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Iain J Mackay
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Bank for International Settlements
CH-4002 Basel
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16 December 2016

Dear Sirs,

Regulatory treatment of accounting provisions – interim approach and transitional arrangements - consultative document

Regulatory treatment of accounting provisions – discussion paper

HSBC welcomes the opportunity to respond to the Basel Committee on Banking Supervision's ('the Committee') consultation document and discussion paper ('the Consultations') related to the interactions of IFRS 9 Financial Instruments with the prudential framework. Although the Committee has published separate papers for transitional and longer-term solutions, we believe the issues and potential solutions are so closely related that we have chosen to consolidate our responses into one letter. In addition, in our appendices we comment on the various options proposed in the respective papers and address each of the separate points where specific feedback has been requested.

As noted by the Committee, while banks have known for some time that IFRS 9 would come into force in 2018, they have also been aware the Committee and other supervisory bodies have been planning a regulatory response to IFRS 9, the extent of which was unknown. This, coupled with the ongoing development in methodologies for calculating Expected Credit Losses (ECL) for accounting purposes, means that great uncertainty relating to the prospective capital impact remains.

To address this ongoing uncertainty, we welcome the Committee's review of both the initial implementation of IFRS 9 in 2018 and the long-term implications of its adoption. We have summarised our key comments below and have provided more technical commentary in the appendices to this letter.

Interaction between the new accounting and regulatory standards

The conceptual consequences of introducing the IFRS 9 ECL approach, particularly the lifetime elements, and its interactions with the evolving regulatory framework is complex and not consistently understood.

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The current regulatory treatment of accounting provisions was defined more than ten years ago under Basel 2. Since then, standard setters have undertaken a transformative overhaul of both the accounting and regulatory frameworks, aspects of which continue to be enhanced. Given this, the full implications of how the respective standards interact and potentially overlap, is as yet unclear to industry. From recent industry and Basel Outreach discussions, there does not appear to be a common understanding of the areas of interaction, the aspects of the regulatory framework that may require adjustment in light of changes to accounting instigated by IFRS 9, and the priority and magnitude of such changes.

In our view, there are technical areas of both the Internal Ratings Based (IRB) and standardised approaches where the suitability of the interaction between the new accounting and current regulatory frameworks is unclear. These include:

- the potential overlap in the IRB approach through the maturity function;
- the misalignment of time horizons and the subsequent treatment of lifetime ECL in excess of 12 months losses;
- the interaction of standardised risk weights with Expected Loss (EL) and Unexpected Loss (UL); and
- the calibration of the recently redeveloped standardised approach.

We have attempted to outline these areas of concern in a technical appendix (1) to this letter.

Potential Capital Impact

If the above areas remain unresolved there is a danger that institutions will be over or inappropriately capitalised and ambiguity in the goals and interactions between the frameworks will continue, with a possible practical risk that the regulatory framework may not be resilient to periods to stress.

Impacts on regulatory capital will be more strongly felt by standardised banks but will also be felt by those IRB banks making use of the standardised approach or where existing regulatory EL excesses over allowances are breached.

It is important to note that the procyclicality of IFRS 9 allowances, and particularly their behaviour under stress is unknown. Given the current status of IFRS 9 implementation, its full impact is likely to manifest over a number of years, only becoming evident after the 2018 application date. The fact that there is potential for volatility in these measures over time, coupled with the likely magnitude of increased allowances, means that caution is required to ensure that the capital impacts are appropriate and understood. IFRS 9 is likely to be significantly more procyclical than IAS 39, in that lifetime expected loss recognition under stressed forward economic outlooks will be accelerated, and this will directly impact risk weighted asssets (RWAs) and CET1 ratios. In light of this, appropriate mitigation of regulatory capital impacts is essential. To that end, we suggest a methodology that could be used as the basis of a tactical approach and potential strategic solution, in Appendix 2.

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Transitioning to a meaningful end-state

The Committee has proposed a number of approaches to mitigate the *initial* impact of the adoption of ECL under IFRS 9. While we strongly support the Committee's efforts to mitigate initial capital impacts, particularly in light of the ambiguity around the appropriateness of those impacts, we disagree with the manner in which this is currently proposed.

