

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

27th February 2009

RE: PROPOSED GUIDELINES FOR COMPUTING CAPITAL FOR INCREMENTAL RISK IN THE TRADING BOOK

Dear Sirs/Madams,

We at HSBC welcome the clarification of scope, soundness standards, and risks to be included, and guidance on the model framework for developing the Incremental Risk Charge model. With this set of proposals, we believe the Committee has developed a coherent framework that would be risk-sensitive and practical to implement within the expected time frame.

The validation framework may still need to be further developed, however as with any new model we would expect further refinement over the course of the next 1-2 years. Apart from this, we have a few concerns regarding specific items in the paper which are outlined below.

We are concerned that the Committee is considering excluding all securitized positions in IRC **{Paragraph 10}** without providing industry participants sufficient incentives to research and develop models to properly take account of these positions within the IRC model. We feel that for most securitized positions there is sufficient data available for IRC modelling purposes. The key data for modelling default and transition risks for any credit position (including securitized positions) are the transition matrices and default probabilities. For most ABS and MBS securities the transition matrices provided by rating agencies could provide a starting point for modelling IRC. We appreciate that there are modelling challenges with certain types of securitized positions, for example LSS options, where valuation models have become unreliable and would need further research. We are working to address these by investing in the development of more comprehensive models. However, a rule that specifically excludes all securitized products will disincentivise further research in this area.

We welcome the clarity provided in the guidelines on the use of liquidity horizons, however we are concerned at the use of a three-month floor **{Paragraph 20}**. We believe that this would potentially lead to IRC being less sensitive to concentration risk, as liquidity and concentration risks are often closely related. For a given portfolio, all else being equal, it should take more time to unwind a larger position than a smaller position, and therefore by having more liquidity periods we can better differentiate between various underlying positions depending on both the observed volumes and the size of the position within the portfolio. We would recommend that paragraph 20 not be included in the final document.

We recognize the Committee's concern regarding arbitrage between the trading and banking book **{Section VI Alternative approach}**. However, it is important to recognize that the defining factors for booking a position into the trading book are the intent, the availability of standardized products, and the existence of a liquid market to transform, reduce or hedge the risks. It is also important to note that the market for securitized products, as with other markets before, has experienced a rapid phase of initial development and growth, and has yet to mature into a stable market with fungible products. We are currently in the midst of a liquidity shortage in the securitized markets, and the key aim should be to support and help develop the market, albeit in a more controlled risk-sensitive way. To implement banking book charges based on a longer liquidity horizon with no incentive for further standardization would be to the long term detriment of this market, and potentially we would lose any of the benefits of securitization.

We would recommend that the Committee not go forward with the alternative approach as outlined in paragraphs 38-42. We believe that these proposals would be a step backwards as they would reduce the market-making activities for credit and securitized products, leading to a further reduction in liquidity and issuance, thereby prolonging the difficulties faced by financial institutions in calculating the fair value for these products. Ultimately, this could lead to the closure of the credit and securitized markets.

In terms of the implications of these proposals for trading portfolios which have both long and short positions, the immediate effect would be a significant reduction in the portfolio diversification effect in the Pillar I capital charge. This may further reduce the return on regulatory capital for securitized and credit products to the point where it may make these businesses unviable as a trading book activity. In other words, financial institutions may be forced to withdraw from market-making activities for the products covered under this alternative approach.

It is important to recognize that most financial institutions are unwilling to provide liquidity in the securitized market due to a lack of transparency in these products. The key to addressing this problem is to develop more fungible products by ensuring further standardization and improving transparency rather than closing down the market.



In conclusion, we recognize that the current framework provided by the Committee, when appropriately calibrated using 'through-the-cycle' data, should result in a non-cyclical capital model. We hope that the Committee will adopt the framework and extend it to all credit and securitized products to ensure consistency in the Pillar I approach.

Thank you for the opportunity to contribute positively to development of the Incremental Risk Charge.

Sincerely,

A handwritten signature in black ink, appearing to read "Mark Smith".

Mark Smith
Global Head, Wholesale and Market Risk