HSBC

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30September 2010

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

Countercyclical capital buffer proposal – consultative document

Summary

The capital adequacy regime requires a variable component to take account of the reality that risk levels fluctuate in any financial system. The BCBS countercyclical capital buffer proposal, while a step in the right direction, requires a broader context and further work.

Response

HSBC has delayed its response to the BCBS Consultative Document on a countercyclical capital buffer proposal in order to take account of the announcement of 12 September on higher global minimum capital standards. HSBC believes that the countercyclical buffer proposal cannot be evaluated in isolation from other "buffer" proposals, or in isolation from the proposed calibration of the buffers.

From the 12 September announcement it is apparent that the overall level of capital that banks will be required to hold under the new Basel III proposals will be determined by four factors:

- A new minimum common equity requirement of 4.5%
- A capital conservation buffer set at 2.5%
- A variable element, in the form of a countercyclical buffer, to be set by "authorities" in each jurisdiction, normally at 0% but at no time higher than 2.5%
- A possible additional buffer to be held by systemically important banks (the "SIFI buffer"), perhaps as part of a combination including contingent capital and bail-in debt.

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This formula has introduced considerable complexity into the setting of the appropriate level of capital. Complexity can be the enemy of stability, and often provides opportunities for arbitrage, both by firms and by different jurisdictions. In commenting on the countercyclical buffer proposal, HSBC would like to offer some constructive suggestions for ways in which this formula could be simplified, to provide a framework for a more stable financial system, with reduced opportunities for arbitrage.

Background

Risk is not static in any economy. It fluctuates over time. Lending into sectors which in normal times are relatively safe can become more risky at other times. Lending into property, for example, can be relatively safe if demand and supply for property are stable, rents affordable and the economy growing steadily. But if exuberant pricing begins to emerge, the level of risk may increase: for example, borrowing may increase against higher prices which may not prove sustainable, raising the likelihood that the borrower will default, and that the lender may lose some or all of his original loan.

The recent crisis demonstrated this point more vividly than any other "bust" since the 1930s. Not only did the price of properties in the US and elsewhere prove unsustainable against the amount borrowed to acquire them; repayment rates were artificially suppressed into levels of temporary affordability by "teaser" packages; and forms of securitisation, far from dissipating the resultant high risks by distributing them through the system, ensured that they permeated the system.

Leverage caused an exponential rise in the level of risk. Just when capital levels should have been rising in anticipation of the losses that would follow if that risk materialised, the markets believed that capital levels were adequate, and indeed through the downrating of its share price punished any firm that tried to hold higher levels of capital. The Basel minimum was irrelevant to the real level of risk, and the Basel regime powerless in the face of the market's power to dictate capital levels. The punchbowl was controlled by the party-goers. It is this situation which needs to change if future crises are to be avoided.

The history of the Basel Committee on Banking Supervision is a chronology of understandable compromise to balance national concerns about how much capital banks need to hold to withstand the losses that follow from a "bust" or a crisis, while avoiding the deleveraging that would follow abrupt recalibration of capital requirements during a period of economic downturn.

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Reaching agreement on calibration is further complicated by the fact that national financial systems have different structural characteristics, are at different stages of maturity in terms of sophistication and serve economies with different resources, demographic trends and growth potential. Basel's approach might be summarised as trying to ensure that a crisis can be accommodated within the system's capital resources. Trying to make crisis 'affordable' is however not the same as trying to build a stable financial system, although these have been equated by some commentators. As long as the target is affordability, there is a simple trade-off between the cost of trying to achieve such a target and the potential for economic growth.

A variety of economic models can give different indications of the possible economic impact of a given capital adequacy regime. Some models produce comfortingly conservative results. A simpler and less contentious calculation, which does not rely on the vagaries of models, is to extrapolate the amount of bank lending capacity potentially extracted or withheld from the economy, at a given estimate of leverage, as a consequence of each additional percentage point of the Tier 1 capital ratio required. A back-of-the-envelope calculation suggests that for the UK banks, an additional percentage point on the Tier 1 ratio translates to around £600-700bn of lending capacity. Calibration of the Tier 1 ratio therefore has similar levels of materiality to the economy as fiscal or monetary policy. This alone suggests that calibration may require input from a politically accountable body in addition to those constituted of central bankers and regulators.