There are individual merits and drawbacks inherent to each of the Committee's proposals, which are discussed in Appendix 3 of this letter. However, they each share an inherent weakness that outweighs many of the advantages of the individual proposals. Namely, all approaches include the intention to amortise the regulatory capital effects of IFRS 9 implementation over a phase-in period. At present the amortisation profile and phase-in period are not confirmed. However, until the point that the strategic direction of the regulatory framework is determined, it is difficult to agree with any amortisation profile. We therefore believe that regulatory capital neutralisation is required as a temporary measure to allow the Committee time to undertake a review of the interaction between the regulatory and accounting frameworks. At this point an amortisation profile may become appropriate.

Although phasing-in of changes was common under Basel 3, the final end point was always known. In this case, as the Committee acknowledges in their discussion paper, the end point is not settled and this is unlikely to be addressed for some time. While this is the case, banks will transition to potentially the wrong end point. In addition, investors invariably ignore transitional approaches, reducing the benefits of any transitional measures.

It is therefore imperative that the Committee concludes its deliberations on the final design of the prudential framework before it starts to recognise the impacts from IFRS 9. Transitional approaches are only truly appropriate if the Committee has concluded that no changes to the regulatory framework are required. In that case, we would strongly support the Committee in realising impacts in a manageable manner, but also recommend that materials, similar to the explanatory notes produced by the Committee supporting Basel 2 implementation, are issued to ensure mutual understanding throughout the industry.

Interactions with other areas of regulatory framework

We note that the Committee has been proposing widespread revision to the Basel 3 framework for some time. This has included extensive review of the credit risk approaches to RWA calculation and proposals to introduce a capital floor based upon standardised approaches. At all stages it has been unclear how the upcoming accounting changes have been factored into these deliberations. The various consultations provide little comfort that the overall design of the framework has been fully considered.

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This is evident in the Committee's proposal to introduce a standardised EL, where it is stated that this would not be expected to fundamentally affect the level of the calibration of the risk weights. It is difficult to understand this stance given the current calibration would be based upon an exposure net of accounting allowances calculated under completely different accounting methodologies. In addition the lack of clarity as to the interaction of the risk weights with UL and EL, as explained in our technical appendix (1), make complete assessment of this approach difficult. The "scaling factors" that are suggested as a prospective solution to this seem inadequate when the treatment of accounting allowances are so fundamental to the credit risk approaches.

Standardised EL is a methodology that has some technical merit. However, the Committee must acknowledge that its introduction would be a fundamental change to the wider standardised approach. As such, it should be explored in a considered manner in conjunction with the ongoing revisions to the standardised approach. Inherent to this, the calibrations of the revised approach must occur with the full incorporation of accounting methodologies. While we note the political imperative to conclude Basel 3 revisions in a timely fashion, it is vital that sufficient time is allocated to undertake this task.

Conclusion

At present, it is unclear if impacts across the industry will be modest or significant, both on transition and under stressed conditions. However, it is also difficult to determine what should be deemed modest in the context of the wider significant changes to the regulatory framework being proposed by the Committee. Nonetheless, irrespective of the impact on implementation, it is important to ensure the frameworks are coherently designed, as impacts could be more significant than envisaged, may impact some banks more significantly than others or may become more material over time and under stress. Where there are possible shortcomings in the design of the regulatory framework leading to potentially inappropriate impacts, these should be rectified, irrespective of size.

At best, it is not fully clear to industry whether the existing design of the accounting and regulatory frameworks is appropriate. It is our view that this assessment cannot be addressed at some undefined future date, whilst potentially large capital impacts are recognised in the interim. This would lead to the manifestation of potentially significant and inappropriate reductions in capital and the publication of misleading disclosures. Consequently, the Committee should consider these points and either:

- conclude that the frameworks are fit for purpose, publishing explanatory notes to set out why that is the case; or
- conclude that the framework requires adaptation and communicate a time horizon to make those changes and suitably mitigate inappropriate impacts in the interim.

