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**HSBC Holdings plc**
Group Risk, Level 40, 8 Canada Square, London E14 5HQ
Tel: 020-7991 8888 Fax: 020-7991 4603



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Submitted via email: baselcommittee@bis.org

Mr Wayne Byres
Secretary General
Basel Committee on Banking Supervision
Bank of International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

**Re: Comment on Discussion Paper: "The regulatory framework: balancing risk sensitivity, simplicity and comparability"**

Dear Mr Byres

HSBC appreciates the opportunity to respond to your discussion paper, *"The regulatory framework; balancing risk sensitivity, simplicity and comparability"*. HSBC supports the responses made by various industry bodies. Our response to your specific questions is in the Appendix, however we would like to emphasise certain aspects and make some additional points on the topics of RWA comparability, the benefits of internal model approaches and the goal of simplification of the current regulatory regime.

**RWA Comparability**

We share your interest in the causes of the disparate outputs from banks' internal models. HSBC has been active in chairing and participating in industry groups that have given this topic much consideration. We have reviewed the many studies on RWA comparability and such is our interest in this area that we welcomed its influence on the work of the Financial Stability Board's Enhanced Disclosure Task Force ("EDTF") co-chaired by HSBC's Chief Accounting Officer, Russell Picot. HSBC also led related work by the 23 banks making up the European CFO Network.

The difficulties involved in comparing internal models and advanced risk parameter calculations are fully acknowledged. However, it is important that this should not lead to the simplistic conclusion that internal models and reported RWAs lack integrity. Rather, we should recognise that the drivers of differences can be complex, and that we should investigate and explain them, seeking to remedy undesirable causes of variation. In this respect, suggestions to solve this problem via proposals such as the disclosure of standardised RWAs, would provide little information on the drivers of firms' risk, the differences in the output of banks' internal models or their capital requirements overall.

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However such a disclosure would impose a large operational burden on banks with little or no added value in terms of understanding and comparison of RWAs. The data required to produce Standardised RWAs is frequently not available, as there is no requirement for banks on more advanced approaches to produce it. Furthermore, it is not readily comparable between banks. For example, in Hong Kong few corporates are externally rated. This factor would drive much higher standardised risk weights than a US corporate book and contribute to undermining its value as an objective measure.

We understand that various hypothetical portfolio exercises have been completed and further studies commissioned which enable comparison across banks due to a consistent basis of data. The results of these exercises are published and in future could potentially name the individual banks. Additionally there is an initiative being pursued by firms, to construct hypothetical portfolios with results submitted to GARP[1] on an anonymised basis. We believe that such initiatives will prove to be an efficient and effective way of making cross firm comparisons and will lead to a better understanding of cross firm RWA differences.

**Should simplicity be an objective?**

While at first sight, simplicity is a desirable property of a model the overriding objective of a risk model must be that it accurately represents and predicts risk. As financial markets have become more complex it has followed that models have also become more complex and investors and regulators require tools to assess the reliability of banks' estimates of the risk. It is these tools that need to be simple and transparent, rather than the models themselves, aiding comparability across banks by greater explanations of how models work as well as their outputs. This does not require non-specialists be able to understand the model in detail.

We also believe that forced simplification of models would not alter the complexity of financial markets or systems; if this is a goal, it would be more effectively achieved through separate regulatory and political initiatives.

**The existing framework against objectives of capital adequacy**

HSBC believes that the existing risk based capital regime broadly achieves the objectives of the capital adequacy framework; specifically it produces a minimum standard of capital adequacy, accounting for effects of capital requirements on banks' risk taking initiatives and promoting improved risk measurement and management within banks. However HSBC acknowledges that more needs to be done to satisfy the BCBS objective to "*deliver a well-understood measure of capital adequacy that is comparable across banks and over time*".

It is for the above reasons that HSBC has been a strong advocate of the enhanced disclosure route and believe that this is the best way to inform investors and analysts about the risk profile of our

[1] Global Association of Risk Practitioners

book and the resulting capital requirements. We believe that this can be achieved through banks providing:

- Greater understanding, of both the methodology applied and the differences in output observed
- Assurance and validation of model performance

HSBC adopted the EDTF recommendations within our 2012 Annual Report & Accounts. This enhanced the transparency in our Risk Weighted Asset (RWA) disclosures (including back-testing of results). To this end, there has been much progress in the area of banks' disclosures in the past year including the development and publication of RWA movement by key driver and RWA densities (RWA / EAD) which we believe already provide a better basis of comparison between firms. However, there is still more that can be done in terms of transparency of disclosures, as it has been disappointing that industry adoption of EDTF principles is far from universal. HSBC remains committed to its delivery, as we believe enhanced disclosure serves as an effective method to make meaningful risk based comparisons between individual banks and to discuss these issues with the relevant management teams.