A second order of materiality flows from the extent to which any given economy is dependent on bank lending, as opposed to other sources of finance, for growth. Development of the US economy has traditionally been less dependent on bank lending, suggesting that US policymakers may be both more willing and more able to dig deeper into bank lending in pursuit of financial stability. The converse is true in Germany, France and in Asia. These differences may well be reflected in the differences of national position taken around the BCBS table.

The irony is that a severe crisis cannot be made 'affordable' simply by the capital calibration approach adopted by the BCBS. It has been estimated that Merrill Lynch would have needed core tier 1 capital at around 25% in order to have survived the recent crisis. The problem lies with the limits to the remit of the BCBS, which restrict it to designing a capital adequacy regime, i.e. a regime in which capital is calibrated to be adequate to absorb anticipated losses. The Committee has never been tasked to design a regime in which increased capital requirements could be used as a policy tool to reflect the nature of risks in the economy and impact the decisions that banks take in response.

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It is perhaps for this reason that a theme which runs through the Basel III documents, including the Consultative Document on the countercyclical buffer, is that moderating the build-up phase of the credit cycle "should be viewed as a positive side benefit, rather than a primary aim." Since there is a strong historical correlation between the exuberant phases of the credit cycle and "busts", leading in some instances to financial crises, moderating the build-up phase of the credit cycle should be the primary aim of some public sector body, even if not regulatory bodies or central banks as presently configured.

The 12 September announcement does pick out the fourth objective identified by the BCBS in its December 2009 document, when it states that "The purpose of the countercyclical buffer is to achieve the broader macroprudential goal of protecting the banking sector from periods of excess aggregate credit growth." The addition of the word "aggregate", is however not an enhancement, because our contention is that an aggregate approach does not deliver stability. Taming credit supply in aggregate does not necessarily prevent it from flowing into activities which offer apparent high returns, and which are generally therefore riskier. Indeed the attractiveness of such high-return activities might mean that activities more likely to contribute to long-term economic development would be hit by credit deprivation instead.

Conversely the buffer proposed will not address the risk to institutions of asset price bubbles and excess credit growth that are concentrated but do not affect the economy as a whole, and therefore do not trigger the suggested credit/GDP measure.

What is money?

There is a more profound reason for the need to mitigate exuberance in the credit cycle than has been explored within the Basel discussions. In normal circumstances, management of the price of a commodity directly impacts the supply. At a higher price, demand reduces, and at a lower price demand increases; fluctuation in demand, if supply is a constant, will conversely affect the price. A simple formula connects price, demand and supply.

Money is different. In its early development, it was a commodity like any other, and under the gold standard, supply of money was a constant: indeed the gold standard delivered stability of supply, stability of price, and, because of its widespread adoption, stability of exchange rates. These three forms of stability make up as good a definition of financial stability as any. Although we associate abandonment of the gold standard with US policy decisions taken at the time of the Vietnam War, historically the abandonment of gold, in favour of an alternative framework to define money, has been progressive, and over a long period.

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That period was not complete by the time the financial crisis of 2007-2009 struck, and indeed the fact that the transition to a new framework was not complete was an important contributory factor to the crisis.

Inappropriate exchange rates following the attempted return to the gold standard in the 1930s were a major cause of the financial instability of that period, and Maynard Keynes sought to address this problem through the Bretton Woods regime established in 1945. Bretton Woods underpinned a period of remarkable financial stability. But global over-supply of dollars, in the light of a US obligation to redeem those dollars at a fixed price while its supply of gold was not increasing at the same rate, created sufficient stresses in the system to cause its demise. Cut loose from gold, the financial system in many countries suffered rampant inflation.

Milton Friedman addressed the problem of price rather than the problem of supply. His solution was monetarism, setting the price of money through the interest rate, against an inflation target. For much of the 1990s and early 2000s, it looked as if monetarism was correctly calibrated, because inflation remained low and the interest rate relatively stable. Exchange rates were no longer fixed, but managed by the markets in a way that could take account of different rates of growth and points in the cycle in different economies. But over the same period, huge levels of leverage were building up in the system, and this was a major cause of the instability of 2007-2009. So although the financial system had evolved under monetarism, the fact that it could not manage the supply of credit into the economy was material.

