HSBC

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Dear Sirs

I am writing in response to your consultation document issued in July 2011 on "Global systemically important banks: Assessment methodology and the additional loss absorbency requirement". HSBC has contributed to the papers submitted by industry bodies on this consultation but I felt that it was important that we provide a separate letter highlighting a number of areas which are of particular relevance to this Group.

OVERVIEW OF G-SIBS PROPOSALS

At HSBC, we support the direction and ambition of the global reform agenda. By virtue of our underlent position – we have more deposits than loans – our greatest risk is from within our own industry. As a consequence, we care deeply about the stability of the financial system not only because we are part of it but because we are inevitably and inextricably connected to the banks and other institutions which operate within it and to the companies and economies which are financed by it. Improving financial system resilience and stability is in our interest and so we support reform measures designed to improve that resilience and stability - as long as these measures, both individually and in the aggregate, meet appropriate cost/benefit analysis.

Regrettably, we believe that there are unfortunate imbalances in the proposals for the identification of global systemically important banks (G-SIBs) and the measures which are proposed to address these. Some of these may well produce perverse incentives, counteracting the progress which has been made in other areas and potentially promoting strategies and business models which would neither reduce the systemic risks from globally important financial institutions nor make them more resolvable.

Consequences of Identifying G-SIBs

We believe that there is a real danger that identification of only a limited number of G-SIBs will itself lead to market distortions, in particular the risk of there being a tendency for a severe concentration of depositor preference during any crisis. This is likely to arise given the perceived advantages of and protection from criticism from depositing funds with a G-SIB, particularly if the depositing party has fiduciary responsibilities for managing monies. At the

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same time, during a crisis there will likely be extreme wariness amongst G-SIBs about re-circulating those funds into the inter-bank market particularly to non-G-SIBs – this would potentially increase the level of key indicators - with the result of potentially constraining the flow of funds to non G-SIBs at a critical time; perception of such a risk is likely to be self fulfilling, pushing market liquidity provision back to the central banks that will be the recipients of the deposit inflows from the G-SIBs.

Similar concentrations of customer/investor preference may well also affect equity investment as well as particular lines of business such as custody and settlement. Taken together, the consequences could be quite perverse in terms of systemic stability just at the point of crisis.

Correlated Risks in Smaller Institutions

We note that during the financial crisis and more recently, there has been a strong trend within markets and by investors to focus not only on the risks associated with individual institutions but also on peer institutions with similar risks; for example, this can be seen as a result of exposures to particular sectors (such as residential or commercial property, trading books), geographic location (and resulting sovereign concentrations), and business model (for example, affecting funding and liquidity risks). The need to manage the collective systemic effects of closely correlated groups of banks is not specifically reflected in the G-SIB analysis, yet these can have significant effects on financial stability in areas which have a material impact on the real economy.

ASSESSMENT METHODOLOGY

We recognise the difficulties in establishing a quantitative methodology which can accurately assess the systemic importance of banks across business models and geographic concentrations and accept that there will need to be compromises in the final solution. However, there are a number of areas of the proposal where we have concerns, particularly the implicit focus on absolute size and the lack of specific recognition of underlying risk and resolvability.

Focus on Implicit Size

The proposals recognise that size is not the defining factor but, in addition to the direct measure of size which has a 20% weighting, there are a number of other measures which are in practice heavily correlated to the total size of any institution, so giving the size dimension significant prominence in the overall score. It may therefore be appropriate to reduce the direct weighting in the overall measurements.

Relevance of Risk

In terms of assets, the majority of the measures which are set out in the proposed approach are not risk-adjusted in any way but are calculated as total asset measures, regardless of the quality of the counterparty or the collateral or other security which have been provided to support the recoverability of these assets. In an extreme case, a fully-collateralised loan to a major diversified international bank would attract the same weighting as a similar size loan to a smaller mono-line bank, even though the latter might represent a much greater proportion of that bank's liabilities and be made without security. Intuitively, this does not feel right and a focus on risk-weighted assets would seem to be more appropriate.

On liabilities and funding, one of the key risks is the duration of the liabilities (whether wholesale or retail) compared to the assets which are being funded and the degree of liquidity in the balance sheet. The wholesale funding ratio does not address these issues in the way which is envisaged in the Liquidity Coverage Ratio (LCR) or Net Stable Funding Ratio (NSFR). It is not clear why new ratios are being introduced when so much effort has been expended on devising the LCR and NSFR, albeit that we believe these are still imperfect and are currently subject to observation periods.

Role of Resolvability

The analysis by the Basel Committee which is set out in this proposal has been undertaken on a Group basis, as set out in Paragraph 90. In the ancillary indicators, 'number of jurisdictions' is listed as a measure of systemic importance but this is a very crude measure if there is no supporting analysis of either size or market and regulatory structure in those locations.