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Given the potential for far reaching implications of these proposals, if it is considered helpful to you and your colleagues, we would be pleased to meet to discuss any of our comments further.

Yours faithfully,

cc. Sam Woods (Chief Executive Officer of the Prudential Regulation Authority)

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Appendix One

Technical Analysis on the Interactions between the Regulatory and Accounting Frameworks

From discussions with regulatory bodies and from comments made at the Basel Outreach meeting in November, there seems to be little consensus as to the appropriateness of the current regulatory framework in the context of IFRS 9. This is reflected in the embryonic nature of the Committee's discussion paper on the strategic direction of the regulatory framework, despite IFRS 9 having been finalised for some time. Reviewing historical Basel documentation does not fully clarify these issues, particularly with reference to the composition of the standardised risk weight and its relation to EL and UL.

Given the magnitude of the changes under IFRS 9 and the lack of clarity as to how allowances under this regime will behave across time, it appears unwise to recognise impacts that could be large and unpredictable, before a decision is made on whether those impacts are appropriate. This is why we have argued for regulatory capital neutralisation as a temporary measure until consensus is reached.

To assist the Committee we have endeavoured to articulate our views on the current viability of the regulatory framework and areas for consideration. In summary, we suggest there are areas of both the standardised and IRB approaches that should be considered with a view to adapting the framework or specifically rejected, prior to recognising such potentially far-reaching impacts.

Internal Ratings Based Approach to Credit Risk

On adoption of the Basel II framework the Committee looked in detail at the most appropriate approach for reflecting UL and EL in the IRB capital calculation. Through this the Committee announced its belief that a separation of UL and EL would lead to a superior and more consistent approach. Consequently, EL was explicitly removed from the IRB risk weight formula and capital requirements determined on a UL-only basis to a pre-specified confidence level. In addition, to retain the strong incentives for banks to provision properly against EL, a separate treatment that compared EL to allowances was embedded, with deductions made from capital where EL exceeded allowances.

Helpfully, the Committee produced supporting material such as *An Explanatory Note on the Basel II IRB Risk Weight Functions.* The relationships of the IRB calculation are shown by the following diagram taken from the explanatory note, which has been adapted to demonstrate the EL and allowances comparison. IFRS 9 is likely to increase allowances significantly. This potentially would erode banks excess EL resulting in reduced equity being offset by Tier 2 add backs, depleting the CET1 ratio.

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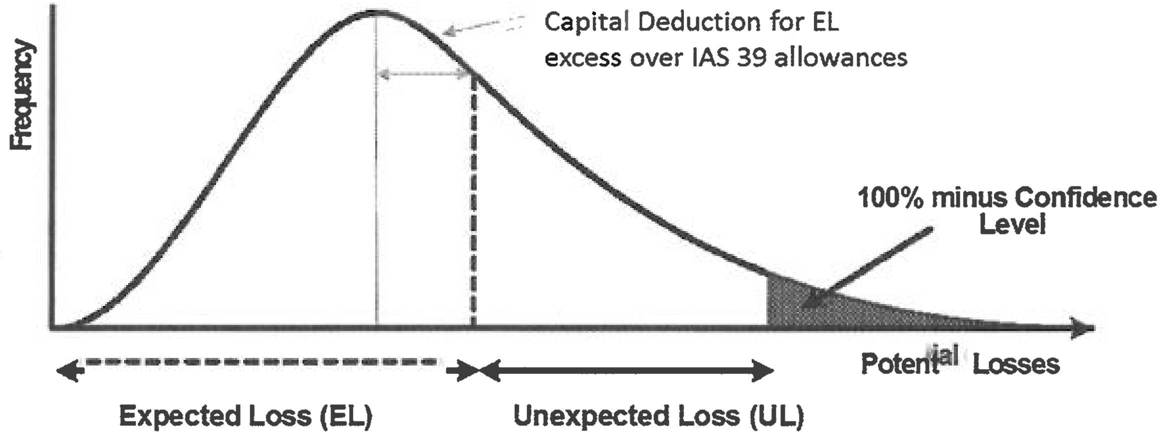

