Mr. Jesús Ibáñez
Ms Victoria Saporta
Co-Chairs, Large Exposures Group
Basel Committee on Banking Supervision
Basel, Switzerland

28th June 2013

Dear Mr. Ibáñez and Ms. Saporta:

HSBC Holdings plc: Response to Supervisory Framework for Measuring and Controlling Large Exposures

We welcome the opportunity to feedback to the Basel Committee of Banking Supervision consultative document on the **Supervisory Framework for Measuring and Controlling Large Exposures.**

HSBC has been pleased to participate in meetings with the Large Exposures Group (LEG) on January 15th and again on May 21st. We have collaborated closely with other industry members in the preparation of the response from the International Institute of Finance and we support the comments set out therein.

Within this letter we emphasis points which, whilst also covered within the IIF response, we regard as especially important, or where we have further comment.

Overall Comments

The framework changes include proposals to amend several interacting aspects of the existing framework contemporaneously, thus affecting several levers of control at the same time.

1. Numerator changes: The proposals contain multiple changes relating to the recognition and aggregation of exposures; and
2. Denominator changes: The proposals redefining the capital base used as the denominator of the Large Exposure Reporting ("LER") calculation moving away from Total Capital to Common Equity Tier 1 or Tier 1 Capital; and
3. Ratio changes: The reporting threshold falls from 10% to 5% and tighter "pillar one" type limits are proposed (10% to 15%) on Inter G-SIBs exposures.

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Tel: 020-7991 8888 Fax: 020-7991 4603

We remain concerned that firms will struggle particularly to reflect the numerator changes in the QIS exercise currently underway and that it will therefore be difficult to assess fully the impact of changing all three components of the LER mechanism at once.

We share the concerns of the IIF regarding the changes to all three components above, however we regard denominator and ratio changes as options to be preferred over changes in exposure definition where the latter are not aligned to existing internal risk or external reporting treatments. Such a preference also better meets the proposal's broad objective of simplicity. The system and change management overhead associated with exposure changes are in many instances severe and will be redundant save for the need to support only the Large Exposure Reporting framework. It is for this reason that the scepticism shown to internal modelling throughout the paper is disappointing.

Aggregation principles:

The extension of principles of aggregation to encompass economically interdependent entities as communicated in the proposals presents difficulties. The aggregation of counterparties to one another is a key feature of the fundamental structure of control within most firms and in the majority of cases we believe firms use control oriented principles as the main locus of aggregation for internal control purposes (such as risk appetite setting and the operation of delegated authorities). Many firms operate principles which meet very closely the principles in paragraphs 32 to 33. Economic dependence is considered but this is in the context of entities which are still associated to one another through their membership of a group, or by virtue of sharing common principals where the test of control is not fully met but where there is dependence upon, for example, common source of funds or material commercial interrelationships, or where they are enjoined in a guarantee structure. These principles generally operate at all levels of aggregation in corporate and commercial risk management and limit systems. They typically also govern the allocation of global relationship management responsibilities.

The guidance provided around economic interdependence requires entities to be associated with one another where they share no relationship beyond commercial reliance. It is difficult to envisage *risk approval* and *relationship management* being oriented to the broader definitions in the proposal and it must be appreciated that it is these two particular aspects of internal management that, together, deliver robust assessments of risk approval and risk dependency. Appetite is not at present assessed for exposure to entities which are not under the direct or indirect control of our customer, or which are close enough to qualify on inter-dependency grounds. Although such matters are considered in the fundamental assessment of credit worthiness the aggregation of more broadly economically dependent limits at the point of risk approval is not currently undertaken because of the

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complexity involved, and the lack of sufficiently robust information necessary to drive such decisions. If the guidance were to be implemented as proposed such tests would be required as a control to ensure that LE hard limits are not breached. We would anticipate a resulting material increase in costs to clients, and a slowdown in the credit extension process.

These points can be particularly difficult to accommodate intellectually where the reason for connection is dependence upon the bank as a source of funds – forcing otherwise even commercially disconnected entities into common reporting groups by virtue of their reliance on the bank itself. It is difficult to avoid concluding that the majority of more fragile solo banked mid-market and smaller customers would be required to be aggregated together on the grounds that the failure of their principal banker would likely lead to many also failing if they were unable to replace their main lender quickly. It also suggests that impaired portfolios of banks would be required to be aggregated for the same reason. We feel sure this was not the intention of the Committee but some further guidance in this regard is required to avoid encouraging inherently meaningless aggregations (from the perspective of a bank managing the risk of third party failure).

If these broader principles are required we would note that they are likely to be implemented in parallel and only for the population at risk of qualifying as a large exposure. Under these circumstances we question whether it will be possible to ensure that the quality of the risk decision necessary to assess the likelihood of interdependent failure is robust and complete.

Risk shifting and second order risks

The inclusion of second order risks (such as credit derivatives and guarantees) within the proposals confuses the prime purpose of the LE regime which is to assess the immediate impact of an obligor failure. Such exposure does not result in a claim (i.e. true exposure) unless the primary obligor first defaults. It is not our experience that the failure of a protection provider will cause the failure of the entities over which it has written protection and see no reason to aggregate exposures for this reason. We support the suggestion from the IIF that exploring significant double default risks is preferable, albeit this will no doubt require accommodating greater complexity.

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Where second order risk is required to be accommodated within the revised framework we believe that it should be shown quite separately to other exposure so that its different nature is understood. Should hard threshold limits be reduced from the current 25% level we would also recommend considering that second order risks be treated differently – perhaps by creating a second higher threshold to accommodate both first and second order exposures.

CIU look through

We concur with the IIF view that the CIU look through approach ("LTA") proposals are unduly burdensome and would require a significant investment in systems and agree that the prudential benefits to be gained would not be commensurate.