However, in applying this approach universally across all banking groups, the Committee gives no recognition to the substantial differences in the ways in which financial groups are organised and, importantly for this exercise, fundamental differences in the ways in which such groups could and would be resolved in periods of stress and, therefore, the financial impact on counterparties and the financial system.

By way of illustration, HSBC operates principally as a series of locally regulated banks around the world, separately capitalised with their own pools of liquidity and funding. There are strict limits on the permitted financial interactions between these banks so that, in the main, they operate on an arms-length basis from each other without cash-sweeping, cross-default or cross-guarantees, albeit under co-ordinated management. Of the 69 banks in the Group, only five have material branches outside of their home jurisdiction. We believe that, in extremis, this structure would give the authorities significant advantages in resolution, as they would be able to effectively ring-fence major areas of the group which could continue in business, in the event that other parts of the Group were to fail.

But this is also a structure which has significant and accepted costs in terms of the pools of both capital and liquidity which are retained at a local level. As there are ever greater pressures on costs and returns, it is disappointing that there are no incentives for others to embrace structures such as this which facilitate resolution and so justify the expense, thereby attracting some compensating reward elsewhere in the regulatory system or from the G-SIBs proposals.

Bucketing Approach

We understand the need to have some form of tiered approach in the outcome of the G-SIBs analysis. However, we are concerned that there is no obvious link between the relative risks which exist within each institution (accepting that an analysis based on individual institutions is appropriate) and the quantum of additional specific capital requirements.

Furthermore, there appears to be a curious consequence that banks will not benefit from improvements to their indicators if all other banks also change their operations to reduce their systemic risk. This flows from the construction of indicators as a relative measure but without any quantitative risk-based thresholds. So benefits only come from relative improvement rather than aggregate improvement which seems an unintended consequence.

Economic Consequences

We are disappointed to see that there is limited cost-benefit analysis in this paper which would provide a better justification for the additional regulatory burden. Additional capital requirements have consequences for the ability of banks to provide support to the real economy. Banks need to be able to deliver returns above their cost of capital so that they can attract or retain equity capital, otherwise lending and economic growth will be constrained as banks shrink activities that cannot meet the returns necessitated by higher capital ratios. As the amount of loans which can be made for every dollar, euro or pound of capital is reduced by higher ratios, the task is much more difficult. In order to avoid contraction, a combination of prices must rise for customers, funding costs and interest on deposits must drop and operating costs must be reduced. The effect on confidence, growth and jobs becomes a vicious circle against a very uncertain macro-economic and geopolitical backdrop.

There are already material requirements for banks to raise additional capital which, in some cases, will be beyond their capacity to generate from forecast retained earnings; in our view this is the primary driver of the current market valuation of banks in most cases well below their book equity value. At the same time, equity fundraising from the private sector is a virtual impossibility when bank valuations remain at a severe discount to net asset value.

Providing an extended timetable for the phasing-in of such capital requirements helps only marginally in the context of a market which immediately discounts such requirements. Given these considerations we would have expected a fuller assessment of:

- evidence from the last crisis that these measures would have identified and addressed the issues which arose within institutions which threatened the global financial system and led Governments stepping in to provide 'rescue' funds or 'engineer' private sector solutions. It is not, for example, clear how many of these institutions would have been categorised as G-SIBs on the basis of these proposals; and

- analysis which demonstrates that higher capital ratios would have, in fact, reduced the probability of failure or the consequential impact if such a failure could not be avoided.

Although no solution can offer 100% certainty of effectiveness, a proper assessment needs to be made of the marginal benefits which may result, compared to the probable economic costs. We look forward to seeing a fuller analysis in the final report from the MAG.

CONCLUSIONS

HSBC recognises that it would likely be classified as a G-SIB under almost any framework proposed by the Basel Committee. However, we are unconvinced that the particular indicators and methodologies which have been put in place in the specific framework which has been proposed accurately reflect a meaningful assessment of the risk of the HSBC Group to the global financial system. We believe that, in many instances, HSBC starts close to the place where the reforms want systemically important banks to end up – with higher capital ratios, a better funding structure, stronger liquidity and a simpler business model, further buttressed in the case of HSBC by virtue of operating through separately capitalised and funded legal entities which are capable of being separated if required.

There are fundamental differences between the structure and business models of certain banks with important consequences for resolvability which have not been reflected in these proposals. As the regulatory framework evolves it is crucial that this level of analysis is undertaken if there are to be proper incentives for banking groups to adopt or retain more resilient and resolvable structures.

Yours sincerely

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