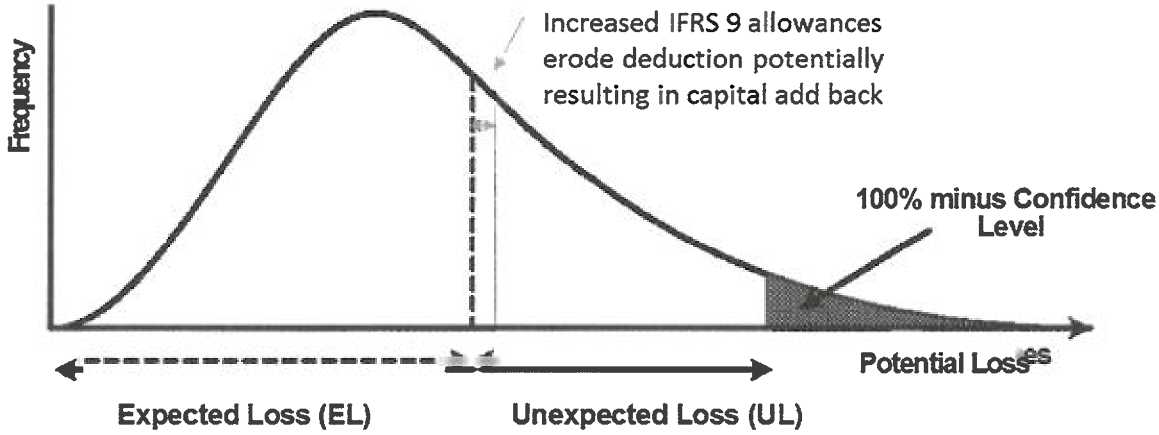

Within the IRB formula, a PD representative of the average rate of obligor default in a 12 month period is used. This forms the basis of the EL calculation and the calibration for UL at a 99.9% (1 in a 1000) confidence level. It is arguable that the capital requirement is calibrated so that it would exceed losses that occur in a 12 month period 999 times in every 1000 years. However, there is also a maturity function embedded into the risk weight calculation which means that for two exposures to the same obligor with the same 12 month PD and EL, different capital requirements based on the relative maturities would be generated. Exposures with longer maturities will have larger capital requirements than those with shorter maturities, all other factors being equal.

Within IFRS 9, for exposures that have deteriorated since origination, lifetime ECL is calculated in excess of 12 months. This appears to be fulfilling a similar objective to that of maturity in the IRB calculation, resulting in a potential overlap between the two frameworks.

Even if the Committee determines that the IRB formula is truly a 12 month measure and IFRS 9 does not cause any overlaps between the frameworks, there remains a misalignment

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in the time horizons. Therefore there may be changes required to ensure the interactions between the two remain coherent. If institutions are only required to hold capital against a 12 month UL to a specified confidence interval, then allowances that are there to protect against longer term expected losses would theoretically be available to absorb unexpected losses on a 12 month time horizon. This would be an argument for allowances that are in place to cover losses outside the time horizon countenanced by the regulatory framework having recognition as CET1.

Standardised Approach to Credit Risk

On adoption of the Basel II framework, when EL was removed from the IRB approach, no change to the method for allocating risk weights under that standardised approach was made. By inference it can be assumed that the standardised risk weights cover both UL and EL, although exposure value is reduced by the amount of allowances held. If this is the case there appears to be overlap between what the ECL covers and what is considered as part of a standardised risk weight.

If standardised risk weights are actually only intended to cover UL there is no overlap with ECL. However, the accounting ECL is likely to increase, as shown on the diagrams above, which means the portion required to cover UL must decrease accordingly. It appears that calibration of the standardised risk weights in the Committee's recent consultation efforts has not taken this into consideration. Given the amount of time and effort the Committee and industry have devoted to the standardised approach, "scaling factors" would not be appropriate, especially given the Committee' goals for comparable and explainable risk weights across jurisdictions and institutions. Calibration must be re-performed in a coherent and transparent manner in light of the increased allowances generated under IFRS 9.