We note that some elements of the regulatory capital framework are complex and may lack coherence. An example of this is the Trading Book where risk can be counted multiple times through VaR, stressed VaR, IRC and CRM. Simple addition of these risk metrics lacks sound theoretical underpinning. We have actively participated in the industry response to the Fundamental Review of the Trading Book, though we support a simpler framework in this area than is proposed by the Trading Book Group.

**The Benefits of Internal Model Approaches**

The internal model approaches adopted by large international banks set benchmarks for risk management, and act as an incentive for smaller or less sophisticated institutions to adopt enhanced risk practices. Given there are many legitimate reasons for RWA differences to arise, any initiative to step away from advanced approaches based on the use of internal models should be very carefully evaluated.

The promotion of simplistic metrics and capital overlays cannot replace the analytical rigour and portfolio understanding which advanced modelling demands. If overlays or parameter floors were to become mandatory, there would be little incentive for firms to continue their significant investment in advanced risk management systems. This could lead to an irreversible drift from a largely consistent global modelling framework toward disparate, bespoke economic capital models which have no basis for comparison. Indeed, it could also lead to unforeseen consequences, such as reduced portfolio diversification and the adoption of higher risk exposures, in turn increasing systemic risk. Any replacement of internal models with measures which lead to floored approaches will not enhance understanding of banks' risk profiles.

## Conclusion

We favour a more holistic and coherent regulatory framework but this should have risk based capital at its core. We also believe that regulators are well placed to receive the model outputs of firms to contribute to broader financial systems models that can be used to anticipate the accumulation of systemic risk, monitor and take action as necessary. Again this would support the use of sophisticated models and not their demise.

In concluding our response to this Discussion Paper, HSBC would encourage that the existing regime of internal models is maintained, as discarding these would represent a backwards step for banks themselves. The promotion of simplistic prudential overlays is no substitute for the analytical rigour and portfolio understanding which advanced modelling demands. Furthermore, the replacement of internal models with measures such as standardised or floored approaches will not enhance understanding of banks' risk profiles. Understanding risks is a pre-requisite for their mitigation. To this end, detailed modelling complemented by transparency of the underpinning assumptions would provide key insights into counterparty and market behaviour. RWA comparability could be effectively addressed via better disclosures of the drivers of model differences and the inherent risks within banks portfolios.

I would be glad to provide any additional information or assistance that would further progress your deliberations.

Yours sincerely,

Mark Smith
Group General Manager
Chief Risk Officer Europe and Global Head of Wholesale Credit and Market Risk

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**Appendix**

**Q1. Does the current framework, with its reliance on the risk-based capital at its core, appropriately balance the objectives set out in paragraph 29?**
See section "Existing framework against objectives of capital adequacy" on Pg. 2, where we generally believe that the current framework achieves the objectives of the framework; however acknowledge that there is a requirement for additional focus on increasing the understanding and comparability

**Q2. Are there other objectives that should be considered in reviewing the international capital adequacy framework?**
HSBC would welcome the inclusion of transparency of calculations and disclosures of the drivers of RWA movements as an objective of capital adequacy framework.

**Q3. To what extent does the current capital framework strike the right balance between simplicity, comparability and risk sensitivity, given the costs and benefits that greater risk sensitivity brings?**
HSBC believes that risk sensitivity of the capital framework is paramount. There should be less focus on the question of balance between simplicity and risk sensitivity, instead the focus should be to achieve greater transparency and comparability through enhanced disclosure.

**Q4. Which of the potential ideas outlined in Section 5 offer the greatest potential benefit in terms of improving the balance between the simplicity, comparability and risk sensitivity of the capital adequacy framework?**
See section "Existing framework against objectives of capital adequacy" on Pg 2, where we support the initiatives of enhanced transparency in disclosures.

**Q5. Are there other ideas and approaches that the Committee should consider?**
HSBC believes that Basel should work toward greater convergence in supervisory practices and support the identification and estimation of model risk. The latter can be achieved through hypothetical portfolio exercises and perhaps exploring a standardised calibration of internal models for benchmark purposes and to better understand the impact of calibration differences resulting from modelling choice and regulatory overrides.