To summarise, money is different because leverage – a unique feature of money over any other commodity – breaks down the formula which connects price, demand and supply. The financial system therefore requires a mechanism for controlling supply which complements, but is separate from, the control of price. A capital adequacy regime which is designed only to position banks to absorb losses when they hit – much like any provisioning regime – cannot be expected to contain an explosion of the supply of credit into an economy. And of course while the capital in such a regime is sitting dormant – waiting for the crisis for which its quantum, on the day, could prove inadequate – it is being prevented from supporting growth in the economy. Indeed it could be argued that this regime creates a fundamentally unstable system, because the owners of that capital – generally shareholders – will require to see a return on that capital, and so the burden of patient but fallow capital awaiting the next crisis will inflame their desire for, and therefore pressure on management to deliver, compensating yield or return elsewhere.

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Simplifying the mechanisms

There is a range of possible tools for managing the supply of credit, many of them already in use in some of the global economies. Many countries make use of caps on lending or lending quotas, limitations on loan-to-value ratios for property lending, and at the central bank level, the raising and lowering of reserve requirements; these countries were notably less impacted during the financial crisis but had other mitigating economic and financial sector structural benefits also. But potentially the smoothest tool for managing supply of credit is the raising and lowering of capital requirements. Whilst the activation of such a tool would need to be signalled at the macroeconomic and systemic level, Pillar II of Basel II already provides a mechanism for ensuring that demands for increased capital could be focused on the areas of risk, by increasing the risk weighting for areas of activity identified to be carrying greater risk. To return to the starting point of this letter, lending into property at times when exuberant pricing is beginning to emerge could be countered by giving such lending a higher risk weighting. This addresses the problem of the aggregate approach identified above.

If it is accepted that the level of risk fluctuates in an economy, it follows that levels of capital should also fluctuate, and to do this dynamically, rather than pre-emptively, will achieve one of two outcomes. Either banks required to hold more capital against riskier activities will lose their enthusiasm for such activities, because the additional capital requirements will neutralise the increased returns, and this will damp out "exuberance"; or banks might judge that the additional capital is a price worth paying in the light of the returns being generated, but will be holding enough capital to absorb the resultant losses if the bubble bursts. Either way the system wins.

A capital adequacy regime which seeks simply to hold high fixed quantities of capital in anticipation of some future loss event will deprive the economy, and then, quite likely, prove inadequate on the day. Either way, such a system loses.

Now that the full shape of the Basel III regime is becoming clear, the only response to the need to have some fluctuation in the level of capital is the proposal for a countercyclical buffer. As such, and set in the wider historical context of the need for a policy mechanism to manage the supply of credit into the economy, the proposal is at this stage unfortunately poorly defined and therefore it is difficult to assess its adequacy (see annex). It also becomes apparent that those who have argued within the BCBS for a higher steady-state core capital ratio have done so consciously in preference to a mechanism which would raise capital levels to track rising risk.

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If they could envisage and be persuaded of the benefits of such a system, the need for a complexity of buffers would fall away, and the system could be simplified to a single variable buffer above the minimum. HSBC has been advocating such a system.

The 12 September announcement already makes a concession in this direction, when it states that the countercyclical buffer would be introduced as an extension of the range of the conservation buffer. But a fixed range to the buffer seems to diminish its utility; an additional 2.5% could prove immaterial at a time of rising exuberance, while, in the other direction, we believe there might well be times at the low point of the cycle where it can be assessed within the macroprudential framework that the level of risk in the system would make a move to lower capital requirements justifiable. In such circumstances, the economy could benefit from the ability of banks to lend at levels which would mean dipping below a 7% core tier 1 ratio without incurring penalties. In short, we believe that once a mechanism is devised for calibrating a variable buffer, there is no longer any need to distinguish between the capital conservation buffer and the countercyclical buffer. And as explored in the Annex to this letter, we believe that Pillar II of Basel II is already sufficiently robust to provide the means for implementing the buffer.