Conclusions

At best, it is not fully clear to the industry whether the existing design of the accounting and regulatory frameworks is fit for purpose. It is our view that this assessment cannot be addressed at some undefined future date, whilst potentially large capital impacts are recognised in the interim. This would lead to potentially significant and inappropriate reductions in capital occurring and misleading disclosures being published. Therefore the Committee should consider the discussions outlined above, as well as any other pertinent issues raised, and either:

- conclude that the frameworks are fit for purpose and publish explanatory notes, as it did under Basel II, to ensure interactions between regulatory and accounting frameworks are fully understood; or
- conclude that the framework requires adaptation and communicate a time horizon to make those changes and suitably mitigate inappropriate impacts in the interim.

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Appendix Two

HSBC's proposed solution

To improve the alignment between the accounting and prudential frameworks the following approach could be used. This could be implemented on both a tactical and strategic basis and we would suggest the Committee consider it as the basis for the design of any additional solutions, for example standardised EL.

1. For all non-defaulted assets, whether under the standardised or IRB approach, the total Lifetime ECL (LTECL) that has been recognised in financial statements should be compared with 12 month ECL (12ECL) and the difference should be added back to CET1 or alternatively converted into an RWA-equivalent and deducted from gross RWAs.
2. 12ECL can then be allowed to flow through the existing prudential regime.

The difference between LTECL and 12ECL is by definition there to protect against losses either already covered by the prudential framework or not countenanced by it. Therefore it is appropriate to treat these allowances as a capital item or by reducing RWAs.

Under point 2 above, we would suggest the Committee looks to make further enhancements to the prudential regime, some of which are identified in its paper. For example, the introduction of a standardised EL could be investigated further, coupled with a recalibration of the standardised risk weights, or 12ECL mapped into redefined General Provisions (GP) and Specific Provisions (SP) under the current framework. However it is our view that enhancements in these areas are refinements but not solutions to address the fundamental disconnect between the frameworks, which would be solved through point 1 above.

It should be noted that, to ensure the capital measure is as cyclically neutral as possible, it would be preferable to ensure that as much symmetry as possible is incorporated into the prudential regime via add-backs to CET1. Therefore it would be advisable to revisit the asymmetry of all capital deductions and add-backs under the existing framework, as this makes the CET1 ratio inherently cyclical, which becomes more important when incorporating an accounting measure that is more responsive to the cycle.

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Appendix Three

The Committee's proposals for transitional arrangements

All the transitional approaches proposed by the Committee have the significant weakness of not being a true transition, given the final end state is unknown. While there remains uncertainty as to the end state of the prudential framework transitioning towards it is flawed, however much the effects are amortised.

Inappropriate transitioning would also lead to significant interpretation issues for end-users of institutions' disclosures as, irrespective of amortisation profiles, analysis would likely be undertaken on an end-point basis. This would be inaccurate unless the Committee was comfortable that no changes to the prudential framework were required.

Importantly, if part way through an amortisation process a change to the end-point was deemed appropriate, the Committee would then be confronted with the question of how to reflect the revised impact, potentially having a second transition process to the final impact if the capital impact was deemed too high at that point. That would generate potential significant uncertainty in banks' capital planning.

In summary, whilst the long-term approach is undecided, any solution the Committee decides to carry forward should be reflected at 100% of the adjustment value and should be made in full to CET1. Transitional approaches as proposed by the Committee are therefore unsatisfactory and should only be used from the point that the strategic direction of the regulatory framework is determined. Nevertheless they are undoubtedly preferable if the Committee does not wish to consider full neutralisation as a temporary measure. Through temporary neutralisation the Committee would mitigate large and potentially incorrect capital impacts whilst allowing time for the strategic questions around the interactions of the framework to be considered and resolved. If the Committee is resolute in pursuing transitional approaches we have provided commentary on each.