Look through of lending to structured vehicles tends to be easier than for other trading relationships with investment vehicles such as funds. This is because the assessment of the former generally will examine the underlyings as part of the on-going risk assessment of the structure. We do however support the IIF's view that the nature of the structure itself should be taken into consideration where an investor is not exposed to a pro rata share of the assets.

The sheer number of funds with whom banks have derivative and foreign exchange trading relationships renders a similar level of analysis almost impossible. This is particularly true as the funds' underlying assets are accounted on marked to market basis meaning that funds could easily move from granular to non-granular pools and back again.

Clear principles will be necessary regarding how fresh LTA assessments need to be to support quarterly reporting. We think it unlikely that quarterly look through to fund investments will be possible. As a matter of principle we therefore recommend looking carefully at particular types of CIU obligors that might, by definition, only ever be capable of being reported in the Single Unknown Counterparty ("SUC") grouping and to ensure that the limitations applied thereto do not have the inadvertent consequence of restricting market activity. Other options might be to proceed to record the exposure to SUC reporting groups but to allow multiple SUC's to differentiate between types of primary CIU obligor so as not to create a single very large bucket of undifferentiated risks covering all obligors. An operating principle that could be followed is to differentiate between those types of CIU obligor where look though is regarded as possible with some effort (where the SUC encourages look through), and very difficult or impossible to accomplish (where regardless of encouragement the SUC cannot realistically incentivise greater analysis).

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We do not accept that CIUs should be aggregated together where they share a fund manager. We are not certain why fund managers should be particularly singled out specifically as requiring aggregation for this reason. This establishes an unwelcome principle that a legitimate reason for aggregation is the ability of one entity to perpetrate fraud upon another so causing failure. We strongly recommend that the primary focus of the LE regime should remain on the credit failure of entities rather than trying to encompass other less proximate operational or commercial risks.

Definition of exposure values:
It is not clear whether unconditionally cancellable facilities would be captured but we assume from the fact that such facilities are not mentioned specifically that it is intended that such facilities are to be excluded. Further points of principle would be welcome to govern what should and should not be included; we assume there is no intention to include unused unadvised limits for example, but this is unclear.

The failure to recognise the benefits of modelling the amount of exposure for certain products is disappointing. First, in market risk at least, large exposures are captured in IRC and CRM quite explicitly, so there is double counting of LE risk across the LE framework and market risk. Whilst the points regarding consistency and simplicity are acknowledged the definition of the amount of expected exposure should be dealt with robustly – we question whether the gross simplification introduced by the application of standard rules and CEM will result in a robust quantification. We note the new NIMM proposal from BCBS and believe that the QIS should incorporate this and other developments such as margin for uncleared trades and should not be assessed piecemeal. The use of standardised models rather than standard rules may provide a more robust risk sensitive approach. For example this is being suggested by ISDA to BCBS as part of a standardised IRC model for bank exposures to Central Counterparty default funds.

There are benefits to using models which do not appear to have been given weight, specifically the internal and regulatory oversight applied through backtesting and the strength of validation required to achieve regulatory approval. We would strongly encourage reconsideration of the use of internal models where these are used for other regulatory purposes.

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Public / Regulatory policy concentrations:

In areas where regulatory direction encourages / forces a particular concentration, the public interest benefits of so doing should excuse the concentration from pillar 1 limit type constraints. We therefore support a reporting threshold rather than a hard limit for cases such as Central Counterparties (CCPs). Care is also required to ensure that the aggregation principles do not result in exposure across CCPs being cross aggregated as many CCPs have overlapping pools of clearing members. If a clearing member fails on one CCP it will likely fail on many and the aggregation principles may encourage cross linking these exposures.

Parallel LER only exposure calculation regimes

The proposal suggests exposure calculation methods that follow neither Risk nor Regulatory Reporting approaches that may be in use within a firm (e.g. the proposals suggest use of supervisory haircuts for SFTs and recognition of credit risk mitigation through a hybrid treatment). The recommendation to encourage the adoption of parallel exposure calculation regimes is unwelcome where for more advanced firms they would exist only to support the LE regime. The use of regulatory haircuts would at the least require the haircuts to be revalidated given their age.

Concluding remarks

Lastly we would note that, outside the interbank sector, the degree of change to exposure recognition principles proposed within the BCBS proposals seem out of line with the risk of failure caused by single large corporate counterparty default. We would welcome some recognition of the relative risks presented.

Whilst risks of large counterparty default are more pronounced in the interbank market due to the sheer size of exposures, we share the concerns of other IIF members regarding the extension of lower hard limits to inter G-SIB exposures. This proposal should be considered against the backdrop of other substantial international regulations (e.g. Basel III, G-SIBS capital surcharges). These regulations not only require more and higher quality of capital to be held against potential losses, but also contain other backstop measures, such as the leverage ratio, which indirectly limit counterparty exposures. Provided there is confidence in the ratio of exposure to capital for the bank population as a whole we do not see the see the logic of singling out the G-SIB population to apply a different relationship.

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The interplay between these changes – many of which have yet to fully be realised - needs to be reviewed to determine whether in aggregate the lower G-SIB limit is expected to impact liquidity under normal and stress conditions. As a backstop supervisors might be encouraged to develop non-punitive excess criteria to permission hard limit excesses – at least until such time as the effect of the regime is fully understood.

We thank you again for the opportunity to comment on the consultative document. Should you have any questions on the issues raised in this letter, please contact the undersigned (pehlaj.malhotra@hsbc.com) or Warren Mockett (warren.mockett@hsbc.com).

per pro

Pehlaj Malhotra

Global Head of Wholesale Credit

RESTRICTED - HSBC Holdings plc
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