An approach which derives from the accurate weighting of risk, taking account of macroeconomic and systemic factors, could also embrace the perceived threat posed by systemically important institutions. Indeed it should be the nature of the risk that determines the weighting, not the nature of the institution that holds it. It is not apparent to us that a particular risk should incur a heavier weighting because it is carried on the books of a large institution. Conversely, it is apparent that a particular type of risk which proliferates to the point that it threatens to become systemic should incur a heavier weighting. Such proliferation should be detected at the macroprudential level, and since it is more likely that large institutions would carry a higher proportion of such risks, an increased weighting would result in an appropriately higher level of capital in large institutions.

On this basis, all three layers of proposed buffer capital could be combined into a single, risk-sensitive buffer, determined in the light of macroeconomic and systemic factors, with a "hard floor" of 4.5% in line with Basel III, and potentially without any upper limit. HSBC believes this would be the optimal way through which the capital framework can be developed so that a macroprudential dictation of appropriate capital ratios will be accepted by the markets, and indeed will take precedence over the views of the markets and banks' internal modelling.

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HSBC's contribution to the debate about the use of macroprudential tools to create a stable financial system will be set out in detail in our response to the UK Treasury's consultation exercise on the proposed new regulatory structures for the UK, which we will make available to the BCBS. In this response we will explore an additional feature of the macroprudential approach relevant to the wider debate: this is that there may be very little difference in practice between an injection of capital triggered by a macroprudential authority in the face of rising risk, and an injection of capital triggered by a contingent instrument in the face of rising risk.

This concludes our general comments on the BCBS proposal for a countercyclical capital buffer. As an annex to this letter, we have included our comments on some of the specific features of the proposal.

In addition to sending this letter to the BCBS Secretariat, I am copying it directly to Mario Draghi, Chairman of the Financial Stability Board; Nout Wellink, Chairman of the BCBS; Jaime Caruana, Managing Director of the BIS; Mervyn King, Governor of the Bank of England; and Lord Turner, Chairman of the FSA.

Yours faithfully

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Annex:

Specific comments on the BCBS countercyclical capital buffer proposal

While HSBC believes that the diagnosis of the problem which the buffer is intended to address, and the broad aims of the proposal, are correct, a number of important areas of detail remain to be resolved.

The decision-making body

The nature of the "authority" which would operate the buffer is left undefined, and the proposal suggests that choice of the relevant authority would be left to the discretion of each jurisdiction. The countercyclical buffer proposal is the only concession within the Basel III framework to the reality that risk fluctuates in any given economy, and that a capital adequacy regime should include a variable to accommodate this. Hitherto, it has been markets that have set expectations for an actual bank capital ratio over the Basel minimum. At times of exuberance, market expectations have generally been too low; and in the period following a crisis, an over-reaction has resulted in market expectations which are probably too high, a factor which has historically delayed the return of bank lending into the economy. If the expectations of the market are to be over-ridden, the "authority" will need to carry significant gravitas, and will probably need to operate at the level of a Monetary Policy Committee, with equivalent levels of transparency and accountability. We understand that the UK proposal for a Financial Policy Committee is conceived on these lines.

Indicators

The proposal is quite confused on the issue of the indicators and data which would inform any decisions by the "authority" on deployment of the buffer. Some emphasis is laid on the credit/GDP ratio, but this is qualified as not always working well, and as not needing to play a dominant role. The phrase "best information available" appears on two occasions, without specifying what this might mean. A list is provided of other possible variables, and there is also reference to "assessment of as much of the relevant prevailing supervisory and macroeconomic information as possible."

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In fact, much work has been done on the kinds of indicator and datum which could be relevant to the deployment of a variable capital tool. Both the original Turner Review and the Bank of England's paper on the Role of Macroprudential Policy offer lists, and valuable contributions on market data have been made by Andrew Smithers. Recent work on Extreme Value Theory may also offer the possibility of deriving usable indicators from market data.