We note that the European Commission in its draft amendments to the Capital Requirements Regulation (CRR), have made an alternative proposal. Although in draft, this appears to follow a derivative of Approach 3, albeit with a full delay in impact recognition for the first year and then straight line amortisation over a 5 year period. However, the timings of the adoption of this legislation appears problematic given the transitions will only become live after CRR revisions are adopted, which is likely to be post 1st January 2018. As written this would lead to the full impact being recognised in early 2018, before being fully reversed and then amortised. This would severely undermine any transitional approach.

Approach 1 – Day 1 impact on CET1 capital spread over a specified number of years

The Committee has correctly identified this approach as a simple method to mitigate a portion of the impact. Whilst it is the Committee's preferred solution because of this simplicity, there are disadvantages that make other solutions superior.

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Given the Committee has not finalised its view of the longer-term solution and has provided no indication of timescales, any interim solution may be in place for a number of years. Post-implementation, the adjustment based on Approach 1 will become increasingly less relevant as balance sheet and ECL measurement changes are not reflected in any way. Therefore this approach is inferior to alternatives which do consider the evolution of a bank's balance sheet and which can be implemented relatively simply.

While simplicity is certainly a goal we would support, it should not be the primary driver of such an important solution. We believe our solution outlined in Appendix 2, as well as some of the Committee's own proposals, are superior but remain sufficiently simple.

Approach 1b – A modified version of Approach 1 (materiality threshold)

The modification of Approach 1 which incorporates a materiality threshold suffers from the weaknesses of the underlying method. However, the materiality threshold is also based on the premise that banks should expect to absorb a "modest" reduction in CET1. The validity of this assertion is unclear, particularly as the Committee themselves clearly intend to consider changes to the prudential framework, in addition to the already extensive changes being undertaken by the Committee in other areas. Prior to understanding the Committee's strategic changes and their impacts, it is impossible to determine what would constitute a "modest" reduction, particularly when the validity of any CET1 effects are unclear. It is our view that any impacts should be treated appropriately, irrespective of size, and the concept of a materiality threshold should not be considered further.

Approach 2 – CET1 capital adjustment linked to Day 1 proportionate increase in provisions

Although Approach 2 is slightly more complicated than Approach 1, it has the significant advantage of recognising changes in the size of the balance sheet, as well as changes in the total ECL, post implementation. While the proportion of ECL attributed to new provisions is fixed, in the absence of an undesirable parallel run of IAS 39 and IFRS 9 after 1st January 2018, this assumption is the most appropriate available. The additional complexity of this approach is not thought to be insurmountable, either operationally for calculating banks or for end users of disclosures. Therefore on balance Approach 2 is likely to be preferable to Approach 1, but is still inferior to our recommended approach.

We would also note that it appears that the calculation suggested in the consultation is incorrect. The increase in allowances based on IFRS 9 should be expressed as a percentage of the provisions in the opening balance sheet on IFRS 9 implementation. The text suggests that this should be expressed as a percentage of the closing balance under IAS 39, which would not provide a coherent answer when applied to IFRS 9 balances in the future.

Approach 3 – Phased prudential recognition of IFRS 9 Stage 1 and 2 provisions

Approach 3 is predicated on the assumption that Stage 3 is equivalent to incurred losses under IAS 39, meaning Stages 1 and 2 are therefore "new" under IFRS 9. Although the Committee recognises the weakness of this assumption, we consider this assumption to be invalid. There will be a potentially material amount of provisions that would have already existed under IAS 39 in Stages 1 or 2, meaning that a reversal of all associated provisions could lead to an improvement in capital terms compared to today, which would be difficult to support. Therefore we are unable to fully support Approach 3 in its current form.

However, there are mechanical similarities to Approach 3 and our proposal set out in Appendix 2, meaning it should be possible for the Committee to modify Approach 3 in line with our recommendation. Such a modification would deliver a superior tactical solution as well as a potential strategic solution. This would be achieved by adding back the portion of the stage 2 allowances that corresponded to the excess of LTECL over 12ECL. For institutions operating under the CECL accounting framework the equivalent portion of all non-default allowances would be added back.

