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Dear Sirs

Consultative Document – Fundamental Review of the Trading Book

HSBC welcomes the opportunity to respond to this consultation. We are supportive of the detailed responses submitted by ISDA, AFME, BBA, and the IIF but we would also like to raise some overarching concerns.

HSBC has consistently supported the direction and ambition of the global reform agenda. We also support the Committee's objective of achieving a regulatory framework that can be implemented consistently by supervisors. We also agree with the Committee that the Basel 2.5 revisions did not address all the shortcomings of the previous capital framework for the trading book and led to double counting. Given the potentially incoherent framework that resulted from this, we agree with the need for a fundamental review of the trading book.

We are concerned, however, that the Fundamental Review has not been wide-ranging enough. The Trading Book Group (TBG) within the Basel Committee does not appear to have been prepared to tackle issues which are integral to providing a coherent capital framework because these have been regarded as outside its remit. But this analysis is necessary to create the backdrop for the TBG to meet its objectives for the trading book. For example, the review:

- considers redefining the banking book/trading book boundary, purely from the perspective of concerns over perceived past regulatory arbitrage, without consideration of materiality or whether such a banking/trading book divide is required at all or what it is trying to achieve; and
- gives notice of plans to consider introducing a market risk charge for interest rate risk in the banking book seemingly without acknowledging that this would alter significantly views on the role of the banking book and the trading book and the divide between the two.

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In discussions with regulators on the Fundamental Review and other topics – for example, the issue of recognising credit and debt valuation adjustments consistently – it becomes clear as well that capital frameworks need to articulate whether the objective is to set minimum capital requirements on a going concern basis or a gone concern basis The answers will not be the same and methodologies should recognise these differences

- On a going concern basis what matters is the firm's ability to hedge risk and this may be done on a risk factor basis and at a portfolio level. In this case it is the time and cost of implementing suitable portfolio hedges that needs to drive the capital requirements
- Where regulators are concerned about the cost of winding-up a bank without recourse to taxpayer resources then it is the cost of exiting positions that matters In this case capital should be driven by the expected time it will take to wind-up the firm – the period of risk - and the cost of exiting positions in products over that horizon, albeit in stressed circumstances In this case, product liquidity becomes the more relevant concept although, of course, if a solvent firm is encouraged to take over a failing one then the ability to hedge risk factors may remain more important than product management

We see many parallels between minimum capital requirements for banks and the role of initial margin for CCPs in the management of a clearing member or client default

Furthermore, we are concerned that the TBG appears to be setting capital requirements at extremely high levels to protect against failure despite the diminishing marginal effectiveness of each additional requirement and, seemingly, without acknowledgement of separate regulatory and industry initiatives, for example·

- overall higher capital levels are required under Basel 3 and supplemented by the regimes for globally and domestically systemically important banks,
- the increasing use of stress testing and macro-prudential analysis to ensure capital adequacy on a dynamic basis,
- the potential use of Pillar 3 disclosures to guard against regulatory arbitrage, and
- the development of detailed recovery plans to avoid failure and resolution plans and bail-in frameworks to deal with it if this occurs

In these proposals, the roles of Pillar 1 and Pillar 2 capital requirements are becoming even less distinct than under Basel 2 5 and the TBG seems to be seeking to tackle all weaknesses in the current framework solely through Pillar 1 revisions.

Finally, in spite of the weaknesses identified in section 2.3 entitled "Drawbacks of the current market risk regime" we feel the proposed new framework suffers from most of the same flaws. It is more fragmented and less coherent. Industry groups have proposed a number of ideas which we believe will meet regulatory objectives and still result in a more coherent framework. At the same time, however, we believe that the broader issues identified above also need to be addressed.

Yours faithfully