HSBC believes that in one specific area of the issue of indicators, the proposal is wrong. Under Principle 2, the proposal suggests that "Authorities in each jurisdiction are free to emphasise any other variables and qualitative information that makes sense to them." HSBC strongly believes that there should be a widespread consensus, at the level of national authorities, the European Systemic Risk Board and the Financial Stability Board, on the categories of indicator and datum relevant to decision making, so that cross-border stresses can be identified as well as those in individual jurisdictions. Information and measures to assess systemic stresses need to be clearly defined, set out explicitly, and made available in all major economies.

Suite of macroprudential tools

HSBC agrees that a range of tools is available in addition to an increase in capital requirements, including loan-to-value limits. For the reasons given in the letter, HSBC believes that additional capital requirements should be focused sectorally, because excess credit growth has, historically, usually been concentrated in specific sectors. Because those sectors usually offer higher rates of return, they tend to attract any surplus capital in the system, which could also be the case if the level of capital has been increased in aggregate, without specific application. But use of targeted additional capital requirements should not preclude the use of other macroprudential tools if appropriate.

Calibration of the buffer

The section of the proposal on calibration provides guidance only on the comparative calibration of the buffer across different banks and jurisdictions, not on the methodology for calibration for a bank within a single jurisdiction. Calibration of a starting rate for each jurisdiction would be necessary before any comparative exercise, and to avoid "calibration by negotiation" when the denominator should be risk.

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Communication

The section of the proposal on communication is unclear. "Regular updates on authorities' assessments of the macro financial situation" already exist in most jurisdictions. In the UK, they take the form of the Bank of England's Financial Stability Reports. It would be feasible for these to carry an assessment of the appropriate level of the capital buffer – particularly if this were to be an amalgam of the conservation buffer, countercyclical buffer and tentative SIFI buffer – on a regular basis. Such assessments would be carefully noted by bank managements and boards, and would provide valuable early warning of the potential build-up of risk.

As set out, the proposal could have a destabilising effect on business confidence and the wider economy. The impact of "announcement risk" for a macroprudential tool has wider implications than just its effect on bank capital. Regularity and predictability would be preferable and more conducive to stability.

Application to off-balance sheet generation of credit

As Lord Turner has pointed out, excess credit growth has often been generated more through off-balance sheet vehicles than on-balance sheet. Any proposal focused on excess credit growth would need to capture the off-balance sheet factor. We note that this issue is addressed by CGFS Paper 36, which should be cross-referenced.

Pillar I or Pillar II

The proposal is confused about the question of use of Pillar I or Pillar II, perhaps because it is also unclear about the "authority" that would take decisions on the buffer and the "authority" that would oversee actual implementation. The notion that "Pillar II will need to adapt to accommodate this buffer" posits a revision to Basel II which is not feasible, and, in the view of HSBC, not necessary. A decision to require an increase in capital should be taken, as suggested above, by a fully empowered macroprudential authority. Pillar II is already more than adequately constructed for the implementation of the authority's decision, through an increase in the risk weighting of the activities identified by the indicators as rising in risk. This can be done in the course of a supervisor review of individual banks, not least because it is at this level that the buffer should be applied. An indiscriminate buffer would penalise business models unrelated to the build-up of additional risk, and would for that reason be unstable. Pillar II can also be used where the authority identifies over-cautious capital treatment of certain activities, such as trade finance or equity finance for SMEs.

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Release of the buffer

A fundamental problem with all "buffer" proposals is that no clear mechanism has yet been indentified for their release. Once applied, they therefore redefine the Basel minimum. This feature will not be welcomed by politicians at times when they wish to see banks contributing to the recovery and growth of the economy. No buffer should be applied, on any timescale, until this problem has been resolved. The approach recommended by HSBC addresses this issue directly.

Other issues

The proposal as drafted carries a danger both of super-equivalence (higher buffers applied by certain regulators) and regulatory competitiveness (application of reduced/no buffers).

Banks have tended thus far to reduce lending in downturns because of their assessment of the risk of losses, rather than from shortage of capital. It is unlikely that the countercyclical buffer proposal, as configured, would change this. A buffer which is only intended to allow banks to keep lending at broadly pre-recession levels, to avoid them contributing to the downturn, is not likely to be effective. And without the ability of the regulatory framework to reduce capital requirements after a recession, shortage of capital is likely to be a greater factor in bank lending in the future.

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