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Appendix Four

The Committee's policy options for longer-term regulatory treatment of provisions

We would support the Committee in its desire to review the prudential framework but believe this cannot be decoupled from the timelines associated with implementation of transitional regimes, as detailed in previous sections.

Option 1 – To retain the current regulatory treatment of provisions, including the distinction between GP and SP, as a permanent approach

As discussed previously we do not believe leaving the prudential framework unchanged is an appropriate option. This is particularly true in light of the unresolved discussions regarding potential overlap and misalignment between the regulatory and accounting frameworks. If, after reflection, the Committee determines that no changes are necessary clarifying publications should be made available to ensure regulators and institutions have a shared understanding of the concepts and linkages of the frameworks.

Option 2 – To introduce a universally applicable and binding definition of GP and SP

The terminology and differentiation between general and specific provisions is no longer meaningful, given the accounting frameworks commonly in place in banks no longer reference this distinction. If any ongoing differentiation is deemed necessary it should be based upon the definitions of allowances generated under contemporary accounting frameworks.

Whichever descriptions of allowances are referenced in the prudential framework, standard definitions and subsequent treatments would assist in standardising the impact of different accounting regimes. This would lead to the establishment of as level a playing field as possible.

We would stress that a more consistent approach to the classification of allowances would not in itself solve the problem of the misalignment between the frameworks. As such, while Option 2 would undoubtedly improve the consistency of application, it should be used in conjunction with a review of the wider prudential framework, such as the measures that we have proposed.

Option 3 – Fundamentally change the current regulatory treatment of provisions – remove the GP/SP distinction and introduce regulatory EL under SA

There is little obvious reason to have such a difference in the methodologies applied to standardised and IRB credit risk under the existing framework. However, it is difficult to see what changes have occurred since Basel II implementation or from upcoming IFRS 9 implementation that would trigger the desire to align the two frameworks at this stage. As such, it is not clear what issue related to IFRS 9 the Committee is looking to solve through this proposal, especially in light of the extensive review that the standardised approach has been subject to during two consultations in 2015 and 2016.

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If the Committee decides to pursue standardised EL, it is vital that this approach is developed in conjunction with finalisation of the standardised approach. HSBC has responded to that consultation and noted several significant weaknesses in both design and calibration that would be compounded through this approach if they remained unaddressed. A full review and consultation process should be initiated to refine and finalise the standardised approach holistically.

In addition, the recognition of credit risk mitigation (CRM) is unclear and needs to be clarified. It is uncertain if CRM would be recognised by adjusting exposure values, as is the case under the current standardised approach, or if banks would be required to adjust the LGD that is the starting point to back solve the new EL measure. From the text it would appear that exposure value adjustment is most likely, however this would remove much of the consistency benefits from development of standardised EL in the first place.

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Appendix Five

Specific Committee Requests for Feedback

Our views on the specific points of feedback requested by the Committee are addressed in the following sections.

General and specific provisions

To reiterate, we see no benefit in retaining the obsolete distinction between GP and SP. We would advocate looking to distinguish between those allowances in place to cover losses over 12 months and those over a longer time period.

Regulatory expected loss

The concept of a regulatory EL for standardised is not something we would disagree with in principle. However, as per the feedback provided above this would need significant development before it was fit for purpose.

In response to the Committee's specific queries:

i) We see benefit in the development of a standardised EL and see it as an option to increase comparability between standardised and IRB approaches. It will also clarify how EL and UL concepts map into the standardised approach.

ii) The approach taken by the Committee is logical but it suffers from the same weaknesses that the standardised risk weights do. There remains a lack of risk sensitivity and poor calibration inherent to the revised standardised approaches. Global EL rates are likely to be as sophisticated as the methodology could meaningfully reflect and if any jurisdictional differences were deemed appropriate it would seem illogical to not reflect them in the risk weights as well.

iii) Regulatory EL must be at least as granular as the underlying standardised approach. However, it is unlikely that this will be risk sensitive enough to provide truly meaningful estimates of expected losses. Standardised EL is likely to be a regulatory backstop and nothing more.

iv) As proposed we would suggest the EL levels should be recalibrated as frequently as it is felt the underlying risk weights require calibration. The ELs provided do not seem to be designed to relate to a true expectation of expected loss, rather they act as a generic backstop which you would not expect to change.

