard which meets the goals of the G20 and the Basel Committee must also be faithful to the primary purpose of financial statements in providing objective and verifiable information to market participants generally.

HSBC observes that while there may be cost efficiencies available in making use of the same systems and calculation requirements for accounting and regulatory purposes, consistent systems and calculations should only be adopted where appropriate, recognising that uniformity is unlikely to be achievable, or indeed be desirable, because of the different objectives of prudential regulation and general purpose financial reporting.

HSBC strongly supports the intention of the Basel Committee to work with the standard setters following due process.

HSBC believes that the IASB's proposal for an Expected Cash Flow model has serious conceptual and practical flaws. In particular, it has been widely commented that 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, the methodology is likely to be impracticable to implement and prohibitive in cost due to heavy additional data requirements.

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 broader range of credit information could be used in an 'incurred loss plus' methodology, or in an expected loss methodology that uses incurred losses as a base but accounts for expected losses based on objective and observable credit information. Where expected losses are included in financial reports, it will be important to retain a clear link to incurred loss information as this is valuable information in its own right for the users of financial statements, as well as providing a means of assessing the significance of expected loss information.

Building buffers through capital conservation

HSBC welcomes the principle of capital buffers as an effective mitigant against procyclical effects and the potential for stressed conditions. We believe that the current regime implemented by the FSA, together with the current FSA proposals to make the capital buffer a discrete Pillar 2 regulatory measure, are effective and sufficient. They align well with internal management practice and function well under the supervisory review processes of Pillar 2.



The FSA have required the calculation of a capital buffer under Pillar 2, included in the ICG, since the implementation of Basel 2. There are current proposals to strip this calculation out of Individual Capital Guidance and calculate it separately with the intention of allowing it to be eroded during a downturn. We believe this flexible, firm specific approach is the most effective way of building and using buffers across the economic cycle.

We do not agree with the creation of a specific Pillar 1 capital buffer as proposed. The rigid formulaic approach suggested will only serve in practice to increase the minimum capital requirement. It will also not be possible to erode this buffer during a downturn, which is the stated aim of the buffer in the first place. Furthermore, regulators already have the ability to prevent discretionary payments, such as bonuses and dividends, if they believe this will threaten the capital position of a firm.

Capital Buffers have been formulated internally within HSBC (albeit implicitly for most of our history) since our incorporation and, for this reason, capital always greatly exceeds minimum regulatory requirements. It is important that this buffer is maintained internally and discussed with regulators, rather than it becoming a rigid Pillar 1 requirement.

Appendix 2

Proposed Text

For convenience we enclose some proposed text which could replace the existing section VIII.

Suggested Amendment

“VIII. Treatment of mark-to-market counterparty risk losses

96. In addition to the capital requirements for counterparty risk determined based on the standardised or internal ratings-based (IRB) approaches for credit risk, a bank must calculate an additional capital charge to cover mark-to-market unexpected counterparty risk losses. This additional charge ~~must~~ may be calculated by treating counterparty exposures as bond equivalents (“the Synthetic Bonds method”) or by stressing the counterparty risks keeping exposure static and using correlation for counterparties agreed by the Firm’s home regulator (“the CVC Variability Charge”), or by such other method as approved by a Firm’s home regulator.

The Synthetic Bonds method ~~and~~ is determined by applying the applicable regulatory market risk charge to such bond-equivalents, after excluding the Incremental Risk Charge (IRC). The additional capital charge is then ~~should be~~ calculated as the stand-alone market risk charge (excluding IRC) for a set of bonds and associated hedges. In this set there is one long risky bond per OTC derivative counterparty and one short risk free bond of equivalent tenor and notional, and ~~this~~ the ~~risky~~ bond has the following characteristics:

- Notional of the bond: the current total EAD of the counterparty across all its OTC derivative netting sets. This EAD should be calculated according to the applicable Basel II CCR approach for OTC derivatives used by the firm, outlined in this Annex (CEM, Standardised or IMM).
- Maturity of the bond: the legal final maturity ~~longest Effective Maturity~~ across OTC derivative netting sets with this counterparty. ~~The Effective Maturity should be calculated according to the applicable Basel II CCR approach for firms under the IMM or IRB approaches. Firms that are not using the IMM or IRB approaches can use the estimates of Effective Maturity outlined in Paragraph 320,~~ or a fixed value to be used as the maturity of the bond.
- Type of bond: zero-coupon.
- Spread used to discount the bond-equivalent: The spread used to calculate the Credit Valuation Adjustment (CVA) of the counterparty where this is computed using CDS spread. Whenever the CDS spread of the counterparty is available this must be used. Whenever the CDS spread is not available, ~~the~~ a proxy spread used to determine the CVA ~~for fair value accounting purposes~~ must be used as the spread of the bond.

This market risk charge is the ~~consists of both general and~~ specific risks **only**, including Stressed VaR but excluding the IRC. In applying this charge, both general interest rate and credit spread risks must be taken into account. If the firm has VaR approval for bonds then the charge should be calculated using the firm’s authorised VaR model for such bonds. If not, the standardised general market risk charge should be used. The stress period to use for the Stressed VaR component of this market risk

charge is the stress period that the firm uses for credit assets for market risk regulatory capital purposes. The liquidity horizon to use for this market risk charge is one year, instead of the 10-day horizon used for market risk capital purposes. If the firm's VaR model does not calculate the one-year VaR directly, and in the case of the standardised approach, this one-year liquidity horizon should be calculated by multiplying the 10-day market risk charge by 5 (the square root of 25).

This capital charge ~~is~~ should be calculated in a standalone manner on the portfolio composed of the set of bond-equivalents described above and their eligible hedges. No offset against other instruments on the firm's balance sheet should be reflected. For this capital charge, the only eligible hedges that can be recognised are single-name CDSs, single-name contingent CDSs or other equivalent hedging instruments directly referencing the counterparty. For contingent CDSs, the notional should be treated as fixed and equal to its current value. Other types of hedges should not be offset against the bond equivalents within this charge, and these other hedges should be treated as any other instrument in the firm's exposures for regulatory capital purposes.

The CVC Framework uses the current expected exposures for each counterparty and defines the CVC as the potential change in value in the CVA over a defined horizon for the expected exposure using a 99.9 percentile 1 year soundness.

A discrete set of credit states between which counterparties can migrate is defined, e.g. corresponding to rating agency categories and for all counterparties, the change in CVA caused by counterparty migration across credit states is calculated. (This process yields a set of numbers for each counterparty representing the change in CVA corresponding to the pre defined credit states.). To account for the correlation between counterparties, a Monte-Carlo approach is applied such that, in each trial, the credit states for all counterparties are selected in a correlated fashion. To create the correlation factors, counterparties are grouped by sector, rating, region, and country and the correlations between the groupings are computed. At the end of each trial, the sum of change in CVA due to the migration of credit state for all counterparties is computed. When the process has been repeated sufficiently to generate a stable distribution from which losses can be determined for a 99% confidence interval to form the CVC measure.

Subject to approval by a Firm's home regulator other methods may be used to define an appropriate regulatory capital requirement for future fluctuation in CVA."