As previously discussed if the Committee is considering fundamental changes to the framework, and if it truly does support the implementation of ECL, it could consider basing its expected loss measures on ECL with suitable recalibrations of both the standardised and IRB approaches and looking to neutralise cyclical effects elsewhere in the prudential framework. However, this would require a fundamental reassessment of the role of RWAs, capital and output ratios to determine which elements should remain cyclical.

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Treatment of general and excess provisions

We would recommend that if the Committee continues to differentiate between different types of allowances it should do this based on contemporary accounting methodologies. IFRS 9 will give rise to allowances that protect against losses that are not contemplated by the capital regime due to the misalignment in time horizon. As such those additional allowances are available to meet UL on a 12 month basis and should therefore be treated as CET1 or removed from RWAs. All excess allowances on a 12 month basis should continue to be treated as capital and the Committee should reconsider whether to include this as CET1 in order to improve symmetry and diminish cyclicality in the CET1 ratio.

It is necessary to question whether excess EL should be added back to Tier 2 or whether it would be more appropriate to add back to CET1. We are of the strong view that excess EL should be included within CET1 so as to ensure symmetry and negate any procyclicality of IFRS 9 allowances flowing into the CET1 ratio. Allowances remain available to absorb losses on a going concern basis and therefore should be considered as CET1.

In any case, to the extent included within regulatory capital then excess provisions/allowances should qualify for total loss absorbing capacity (TLAC) purposes since TLAC is an extension of the capital framework.

Level playing field

It is important that the Committee ensures a level playing field as far as possible between banks subject to different accounting standards. The preferred HSBC approach of splitting allowances into those to cover 12 month losses and those over other time periods could be used as the conceptual basis for other accounting regimes. Even where an accounting regime does not specifically require a 12 month expected loss, as under CECL, it is highly probable that a bank would have this measure as part of their assessment of lifetime losses. The prudential framework could then be adapted to treat the allowances in a consistent manner.

It is important for the Committee to consider the timescales for implementation of IFRS 9 and CECL and to ensure that any impacts are realised at the same point. This will allow for as level a playing field as possible. This should be considered in the context of impacts caused by any transitional arrangements, as well as those from a strategic solution.

Complexity and simplification

If the Committee decides to pursue the concept of standardised EL, the Committee could consider recognising ECL directly rather than instigate an EL based on a measure back-solved from IRB LGD and standardised risk weights. However, this would remove all the advantages that the Committee is seeking through its introduction of standardised EL as IRB would not directly recognise accounting whilst standardised would. If the Committee decides to implement a standardised EL it should be derived on the same basis under IRB and standardised. It is also unclear as to how meaningful the regulatory minima proposed would be, given it appears that accounting ECL under IFRS 9 is being used as a floor to itself.

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As previously stated, allowances used for timeframes greater than 12 months should be treated as CET1 or deducted from RWAs. Given this, HSBC could support either the direct recognition of ECL for regulatory purposes, if this was done consistently between standardised and IRB, or regulatory defined measures compared to 12ECL with suitable recalibration of the standardised risk weights. However, the concept of cyclicality in the regulatory framework would have to be reconsidered as capital measures would become increasingly cyclical, something HSBC sees as a significant weakness.

Burden

There is currently a significant amount of regulatory change in progress both at international, European and national levels. There is no doubt that this level of flux continues to prove challenging. However, HSBC remains committed to ensuring that the regulatory framework is appropriate at all times. As such, we would suggest that all necessary changes to the treatment of accounting allowances in the regulatory framework are made in as thorough and timely manner as is reasonably possible. Given how long IFRS 9 has been in a finalised state we would assume that the Committee's thinking on the scope and magnitude of these changes is well progressed. However, if this process continues past the implementation of IFRS 9 in January 2018 the Committee should consider neutralisation until the point of completion of the revised regulatory framework.

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